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The Leading Auditor – UCITS Hedge

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The rapid growth of the use of the UCITS wrapper to create alternative products has seen some service providers better positioned than others to take advantage of this new interest from traditional and alternative investment fund managers.

Ernst & Young has won a leading market share of onshore UCITS funds following hedge fund strategies. We spoke to Michael Ferguson, Partner and Asset Management Leader with Ernst & Young in Luxembourg.

What is driving the growth of alternative UCITS?
The new interest in alternative UCITS is being driven by a number of factors. On the investor side, post-2008, investors have been focusing on products that, in particular, provide both transparency and liquidity.

In addition, certain institutional investors are restricted to, or feel "more comfortable" with, a UCITS product. They also appreciate its advantages including brand recognition, investment diversification and risk management requirements and its substantial level of regulatory and governance oversight, including the requirement to have a depository bank.

Managers, on the other hand, are obviously keen to meet this investor demand and in many, but not all, cases find that the UCITS regulations enable them to create products meeting investors' requirements. Some of the alternative UCITS' growth has been driven by alternative managers wishing to broaden their investor base, benefiting from the passport to distribute the product within the EU, some by traditional managers wishing to offer their investors a wider range of products, and take a share of the higher return hedge fund market.

In Ernst & Young's experience, in this space where the traditional and hedge fund sectors converge, some of the most successful alternative UCITS are launched by joint ventures of hedge fund and traditional managers – each bringing the added value of its own core competencies to the fund.

Domiciles for alternative UCITS ?
As expected Luxembourg and Ireland have become the dominate domiciles for alternative UCITS. Recent surveys and studies have indicated Luxembourg has a 50% + market share. This is for a range of reasons. Luxembourg is the leading domicile for UCITS, and for cross-border distribution both within the EU and internationally, particularly in Asia, the Middle East and South America. Many continental institutional


Michael Ferguson, Ernst & Young

investors prefer Luxembourg funds, and the large continental European managers, such as the French, German and Swiss managers, which have launched alternative UCITS, already had Luxembourg fund ranges. Over the past 20 years, Luxembourg has also established itself as an alternative fund centre offering a complete range of alternative investment funds.

When it comes down to the diversity and quality of the service providers, Luxembourg has a very deep bench. Seven of the top 10 global hedge fund asset servicers are based in Luxembourg, offering a full range of services to meet the needs of alternative UCITS. These service providers leverage the network of their competency centres throughout Europe and beyond.

Luxembourg has an excellent country risk profile, and a reputation for stability in relation to such issues as personal and corporate taxation and domestic legislation, and offers a favourable tax environment, which is key for funds marketed to multiple jurisdictions.

What does UCITS mean for Ernst & Young's hedge funds practice?
Ernst & Young has a considerable footprint both in the traditional and hedge fund spaces. In response to the growth of UCITS-compliant hedge funds, Ernst & Young pooled the resources of the two practices.

For UCITS, Ernst & Young already had a strong practice in Luxembourg – one that has already invested considerably into the future world of UCITS, including UCITS III, IV and V. For hedge funds, we have a leading market share both in audit and advisory services.

We've essentially combined the DNA of these two practices, and it's been a success. Ernst & Young has thus been quick to respond to the demands of hedge fund managers who have been looking to launch UCITS funds, and traditional managers stepping into the hedge funds.

What sort of services have you been able to offer hedge fund managers looking at the UCITS route for their distribution?
As the Grand Duchy of Luxembourg has emerged as the leading jurisdiction for alternative UCITS, Ernst & Young moved quickly to meet the demand for information and insight from both traditional and hedge fund managers. This included publishing a definitive guide to setting up alternative UCITS, as well as a series of events and symposia that helped to raise awareness of the UCITS option amongst fund managers.

Ernst & Young has advised fund managers looking at the UCITS option on a wide range of issues.

Launching a cross-border, regulated UCITS product onshore is a very different challenge for hedge fund managers who have been used to marketing an offshore Cayman structure, so we support hedge fund managers on structuring, tax, governance, obtaining authorization, meeting the detailed investment restrictions and risk and liquidity management requirements of UCITS, capital requirements, service provider selection and monitoring, reporting, and on distribution.

On the other hand, traditional managers are challenged by the much greater complexity of alternative products, so we help traditional managers to understand the hedge fund business, obtain authorization, implement appropriate risk management and valuation processes, service provider selection and monitoring and on implementing fee structures. Critical issues include derivative fair valuation and risk management, appointment of prime brokers, collateral management and reconciliation and handling performance fees.

As we have said, we feel that it is important that the traditional and hedge fund managers leverage the strengths of the other, so we have also been running dedicated training courses for groups of directors of alternative UCITS.

And of course, we are on hand to provide the comfort of a Big Four audit.

Where do you feel your UCITS tax practice has been particularly strong?
Firstly, of course, we provide international tax advice on the proposed fund structure, as well as on the proposed management company set-up. We advise on the tax-efficiency of investment strategies. We provide local tax and compliance reporting (for example for German investors) and also support service providers, helping them to meet complex tax and compliance reporting requirements. For investors, we provide tax planning. We also advise on VAT issues relating to the investment fund industry and assistance with VAT compliance.

Does Ernst & Young operate on a jurisdiction by jurisdiction basis when it comes to UCITS advice?
Not at all. The firm took the conscious decision to operate as a European partnership. We don't see national boundaries affecting governance or economics. As a result, it makes it easy for us to combine the skills of our teams.

We're not just talking about Luxembourg here, but a team combining professionals from Dublin, London, and elsewhere across Europe. Indeed, when it comes to actually managing hedge funds in Europe the main domicile is London, and so it is important for us to have a strong UCITS team in London too.

We don't express a preference for jurisdiction. It comes down to investor choice and what the manager is looking to achieve. We also have to consider what the manager has in terms of existing arrangements, both operationally, and as far as its existing clients are concerned.

How have you been able to get the UCITS message across to hedge fund managers?
We recognise that the Cayman Islands remains the domicile of choice for hedge fund managers, particularly in North America, but the education process we have initiated has helped to generate significant interest in UCITS amongst hedge fund managers. Investors are demanding UCITS. Managers often lacked awareness about what could be achieved in a UCITS structure. We have provided this insight through our thought leadership, at events and on a one-to-one basis.

What has been the feedback you have been getting on UCITS?
The UCITS route has much to recommend it to the investor. We are raising many of these advantages of UCITS at the road shows we do for key managers. UCITS are now garnering a great deal more press attention, and we're seeing some very high profile managers launching alternative UCITS. Obviously, UCITS will not be for all managers – many strategies cannot be replicated under the UCITS requirements, and some managers look askance at the cost issues and the potential tracking error.

How do you see the UCITS hedge fund segment evolving in the future, particularly over the next year or so?
We're upbeat about the business prospects for alternative UCITS this year: there is a sizeable pipeline of new funds about to launch. Soon, we will see most managers of any significant size or scale launching or managing one or more UCITS products. Furthermore, we are starting to see a lot of assets coming back into the market.

Going forward, with the implementation of the AIFM Directive looming, managers will rethink their use of onshore structures for hedge funds, including QIFs, SIFs and UCITS. Some will continue to use offshore structures, at least until the AIFM Directive passport becomes required for offshore managers and funds, but others will set up onshore structures to meet investor demand, particularly from European institutional investors. Institutional investors, which represent around over 70% of the total hedge fund investor base, generally expect managers of the funds they invest in to have an infrastructure, a governance structure, compensation models, etc. broadly in line with the requirements of the UCITS or AIFM Directives. They will therefore derive comfort from, or even require, compliance with European regulation from their managers.

But Cayman will continue to be popular – at the end of the day, the Cayman fund is a different sort of product.

Do you expect to see more interest from US managers in UCITS funds?
We're very busy at the moment advising start-ups. We're seeing quite a few spin-outs as a consequence of the Volcker Rule, as well as some second generation hedge fund spin-outs. Obviously, these start-ups will tend to go with a Cayman Islands structure initially, but once people have successfully gathered initial assets, they may start moving into regulated vehicles. I can't say we're seeing massive interest at the moment on the part of US hedge fund managers, I think it is a long way down their list of priorities when compared to what they are dealing with in their home market. Plus, you have to realise they have a large, homogenised market right on their doorstep which is starting to get interested in hedge funds again. If anything, we're fielding more enquiries about UCITS from managers in emerging markets, particularly Asia. It will be interesting to see how the current crisis in Japan plays out, but there is certainly scope for growth from Asian fund managers in the UCITS space.

What are the UCITS-specific issues your firm needs to advise hedge funds about?
The major challenges are risk management/compliance, liquidity requirements, tax structuring for both the advisor and the institutional/HNW investors, obtaining and maintaining cross-border distribution and operational risk reduction, and for this reason UCITS are not for everyone. As a consequence, we tend to see bigger firms going down the UCITS route, those with the resources and the sort of supportive environment that can handle the more frequent trading in and out of their funds.

So in summary, we're doing far more than just providing the audit for alternative UCITS; we're guiding the manager through the set-up and authorisation process, and providing ongoing advice alongside the audit service. **THFJ**

BIOGRAPHY

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Ferguson is also the Ernst & Young EMEIA Regulated Investment Funds Leader. He joined Ernst & Young Luxembourg in 1994 and has been the Audit and Advisory Partner there since 2002. His primary responsibility is to lead and develop audit and related services that E&Y delivers to an international investment management clientele.

He has over 20 years of experience in the investment management industry, primarily in Luxembourg, Ireland, the UK and the US. He is a member of Ernst & Young's Global Asset Management Advisory Board and of its Global Hedge Fund Committee. His clients include a wide variety of mutual funds, hedge funds, and structured products promoted by global asset managers.

Ferguson is a member of AIMA, Chairman of the ALFI SIF committee, co-chairman of the ALFI Hedge Fund committee and Chairman of the ALFI Accounting and Reporting committee. He has written many articles and publications about the investment funds industry. He speaks regularly at various investment fund conferences, including numerous ALFI conferences and road shows worldwide.