

# Overview of UCITS

## Long-Short Equity Funds

The introduction of UCITS III paved the way for UCITS to pursue alternative investment strategies such as long/short, market neutral, CTA and managed futures funds and relative value strategies to name but a few. Following the implementation of UCITS III in 2002, the Committee of European Securities Regulators (CESR) (now the European Securities and Markets Authority (ESMA)) clarified the range of eligible assets for UCITS and domestic regulators, including the Central Bank of Ireland, have recognised the increased investment scope of UCITS.

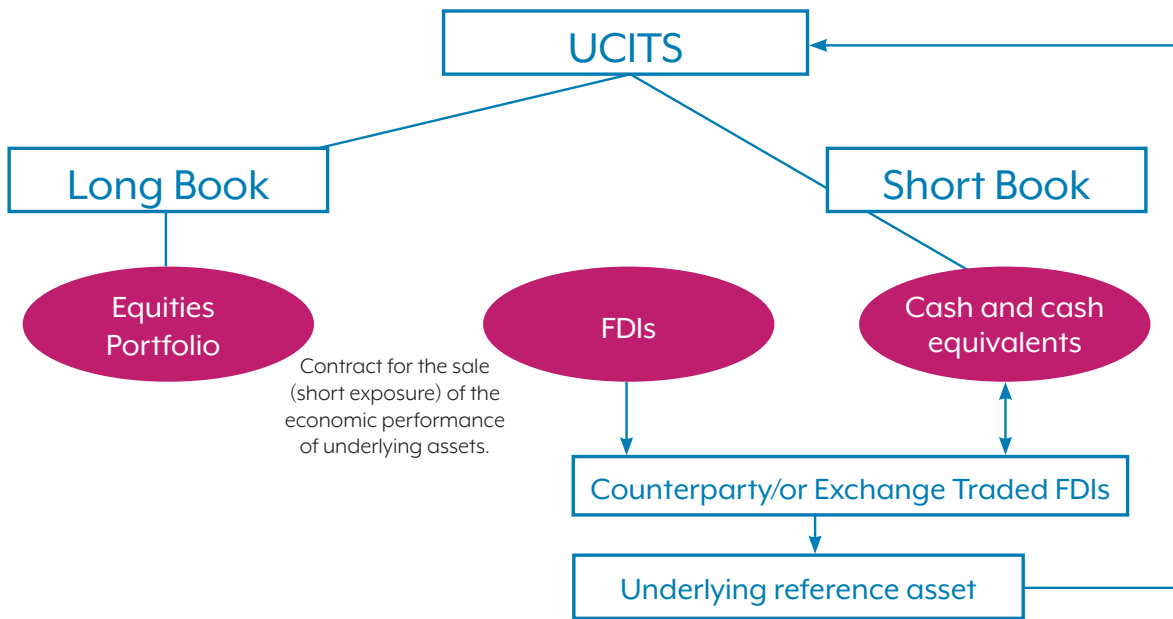
These developments, in combination with the adoption of UCITS IV in 2009, have provided for the introduction of a range of complex alternative type strategies by UCITS in recent years and in particular the use of long-short equity strategies.

Although not permitted to take uncovered short positions, a UCITS can pursue a long/short investment strategy and achieve short exposure synthetically through the use of financial derivative instruments (FDIs). Global exposure (understood as leverage)

and counterparty exposure restrictions apply to synthetic short positions, as discussed further below.

The example below illustrates a UCITS long/short equities fund. In the diagram, the UCITS manages both long book and short book. The long book is comprised of equities or equity related securities that are used to generate investment returns for the long assets held by the UCITS. The short book is comprised of a combination of cash/liquid instruments and FDIs which take short economic exposure to underlying reference assets such as a financial index, basket of securities or individual stocks. The cash/liquid portfolio is used as cover or collateral for the UCITS derivative positions, as required by UCITS IV risk management purposes. The FDIs themselves provide the desired exposure to returns linked to the performance of underlying reference assets and typically use forwards/futures, swaps, options, and contracts for difference (CFDs) for this purpose.





### Use of Prime Brokerage

Global prime brokers are providing solutions for UCITS that utilise long-short investment strategies by means of “synthetic prime brokerage” products. Although UCITS are not permitted to take direct uncovered short positions or to borrow stocks for the purposes of short selling (or, for that matter, to appoint a “prime broker” to facilitate financing for investment purposes), synthetic prime brokerage is an alternative solution that enables UCITS to take positions in equity and fixed income derivatives that provide exposure (either long or short economic exposure) to underlying securities.

In the synthetic prime brokerage model, FDIs are deployed as a substitute for borrowing equities to achieve a short position, or as a substitute for financing that is used to achieve leverage on the long portfolio. By entering into a FDI, such as forwards, futures, CFDs or swaps, the UCITS (or its “prime broker”) will economically buy or sell the performance of an underlying reference asset and profit if the reference asset increases or decreases in value as the case may be. The FDIs may provide the economic position of being long or short securities, however, because the UCITS does not hold the underlying securities, there is no custody, clearing or settlement attached to the trade. However, counterparty exposure limits and position cover requirements as well as limits on global exposure continue to apply to such synthetic short positions, as discussed above.

### Overview of Use of Financial Derivative Instruments for Performance Purposes

The Central Bank’s UCITS Notice 10 sets out the rules on the use of FDIs by UCITS, including a summary of permitted FDI, cover requirements and risk management requirements. This is complemented by the Central Bank’s Guidance Note on FDIs which contains detailed provisions for the use of FDIs by UCITS. The following is a brief summary of the Central Bank’s conditions for the use of FDIs for performance purposes (and not just for efficient portfolio management) by UCITS.

#### Conditions for the Use of FDIs

UCITS may invest in any type of exchange traded or OTC FDIs for investment purposes subject to the following conditions:

1. The FDIs only give the UCITS exposure to assets that the UCITS is permitted to directly invest in. Accordingly, the underlying assets must be comprised of the following:
  - A UCITS eligible asset (i.e. transferable securities, money market instruments, units in collective investment schemes, deposits with credit institutions, FDI (that meet the requirements of UCITS Notice 21 and the Central Bank’s Guidance Note 2/07)) including financial instruments having one or several characteristics of those assets:

- Financial indices
  - Interest rates
  - Foreign exchange rates
  - Currencies
2. The FDIs do not expose the UCITS to risks which it could not otherwise assume (e.g. gain exposure to an instrument or issuer which the UCITS cannot have a direct exposure)
  3. The FDIs do not cause the UCITS to diverge from its investment objectives
  4. Where a UCITS enters into a total return swap or invests in other FDIs with similar characteristics, the assets held by the UCITS must comply with the UCIT Regulations (the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011).

Positions may create long or short exposure to the underlying asset and may result in leverage to the portfolio.

### Counterparty Exposure Limits

UCITS are required to limit their exposure to any single counterparty to 5% of net asset value. This can be extended to 10% where the counterparty falls within the category of certain credit institutions. Counterparty exposure must include all exposures to the counterparty (i.e. exposures related to OTC FDI and any other exposure to the counterparty). The counterparty exposure can be controlled through enforceable netting arrangements or the receipt by the UCITS of acceptable collateral.

### Position Cover Requirements

Where a UCITS has an obligation/commitment under a derivative contract including synthetic short positions, the UCITS is required to have either cash or securities to settle its obligation under the instrument. Where the FDI is cash settled, the UCITS must hold liquid assets (i.e. cash or money market instruments) as cover. Where physical delivery of the underlying asset is required for settlement, the UCITS must hold the underlying asset at all times or sufficiently liquid assets where the underlying asset consists of highly liquid fixed income securities and/or the UCITS considers that the exposure can be adequately covered without holding the underlying asset and details are provided in the UCITS' prospectus.

### Risk Management Process

In accordance with the requirements of the Central Bank, UCITS are required to implement a detailed risk management process ("RMP") that sets out how the UCITS will monitor and manage risk relating to the use of FDIs. UCITS may apply either the "Commitment Approach" or alternatively use an advanced risk measurement methodology such as the Value-at-Risk model ("VaR"), as further described below.

Previously, a UCITS was required to categorise itself as being either a "sophisticated" or a "non-sophisticated" user of FDI, and this categorisation determined the appropriate risk management methodology the UCITS should adopt. Sophisticated users of FDIs would apply the VaR model, whereas non-sophisticated users of FDIs would apply the Commitment Approach. Although such categorisation is no longer required, if a UCITS uses FDI as a material part of its investment strategy or uses FDIs in a sophisticated manner, as opposed to using FDIs only for efficient portfolio management, the Central Bank will expect the UCITS to monitor and manage market risk by using the VaR model.

When using the Commitment Approach, a UCITS must ensure that its global exposure does not exceed its net asset value. Therefore, under the Commitment Approach a UCITS may not be leveraged in excess of 100% of its net asset value. In other words, the gross exposure of a UCITS should not exceed 200% of the UCITS' net asset value. Given the hard limit on leverage exposure under the Commitment Approach, a UCITS implementing an investment strategy that takes on significant market exposure will need to use a different risk management methodology such as VaR.



VaR is a methodology that is used to estimate the risk or probability of loss in a portfolio. It is based on statistical analysis of simulated or historical price trends and volatilities and is designed to predict the likely scale of losses that might be expected to occur in a portfolio over a given period of time. VaR is used by UCITS that use FDIs for complex investment strategies.

The VaR model (absolute VaR) must adhere to the following parameters:

1. The confidence level should be 99%
2. A maximum holding period of one month
3. A minimum historical observation period of one year (less if justified, for example on the grounds of recent significant changes in price volatility)
4. Stress tests carried out at least quarterly (to assess the likely impact of potential movements in interest rates, currencies and credit quality)
5. Back testing of the VaR model (a formal statistical process to compare actual portfolio returns to the VaR predicted)

It is the responsibility of the UCITS to select an appropriate methodology to calculate global exposure. The selection should be based on an assessment by the UCITS of its risk profile resulting from its investment policies. A UCITS should generally use an advanced risk measurement methodology (supported by a stress testing program) such as VaR to calculate global exposure where:

1. It engages in complex investment strategies which represent a material part of the UCITS' investment policy
2. It has more than a negligible exposure to exotic FDI, or
3. The commitment approach does not adequately capture the market risk of the portfolio

Although the governing body of the UCITS is required, as part of its overall governance of the UCITS, to provide oversight of the risk management function, in practice the decision on the appropriate risk measurement methodology is for the investment manager's risk manager (in consultation with the governing body) to determine. In considering the appropriate risk measurement methodology, the risk manager should consider:

1. Which method is appropriate taking into account the investment strategy, the complexity of FDI and the proportion of the portfolio that will be comprised of derivative positions
2. The limits on leverage exposure under the Commitment Approach and whether this fits within the constraints of the investment strategy, and
3. Operational considerations such as the costs and ease of complying with the relevant risk measurement methodology

Typically, UCITS that use FDI to generate investment returns in a long-short strategy use the VaR model. The VaR model allows for a greater degree of leverage, and we have observed a number of UCITS whose gross exposure exceeds 500% of the UCITS net asset value.

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