UCITS Or AIFMD: Better the Devil You Know?

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I had always thought that the advent of a UCITS equivalent for alternative funds under the Alternative Investment Fund Managers Directive would lead non-European hedge fund managers to establish alternative investment funds (AIFs) as the default when considering setting up a European fund.

That view was based on multiple factors: (1) that the Undertakings for Collective Investments in Transferable Securities had investment restrictions that were too limiting for certain strategies, (2) that the UCITS required at a minimum biweekly liquidity, and (3) AIFs allowed fund managers to replicate their offshore strategies in an onshore regulated fund.

This runs contrary to what DMS has seen in the 10 European management company appointments secured during July and August. These appointments have seen six UCITS funds, compared to four AIFs.

It may be that these 10 cases do not fully represent the market as a whole, but they certainly lead us to ask a pertinent question: why are alternative investment managers willing to take on the more restrictive regulations of the UCITS, when a tailor-made alternative is available?

On analysis, we note that one of the strategies — a U.S. long-only strategy — fits well in a UCITS fund, requiring no adjustments to the strategy.

The strategies employed in the four AIFs cannot be constrained to fit a UCITS mandate. One was a U.S. direct lending strategy, the other a private equity fund with a 10-year lockup, and the others were two real estate funds.

What this means is that five of these investment managers have chosen UCITS structures, despite employing strategies that would enjoy greater flexibility in an AIF. Among the five were two commodity trading adviser (CTA) funds that will employ an index/swap solution. This facilitates the strategy well, but adds operational complexity.

Another is a long/short fund that will have to employ a swap for the short positions. The others include an activist equity fund that will be restricted in the concentration of positions they can take and may have to redeem positions before the envisaged activist action due to the liquidity, and a debt fund, which is restricted in its ability to invest in collateralized debt obligations/collateralized loan obligations.
and mezzanine debt.

When we analyze the AIFs, two very critical points are evident. Firstly, they have been able to employ their strategies as they currently do in a U.S. or Cayman fund. There is the additional cost of the depositary and the management company (in the range of 4 to 8 basis points combined), but generally, the investment managers have not encountered any unexpected issues.

The second critical point is that European investors are very comfortable investing in the AIF. We have seen significant investments in these funds from countries that would not generally have invested in offshore funds, such as Germany and Denmark.

The large institutional tickets from Germany in particular, seem to represent pent-up demand for alternative strategies. German insurance companies, for example, are restricted in how much they can invest in nonqualifying funds such as offshore funds.

As a result, access to strategies such as direct lending has been significantly restricted. Now with these strategies being employed in a European regulated fund, they have a greater flexibility to invest in these strategies and thus look to add alpha to flat portfolios.

So if the AIF works as an investment vehicle for the strategy and for the investors, why are investment managers choosing to employ their strategy in the more restrictive UCITS product?

It would appear to be a consequence of two factors, the more important being the desire to target the 39 percent of capital invested in hedge funds that is known to come from Europe.[1] This could previously have been targeted via an offshore fund and marketed on a private placement basis to European high net worth individuals, trusts and institutional investors. However, post-AIFMD, this route became restricted and each country imposed its own interpretation of the ESMA guidelines on how to market non-European funds.

This process, known as the National Private Placement Regime (NPPR), has confused not just investment managers, but fund advisers, as it varies from country to country. For example, Germany requires approval of the non-European fund Annex 4 reporting (similar to Form PF reporting) and a depositary lite (an oversight function).

The U.K. requires registration and Annex 4 reporting only. This is similar to Belgium, for example, but there are still further variances. Belgium requires look-through to the master fund in a master-feeder structure, while the U.K. does not require look-through.

Other countries have not even implemented AIFMD as yet. So we are starting to see where the uncertainty can come from.

There is also the uncertainty as to whether a passport will be implemented that will allow a non-European fund to be distributed on a pan-European basis, if the local domicile of the fund is of an equivalent and approved standard.

This looks uncertain for a number of reasons, not least because of the requirement for the U.S. to implement changes in the law governing U.S. funds to meet European requirements.

Offshore domiciles such as the Cayman Islands, Bermuda and the British Virgin Islands are showing a
desire to meet the European requirements, but certain European regulators such as the Federal Financial Supervisory Authority (BaFin) in Germany do not appear to be supportive of the development of a pan-European passport for non-European funds.

Consider it from this perspective: The European Securities and Markets Authority, the European regulator responsible for AIFMD, has mandated and implemented legislation to ensure that all funds distributed on a pan-European basis are subject to oversight by a European regulator. They have the additional safekeeping functions provided by the management company and the depositary. These are all designed to protect European investors, and they equip European regulators with the ability to monitor and manage systemic risk.

European investment managers of any significant size have become, or have employed a third-party, AIFM. So expanding the passport will work against the initial intent of enhanced European oversight of European distributed funds and disadvantage European investment managers who have taken on the extra costs of dealing with the AIFMD.

As such, there is no clarity as to when a definitive AIFMD model will be in place.

This is an opportunity missed, as the product works well when implemented and used as intended. Quite simply — set up a European AIF, with a European substance and you can avail yourself of the European passport.

This has been lost in the search for potential workarounds such as the NPPR and potential passporting for non-European AIFs. Thus, we have ended up with investment managers deciding whether to implement a full AIF, wait for the potential workarounds to be finalized or go with the alternative.

With the investment management community being presented with too many variables on how to implement AIFMD, and with certain industry commentators and advisers suggesting a wait-and-see approach, managers are taking on the relative certainty implicit in the UCITS fund and doing the extra work required to make their strategy work within this more restrictive model.

It’s not the ideal choice, but at least it’s "the devil they know."

—By Derek Delaney, DMS Offshore Investment Services (Europe) Ltd.

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