

Sophisticated UCITS funds

A regulated alternative

As hedge fund managers increasingly look for more regulated products, the use of sophisticated UCITS funds are being seen as an alternative option. At the same time we are witnessing a convergence with traditional managers who are looking to expand their range into more flexible products. The result is an increase in the popularity of the sophisticated UCITS product. Ireland has a heritage of servicing both hedge funds and traditional UCITS and is ideally placed to meet the demands of sophisticated UCITS funds.

What are they?

A sophisticated UCITS is a fund that widely invests its assets in Financial Derivative Instruments (FDIs) or uses complex strategies and instruments. A UCITS fund may be considered to be 'sophisticated' where the use of FDIs forms a fundamental part of the UCITS fund's investment objective and they would be expected to be used in all market conditions.

Why choose a sophisticated UCITS fund?

There are a number of advantages of a sophisticated UCITS fund which include:

- Access to the benefits of sophisticated hedge funds, but with lower minimum investment amounts.
- Greater level of regulation compared to offshore funds.
- Funds can be tailored to the client's risk profile.
- Wider distribution than non-UCITS funds

Sophisticated UCITS funds can invest in a variety of FDIs. A sophisticated UCITS fund can hold no physical stocks and instead consists entirely of FDIs and cash or cash equivalents. Further to investing in FDIs, a sophisticated UCITS fund can also invest in a range of other collective investments, including index funds and exchange traded funds.

Investment restrictions

Sophisticated UCITS funds are subject to the investment restrictions as laid out in UCITS Notice 9 "Eligible Assets and Investment Restrictions" and also UCITS Notice 10 "Financial Derivative Instruments". UCITS Notice 9 prescribes that investments of a UCITS fund are confined to transferable securities, recently issued transferable securities, money market instruments, units of UCITS and certain Non-UCITS funds, deposits and FDIs. UCITS Notice 10 prescribes the conditions surrounding investing in FDIs. It prescribes that a UCITS may invest in FDIs provided that:

- (i) The relevant reference items or indices consist of the instruments to which UCITS are confined to under UCITS Notice 9 and/or financial indices, interest rates, foreign exchange rates and currencies
- (ii) The FDIs do not expose the UCITS to risks which it could not otherwise assume
- (iii) The FDIs do not cause the UCITS to diverge from its investment objectives

Risk management

A sophisticated UCITS fund is required to calculate risk measures daily using the Value at Risk ("VaR") model to quantify maximum loss in normal market conditions. Absolute VaR or Relative VaR may be applied and the fund must use stress testing in order to help manage risks related to possible abnormal market movements. A UCITS fund must submit a report on its FDI positions annually to the Financial Regulator which is included within the annual report of the UCITS. A UCITS must, at the request of the Financial Regulator, provide this report to the FR at any time.

Operational challenges

With the increase in complexity of the instruments within sophisticated UCITS funds there are operational challenges for those who are more used to dealing with traditional UCITS funds. As sophisticated UCITS funds require daily Net Asset Value calculation, the increase in the use of non-listed investments means that pricing policies have to be thorough and robustly implemented. As sophisticated UCITS are often competing with alternative funds this often means replicating the fee structures of these funds, particularly performance fees. Considering the possibility of daily capital movements to ensure equality for investors, a performance fee calculation system needs to be implemented.

Sophisticated UCITS: the possibilities

Sophisticated UCITS offer a greater choice to both investors and investment managers. For investors sophisticated UCITS allow them to match their risk/reward profile more closely in a more regulated market with daily liquidity. For the investment manager sophisticated UCITS allow them to use a variety of FDIs to gain further exposure and the possibility of enhanced returns for their investors.

Set-up requirements

In order to initiate the set-up of a Sophisticated UCITS fund, a number of key documents are required to be submitted to the Financial Regulator including application form, business plan, prospectus, applicable agreements such as administration/advisory/custody/distribution/placing, and for sophisticated UCITS, also the FDI Report as described in the risk management section.

Why Ireland?

Compelling reasons to domicile sophisticated UCITS funds in Ireland including:

- The expertise that comes with being the largest administration centre in the world for hedge funds and alternative investment products
- Wide-ranging expertise in servicing complex financial instruments
- One of the fastest growing UCITS/ European fund administration centres
- 50% of overall assets under administration in

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- Ireland are alternative investment funds
- Pro-active regulatory regime
- An experienced legal, tax and audit industry that supports the fund industry

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