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A View from BNY Mellon

The Alternative UCITS industry continues to attract healthy inflows of capital and seems set to expand its share of the total UCITS market in the future. Accordingly, it is worth examining the growth factors behind this trend, as well as looking at the key features which new entrants need to be aware of and considering some enhanced operating features which custodians may offer. A brief review of some of the pending regulatory changes which will impact this industry is also pertinent.

Certain key drivers have contributed to the impressive growth of the Alternative UCITS industry. Uncertainty regarding the provisions of AIFMD remains an important factor in relation to the ability to access EU markets post the implementation of the Directive for non-UCITS funds and the potential cost impact of the introduction of strict liability on Custodian fees. UCITS are not in scope for the Directive and therefore the strict liability issue is avoided for now.

Institutional investors are now the largest constituency in the hedge fund investor category overtaking high net worth and private investment. These institutional investors, which include pension funds, insurance companies and fund of funds, are attracted to UCITS due to certain structural features of this product.

Finally, alternative UCITS platforms have extended the appeal of UCITS further by offering hedge fund managers the ability to diversify their investor base without incurring the cost of setting up their own legal structures in Europe or by offering distribution services linked to the platform which provides the opportunity for the hedge fund manager to access new distribution channels.

The key features of the UCITS structure can be summarised as follows:

- **Liquidity:** UCITS funds must offer liquidity at a minimum of twice a month, which means that investors can redeem at this frequency. This remains one of the key determinants in whether a hedge fund strategy can operate within the confines of a UCITS as strategies which employ a high proportion of illiquid investments may not find this requirement workable.
- **Transparency:** UCITS regulations require the publication of annual and semi-annual reports, which will include details of the investment portfolio. In addition the Prospectus, Simplified Prospectus and Key Investor Information Document contain significant levels of disclosures.
- **Investment restrictions:** the regulations contain clear guidelines on what constitutes eligible assets for investments and has minimum levels of diversification for these asset classes.
- **Risk measurement:** the UCITS regulations impose a detailed risk management framework that aims to ensure a minimum level of investor protection.

All UCITS funds must appoint a custodian or depositary to safekeep the assets of a fund. The assets are held in

segregated custody accounts – it is important to note that the assets are legally segregated from the balance sheet of the custodian. The UCITS regulations contain various investment restrictions, which must be adhered to by the fund, and the custodian must monitor these and report on any breaches. In the case of an alternative UCITS, emphasis needs to be placed on monitoring counterparty exposures because of strict limits in place in relation to these exposure levels and to other areas such as leverage.

There are certain investment restrictions pertaining to a UCITS that alternative managers need to take into account. Short selling is not permitted, which means that the traditional hedge fund model – employing a prime broker to lend securities to sell – is not available to them. Therefore, in order to replicate short selling, a derivatives contract will be entered into with an investment banking counterparty. The short selling of equities is often replaced by contracts for differences or equity swaps. The manager can also replicate the short selling strategy synthetically by investing in a total return swap.

Synthetic replication of a hedge fund strategy is quite common, and allows investors access to asset classes which would not be permitted as direct eligible investments under UCITS regulations. For example, while UCITS funds cannot invest in commodities directly, they can offer the same economic exposure to investors by holding a derivative such as a total return swap based on a hedge fund or basket of securities which does trade in commodities.

Given the importance of derivatives to most alternative UCITS, custodians are looking to support these structures by offering customised collateral management services and legal structures designed to minimise counterparty exposure.

A comprehensive collateral management service will support derivative processing through the full lifecycle of the OTC trade. Due to the restrictive rules in relation to counterparty exposure, it is standard for UCITS margin calls to take place on a daily basis. As a custodian, we reconcile open OTC positions with counterparties and then perform an independent valuation in order to verify the margin requirements. This needs to be performed within a short timeframe so that the deadline for margin payments may be met.

UCITS OTC counterparty limits need to be adhered to and funds cannot have exposure to OTC counterparties in excess of 5% (increased to 10% for certain financial institutions). BNY Mellon offers a pledge account structure, whereby the collateral is held with the custodian rather than the counterparty, and therefore can be excluded when calculating the UCITS exposure to the OTC counterparty. In the event of default, the OTC counterparty can only realise the pledge over the initial margin account in the event of default by the fund.

There currently is a considerable body of draft regulation in the pipeline relating to UCITS, which will

have a significant impact on the industry. Firstly, UCITS V will bring quite significant changes for this industry as it seeks to enhance investor protection. The measures being introduced largely mirror those almost finalised within AIFMD and directed towards the hedge fund industry. In effect, it introduces a liability regime for custodians, which exceeds that already in existence. While it is difficult to make predictions it seems likely that custodians' fees may inevitably rise as a result of this increased liability.

In addition, ESMA has issued guidelines for UCITS ETFs and on other UCITS related issues, which will impact UCITS whose performance is linked to alternative strategies such as commodities. For index tracking funds ESMA proposes that further information should be made available in the prospectus and the financial statements of such funds regarding tracking errors and how a fund is designed to track the index. The ESMA guidelines should result in investors having detailed information in relation to calculation methodologies and index composition.

Finally, the European Commission has issued a consultation paper on UCITS VI, which will look at whether the scope of assets and exposure that are deemed eligible for a UCITS fund should be reviewed. This will open the debate on whether asset classes such as property, commodities and hedge funds should be eligible.

UCITS funds have proven to be increasingly attractive to investors due to their transparency, liquidity and regulatory oversight. The full impact of changing regulation on the industry remains to be seen but there is no doubt that the alternative UCITS industry will continue to grow providing opportunities for both asset managers and custodians.



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