

On AIFMD, UCITS: The view from Custom House



Dermot Butler:
“It appears that there is an impasse between the European Parliament and the European Commission and, if there isn’t a sensible compromise, then we will have chaos.”

Much has been written about the potential effect of the EU’s AIFM Directive, and much more will certainly be written. Dermot Butler shares with ISJ and its readers his thoughts on the Directive and other popular topics of discussion, even though the final result is not yet known at the time of writing.

I have no idea when it will be finalised. It appears that there is an impasse between the European Parliament and the European Commission and, if there isn’t a sensible compromise and the Directive is passed on the basis of the worst options, then we will have chaos. I personally think it is unlikely to be passed before the end of this year and, therefore, will run into the next presidency. Whatever happens, I think it is unlikely that it will be implemented before the end of 2012 and, speaking in the industry, there are those who think it will just wither on the vine.

I don’t think that we will have forgotten the lessons of the past three years, although I am not sure that is a relevant question to AIFM. The AIFM Directive was definitely a political move that had no real direct relationship to either the involvement of hedge funds in the economic debacle, or the potential for systemic risk and the requirement for investor protection.

Marketing Non-EU Funds Into Europe

It would appear that the only way non-EU funds will be able to be marketed into Europe and sold to EU member state investors, will be if those non-EU funds are able to comply with EU regulations. More importantly, the managers of those non-EU funds, if they are not EU registered, will have to undertake to comply with EU regulations on transparency, reporting, etc., and the regulator of the non-EU manager will have to confirm that they will police the manager’s compliance with the EU regulations. I think this is never going to happen in the context of the US regulator and, therefore, it is unlikely that a US-resident manager will be able to manage either an EU fund or a non-EU fund that can be sold in the EU.

Therefore, in order to be able to market a fund to EU member state resident investors, a non-EU regulated manager will probably have to set up an EU-regulated manager who will be able to comply without tainting the non-EU parent of the management company.

Thus, it will be much more difficult for managers to market their products, however structured, into the EU. This will reduce competition to the extent that many managers will probably just not bother to market to the EU, but, more important than reducing competition will be the fact that investors will be limited in the choice and probably the quality of service with regard to certain hedge fund products. It is certain that investors will miss out on sound investment opportunities. I would like to think the authorities do not have the faintest idea about what they are doing, because if they do understand what

they are doing, then it would appear that they have positively evil motives.

I do not believe it is a measured reaction to recent times in the context of hedge funds, because, as already stated, hedge funds were not responsible for the financial debacle. I do think that it is a knee-jerk reaction and the draft Directive, when it was first issued in April of last year, was so blatantly obviously politically motivated and, unless it is improved substantially more than it has been to date, it will turn out badly.

There is a contention that one of the main motives is investor protection and this follows the Madoff scandal. The irony is that Madoff never had a hedge fund and that there were several UCITS funds which invested in Madoff and lost all their money. This somewhat destroys the illusion that the regulated UCITS fund adds to investor protection.

Restrictions on EU-resident investors investing out of the EU into non-EU authorised funds

This seems to be very dictatorial and unreasonable Big Brotherism. Investors into hedge funds are, virtually without exception, Sophisticated Investors. It seems to me that this regulation is infringing their liberties and could, no doubt, result in some legal action down the road, under EU freedom or human rights legislation. Where are Phil Goldstein’s cousins when we need them? [Phil Goldstein was the hedge fund manager who won a landmark action against the SEC for trying to force registration of funds when they had no legal authority to do so]. Such a regulation will reduce the competition and it will be bad for investors in the context of choice and the fact that they will miss out on some perfectly good investments opportunities.

My comment above about authorities not having the faintest idea about what they are doing applies, although in this case I



Regulation EFAMA ON UCITS

think it is likely they do know what they are doing and one of their objectives is to find out where everybody's money is and to control it. It is not a measured reaction to anything and it may well be a knee-jerk reaction and will turn out badly.

The likelihood is that both of these regulations are likely to lead many non-EU managers deciding to ignore the EU market and that will lead to an increase in isolationism because I think many European managers will have the same reaction to the recently introduced US regulations.

The benefit of setting up in the EU as a manager or fund

Obviously the main benefit of setting up in the EU, whether setting up either a manager and/or their fund in the EU, is that their fund will be able to be marketed to EU residents. I think it is likely that, if a manager wishes to go through the hassle in order to market to EU investors, they will have to establish a manager in an EU jurisdiction on the understanding that that manager will have to comply with the EU regulations which we have already discussed. On that basis they will also be able to set up the fund in the same or another EU jurisdiction and will then be able to market their fund in the EU, to EU Investors.

UCITS

UCITS were originally introduced in 1985 as a counterpart to the US mutual fund and is a product that could be marketed to retail investors in Europe. Although it has gone through several changes, UCITS have always had restrictions regarding investments and quite strong regulation to protect investors. Although some of those restrictions have been eased, nevertheless there are only very few hedge fund strategies that can utilise UCITS without substantial amendment to their normal strategy. Selling short for any reason other than hedging is very difficult but this has been achieved by introducing derivatives including swaps.

It seems to be that the current popularity of UCITS is based on three perceptions:

They will automatically give access to the European market;
They are strongly regulated and therefore "safer";
They will not be subject to the restrictions under the AIFM Directive, however the manager will in all likelihood have to comply with the restrictions, that have been discussed above, with regard to complying with AIFM requirements.

The drawback with regard to UCITS and hedge funds strategies as I understand it, is that it is still not possible to have naked shorts within a UCITS strategy, although short positions can be established in indices or similar vehicles if they can be shown to be hedging the portfolio or specific parts of the portfolio. Thus, it would be possible to hedge by going short of an index or ETF providing the fund was long of securities that comprise, in part, the index or ETF in question. Similarly presumably the fund could sell short of stock-specific futures contracts. However,

as I understand it, a fund cannot sell short of a motor index in order to hedge a long position in pharma stocks.

It can be seen that the now common or garden merger arbitrage, convertible arbitrage and even long-short equity funds will have to modify their strategies in order to meet UCITS regulations. Some will never be able to do so. On the other hand a professional investor, long-short hedge fund, can be more precise about what it wishes to short and therefore presumably generate greater profits or smaller losses.

UCITS are more expensive to establish than a professional investor fund and have higher operating costs. This is because:

Legal costs in terms of UCITS funds are very much higher than they are for what are almost 'boiler plate' professional investor funds. Those establishment costs have to be written off in the first year of operation unless the auditors are reasonably flexible; Annual operating costs are higher because you have to have a custodian and the reporting and supervision requirements for UCITS are very much more onerous and penalties for error are very much higher for UCITS funds. Director fees are higher, audit fees tend to be higher, and there is almost certain to be some ongoing legal work with lawyers attending every quarterly board meeting and very often having to update or amend documentation.

Investment manager fees don't come into the picture, as they are the same for both types of funds. I don't think that non-UCITS funds are charging too little – just that the structure of UCITS funds makes it more expensive. It is correct that most UCITS funds, which are generally mutual funds, have more than \$1m NAV (net asset valuation), but that is not the case with hedge funds anymore.

To go back to my previous comment, the perceived benefits of UCITS funds are:

Greater distribution and a way of attacking the retail market. This is true, providing you have the distribution. Most hedge fund houses do not have the distribution and have to rely on third parties. Hedge fund strategies are much more difficult to explain and many long only funds – mutual fund/unit trust marketers - do not wish to fall foul of the best advice regulations in terms of marketing a hedge fund UCITS to retail clientele.

UCITS are more expensive to establish than a professional investor fund and have higher operating costs. This is because:

1. Investors may think that because a UCITS fund has higher regulation, it needs less due diligence. Good regulation does not prevent the appointment of an incompetent investment manager.
2. It seems to be forgotten that there were at least two and possibly four UCITS funds in Ireland and Luxembourg that were invested in Madoff. Therefore the UCITS structure has not, to date, prevented a crook taking money out of the UCITS



If the manager does not fall in under any of these options then, to make the UCITS successful he will need to establish some form of distribution arrangement.

seed their UCITS by way of a transfer of subscriptions from their existing offshore funds into their UCITS fund. Others have very effective distribution networks such as MAN'S AHL FUND, and Winton, and I have no doubt that if they establish UCITS they will be able to get investors interested and meet their \$100m level quota in a relatively short time.

It may be that a manager is in contact with a European institution, or for that matter an Asian institution, which is mandated to restrict investments into hedge funds by way of UCITS. They come across an investment manager whose strategy they like and are prepared to invest \$100m but require a UCITS. It would be a very arrogant manager who didn't go through the process of establishing their own UCITS to meet the requirements of those investors.

If the manager does not fall in under any of these options then, to make the UCITS successful he will need to establish some

funds;

3. The UCITS fund avoids the AIFM Directive. This is true as far as the fund goes, but it does not reduce the burden that has to be borne by the investment manager – it is after all the Alternative Fund Investment Management Directive.

If the manager has qualified distribution arrangements, then it may be worth setting up a UCITS.

Some of the big hedge fund managers have been able to

form of distribution arrangement. The problem, that I have already alluded to, with hedge fund and CTA strategies, is that they are more complex and therefore more difficult to explain to the average 'retail investor', who is likely to be influenced by somewhat biased tabloid and broadsheet press, but that is a whole other subject. It is my understanding that several UCITS – i.e. many more than can be counted on one hand – have been formed, but I'm sure only a very few have raised any meaningful money. That is probably because they fall under one of the three examples above.

You ask if we are going to see more fraud and theft. I am not sure that I see the connection between fraud and theft and an institution that wishes to invest in a particular strategy but is restricted from investing in anything but a UCITS vehicle. Having said that, it must be realised, that in any situation where large sums of money are circulating, whether it is in the hedge fund industry or anything else, that fraud and theft are likely to be seen. Prohibition is the perfect example.

I have never believed that regulation per se stops the dedicated crook. It may stop or hinder the opportunistic thief, but the dedicated crook will carry on regardless. I agree that without trust the Western economy is doomed but I don't think that it is doomed just because of some high-flying crooks. To put it another way, you may only want to buy a house that has got a good alarm system, but we all know that won't prevent a clever burglar, especially if you happen to be away from home. The fact that you may be the victim of a clever burglar does not mean that you do not buy a house and choose to live in the park instead.

My comments, specifically regarding Madoff, are not that UCITS regulation is imperfect because Madoff existed. What was imperfect about the UCITS regulations was that several

UCITS funds were able to invest money with Madoff, either because the managers were careless or because the managers did not follow the investment restrictions that were imposed on their funds. Madoff never had a fund. The error in this case appears in regard to the managers of the UCITS funds failing to do their due diligence on Madoff. The problem with Madoff was that it was a huge sum of money that itself was dwarfed by the sub-prime collapse. If you read "The Big Short" by Michael Lewis, then one is inclined to think that the sub-prime mortgage market was run by bigger and better crooks than Madoff ever was.

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