UCITS Guide for Investment Managers

A guide for investment managers, promoters and distributors to establishing UCITS funds

By Carne - “the UCITS experts”
Some quick UCITS facts:

- UCITS funds accounted for assets of €6.9 trillion at the end of 2013
- Global Brand - UCITS are widely sold outside of the EU in Switzerland, Asia, South America and South Africa
- 70-80% of publicly sold funds in Asia are UCITS
- Luxembourg and Ireland are the main domiciles for UCITS distributed cross-border
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About Carne

Carne is a leading provider of governance and oversight support for the global asset management industry. We are experts in UCITS funds, but we also cover non-UCITS and unregulated funds in various jurisdictions both within and outside the EU. We have UCITS and AIFM compliant management companies in both Ireland and Luxembourg available to fund managers. Carne has offices in Luxembourg, Ireland, London, Channel Islands, Cayman Islands, New York, Chicago and Switzerland.

Our services include:

- Directorships
- Management Company Services for AIFM and UCITS funds
- UCITS Oversight
- Fund Registration for Cross-Border Distribution
- Risk Management
- Fund Structuring
1. Preface

The UCITS fund structure and the UCITS brand have become a storied success in the growth of the European cross-border funds market. Introduced in 1985, UCITS has been embraced by both the long only and the alternative investment community. With the introduction of UCITS IV, the latest iteration of the directive, we at Carne have seen yet more interest from alternative fund managers around the world in the possibilities offered by a UCITS launch. Beyond that, however, it is important to also recognise the preference that institutional investors have for regulated UCITS products. The attractiveness of the UCITS brand goes beyond Europe’s shores, to South America and Asia.

Carne has produced this guide to provide both fund managers and investors interested in UCITS products with a better idea of what is involved in launching a UCITS fund, along with some of the regulatory and operational criteria that ought to be considered. As a firm with a permanent presence in both Ireland and Luxembourg, the two predominant domiciles for UCITS funds, we continue to work closely with some of the largest promoters of UCITS funds and some of the major fund platforms. Carne is recognised for its independent insights into cross-border fund promotion and its recognition that there is no one size fits all approach that works for the fund industry. Our directors have worked together to distil some of their considerable knowledge into the pages of this guide. We hope it provides a useful starting point for the launch of successful UCITS vehicles.

John Donohoe, CEO Carne Global Financial Services

2. What are UCITS funds?

UCITS (Undertakings for Collective Investment in Transferable Securities) is the European harmonized regulated fund product which can be sold on a cross border basis within the European Union ("EU") based on its authorization in one EU member state. UCITS also enjoy a high level of recognition in many non EU countries. UCITS funds, while being suitable for sale to retail investors, are also widely sold to institutional investors.

Some quick UCITS facts:

- UCITS funds accounted for assets of €6.9 trillion at the end of 2013.
- Global brand - UCITS are widely sold outside of the EU in Switzerland, Asia, South America and South Africa.
- 70-80% of publicly sold funds in Asia are UCITS.
- Luxembourg and Ireland are the main domiciles for UCITS distributed cross-border, together accounting for more than 90% of UCITS sold into more than three countries.
3. **UCITS IV**

In 2002 the update of the UCITS Directive, initially introduced in 1985, was termed UCITS III. One key development of the revised directive was to give asset managers a broader scope of eligible assets (i.e. beside transferable securities UCITS funds could also contain money market instruments, fund shares, and derivatives). However, the European legislator/regulator simultaneously increased the requirements on investor protection and asked in particular for an independent risk management function (to limit/monitor leverage, counterparty risk, concentration limits, etc.)

The latest version of the UCITS directive, UCITS IV, was agreed by the EU in 2009 and took effect on 1 July 2011.

The key changes were:

a) **Management Company Passport and Enhanced Governance Requirements of UCITS Management Companies**

Pursuant to the UCITS III legislative framework, a UCITS, a UCITS management company and a depositary appointed to a UCITS, all had to be located in the same EU member state. All activities related to collective portfolio management and administration of the UCITS were subject to the law of the UCITS home member state (i.e. the member state in which the fund and/or management company was domiciled) and accountable to a single enforcement authority.

The introduction of the management company passport under UCITS IV allows a UCITS to be managed by a management company authorised and supervised in a member state other than its home member state.

On the other hand, UCITS IV has increased the governance (“organisational”) requirements of UCITS management companies and funds and has brought these requirements more in line with MiFID, the EU regulation governing EU asset managers. In particular, a UCITS fund or its management company needs to establish independent compliance and audit functions in addition to the independent risk management which was already required under UCITS III but which has been expanded to formalise the management of a variety of risks. These enhanced governance requirements under UCITS IV came into effect on 1 July 2011 and had to be fully met from that date by UCITS management companies. UCITS IV requirements have to be met also by so-called self-managed UCITS funds that have not appointed a management company.

b) **Notification Procedures for Cross-Border Marketing within the EU**

UCITS IV has brought a simplification of the notification procedure for passporting a UCITS into other EU member states. In order to passport a UCITS to a host member state, the competent authorities of its home member state need to be notified of the intention by the UCITS or its promoter to do so. The competent authorities of the UCITS home member state will then transmit the required documentation to the competent authorities of the member state in which the UCITS proposes to market its units (called regulator-to-regulator notification procedure).
Upon the (electronic) transmission of the documentation, the competent authorities of the UCITS home member state shall immediately (ESMA has set a turn-around of no more than two weeks) notify the UCITS that the transmission has taken place. The UCITS may access the market of the host member state as of the date of this notification.

c) Master / Feeder Structures

In order to foster efficient pooling of assets, the UCITS IV Directive introduced master-feeder structures to the UCITS world.

A feeder UCITS is a UCITS or an investment compartment which invests at least 85% of its assets into units of another UCITS or an investment compartment (also called a sub-fund) of another UCITS. A master UCITS is a UCITS or an investment compartment of a UCITS which must have among its unit-holders at least one feeder UCITS, is not itself a feeder UCITS, and does not hold units of feeder UCITS.

d) Fund Mergers

UCITS IV has introduced a regime for both cross-border and domestic mergers of UCITS, introducing a basic principle that all UCITS are entitled to merge regardless of their structure (e.g. corporate, unit trust or contractual) or domicile.

The law of the merging UCITS’ home member states shall entrust either a depositary or an independent auditor with validating the criteria adopted for the valuation of the assets and the liabilities on the merger date, the cash payment per unit and the calculation method of the exchange ratio, as well as the actual exchange ratio determined at the merger date.

Fund mergers are subject to members’ voting provisions of the merging funds. Voting provisions are set out in the funds’ constitutional documentation and minimum requirements are set by local law. The hurdles for voting to adopt a merger can be high, for example that valid votes have to be received for at least 75% of shares / units eligible to vote and those votes in favour of a merger have to represent at least 50% of the available votes.

e) Key Investor Information Document

The simplified prospectus – which was a UCITS III requirement - was replaced by a Key Investor Information Document (KIID). The aim of the legislator is to have a two-page document which contains fair and clear information “in plain language” and is not misleading.
The regulations around the KIID are very prescriptive in terms of their content and layout. It shall provide the investor with information on the essential elements in respect of the fund, including the investment objective/policies, key risks, risk/reward rating and fees, and specify where and how to obtain additional information. These essential elements shall be understandable by the investor without any reference to other documents. The KIID should be written in a concise manner using non-technical language. The KIID is share class-specific; however, a representative share class can be chosen instead of producing KIIDs for all share classes of a UCITS. The KIID is required to be translated into the official languages of all EU jurisdictions where a UCITS or a compartment/sub-fund or share/unit class is registered for distribution.

In addition, the UCITS IV implementation measures include:

Revisions to the requirements for a Risk Management Process (“RMP”) which is required for each UCITS management company and fund- for details see chapter 11.

Pursuant to the UCITS IV directive, the European legislator has issued further so-called level II and level III measures in order to achieve a more harmonised implementation of UCITS across Europe. The European Securities and Markets Authority (ESMA) continues to issue clarifications in delegated regulations which become directly effective in all member states without having to be transposed into local law. These measures include:

- Guidelines on ETFs and other UCITS Issues (ESMA/2012/832), effective 18 February 2014:
  - Setting standards for UCITS ETFs in relation to naming and disclosure, index-tracking ETFs, actively managed ETFs and treatment of secondary market investors;
  - Setting standards generally for index-tracking UCITS, including leveraged index-tracking UCITS;
  - Requirements around the use of efficient portfolio management techniques (securities lending and repos);
  - Setting rules for indices including rebalancing frequency, publication of index rules and disclosure of constituents;
  - Collateral rules including quality, liquidity, valuation, risk management, reinvestment and diversification (ongoing ESMA consultation on certain aspects as at March 2014).

- Investment by UCITS in non-UCITS collective investment schemes (ESMA opinion 2012/721 effective since 31 December 2013).

- Clarification of requirements for the recallability of repos and reverse repos (ESMA guidelines 2012/722 effective since 4 February 2014).
4. **Why launch a UCITS?**

The success to date of UCITS has to do with the fact that the UCITS product can meet the demands of both the fund promoter (including the manager and distributor) and the investor. In addition to being an investment vehicle, UCITS provide a robust risk management framework through their prescribed rules on governance, risk diversification / limitation, regulation of service providers and the safekeeping of assets.

4.1 **What do Fund Promoters/Managers/Distributors Want?**

i) **Increased Distribution**

A fund manager setting up a UCITS fund for the first time should be able to attract new investors and money that would not otherwise be available to them. European and Asian investors have a preference for regulated funds, especially UCITS funds, due to their greater liquidity and strong risk framework.

Absolute return and alternative strategies in UCITS funds are not necessarily deemed by regulators and investors to be hedge funds. This allows certain investors (e.g. pension plans) to invest higher allocations into UCITS compared to other investment vehicles such as unregulated funds. A significant number of Carne clients have established UCITS funds based on their investors stating that they were withdrawing money from the clients’ unregulated hedge funds but would reinvest and add to the original allocation if a UCITS equivalent fund was available.

UCITS funds benefit from being EU regulated products and are widely sold to institutional and retail investors both within and globally outside of the EU (excluding US onshore taxable). The investor base is very wide and includes private investors, pension funds, insurance companies, fund platforms, fund of funds, private banks, private wealth managers and retail banks. UCITS have the ability to be registered for “public distribution” across the EU and in many non-EU countries. For example in the UK, UCITS funds have enjoyed some success on platforms used by Independent Financial Advisers (IFAs), while other managers have made use of white label platforms to access retail opportunities not available to unregulated funds.

Once approved in the “home” country (i.e. the country of the fund’s domicile), registration in other EU countries will be granted subject to a registration process in the “host” country. UCITS also enjoy a high level of recognition by regulators and investors alike in many non-EU countries or regions such as Switzerland, Asia, South America and South Africa, and the process of registration in these countries is a well-trodden path.
From an investor’s perspective, the required due diligence on a UCITS fund is significantly less than for an unregulated fund from a compliance and operations perspective, with more focus typically on performance. Information on UCITS funds is more publicly available and easy for investors to find. Investors also appreciate the fact that UCITS have higher risk management requirements than non-UCITS funds. This reduced onus on due diligence benefits promoters and distributors of UCITS funds.

ii) Fees

Management fees would typically be in the range of 0.75% to 2.00% of net asset value.

For managers of alternative UCITS, a performance fee is often also levied. Performance fees of between 10% and 20% of performance or outperformance of a benchmark are also acceptable.

Distributors can charge an additional ad valorem distribution fee or can receive a trailer fee from the manager of a proportion of the management fee. Additional up front sales charges and redemption charges are also possible.

Within a UCITS fund there can be different share classes for different types of investors. There is no legal limit on the number of share classes that can be launched. Different share classes can be launched to accommodate:

- Different fee levels (management fees, performance fees, upfront sales charges and redemption charges)
- Different currencies
- Hedged and unhedged share classes
- Distributing and accumulating share classes

When setting fee levels, managers should consider what fees are being levied by other managers for similar products and performance / risk as well as looking at what fees are being charged in their existing hedge funds.

iii) Variety of Products

The UCITS framework is very flexible from a product perspective and permits a broad range of investment strategies. The UCITS rules allow managers to use derivatives (both exchange traded and OTC) and also to employ leverage (using derivatives) as well as allowing short exposures through the use of derivatives. Most “alternative” strategies will work within a UCITS framework although some will not work and others will have to be toned down in order to be acceptable for retail distribution. See below for more details on the types of UCITS strategies that can work in UCITS.
iv) Diversification of Business Model

Increasingly alternative asset managers are launching UCITS products as a way of diversifying their client base and product range. This can be a “defensive” tactic to retain investors looking to reduce exposure to alternative asset classes as well as an “offensive” tactic to increase distribution potential.

v) ‘Tax Havens’

There exists a negative political opinion with regard to jurisdictions deemed ‘tax havens’. However Irish and Luxembourg UCITS do not fall within this category despite having access to advantageous double taxation treaties which allow for reduced withholding tax rates to apply on dividend income from certain countries.

4.2 What Do Investors Want?

i) Liquidity

UCITS funds are required to be “liquid” which in practice means they must be able to meet redemption requests on at least a bi-monthly basis (i.e. twice a month) and redemption proceeds have to be paid within a maximum of ten business days. Most traditional UCITS funds offer daily liquidity although some offer weekly or bi-monthly liquidity. In order to meet this liquidity requirement, the underlying investments in UCITS funds must also be liquid. In practice this is achieved by adherence to the eligible assets requirements and diversification requirements (see Appendix 1 for details). Redemptions on any dealing day can be limited to 10% of NAV of the fund with the balance carried over to the next dealing day. If a UCITS opts for bi-monthly liquidity, this therefore means that the maximum redemption payout in any one month can be limited to 20% of NAV. It should be noted however that this 10% limit is not a “gate” as usually understood in the asset management world, but rather is the ability of a UCITS to defer a portion of redemptions to the following business day to ensure the UCITS can liquidate positions in order to meet large redemption requests in an orderly fashion and does not have to borrow money in order to meet redemption requests. UCITS are not allowed to borrow except for temporary cash flow mismatches up to a limit of 10%. This mechanism is thus designed to protect the interests of the remaining shareholders in the case of large redemptions.
ii) Security of Assets

A UCITS fund must appoint an independent custodian / depositary to hold fund assets. Such assets (excluding cash, derivatives and investment funds) must be held in segregated custody accounts with the relevant custodian / depositary (i.e. the assets must be segregated from the balance sheet of the custodian / depositary). Custodians are permitted to appoint sub – custodians and local agents but are responsible for performing regular due diligence over such sub – custodians and local agents to ensure that the assets are being held safely for the account of the UCITS fund on an ongoing basis. Custodians / depositaries have, in addition, certain oversight responsibilities in relation to aspects of the UCITS' management and administration functions.

iii) Risk Framework

UCITS funds are viewed as having a very comprehensive risk-control framework. There are detailed investment and borrowing limits which apply to all UCITS to ensure the spreading and / or limitation of investment risks. In addition, there is regulation on the use of derivatives and limits in relation to leverage, counterparty risk and position exposure applying to derivatives and the combined exposures of derivatives and transferable securities. All UCITS funds must draft and have approved by the home regulator a “Risk Management Process” (RMP) document which sets out the types of derivatives that the fund will use, the risks associated with the derivatives, and how those risks are managed and controlled. In addition to that, UCITS IV has introduced the requirement of a UCITS to consider and document the management of all relevant (material) risks to the UCITS, including liquidity risk and operational risks (i.e. a holistic risk management approach). Some jurisdictions require these other risks to be included in the RMP, others allow them to be documented in other ways.

UCITS (supplemented by local regulation) also require a comprehensive governance framework which includes local substance such as independent directors, quarterly board meetings and conducting officers / designated persons responsible for the oversight of the management of the UCITS. As mentioned above, UCITS IV has significantly enhanced the governance requirements, also referred to as organisational requirements, for UCITS funds and management companies.

All UCITS must have a custodian / depositary, administrator and independent auditor. The assets held on behalf of the UCITS are separated from the assets of the custodian / depositary (with the exception of cash, derivatives and investment funds) which means there is no counterparty risk to the custodian / depositary (other than for cash positions held). All parties to a UCITS fund including the investment manager must be approved by the home regulator and both the UCITS fund itself and the various parties to the UCITS are subject to ongoing supervision by the regulator.

With the introduction of the management company passport under UCITS IV, i.e. the ability of a management company domiciled in one EU member state (the home member state) to launch UCITS funds domiciled in other EU member states (host member states), the regulatory supervision will be shared by the regulators of both jurisdictions. In order to enhance the co-operation of EU regulators
and to ensure a high standard of regulation and supervision across the EU, at the end of 2010 the EU created the European Securities and Markets Authority, ESMA. ESMA is expected to further strengthen the regulatory robustness of UCITS, which will be of benefit to investors in UCITS schemes. The home regulator of the UCITS fund, or the UCITS management company if passported, will only approve an entity as investment manager if it is regulated and supervised by a regulator meeting the standards of the home regulator. The regulations applying to UCITS funds also include detailed guidance on valuation rules, eligible collateral and minimum standards for counterparties.

Certain investors have become nervous about unregulated funds and have requested to switch their funds into managed accounts. Managers with UCITS funds can demonstrate that UCITS funds offer greater investor protection than managed accounts due to the risk framework described above and the liquidity requirements. Managers who offer UCITS funds may be able to retain investors that would otherwise redeem their holdings, and operationally it is easier for a manager to operate a pooled UCITS vehicle rather than a large number of managed accounts.

iv) Global Exposure/Leverage Limit

UCITS funds can offer leverage (in UCITS also called global exposure). Direct short selling is not permitted nor is borrowing other than on a temporary basis in order to bridge settlement mismatches between investor and fund transactions and is limited to 10% of NAV. However, leverage can be generated through the use of derivatives or through repos. See Appendix 1 (UCITS Investment Rules) on the rules applying to derivatives and the types of derivatives that are permitted. Global exposure / leverage can be measured in one of two ways:

1) Commitment Approach: A UCITS that does not extensively use derivatives nor uses complex derivatives can opt to measure leverage using the “commitment approach”. This approach looks at the market value of the asset underlying the derivative (which can be delta adjusted for options) and takes a simple aggregate of the absolute values of the underlying exposures (or notional values). Adjustments can be made for netting arrangements, and contracts that are used for hedging purposes (risk reducing) do not need to be included in the calculation. Global exposure / leverage up to 100%, i.e. a total gross market exposure of 200% of NAV, is permitted under the commitment approach.

2) Value at Risk: A UCITS may alternatively choose to measure leverage based on a Value at Risk (“VaR”) measure. This will be required for strategies that make extensive use of derivatives and / or use complex derivatives resulting in commitment from derivatives positions greater than 100% but may also be chosen by managers with long only strategies. The regulations permit two types of VaR measure: absolute VaR and relative VaR. The absolute VaR limit depends on the risk profile of a fund but the maximum absolute VaR limit is 20% over a 20 day holding period based on a confidence interval of 99%. The relative VaR limit is twice the VaR of a derivative free benchmark. There are some further
conditions on the use of VaR as a tool to measure global exposure such as having in place an appropriate stress testing and back testing regime.

Furthermore, a fund applying a VaR method needs to provide additional information in its prospectus on the expected level of leverage and the possibility of a higher level of leverage. The annual report also has to contain information on leverage. In order to compute such leverage ESMA requires the UCITS to apply another (more crude) calculation method, the so called “sum of notionals” method. The gross method adds together all notional amounts of any derivative positions while no netting / hedging effects can be considered. The UCITS can additionally calculate and disclose leverage according to the commitment approach. ESMA has clarified that it does not view the disclosed leverage figures as hard limits but rather as additional information to be given to the investors (see also ESMA 10/788). However, UCITS are required to monitor the actual levels of leverage against the disclosed figures.

The choice of VaR model (variance-covariance, historical simulation, Monte Carlo simulation) used is also important as these models have different strengths and weaknesses. In particular, the variance-covariance method is usually not regarded as the best model where a portfolio will contain many options resulting in non-linear performance behaviour on underlying market movements. Additional measures such as CVaR or other sophisticated risk measurement methods may be approved to be used by the fund’s regulator and might be used in addition or alternative to the standard VaR approaches. The overriding requirement is that an appropriate method for measuring global exposure is used for the type of investment strategy employed.

v) Documentation / Transparency

UCITS funds must publish a prospectus which contains inter alia detailed risk warnings. Besides the prospectus itself, the fund has to publish the so-called KIID which shall provide the investor on two pages with information on the essential elements in respect of the fund and specify where and how to obtain additional information on the proposed investment. Financial statements must be published semi-annually and annually (the latter must be audited) in accordance with generally accepted accounting rules.

vi) Taxation issues

Most UCITS funds can avail themselves of “reporting status” in the UK. This means that any individual’s capital gains are taxed at the current rate of capital gains tax (as adjusted for indexation relief). The overall level of tax paid would usually be less than 20% of the gain. Unregulated funds often do not register for UK reporting status in which case taxable individuals in the UK would be taxed on their capital gains at the current rate of income tax (50%). This also has implications for funds of funds. A fund of funds can also apply for UK reporting status if the underlying funds into which it invests also have UK reporting status. Please also refer to other sections below on taxation (note that this UCITS guide does not purport to provide tax advice).
5. **Product types that are available in UCITS**

The following is a non-exhaustive list of product types that can be structured within a UCITS. Between 2008 and 2013 we have seen the launch of many alternative strategies as UCITS. The stream of new umbrella fund launches has slowed but the establishment of new alternative UCITS continues, mainly within existing umbrellas and on platforms. The product opportunities in the alternative UCITS space are continuing to evolve albeit at a slower pace. On the other hand we have noted that additional regulations (e.g. on money market funds, ongoing consultation by ESMA on UCITS ETFs and complex, structured UCITS) might impact the product strategy. We would encourage asset managers to speak with us to see whether and how their products can be structured as a UCITS:

i) **Traditional (long only) strategies:**
- Long equity
- Long fixed income / credit
- Money market funds
- Index tracking / replication
- Convertible bond funds
- Funds of long only funds

ii) **Exchange-traded funds:**
- Replication ETFs
- Synthetic ETFs

iii) **Structured products**
- Structured index products
- Guaranteed products

iv) **Alternative strategies:**
- Long / short equity
- Long / short credit
- Convertible arbitrage
- Sophisticated fixed income / absolute return
- Commodity index funds
- Global macro
- CTA / Managed futures (with limitations on commodities exposures)
- Multi strategy
- Event driven
- Funds of UCITS alternative funds (see below)
An alternative manager setting up a UCITS could be able to attract new investors and money not otherwise available to them.
The UCITS rules are very broad and to some extent principles based. As noted above, most alternative strategies can work within the UCITS rules, albeit sometimes requiring some adjustment. For example, there are the liquidity requirements - i.e. minimum bi-monthly liquidity (subject to a maximum pay out of 10% of NAV on any one dealing day), eligible asset types, diversification rules, leverage limits and limits on counterparty risk.

For an alternative manager looking to replicate their existing alternative fund product in a UCITS, it will be necessary to conduct a thorough analysis of the existing strategy against the UCITS rules to see if there are any issues. Sometimes the strategy fits within the UCITS rules with minimum adjustments and in other cases, certain aspects of the strategy may need to be adjusted. Sometimes a similar result can be achieved in UCITS but using a different technique, for example the use of derivatives to gain short exposure versus physical shorting (which is not permitted).

There are also some structuring techniques available (such as the use of financial indices) which have been approved by the regulators. These techniques can be used to link a strategy which may not work directly in a UCITS fund but which may become possible in a UCITS via a structuring technique. As noted above, ESMA has set additional standards in relation to UCITS ETFs, index-tracking UCITS, efficient portfolio management techniques, eligible indices for UCITS and others.

6. UCITS funds of alternative UCITS funds

The launch of many alternative strategies in UCITS funds has resulted in an increasing number of UCITS funds of alternative UCITS funds being launched. Only a few years ago it was questionable whether the universe of alternative UCITS was large enough, compared to the universe of unregulated funds, to allow for meaningful and competitive UCITS funds of alternative UCITS to be managed. Many believe that the alternative UCITS arena has matured sufficiently to allow for these funds to be run efficiently.

Distribution opportunities

UCITS funds of alternative UCITS funds are particularly interesting to private wealth managers targeting the mass affluent and high net worth market. This product has potentially lower volatility than a single strategy alternative UCITS due to its diversification. The product can be sold as “best of breed”. There are also certain tax advantages to individual investors versus an unregulated fund of funds. This can result in a significant tax saving for individual investors versus an equivalent product that does not benefit from UK reporting status.
**Investment rules (see also Appendix 1)**

The investment rules applying to UCITS funds of alternative UCITS funds are as follows:

- Max 20% of NAV can be invested into any one open-ended fund*
- Max 30% of NAV can be invested, in aggregate, into non-UCITS open-ended funds**
- Investee open-ended funds must limit their own investment in other open-ended funds to 10% NAV
- A UCITS cannot own in excess of 25% of the shares or units of another single fund

* For umbrella funds, this limit is applied at the sub-fund level i.e. you can invest up to 20% in each sub-fund.

** Non-UCITS funds must have investor protection measures and regulation equivalent to UCITS.

It is possible also to have derivative overlays in the UCITS fund. Investment in open-ended funds can also be combined with investments in transferable securities and other eligible asset classes.

### 7 How to launch a UCITS fund

#### 7.1 Choice of Location: Luxembourg v Ireland

For promoters / managers looking to launch a UCITS product, the first decision to make is often the choice of domicile. The UCITS rules are set out in various EU directives which are then transposed into national legislation in every member state of the EU. It is possible therefore to launch a UCITS fund in any EU state. Once you choose your fund domicile, you must apply to the local regulator in that country to establish the UCITS fund. Luxembourg and Ireland are the two main countries of choice for fund promoters seeking to establish UCITS funds that will be marketed cross border, i.e. for funds that will offer more than just domestic distribution. These two fund centres have the necessary infrastructure to service UCITS funds for international investors with a wide choice of administrators, custodians, law firms and consultants. It is important to also note that UCITS funds established in Luxembourg and Ireland do not levy taxation on the income or capital gains of the fund (except see below re taxe d’abonnement in Luxembourg).

Malta and Gibraltar are also developing a cross border fund business. In this guide we concentrate on Dublin and Luxembourg as the more mature and dominant domiciles of UCITS for cross border distribution.

Luxembourg and Ireland are materially very similar as domiciles for UCITS funds. There are however, some subtle differences between these two locations. Some of these are outlined below:
i) Promoter Approval

Until recently, UCITS funds launched in Luxembourg and Ireland required the appointment and approval of a fund “promoter”.

The promoter requirement was effectively removed in Luxembourg in 2013 on the basis that management companies and funds located in Luxembourg have to meet increased substance requirements under local regulation.

In Ireland, the Central Bank has proposed as part of a consultation with the Irish funds industry, which is ongoing in March 2014, to also remove the requirement of a promoter for UCITS funds. This follows the removal of the promoter requirement for non-UCITS funds under the AIFMD. The promoter in Ireland has a capital requirement of €635,000 and is usually the investment manager or distributor but can sometimes also be another party. The promoter must be a regulated entity in an approved jurisdiction and must have a track record in promoting funds or be able to demonstrate that it has sufficient expertise. Where the investment manager acts a promoter, there is a single approval process for this entity assuming both functions.

ii) Legal System

Luxembourg has a continental European legal system whereas Ireland has an Anglo Saxon legal system. Despite the different legal systems, the nature of the legal agreements and fund documentation are similar. Both jurisdictions have excellent law firms, both locally based and subsidiaries of the international law firms.

iii) Language / Culture

Business in Luxembourg is usually conducted in French although German and English are widely spoken and legal documentation can be drafted and submitted to the CSSF in English, French or German. All business in Ireland is conducted in English.

iv) Service Providers

Both Luxembourg and Ireland are very well served by administrators / custodians. Most of the international service providers have substantial operations in both locations. Luxembourg service providers are better suited to administering funds that sell directly to high volume retail investors although funds that sell to retail investors through distributors / nominees are well serviced in both locations.
v) Taxe d’abonnement

Luxembourg has a tax on fund assets at 5 bp NAV for non-institutional funds / share classes and 1 bp for money market funds / share classes and institutional funds per annum. Ireland has no equivalent tax.

vi) Role of Custodian / Depositary

The custodian / depositary has similar responsibilities in Luxembourg and Ireland in relation to the safekeeping of assets and settlement of transactions. The UCITS directive places certain other oversight responsibilities on the custodian / depositary in relation to the administration of the fund. In Ireland, local regulation has added some extra responsibilities on custodians over and above what is required in the UCITS directive with regards to independent investment restriction monitoring and reporting to shareholders. Funds established in Luxembourg as SICAVs (corporate structures) do not have similar responsibilities imposed on the custodian / depositary whereas funds established as FCPs (non-corporate structures) do. One main aspect of the next update to the UCITS regulations, coined UCITS V, is in relation to depositary liability. It is generally expected that depositary liability standards for UCITS will at least be equivalent to those already in effect for alternative investment funds under the EU’s Alternative Investment Fund Managers Directive (AIFMD). AIFMD currently has stricter depositary liability rules than UCITS.

vii) Independent Directors / Conducting Officers

In Luxembourg, none of the directors need be Luxembourg resident although there is usually at least one Luxembourg director.

In Luxembourg however, there must be at least two Luxembourg resident conducting officers / dirigeants either in the appointed management company or in the UCITS fund itself if the fund has not appointed a management company. The CSSF circular 12/546 outlines the expectation of the CSSF in relation to governance and substance for UCITS. Key pillars of the substance requirement are the need to have a local “decision making centre” (i.e. to have at least two local conducting officers) and also to have an “administrative centre”.

The conducting officers who are responsible for conducting and overseeing the UCITS management company / fund need to demonstrate inter alia that they work closely together in a management committee (regular management meetings, etc). The UCITS management company / fund also needs to have its own bricks and mortar office – i.e. simply a registered address is not sufficient anymore.

Beside the above mentioned CSSF circular, the Code of Conduct issued by the Luxembourg Fund Association (ALFI) provides further guidance on good practice in relation to substance / governance for Luxembourg funds:

In relation to the board of directors of a UCITS fund, there is no legal or regulatory requirement to have local directors in Luxembourg. However it has become market practice to have at least one local director appointed.
In addition to regulatory substance requirements and local market standards in Luxembourg, one also needs to consider substance requirements for UCITS funds that might be triggered by the registration of a UCITS fund outside of the EU (for example the Swiss regulator FINMA has additional requirements that one needs to consider when distributing a UCITS fund in Switzerland). For this reason many funds appoint a Luxembourg management company which carries out the local “substance” (in which case there is no additional requirement for the UCITS fund to have conducting officers or an administrative centre).

In Ireland the fund must appoint a minimum of two Irish resident directors. Regardless of the domicile of the UCITS, it is considered good practice to have locally resident directors to anchor the tax residency of the fund in the domicile of the UCITS.

The Irish funds industry issued a voluntary Corporate Governance Code in December 2012 which sets out, among other things, the requirements as to the role and make-up of the board of directors of an Irish fund or management company. The code stipulates the requirement of at least three directors, the majority of which should be non-executive directors, as well as one fully independent director who does not have to be resident in Ireland. The independent director, according to the Code, would not be an employee, partner, significant shareholder or director of a services provider firm, or a provider personally of services receiving professional fees other than directorship fees (directly or indirectly through a company) from the fund or management company. The Central Bank of Ireland has endorsed the voluntary governance code which is applied as an “adopt or explain” rulebook.

Furthermore, the Central Bank of Ireland operates a new fitness and probity regime which places obligations on a fund or management company in respect of the fitness and probity of its directors and officers and sets standards for Central Bank approvals for individuals to act for Irish fund or management companies. This regime forms part of an Irish framework for investor protection.

7.2 Authorisation Process

i) Promoter Approval

The Luxembourg regulator has removed the promoter requirement.

In Ireland, the first step is to have a suitable promoter approved for the proposed fund (note that in Ireland the Central Bank has proposed to remove the promoter requirement for UCITS). The Central Bank of Ireland will assess the promoter’s suitability to promote a UCITS fund based on criteria such as the promoter’s own regulation together with the level and depth of its experience in the investment fund area. There is also a minimum capital requirement in Ireland of €635,000.
ii) Fund Approval

There are a number of aspects to the fund approval process:

**Approval of Service Providers**

The fund must appoint various service providers in relation to the running of the fund. The main service providers will need to be authorized by the CSSF / Central Bank of Ireland:

<table>
<thead>
<tr>
<th>Role</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Directors</strong></td>
<td>All directors appointed to a UCITS fund or management company will need to be authorized and approved by the CSSF / Central Bank of Ireland. In Luxembourg, a detailed and signed CV, a copy of the passport, a declaration of honour, extract of police records and a list of mandates must be submitted. In Ireland, there is a detailed online questionnaire which must be completed, that enforces the provision of supporting documentation such as CV and proof of third-level education and professional qualifications. See Section 16 for services that Carne can provide.</td>
</tr>
<tr>
<td><strong>Promoter</strong></td>
<td>As above</td>
</tr>
<tr>
<td><strong>Investment Manager</strong></td>
<td>The CSSF / Central Bank of Ireland will request details of the investment management company. If the IM is already a regulated entity in a recognised jurisdiction then approval is usually a formality.</td>
</tr>
<tr>
<td><strong>Administrator</strong></td>
<td>A UCITS fund must appoint a regulated administrator. The UCITS directive is silent on the domicile of the administrator but for operational reasons it seems logical if the administrator is domiciled either in the country of domicile of the UCITS or the management company, if different. It is possible for the administrator to delegate certain elements of the administration process outside of the jurisdiction.</td>
</tr>
<tr>
<td><strong>Custodian / Depositary</strong></td>
<td>A UCITS fund or management company must appoint a regulated custodian / depositary in the country of domicile of the UCITS. Normally the custodian / depositary will appoint a global sub-custodian who may be based in another country. The custodian / depositary has a duty of oversight over any appointed sub - custodians. See section 9 for options on using prime brokers for UCITS funds.</td>
</tr>
<tr>
<td><strong>Management Company / Conducting Officers / Designated Persons</strong></td>
<td>In Luxembourg, a UCITS must either appoint a management company or as noted above, must appoint two local conducting officers plus an “administrative centre” i.e. an office with appropriate IT infrastructure where the conducting officers can carry out their work. In Ireland a management company can also be appointed or this function can be performed by the directors of the fund (so called “designated directors”) or by appointing “designated persons” to carry out the various oversight functions. See Section 16 for services that Carne can provide.</td>
</tr>
</tbody>
</table>
The other parties to a UCITS fund who are appointed but are not required to be authorised by the CSSF / Central Bank of Ireland include:

**Product Structuring Services**
See section 16 below for services that Carne can provide.

**Legal Advisors**
A law firm in Luxembourg or Ireland will be appointed. The law firm will draft the prospectus and prepare / review all legal documentation. They will liaise with the CSSF / Central Bank of Ireland, prepare the submissions, deal with all queries and re-submit revised documentation until authorisation is granted.

**Auditors**
An annual audit is required.

**Tax Advisor**
Usually a tax advisor is required to review the section of the prospectus relating to taxation and to register the UCITS for tax reporting if necessary.

**Distributor(s)**
The party or parties appointed to distribute / market the fund in different countries.

**Company Secretary / Domiciliary Agent**
Required for corporate structures to keep company minute book, arrange board meetings, organize general meetings etc.

**Listing Agent**
If the fund is to be listed on the Luxembourg or Irish Stock Exchange, it is usually necessary to appoint a local listing agent.

**Foreign Registration Service - Foreign Lawyers / Tax Advisors / Paying Agents**
If the UCITS fund is to be registered for public distribution in various countries (either within or outside the EU), it will sometimes (depending on the country) be necessary to appoint local lawyers, translators, paying agents and tax advisors. Each country has different registration requirements and it is necessary to register separately in each country. There are ongoing filing requirements and additionally in some countries, ongoing taxation obligations.

Carne offers foreign registration services and will ensure that the initial application / registration requirements are met as well as ongoing filing requirements. With the EU passport for UCITS, in many EU member states the requirements are not onerous but there are still requirements to be met. For registration outside the EU the local regulations in each host country determine the requirements, which can be onerous.
Prospectus

The prospectus is the main document which sets out the operation of the fund, investment objectives and policies, risk factors, parties involved, valuation rules, how to buy and sell shares etc. The prospectus forms part of the contract between the fund and the investor.

Key Investor Information Document - KIID

As described above, the KIID is designed to provide investors with essential information on each UCITS (share class) in a prescribed format on two pages in simple language.

Risk Management Process Statement

UCITS IV introduced additional requirements to the overall risk management of a UCITS, not just with respect to derivatives. The risk management procedures now need to include an adequate liquidity risk management policy and in addition operational risks need to be considered. In both Luxembourg and Ireland a risk management process statement ("RMP") must be submitted to the CSSF / Central Bank of Ireland, although the CSSF and the Central Bank of Ireland deal with the requirements in different ways. The Central Bank of Ireland continues to require a standalone document called the RMP for the use of derivatives and the management of related risks. The additional non-derivatives related risk requirements are to be covered in the business plan (see below). In contrast, the CSSF requires (per Circular 11/512) that the RMP in Luxembourg covers all material risks of a UCITS, including derivatives-related and other risks. Both the CSSF and the Central Bank of Ireland have issued detailed guidance on the format and content of the RMP. The derivative aspects of the RMP outlines the use of derivatives in a UCITS fund, the risks associated with those derivatives and the controls and procedures in place to mitigate those risks. It describes the systems in place and the people involved in trading the derivatives and managing the risks. It sets out how the fund will ensure compliance with the UCITS rules governing global exposure (leverage), counterparty risk, position exposure and cover. It also deals with aspects such as netting and use of collateral.

Business Plan / Substance Application

The “Business Plan” in Ireland sets out the governance framework for a UCITS management company or self-managed fund. It names the directors and designated individuals, their roles and responsibilities, frequency of board meetings, reporting items that they will receive, escalation process, etc. See further detail below in section 10. The CSSF has a questionnaire which is required to be completed for all new management company / SIAG (self – managed UCITS) authorisations dealing with various aspects of Circular 12/546, which deals with the Luxembourg “substance” requirements. In Luxembourg the completed substance questionnaire must provide the address of an office in Luxembourg for the UCITS management company or self – managed fund and details of the IT infrastructure. In Luxembourg, a business plan must also be submitted to the CSSF in addition to the substance application, which shows forecast growth in assets under management, target markets etc.
Constitutional Documentation

Depending on the legal structure (company, SICAV, trust, FCP) this will be the memorandum and articles of association, trust deed, deed of constitution etc.

Legal Agreements

The main legal agreements will be the administration agreement, custody agreement and investment management agreement. There may also be distribution agreements if distributors are appointed and a management agreement where a management company is appointed.

Operating Agreements

Funds that use derivatives will usually enter into various operating agreements with brokers and counterparties such as ISDA / CSA, collateral management agreements, give up agreements, etc.

Application Form/Letter

Application for a UCITS fund to the CSSF / Central Bank of Ireland also involves completion of an application form and letter.

The approval process with the regulator normally takes 6-10 weeks from the date of the first submission to the regulator with first drafts of the prospectus and other documentation.

7.3 Cost of approval process

The costs of launching a UCITS fund are approximately the same in Luxembourg and Ireland. The costs involved will depend on the size and complexity of the structure, number of sub-funds, whether there will be a UCITS management company appointed and how much of the work (e.g. legal work) can be carried out by the promoter versus how much will be outsourced.

If the fund is to be registered for public distribution in various other countries there will be costs associated with the registration process involving, for example, legal fees, tax advice and translation costs. We can provide indicative costs if requested. Normally all of these costs can be charged to the fund as establishment expenses. Often the establishment costs are capitalised and amortised over the first few years of the fund.
Most alternative strategies can work within the UCITS rules.
8. Distribution Opportunities/Channels

The UCITS Directive grants UCITS funds the ability to distribute cross-border in the EU, whereby funds authorised as UCITS in one EU jurisdiction can be publicly distributed and marketed to retail clients in all other EU jurisdictions, subject to a notification process to the relevant regulatory authorities.

The distribution opportunities for UCITS funds are therefore not confined to the home domicile of the fund but instead can be found across the wider EU market. In addition, there are extensive distribution opportunities for UCITS funds further afield in Switzerland, Asia, South America, and South Africa. In those countries, UCITS funds are widely recognised by the supervisory authorities and investors and are regarded as being highly regulated and investable products characterised by a strong governance and oversight framework and bound by careful investment restrictions.

While the UCITS status of a fund and its cross-border distribution potential are technically not required for distribution to non-retail clients, UCITS funds are increasingly the preference of a large number of professional investors across EU jurisdictions and globally, including insurance companies, corporate and retail banks, funds of funds, pension funds, private banking groups and distribution platforms. Investors such as insurance companies, funds of funds or pension funds will devote (either due to regulatory or self-imposed restrictions, risk appetite, transparency requirements, liquidity, or for tax reasons) a greater allocation of their portfolios to regulated funds such as UCITS, in contrast to a diminishing allocation for unregulated funds.

Setting up a fund as a UCITS can also bring benefits from the cultural predilection and savings behaviour of investors in certain regions. For example, in Continental Europe or Scandinavia, investors have historically held a strong inclination for regulated products.

Finally, the lack of a coherent private placement regime across Europe (in the wake of the EU’s Alternative Investment Fund Managers Directive (AIFMD) a number of EU countries even have withdrawn or are about to withdraw their private placement regimes) and uncertainty surrounding the rules on the distribution of unregulated funds in foreign jurisdictions means that any marketing of unregulated funds generally incurs extensive legal costs for ongoing and ad-hoc advice. This is in contrast to the clarity underpinning the distribution and marketing activities applicable to UCITS funds where cross-border distribution is guaranteed in light of an unambiguous registration process, as defined in the UCITS Directive.

The AIFMD, which has come into force but due to transitional arrangements is only slowly being applied to non-UCITS funds and their managers, introduced an EU passport for non-UCITS funds. However, it is not expected that the AIFMD will compete directly with the UCITS brand due to the more stringent diversification rules and eligible assets criteria of UCITS. Where the AIFMD already applies, an AIF manager needs to comply with similar organisational / governance requirements as a UCITS, which in some respects are more stringent and prescriptive than UCITS requirements. Where UCITS requirements are lagging behind the AIFMD, it is expected that they will catch up before long with the implementation of the next iteration of the UCITS regulations (i.e. UCITS V).
Examples of Distribution Opportunities for UCITS not available to unregulated funds

- **Retail distribution.**

- **Pensions and institutional (e.g. insurance) investors.** Although most pension plans and insurance companies can allocate investment to unregulated funds, normally they are limited to a certain percentage (e.g. 10%). UCITS funds are regulated products and usually there is no limit to how much a pension scheme or insurance company can invest into UCITS funds (even those launched by alternative managers). Consequently UCITS can often demand a higher allocation from those investors. In France for example, most pension schemes and insurance companies can allocate 100% to investment in UCITS whereas investment in unregulated schemes is limited to a smaller percentage.

- **Wealth management platforms.** Many of the wealth management platforms and their private banking equivalents require that a fund be registered in the local country. As mentioned above, the local registration process is much more straightforward for a UCITS fund versus a non-UCITS.

- **Funds of funds.** A number of UCITS funds of UCITS alternative funds have been established selling into the mass affluent and high net worth market. These offer investors attractive liquidity terms and a robust risk framework. In some countries as noted above, UCITS funds enjoy a tax advantage over unregulated products for individual investors.

It should be noted that the AIFMD provides for retail investor alternative investment funds to be established which reside somewhere between UCITS and qualifying investor alternative investment funds / specialised investment funds. However, for typical unregulated funds, such as Cayman-domiciled funds, retail distribution in the EU is not permitted. It is furthermore unclear whether investor groups such as insurance companies and pension funds will have similar restrictions for investing in funds established under the AIFMD as they currently have for unregulated funds such as funds established in Cayman and other offshore jurisdictions.

**Registration versus Private Placement**

Once a UCITS has been registered in the home country, it can be marketed for public distribution in that country. Subscriptions can also be accepted from non-retail investors in other countries on a private placement basis, subject to the fund being compliant with private placement regulations in the various countries. Many UCITS funds choose not to register the fund in other countries. However, registration of the fund in other countries opens up a number of distribution channels that are not otherwise available to the UCITS (see above). As discussed above, Luxembourg and Ireland are the main domiciles for UCITS funds that will be sold in multiple jurisdictions. Also, as mentioned previously, some countries in the EU have either abolished or are planning to abolish their private placement regimes in the wake of the AIFMD’s adoption.
Process for Registering Funds

A UCITS authorised in one EU country benefits from the passport which allows it an automatic right to register in all other EU countries. The registration process under EU law has been improved by UCITS IV and is now a regulator to regulator notification which is supposed to take no more than two weeks. The rules for registration vary from country to country. In some countries the process is very straightforward (e.g. the UK). In other countries, registration is more complicated and can require appointment of a local paying agent and additional tax registration and reporting (e.g. Germany and Austria) may be required.

The requirements for providing translations of documents have also been standardised under UCITS IV which stipulates translation into the official or one of the official languages of the host member state of the KIID as a minimum. Other documents do not have to be translated but in order to facilitate the distribution of a UCITS the promoter and distributors might decide to provide translations of certain documents, e.g. the prospectus.

The process for registering funds in non-EU countries does not benefit from the EU passport and there is therefore no automatic entitlement for a UCITS fund to register in a non-EU country. However, many non-EU countries are very familiar with UCITS products and registration is possible by following a standard process. In some countries there are rules which make it difficult for certain “sophisticated” strategies to be sold to retail investors. In these countries, there may be an option to register the fund on an institutional rather than a retail basis.

9. Operating Model

Choice of Service Provider

Luxembourg and Ireland are both very well serviced with administrators and custodians. Most of the large international administrators / custodians are based in both locations as well as a number of local companies. As set out above, under UCITS IV only the depositary / custodian has to be located in the domicile of the UCITS fund. Other service providers can be located in other jurisdictions but may have to be regulated to service UCITS funds, as is the case for the administrator. When choosing a service provider for the launch of a UCITS product, promoters should take into consideration the following factors:

Existing Relationships

A fund promoter / sponsor may already have an existing relationship with a service provider in relation to the servicing of a non-UCITS fund or another part of the service provider’s organisation may be providing some other service to the promoter. Leveraging an existing relationship can be advantageous for various reasons: familiarity with the people / organisation / processes, existing IT and operational links, and economies of scale on fees, etc.
Although the service provider market is very competitive, fees can vary significantly. The methodology for levying fees also varies between companies. Some service providers have simple charging methodologies where various services are bundled together, whereas others have much more granular methodologies where everything is charged for separately. It is important therefore when comparing the fees of different providers, to model the potential fees under different scenarios such as asset levels, shareholder trading volumes, security trading volumes, etc. It is also important to examine the effect of minimum fees, especially when the assets of the fund may be lower in the first year.

The chosen service provider should be a good fit for the UCITS from a client servicing perspective. Service quality can vary not only between service providers but also for different clients within the same service provider. In our experience, the key point is that the service provider values the promoter’s business sufficiently and can provide enough evidence of this. Changing service providers after a fund has launched can be a costly and time consuming process.

Although all the large service providers offer a good all round service, there are differences in the capabilities of the service providers themselves. Depending on the type of UCITS fund being launched there may be some service providers who will have an operating edge over others in certain key respects. In our experience, some of the key points to consider are:

- Transfer agency systems / retail capabilities and links to distribution platforms
- Performance fee calculations and ability to calculate performance fee adjustments at shareholder level
- Derivatives pricing capabilities
- Extent of sub - custody network
- Reporting tools
- Communications links to investment managers (trade reporting and reconciliations)
- Specialised processes, for example for ETFs, tax transparent fund structures, multi-manager structures or pooling structures
Custodian / Prime Broker

For alternative funds structured as UCITS there are potentially some different models that can be employed in relation to the custody of assets. UCITS funds must appoint a custodian / depositary to hold assets in safe custody in a segregated account for the fund (i.e. the assets of the fund except cash are segregated from the proprietary assets of the custodian / depositary). The traditional hedge fund model usually involves the appointment of a prime broker. The prime broker model has some aspects which require adjustment within the UCITS framework such as:

- Fund assets cannot be re-hypothecated
- Stock borrowing and physical shorting is not permissible
- Cash borrowing is not permissible for investment purposes

An alternative manager who would normally use a prime broker to provide leverage and carry out physical shorting will need to adjust its operating model for UCITS. This normally involves the use of derivatives to achieve leverage and shorting synthetically as opposed to physically. There may be different ways to structure this operationally. There are two main models for a UCITS fund to deal with a prime broker. The choice of model will depend on what works best for the investment manager and broker.

Prime Broker appointed directly by UCITS or as a sub-custodian

In this scenario, the fund appoints a prime broker directly (or as part of a tri-party agreement involving the fund, the broker and the custodian / depositary). The prime broker would hold the assets in segregated custody for the fund but would not be able to re-hypothecate those assets. The prime broker may also act as an OTC derivative counterparty and / or as broker for exchange traded derivatives. As the broker would have custody of the assets it may not require initial margin collateral for the derivatives trading activity.
This model has the advantage of being closest to the standard PB model in hedge funds. It may suit smaller alternative managers who do not have existing operating links with custodians / depositaries.

**Prime Broker appointed as OTC counterparty**

In this model the custodian / depositary would hold all of the assets of the fund (excluding derivatives). The fund would independently engage with derivatives counterparties (either exchange traded or OTC). Counterparties may look for initial margin as collateral. The extent of the initial margin demanded by a counterparty will depend on their risk assessment of the fund and factors taken into consideration will include:

- Size and reputation of the promoter / investment manager
- Size of assets under management
- Size of derivatives contracts

Some counterparties will not demand initial margin from a UCITS fund as they view a UCITS as being a less risky product. It is also possible for a UCITS fund to grant a floating charge of its assets in favour of a counterparty which may reduce the counterparty’s demand for initial margin collateral. Some counterparties operate a pledge account system where the custodian / sub custodian will maintain the assets of the fund in two separate accounts, one a regular account for the fund and the other an account which benefits from a pledge over the assets in favour of the counterparty.

This model may be favoured by larger investment managers who have existing operational links to custodians / depositaries.

One of the main considerations in dealing with OTC counterparties is that the fund remains in compliance with the UCITS OTC counterparty limits of 5% NAV (or 10% NAV in the case of approved credit institutions). One of the ways to deal with this is for the fund to operate a daily variation margin movement with the OTC counterparty. At the end of each day after the passing of the variation margin, the counterparty exposure is re-set to zero. There are other similar techniques to mitigate OTC counterparty risk such as re-setting the derivatives or the passing of margin (or collateral) when certain thresholds are reached.
10. Business Plan / Substance Questionnaire (per CSSF Circular 12/546)

Ireland
The business plan must be submitted and approved by the Central Bank of Ireland. This sets out the governance regime in place for the fund, recently expanded as part of UCITS IV. The business plan is a requirement of the UCITS management directive. This directive states that the management of the UCITS management company or self-managed UCITS must include the appointment of at least two persons who will be responsible for performing oversight of the operation of the UCITS management company / fund. The regulations specify a number of managerial functions which must be overseen on an ongoing basis. These include:

- Decision taking
- Monitoring of investment policy, strategies and performance
- Compliance monitoring
- Risk management
- Financial control
- Monitoring capital
- Internal audit
- Supervision of delegates
- Complaints handling
- Accounting policies and procedures

The purpose of the directive is to ensure that the UCITS management company / fund has sufficient substance and is not a “letterbox entity”. The managerial functions can be carried out in a number of ways:

- The UCITS management company / fund has employees to carry out the managerial functions;
- The directors of the UCITS management company / fund carry out the managerial functions (“designated directors”);
- The management company / fund appoints “designated persons” to carry out the managerial functions. In this model a third party company such as Carne may be appointed to provide the designated persons.

In the case of a self – managed UCITS, the designated directors / persons act on a part time basis for the UCITS management company / fund. They carry out all of the oversight functions and present a report to the board of directors at each board meeting. In between board meetings, they would follow up on any issues arising and if necessary escalate issues directly to the board if sufficiently material.

Luxembourg
The management company model is more common in Luxembourg than in Ireland primarily for reasons associated with the authorisation of Luxembourg funds for public distribution in certain countries such as Switzerland. If a UCITS fund appoints a management company in Luxembourg, then the management
UCITS provide a robust risk management framework through their prescribed rules on governance, risk, regulation of service providers and safekeeping of assets.
company must comply with the various substance requirements as set out in the CSSF’s Circular 12/546. Self-managed funds (“SIAGs”) are also possible but are less common. The management company or the SIAG must comply with Circular 12/546, the principal requirements being:

- There must be two Luxembourg resident conducting officers / dirigeants who are responsible for all of the activities of the management company / SIAG. The activities are similar to those listed out above for Ireland although there is no prescribed list of functions in the Circular. The conducting officers will need to demonstrate that they have appropriate resources / support to carry out their functions.
- There must be a separation of the risk management function from the investment management and internal audit functions. Additionally, the risk management function cannot be carried out by a member of the board of directors.
- There is a requirement to have a “decision making centre” and an “administrative centre”. In practice this means that there must be a dedicated physical presence to the management company / SIAG i.e. an office with appropriate IT infrastructure.
- There must be adequate policies and procedures for the management company / SIAG covering items such as supervision of delegates, risk management (see the RMP above), valuation of assets, AML / CTF, conflicts of interest, complaints handling, voting, BCP etc.

The CSSF has a questionnaire which is required to be completed for all new management company / SIAG authorisations dealing with various aspects of Circular 12/546.


Section 4.2 above refers to the risk management process statement (“RMP”) for UCITS and some of the items that must be included in the RMP.

It is important to understand that for proper risk management under UCITS IV a holistic approach is expected by regulators; i.e. the UCITS / management company needs to identify and thus manage all relevant material risks a UCITS is exposed to. This means that in addition to portfolio risks such as global exposure, issuer, counterparty risk etc., an asset manager also needs to have an adequate liquidity risk management process in place and fully consider operational risks.

In relation to portfolio risks there is in particular a need to be clear how derivative risks will be managed. An analysis of how the fund will comply with the various derivative risk spreading rules and what methodologies will be employed to measure risk must be included in the RMP:

- **Global exposure / leverage**

  As described above in section 4.2, there are limitations on the amount of global exposure or leverage in a UCITS fund measured either under the “commitment approach” or under VaR.
• **Counterparty risk (“CP risk”)**

The maximum exposure to an OTC counterparty is 10% in the case of qualifying credit institutions or 5% in all other cases. The regulations explain how to measure counterparty risk. UCITS IV has harmonised the calculation method for counterparty exposure within the EU with the result that there is a single harmonised approach now.

Counterparty risk can be reduced by the UCITS accepting collateral from counterparties. The collateral must meet certain criteria and may be subject to a haircut depending on the types of assets being used as collateral.

• **Aggregate counterparty risk (also referred to as “issuer-concentration risk”)**

The overall combined exposure to any one entity (such as an OTC counterparty) taking into account transferable securities, money market instruments, deposits, cash, OTC counterparty exposures and position exposures from the assets underlying derivatives as well as from securities lending and repo positions cannot exceed 20% of NAV. There is also an overall group exposure limit of 20% of NAV in respect of transferable securities and money market instruments issued by members of the same economic group.

• **Position exposure / concentration limits**

Position exposures from assets underlying derivatives must be combined with directly held positions in transferable securities / money market instruments for the purpose of compliance with the UCITS risk spreading rules (e.g. 5/10/40 rules). There is an exemption for index based derivatives.

• **Cover rule**

A UCITS fund must have sufficient cover in place for derivative positions to ensure any liabilities such as margin calls can be met. Usually long positions held by the fund qualify as cover provided that they are sufficiently liquid.
12. Taxation

Generally speaking UCITS funds that are domiciled in either Luxembourg or Ireland are regarded as “tax neutral”. This means that there is no tax levied at the fund level (subject to some exceptions, see below). Investors must consider their own tax position when investing in UCITS funds. Some tax considerations to be aware of are as follows:

Luxembourg imposes a “taxe d’abonnement” on fund assets at 5 bp for non-institutional funds / share classes and 1 bp for money market funds / share classes and funds marketed to institutional investors.

The EU Savings Directive requires (for certain types of funds - mainly fixed income funds) that paying agents report shareholder redemption and distribution activity to local tax authorities. Some countries operate a withholding tax on distributions and redemptions in lieu of reporting information to the tax authorities. Luxembourg investors can opt for either system – withholding or disclosure. The rules apply to payments made by paying agents to individual investors who are resident in a different country to the paying agent.

Funds invested in transferable securities may suffer withholding taxes on coupons or dividend payments. This is an issue mainly for equity funds as most bonds pay coupons gross. Withholding taxes affect all funds and not just UCITS funds. Luxembourg and Ireland, however, benefit from access to many double taxation treaties with other countries.

There are other taxes that may apply in certain markets on securities transactions such as stamp duty (UK) and capital gains tax (some emerging markets). Again, these issues are not unique to UCITS funds.

Value Added Tax (VAT) is a tax that is levied on certain types of expenses, usually professional fees. Generally the main expenses in a fund such as management fees, administration fees and custodian or depositary fees are exempt from VAT. However, expenses such as legal, audit and professional fees will usually have VAT levied at the rate applicable in the home EU member state.

Certain countries have tax rules that if followed offer a more favourable tax treatment to some investors (or avoid a less favourable treatment). Examples include reporting status for certain UK investors and tax transparent status in Germany and Austria. Funds that have investors in such countries will need to consider complying with local tax rules in these countries which usually involve submitting an annual tax return and ongoing publication of certain information. Most administrators in Luxembourg and Ireland will be familiar with these requirements and will be able to produce the required reporting. It may be necessary to appoint local tax agents for the filing of annual tax returns in these countries.
13. Key considerations in converting existing non-UCITS funds to UCITS status (and for determining if an existing strategy works in UCITS)

It is possible to convert an existing non-UCITS fund to UCITS status where there is no change in fund domicile involved. For example, an Irish Professional Investor Fund (“PIF”) or Qualifying Investor Alternative Investment Fund (“QIAIF”) can have its authorisation changed to UCITS. Likewise, a Luxembourg Specialised Investor Fund (“SIF”) can be converted to a UCITS. Funds established under the AIFMD can potentially also be converted to UCITS.

**Fund re-domiciliation**

For funds that are domiciled in a different country, both Ireland and Luxembourg have legal provisions that allow, following a legal process and after obtaining shareholder approvals, the re-domiciliation of a fund into an EU country as a UCITS or another fund type (e.g. SIF or QIAIF – see section 14 below). The re-domiciliation process generally avoids any tax issues for the fund or investors (as there is no change in the legal structure of the fund). It is also possible to establish a new UCITS and perform a scheme of amalgamation or fund merger to transfer the assets and investors of an existing fund across to a new UCITS fund. There are a number of considerations in such a scheme: e.g. the taxation implications of moving from one fund scheme to another may trigger capital gains tax for investors. Under a scheme of amalgamation however, roll over relief in some markets may be available to certain investors to reduce or eliminate such a potential tax liability.

Some of the key considerations in converting a non-UCITS fund to UCITS status are as follows:

**i) Appropriateness of strategy / existing funds**

Existing strategies / holdings must be reviewed in order to identify any UCITS compliance issues. Liquidity of investments must also be reviewed. The UCITS rules are very broad and permit a wide range of different investment strategies including many alternative and leveraged strategies. However, there are some asset classes that are not permitted in UCITS or there are restrictions on how they can be accessed. As mentioned previously, there are also detailed investment limits, borrowing rules and rules governing the use of derivatives. In our experience, most alternative strategies work well within the UCITS rules although some may need a degree of alteration to comply with UCITS regulations.

For investment managers who are thinking about converting their existing non-UCITS strategy to UCITS, our recommendation would be to have a review performed by a UCITS expert advisor such as Carne of a recent portfolio, along with the prospectus, to see if there are any barriers to conversion.
ii) Taxation

If the change to UCITS status is simply a change of regulatory status and does not involve a scheme of re-construction then there should be no taxation implications. If the change involves moving the assets of an existing non-UCITS fund to a new UCITS fund then there will be taxation considerations:

- Investors will be redeeming from an existing fund and investing into a new fund. The existing investor base must be reviewed in order to determine whether any investor tax may arise and whether relief is available under a “scheme of amalgamation / reconstruction” such as rollover relief.

- Investment may be “in-specied” from the existing fund to the new fund. This may result in a transfer of beneficial ownership which may trigger taxes on securities in certain countries, e.g. stamp duty in the UK. It may also be necessary for securities in certain markets to be transferred “across market” which may result in market costs.

iii) IT and Operating Model including:

If the existing fund uses a prime broker, then this operating and fiduciary model may need to be reviewed in the context of UCITS rules as noted in section 9 above. In particular:

- Re-hypothecation of assets is not permissible under UCITS regulations;
- Stock borrowing / physical shorting is not permissible under UCITS regulations, although, synthetic shorting is possible through derivatives;
- Exposures to OTC counterparties must be maintained within the UCITS limits.

- Certain administrators often offer enhanced transfer agency functionality including links to investor settlement platforms. Depending on your distribution strategy this may be important.

- Compliance / Risk Monitoring: A comprehensive compliance and risk monitoring process is required by the investment manager which includes pre-trade as well as post-trade compliance for UCITS rules. Many alternative managers do not have this functionality and this may require some development prior to launch of the UCITS.

iv) Performance History

Performance history should be transferred if possible. It will be necessary to demonstrate that post re-organisation the funds will trade in the very same way and expenses will be equivalent.
v) Performance Fees

It is possible for UCITS funds to pay performance fees but there may be some practical issues to consider. Most UCITS funds operate with daily liquidity. The minimum requirement for a UCITS fund is that it must have at least two investor dealing days per month. Although it is possible to have performance fees with equalisation at shareholder level in a UCITS, in practice most UCITS funds that operate performance fees charge the fee at the fund level (as an expense of the fund) and make no equalisation adjustments at shareholder level. The reasons are twofold: 1) for daily dealing funds it is operationally challenging to make equalisation adjustments at the level of the shareholder and 2) many sub-distributors and nominees cannot process equalisation adjustments.

vi) Investor communication and approval

An investor approval strategy needs to be drawn up explaining the restructure, its benefits and costs. Investor approval is required to change a fund to UCITS status. Investors must be offered a period of time to redeem their shares in the fund before the fund converts to UCITS status. Normally the change to UCITS status will involve no negative changes to the fund from an investor’s perspective (unless there is a change in investment approach) and can therefore be easily “sold” to investors. UCITS offer increased governance and improved investor protection measures over non-UCITS. Provided there are no material changes to the investment policy or costs, investors will normally see a conversion to UCITS status as a net benefit. If the conversion to UCITS is effected within the existing legal structure then there should be no tax issues for investors.

vii) Costs

The costs associated with changing a fund to UCITS status will be mainly for legal and professional fees. The prospectus and nearly all of the legal agreements of the fund will be affected by the change to UCITS status and will need revising. The process is akin in many ways to a new UCITS fund launch. Fund documentation must be submitted to the CSSF / Central Bank of Ireland for review and comments will be issued. A Risk Management Process and Business Plan / Substance Application Questionnaire (per Circular 12/546) will need to be drawn up as detailed previously in sections 9 and 10. Various application forms will also need to be submitted. There may also be securities charges associated with the transfer such as custodian / depositary and sub-custodian charges.

viii) Process

The process for converting a fund to UCITS status involves two work streams which can run in parallel:

1. The legal and regulatory aspects. This for the most part will be coordinated by the fund lawyers. It will normally take a few weeks for all relevant changes to the prospectus and legal agreements to be drafted and agreed with the various parties (promoter, investment manager, administrator, custodian / depositary, directors, etc). Additionally, the Risk Management Process and Business Plan / Substance Application Questionnaire will need to be written / completed. Once the documents have been submitted to the CSSF / Central Bank of Ireland for review it will take a few weeks for
the regulator to revert with their first round of comments. Subsequent rounds of comments are generally received more quickly. Once the documents are finalised or close to finalisation they will need to be sent to shareholders for approval. Depending on the provisions in the fund constitutional documentation there is normally a minimum notice period to give to shareholders to allow them to consider the changes before voting on the matter at a general meeting. There will usually be a period after the shareholder vote to enable any dissenting shareholders to redeem their shares before the fund converts to UCITS status. The whole process of converting a fund to UCITS will usually take between two and four months.

2. The operational aspects. The operational aspects of changing a fund to UCITS status may or may not be significant depending on the structure of the existing fund. For example, if there are no changes in investment policy, dealing frequency, fees or custodian / depository model then there may in fact be minimal changes required from an operational perspective. Usually at a minimum, the pre-trade and post-trade compliance checks at the investment manager (and also possibly the custodian / depositary) will need to be amended for the UCITS eligible assets and investment and borrowing limits. This may require some changes to the compliance monitoring systems.

In certain circumstances however, there may be some operational complexities in converting to UCITS. These include:

• If the existing fund has a prime broker relationship. As stated above, there may be changes required to the relationship between the fund and the prime broker. For example, securities cannot be re-hypothecated and physical borrowing of cash or securities is not possible. There are also limits to the amount of exposure a UCITS can have to an OTC counterparty.

• If the existing fund operates performance fee equalisation at shareholder level or series of shares. As noted above, the administrator may not be able to support this in a UCITS fund.

• Dealing frequency. If the change to UCITS status involves an increased dealing frequency then the administrator will need to make changes to their fund accounting, pricing and transfer agency systems.
The UCITS product can meet the demands of both the fund promoter and the investor.
14. Regulated Non-UCITS Funds

Although this booklet is intended to provide information on UCITS funds, it is worth mentioning that there are other non-UCITS fund schemes in both Luxembourg and Ireland that are worth considering for promoters whose investment strategy does not comply with the UCITS rules.

On the 1st July 2011, the Alternative Investment Fund Managers Directive (AIFMD) was published in the Official Journal of the European Union. This directive regulates the activities of entities engaged in the management and administration of funds that are not UCITS funds. It also lays down rules for the marketing of those funds to professional investors within the EU. Although the AIFMD came into force in July 2013, transitional arrangements mean that only a small number of non-UCITS funds domiciled within the EU have in fact been transposed to AIF status as at March 2014. Existing non-UCITS funds domiciled within the EU are expected to convert to the AIFMD by 22nd July 2014. However, where the alternative investment manager, the AIFM, is located outside of the EU, grandfathering carries on until July 2015. The AIFMD also has reach on funds that are not domiciled within the EU but who wish to distribute into the EU. Transitional arrangements mean that some such non-EU funds have until 2018 before they have to adopt the AIFMD. However, they cannot benefit from the passport afforded under the AIFMD and may be restricted in selling units into the EU where some countries have abolished or are in the process of abolishing their private placement regimes. There are some exceptions to the applicability of the AIFMD but the regulation is very far-reaching and most funds will not meet the criteria for being out of scope of the AIFMD.

Some AIFMD requirements exceed those of UCITS, in particular on risk management, depositary liability and remuneration controls. It is widely expected that the next iteration of UCITS regulations, UCITS V, will at least close this gap.

Ireland

The other fund structures available in Ireland are as follows:

1. Retail non-UCITS (the AIFMD led to the introduction of the “Retail Investor Alternative Investment”, or “RIAIF”, which is due to replace this fund type).

This fund type is suitable for retail investors. Passporting may be possible into some countries but it does not have the UCITS brand and (unlike UCITS funds) registration in other EU countries is not guaranteed.

Retail non-UCITS funds can invest into asset classes a UCITS cannot invest in such as commodities, property and unregulated funds. Feeder funds and master / feeder structures are permissible subject to certain investor protection restrictions. Closed ended funds are also possible.

Under the AIFMD, a RIAIF is available to investors who are not qualifying investors (see below). Like current retail non-UCITS funds, RIAIFs do not have some of the restrictions UCITS funds have but other requirements such as for risk management are much closer to UCITS than they have been prior to the introduction of the AIFMD.
2. Qualifying Investor Alternative Investment Fund ("QIAIF") (the AIFMD led to the introduction of the “QIAIF”, which has replaced the Qualifying Investor Fund or “QIF”)

Qualifying Investor Alternative Investment Funds are available only for sale to “qualifying investors”:

- Any natural person owning >€1.25 million (excluding main residence) OR
- Any institution with assets under discretionary management of > €25m
- Or any institution whose beneficial owners are qualifying investors in their own right

There are exceptions from qualifying investors for the management company, general partner, investment management company, investment advisory company, directors and certain employees of same. The minimum investment requirement in a QIAIF is €100,000.

This is a popular fund type for certain alternative strategies. There are very few investment or borrowing limits that apply although there are some rules for certain fund types, such as property funds. Physical short selling and re-hypothecation of assets is permissible. There are no limits on leverage. There are no asset class restrictions and less liquid asset classes can be accommodated (e.g. private equity). Feeder funds and master / feeder structures are permissible. Closed ended funds and limited liquidity funds are also possible.

As the QIAIF is not suitable for retail investors, it can only be marketed on a private placement basis. Although not suitable for retail investors, the QIAIF has the advantage of being considered a regulated product in Ireland. The directors and service providers (including the investment manager) must be approved by the regulator. Periodic information must be sent to the regulator and the fund is subject to various regulations such as rules on the valuation of securities.

Under the AIFMD, a QIAIF shall only accept subscriptions from an investor who:

(a) is a professional client within the meaning of Annex II of MiFID; or
(b) receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the Qualifying Investor AIF; or
(c) certifies that they are an informed investor by providing the following:
   • Confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or
   • Confirmation (in writing) that the investor’s business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the Qualifying Investor AIF.

QIAIFs have additional requirements compared to QIFs in particular on risk management and governance.

3. Professional Investor Fund (“PIF”) (this fund type is not available under the AIFMD where there is a choice between the RIAIF and QIAIF)

The PIF is a kind of “half way house” between a retail non-UCITS fund and a QIAIF. It does not have the same blanket exemptions from investment and borrowing rules that a QIAIF would have. There are a number of investment limits, borrowing and counterparty limits that apply and as such the PIF is a less flexible product than a QIAIF. The advantage of the PIF over the QIAIF is that there is no investor test while the minimum investment requirement is the same as the QIAIF’s at €100,000 subject to similar exemptions to those noted above for QIAIF investors.

Like the QIAIF, a PIF is not suitable for retail investors and it can generally only be marketed on a private placement basis.
Luxembourg

Similar to the Irish funds mentioned above, these funds now fall under the AIFM regime and therefore must appoint an Alternative Investment Fund Manager (“AIFM”) by at latest 22 July 2014 (unless they qualify for one of the exemptions or fall below one of the assets under management thresholds). All of the provisions of the AIFM directive will apply including the requirement to have a Risk Management Process. The application of the AIFM directive will affect the roles and responsibilities of the various delegates to the fund (AIF), in particular the AIFM and the depositary.

1. Part II Funds

These are similar to the Irish retail non-UCITS fund (see above). They are also regulated products with various investment limits applying. Although they can be passported into certain countries, they do not benefit from an automatic ability to passport within the EU. The range of eligible assets is also broader than UCITS.

2. Specialised Investment Fund (“SIF”)

The Luxembourg SIF is a similar product to the Irish QIAIF. The SIF law was updated in March 2012. The Law of 13 February 2007 was amended (the “Amendments”) by a law adopted by the Luxembourg Parliament on 6 March 2012.

Only “well informed investors” may invest in a SIF. A well informed investor meets the following criteria:

- he / she has confirmed in writing that he / she adheres to the status of a well-informed investor and
- (i) he / she invests a minimum of €125,000 in the specialised investment fund, or (ii) he / she has been the subject of an assessment made by a credit institution within the meaning of Directive 2006/48/EC, or by an investment firm within the meaning of Directive 2004/39/EC or by a management company within the meaning of Directive 2001/107/EC, certifying his / her expertise, his / her experience and his / her knowledge in adequately apprising an investment in the specialised investment fund.

3. Risk Capital Investment Company (“SICAR”)

The SICAR is a fund that is restricted to investment in securities that represent risk capital. This is generally for investment either directly or indirectly in unlisted companies that have an intention to list an IPO. There are no diversification requirements. Investment can be in the form of shares, bonds, warrants and other security types.
The SICAR is a fund that is restricted to investment in securities that represent risk capital.

Risk Capital Investment Company.
The investor criteria and minimum investment limit are similar to the requirements of the SIF (see above).

4. **Securitisation Vehicle**

This vehicle is used for securitisation type investments. There are no diversification requirements and all investors (including retail investors) can invest in such a fund.

15 **Future Developments in UCITS**

**UCITS V**

On 25 February 2014, the European Parliament and Council reached an agreement on some outstanding issues in relation to the draft UCITS V directive, the next update of the UCITS framework. This reflects a final position on some specific UCITS regime enhancements that have been the subject of legislative debate since the first draft UCITS V proposals were released on 3 July 2012.

UCITS V has the following key elements.

**Remuneration**

Remuneration rules will be introduced to deter excessive risk taking by managers of UCITS and increase transparency. The rules will be broadly consistent with those contained in the AIFMD. The European Securities and Markets Authority (“ESMA”) will draft guidelines on the scope of staff to be covered by the remuneration rules.

**Depositaries**

The agreement reached requires each UCITS to appoint a single depositary and clarifies the categories of entity that shall be eligible to act as a depositary. The depositary’s liability has also been adjusted, consistent with the standard of liability of a depositary under AIFMD albeit that the contractual discharge of liability possible under AIFMD will not be possible under UCITS. This represents a higher standard than currently applied for UCITS.

**Sanctions**

The agreement reached has also harmonised the administrative sanctions with maximum penalties of €5 million (or 10% of annual turnover) for a company or €5 million for individuals. The use of criminal sanctions is also captured so as to ensure a harmonised approach across EU member states.

**Next Steps**

The UCITS V directive can be expected to be implemented into national law across EU member states by mid-2016 (subject to change).
UCITS VI

UCITS VI is already being considered with the following key aspects.

- Review of eligible assets and risk management rules;
- Considerations around efficient portfolio management techniques (“EPM”), relating to securities lending and repurchase agreements;
- Proposal that the exposure of a UCITS to a single counterparty and issuer concentration should be calculated on at least a daily basis to correspond to the existing requirement with respect to the calculation of UCITS global exposure;
- Proposal for developing a common framework for dealing with liquidity bottlenecks, including guidance on the “exceptional cases” where redemptions may be suspended and the imposition of time limits on the suspension of redemptions and deferred redemptions;
- Proposal of the introduction of a depositary passport, which would remove the requirement that the depositary of a UCITS must have its registered office in or be established in the UCITS’ home member state;
- Proposal for a common framework dedicated to long-term investments for retail investors to promote investment in long-term assets and companies including infrastructure, transport and sustainable energy projects. As well as complying with the LTIF regulation, it is proposed that any LTIF manager would also have to be authorised under the AIFMD and comply in full with the AIFMD requirements to provide adequate protection for its investors;
- Considerations for a number of improvements to UCITS IV rules, including regulator-to-regulator notification for changes (post initial notification), clarification of timelines in the process for mergers and possible further alignment with the AIFMD.

Money Market Funds (“MMFs”):

Suggested reforms for MMFs include additional requirements for constant NAV MMFs (or prohibiting constant NAV MMFs entirely), capital buffers for MMFs, liquidity fees for investors who redeem first, redemption restrictions and liquidity restraints. New money market rules are being considered currently by the European Commission and could come into effect independently of UCITS V or UCITS VI.
16  How Can Carne Help?

Carne is a leading provider of governance and oversight support for the global asset management industry. We are experts in UCITS funds, but we also cover non-UCITS, AIFMD-compliant and unregulated funds in various jurisdictions both within and outside of the EU. We offer AIFMD and UCITS-compliant management company services in both Luxembourg and Ireland. In addition, Carne has offices in, London, Cayman Islands, Channel Islands, Chicago, New York and Switzerland.

Our services include:
1. Directorships
2. Management Company Services
3. UCITS Fund Support
4. Foreign Funds Registration
5. Fund Structuring

Directorships
Carne is an established provider of independent fund board directors and other governance-related services. We have offices and resident fund directors in all of the leading domiciles for offshore and cross-border investment vehicles. Our expertise in governance makes us the preferred service provider for independent directors and a thought leader in the field of fund oversight.

Carne directors already sit on the boards of some of the leading alternative and traditional funds globally. We are regularly consulted by industry trade bodies and regulators for our views on the development of good governance and oversight within the fund management industry. Over the years the Carne brand has become synonymous with a professional and seasoned approach to fund oversight.

Management Company Services
Carne can help to establish and support management companies in both of the leading cross-border fund domiciles in Europe. We offer clients the option of launching funds under our own management companies (we have UCITS and AIFM authorisation), setting up their own dedicated management company or the establishment of a hosted solution. This will help to meet the substance requirements as laid down by the UCITS Directive. Carne also supports self–managed funds / SIAGs through the provision of designated persons / conducting officers.

UCITS Fund Support
With offices in both of the leading domiciles for UCITS funds (Ireland and Luxembourg), Carne is well-placed to support the launch and ongoing operations of a wide range of UCITS-compliant investment vehicles. We work with law firms and other service providers to deliver a smooth and error free product launch. Carne can advise on investment strategy and compatibility with UCITS regulations, provide training on UCITS, guidance on appropriate domicile, choice of service providers and warn against potential legal pitfalls. Our seasoned team regularly project manages the fund authorisation process, including the writing of business plans, risk management processes and substance applications and our experts act as compliance officers, risk officers and money laundering reporting officers on funds and management companies.
Foreign Funds Registration
Carne has earned industry-wide recognition for our country registrations service, acting as a single point of contact between investment managers and service providers in different fund jurisdictions. Thanks to our independence from other third party service providers, we can also offer clients a choice of third parties to be appointed to any project, and can often achieve competitive pricing. Carne’s multi-lingual, multi-skilled passporting team can provide tailored services to meet your needs. Carne delivers regular reports to fund boards and frequent registration updates. We can also advise on regulatory developments.

Fund Structuring
Carne’s services have been designed to help our clients cope with some of the intensive short-term challenges that can sometimes confront them. Carne’s resources, including our experienced staff and extensive knowledge base, can be drawn upon when needed. We are often called in by clients to help them meet short term operational challenges, particularly those that arise with new fund launches or changes to an existing fund range.

We can provide onsite and offsite support, including in interim management roles, and clients can be confident that they will be working alongside individuals with proven track records within the fund industry at a senior management level.

For further details on Carne’s services, please contact your local Carne office (contact details on the back page).
Appendix 1: UCITS Investment Rules

The UCITS regulations contain many investment rules. The rules flow from EU UCITS directives and have been implemented into national legislation in the various EU countries. There are also other sources of UCITS regulation such as advice issued by ESMA and each country’s regulator will occasionally issue regulation and guidance papers. Overall, the UCITS rules are the same across all EU countries and ESMA has issued further technical standards, e.g. on risk management, to assure a high degree of harmonisation across the EU. Hence, with continued updates to the UCITS regulations culminating in UCITS IV, there are fewer differences now in how certain rules are applied but some rules are interpreted slightly differently between fund jurisdictions.

The following is a summary of the main UCITS investment rules. We would be happy to provide further details on any of these rules, on request. We divide the UCITS rules into the following categories:

1. Eligible assets
2. Eligible markets
3. Liquidity rules
4. Risk spreading rules
5. Rules relating to derivatives
6. Rules relating to efficient portfolio management

i) Eligible Assets

The eligible assets categories in UCITS are as follows:

1. Transferable securities
2. Money market instruments
3. TS and MMI embedding a derivative element
4. Financial derivative instruments (“derivatives”)
5. Open-ended collective investment schemes
6. Deposits with credit institutions
7. Ancillary liquid assets
8. Financial indices

For each of the asset classes listed above (1 – 8) as eligible assets, there are definitions in the regulations setting out the criteria for each asset class.
The following asset classes are generally not permitted:

Direct and indirect (through derivatives) investment in
  • Commodities (Including precious metals or certificates representing them)
  • Property/real estate
  • Private equity
  • Hedge funds
  • Non-financial indices

But
  • UCITS may be permitted, within limits, to gain exposure to the above through financial indices.
  • Some exposure is possible up to 10% in unlisted securities.

Physical short selling is not permitted in UCITS although synthetic shorting is possible.

ii) Eligible Markets

For transferable securities and money market instruments:
  • UCITS can only invest in regulated markets (subject to 10% limit in unlisted securities and rules regarding issuers of money market instruments – see below)
  • The onus is on the UCITS to ensure that all markets into which the UCITS will invest are regulated markets (the regulator will not confirm this) i.e. that the markets are open to the public, recognised, regulated and operate regularly.

iii) Liquidity Rules

  • A UCITS fund must re-purchase or redeem its shares / units at the request of any unit holder. UCITS funds can operate via daily, weekly or bi-monthly dealing. A UCITS can impose a 10% of NAV limit on the amount of redemptions that are paid out on any one dealing day. The balance is then carried forward to the next dealing day in priority to other redemption requests.
  • A temporary suspension of redemptions is permitted in exceptional circumstances if in the interest of unit holders.
  • A liquidity risk management policy is required and needs to be documented as part of the RMP. The liquidity risk on the asset side must be monitored, as well as risks related to the liability side (e.g. only a few investors in a fund with significant shareholdings). Furthermore, stress tests / scenario analyses must be performed.
iv) Risk Spreading Rules

The risk spreading rules can be divided into the following categories:

- Unlisted securities
- 5/10/40 exposure rules
- Control rules
- Borrowing rules
- Other limits

Unlisted securities:

- Max 10% of NAV in unlisted / unregulated securities
- Additional 10% permitted in recently issued transferable securities with an intention to list within one year
- Limit does not apply to certain 144A securities provided they register with SEC within one year and are not illiquid (the Central Bank of Ireland has provided specific guidance on regulated markets, etc.)

5/10/40 rules:

- Maximum 10% of NAV in transferable securities and money market instruments issued by same body
- Where investment in transferable securities and money market instruments in same body exceeds 5% of NAV, maximum allowed of these investments in total is 40% of NAV
- 10% limit may be raised to 25% NAV for bonds issued by EU credit institutions subject by law to special public supervision designed to protect bond holders.
- For these bonds, holdings in excess of 5% NAV cannot in aggregate exceed 80% of NAV.

Control rules:

- Max 10% of non-voting shares of any issuing body
- Max 10% of debt securities of any issuing body
- Max 10% of money market instruments of any issuing body
- Cannot acquire shares with voting rights enabling significant influence over an issuing body (rule of thumb is 20%)

Index tracking funds:

- Where the investment policy of a fund is to replicate an index, the 10% of NAV limit in any one issuing body may be raised to 20% of NAV.
- This 20% limit may be raised to 35% of NAV for a single issuer in exceptional circumstances.
- The index must satisfy certain criteria such as:
- Acting as an adequate benchmark for the market
- Published in an appropriate manner
- Independently managed from the management of the UCITS

Government Securities:

- Max 10% of NAV limit in any one issuing body is increased to 35% of NAV for transferable securities / money market instruments issued by:
  - EU member state or its local authorities
  - Non-member state
  - Public international body of which at least one member state is a member
- 5/40% of NAV rule does not apply to these securities
- Up to 100% of NAV may be invested in transferable securities and money market instruments issued by a member state (or local authority), non-member state or public international body:
  - If investing more than 30% in one government issuer, the UCITS must hold at least six different issues from that issuer
  - max 30% of NAV in any one issue
  - UCITS must specify in constitutional documentation the names of government bodies in which it intends to invest more than 35%
- Such government bodies are limited to certain countries – e.g. OECD / investment grade

Cash and Deposits:

- Max 10% of NAV can be held in cash / deposits with the same credit institution
- 10% limit increased to 20% for:
  - Credit institutions authorised in EEA (EU plus Norway, Iceland and Liechtenstein)
  - Signatory state to Basel (Switzerland, Canada, Japan, US)
  - Jersey, Guernsey, Isle of Man, Australia, New Zealand
- Max 20% with Custodian / Depositary

Investment in other open-ended collective investment schemes ("CIS"):

- Max 20% of NAV in any one CIS*
- Max 30% of NAV in aggregate in non-UCITS CIS**
- Investee CIS must limit their own investment in other CIS to 10% of their NAV
- UCITS may not hold more than 25% of the units in issue of a single CIS (control limit)
* For umbrella funds, in Ireland this limit is applied at the sub – fund level i.e. you can invest up to 20% in each sub – fund while in Luxembourg it is applied at umbrella level
** Non-UCITS funds must have investor protection measures and regulation equivalent to UCITS
Other / general rules:

- Max 20% of NAV in respect of investment in the same issuing body taking into account:
  - Investment in transferable securities and money market instruments
  - Deposits / cash
  - Counterparty exposures through OTC derivatives
  - Position exposure of assets underlying derivatives
- Max 20% of NAV in respect of all exposures to issuing bodies within the same corporate group
- Max 5% of NAV in warrants
- Cannot carry out uncovered sales of transferable securities, money market instruments, collective investment schemes or derivatives
- Limits do not apply when exercising subscription rights (although this may result in an inadvertent breach)

Borrowing rules:

- A fund may borrow up to 10% of NAV for temporary purposes only
- Credit balances may not be offset against borrowings in other currencies / accounts in calculating % borrowed

v) Rules relating to derivatives:

General criteria: To invest in a derivative one needs to assure that the underlying is an eligible asset according to the UCITS (look through principle)

- Underlyings consist of one or more of
  - Transferable securities, money market instruments, collective investment schemes, derivatives or deposits;
  - Financial indices
  - Interest rates
  - FX rates / currencies

OTC Derivatives:

- General criteria for derivatives plus:
- Deal with counterparties fulfilling certain requirements
- Counterparty will provide reliable valuations
- Counterparty will close out transaction at fair value at the request of the UCITS

Credit Derivatives:

- General criteria for derivatives plus:
- Criteria for OTC derivatives plus:
- Transfer of credit risk of accepted underlyings only
- They will not result in the delivery or transfer of assets other than eligible assets
Global Exposure - Commitment approach:

• Looks to the positive market exposure of the asset(s) underlying the derivatives* (i.e. the notional value)
• Global exposure is NIL for derivatives used for hedging purposes (risk reducing) if certain criteria are met
• Options can use delta adjusted exposure
• Must have sufficient “cover” in place for derivatives
• Purchased and sold derivatives can be netted if certain criteria are met
* So absolute values of long and short positions underlying the derivatives must be aggregated

Global Exposure - Value at Risk (VaR):

• Fund employing VaR as risk measure for global exposure can choose between:
  - Relative VaR: This is the VaR of the fund divided by the VaR of a derivatives-free benchmark or reference portfolio. The fund’s VaR must not exceed twice the benchmark’s VaR, OR
  - Absolute VaR: This is the fund’s VaR relative to its NAV. Absolute 20-day VaR cannot exceed 20% of NAV
• VaR model must meet certain criteria and satisfy regulator:
  - 99% confidence interval (however one can adjust such parameters to e.g. 95%)
  - historical observation period minimum of one year
  - stress testing and back testing must be applied
  - adequate internal controls, staffing and experience in risk area
  - description of VaR model including any third party verification
  - overview of software and work done to ensure accuracy of results
• In addition, all funds applying a VaR need to provide additional disclosure on the expected leverage (gross exposure) of the fund:
  - Disclose a leverage range in the prospectus
  - Disclose the leverage of the period
• As a calculation method regulators require UCITS to use the sum of notionals. UCITS may additionally disclose leverage levels in accordance with the commitment approach

Position exposure / concentration risk:

• “Position exposure” to underlying investments combined with exposure from direct investments not to exceed standard risk spreading limits in UCITS regulations.
• For example, 10% in single issuer limit and 5/40% limits must also combine with exposures to assets underlying derivatives in the fund.
• Position exposure can be ignored for index based derivatives meeting certain criteria.
Counterparty exposure:

- “Risk exposure” to an OTC counterparty – which is the unrealised profit - may not exceed 5% NAV or 10% (in case of EU or equivalent credit institutions).
- Counterparty risk may be reduced by fund receiving collateral from CP that meets certain conditions.
- Positive and negative positions with the same CP may be netted if a contractual netting agreement is in place which creates a single legal obligation.
- When assessing counterparty exposure, UCITS have to take into account margin paid to the OTC counterparty or margin due from the counterparty where the margin is not subject to client money rules.

vi) Rules relating to efficient portfolio management:

A UCITS can enter into repo agreements, reverse repos and stock lending arrangements subject to certain conditions:

- Transactions must be entered into in accordance with market practice.
- Collateral must be posted.
- ESMA has published rules on collateral including rules on credit quality, diversification, liquidity, valuation, reinvestment of collateral.
Notes:
A UCITS has certain tax advantages for individual investors versus an unregulated product.
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