



“Public Hedge Funds” in Europe and the US

How do they compare?

BARRY Y. GREENBERG and SAMUEL T. BROOKS, INVESTMENT FUNDS & PRIVATE EQUITY GROUP, AKIN GUMP STRAUSS HAUER & FELD LLP

It is now well established that alternative investment managers are able to, and are increasingly choosing to, deploy hedge fund-type products within the regulatory framework of UCITS III in Europe. In the current uncertain financial climate, such products offer investors a compromise between the higher returns of hedge funds and the perceived security of a more traditional UCITS product; and for investment managers, the appeal of using the UCITS vehicle to reach a broader base of investors is obvious.

Fewer investment managers may be aware of the possibility of launching equivalent regulated

hedge fund-type products in jurisdictions outside the European Union (EU). In the US, an investment company registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940, as amended (a Regulated Investment Company (RIC)) is a comparable vehicle to the UCITS, with a still more established pedigree.

Like the UCITS, the RIC has primarily been employed by long-only retail funds. Now, however, driven by the same pressures that gave rise to the current popularity of the UCITS hedge fund, a market for RICs offering hedge fund investment strategies is developing.

This article looks at the extent to which alternative fund managers can make use of UCITS and RICs and the consequences, in each case, of doing so: in terms of regulatory oversight, investor liquidity, fund governance and reporting obligations.

Comparable Strategies

Hedge fund strategies launched within the UCITS framework have often pursued long/short equity strategies. However, subject to certain constraints, other strategies are also, in principle, compatible: including market neutral, event driven, and global macro strategies. Many of these strategies are also, with certain modifications, compatible with

Table 1

	UCITS Funds	RICs
Regulation	Fund – national regulator of the country of the fund’s domicile. Investment Manager – national regulator of an EU member state (or equivalent regulator, such as the SEC). A regulated “promoter” is also required to stand behind the fund. Often this will be the same entity as the Investment Manager. Service providers must also be regulated.	Fund – SEC. Investment Adviser – SEC (including non-US investment advisers). Service providers are not required to be regulated (although typically will be).
Summary of Fund Investments	<ul style="list-style-type: none"> Listed and soon-to-be listed transferable securities and money market instruments. Other money market instruments where issue or issuer is regulated. Units of UCITS and units of certain non-UCITS funds. Deposits with credit institutions. Financial derivative instruments where either the underlying asset is itself eligible or is a financial index meeting certain criteria. Other transferable securities and money market instruments, subject to maximum aggregate limit of 10% of NAV. 	<p>“Diversified” and “non-diversified” RICs must invest at least 75% and 50%, respectively, of total NAV in the following:</p> <ul style="list-style-type: none"> Cash and cash items (including receivables). Government securities. Securities of other registered investment companies. Other securities that are limited in respect of any one issuer to an amount not greater in value than 5% of the RIC’s NAV and to not more than 10% of the outstanding voting securities of the issuer. <p>In addition, at the end of each quarter of the RIC’s taxable year, not more than 25% of total NAV may be invested in:</p> <ol style="list-style-type: none"> the securities of any one issuer (other than US government securities or the securities of other RICs); the securities (other than the securities of other RICs) of any two or more issuers that the RIC controls (by owning 20% or more of their voting power) and that are determined to be engaged in the same or similar trades or businesses or related trades or businesses; or the securities of one or more qualified publicly-traded partnerships. <p>Prohibitions on transactions with affiliates apply.</p>
Leverage	Generally a gross exposure limit of 200% of NAV (through derivatives). For “sophisticated” funds, leverage limit based on a fixed percentage of VAR limit or twice benchmark VAR.	<p>Open-ended RIC - significant limitations</p> <ul style="list-style-type: none"> May not issue preferred stock or debt securities. May not borrow from any entity other than a bank. Must maintain 300% asset coverage for any borrowings and investments in instruments which create leverage. <p>Closed-ended RIC - somewhat greater flexibility:</p> <ul style="list-style-type: none"> May issue three classes of securities. With respect to any preferred stock issuances, only subject to a 200% asset coverage requirement.
Marketing	Retail and institutional investors across the EU, subject to notification to regulator of country in which public marketing is to take place (soon to be simplified to require notification to fund’s home regulator only).	Retail and institutional investors across the US If performance-based compensation is charged, marketing limited to “qualified clients”.
Investor Liquidity	Redemptions at least twice per month. Limitations such as “gates” are restricted.	Redemptions daily for open-ended RICs. No required liquidity required for closed-ended RICs (although may be created, if desired).
Fund Governance	Requirements largely depend on the legal form and jurisdiction of fund. Board of directors/trustees will generally be required to meet regularly. Compliance officer or external consultant generally required. Fund must have an independent auditor.	At least 40% of directors/trustees must be independent (and typically at least 75% will be independent). Board will typically meet on a quarterly basis. Board must have an audit committee. Compliance policy and code of ethics required. Chief compliance officer required (which may be external). RIC must have independent accountants.
Reporting Obligations	Requirements depend on jurisdiction of fund. However, all funds must provide annual and semi-annual reports to investors.	Audited annual reports and unaudited semi-annual reports to investors. Various regular filings with the SEC (which are publicly available).

the RIC model. Regarding permitted investments, a RIC must, on formation, elect in its registration statement with the SEC to be classified as either “diversified” or “non-diversified”. Most RICs seeking to employ hedge fund-like alternative investment strategies elect to be classified as “non-diversified.” To qualify as a RIC for US federal income tax purposes for a taxable year, an entity must satisfy two tests relating to its assets.

First, at least 50% of its total net asset value must be invested in: cash and cash items (including receivables); US government securities; securities of other registered investment companies; and other securities that are limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the RIC and to not more than 10% of the outstanding voting securities of the issuer.

Second, at the end of each quarter of the RIC’s taxable year, not more than 25% of the value of the entity’s total assets may be invested in (a) the securities (other than US government securities or the securities of other RICs) of any one issuer, (b) the securities (other than the securities of other RICs) of any two or more issuers that the entity controls (by owning 20% or more of their voting power) and that are determined to be engaged in the same or similar trades or businesses or related trades or businesses, or (c) the securities of one or more qualified publicly-traded partnerships.

In addition to the above, affiliated persons of a RIC, and affiliated persons of such persons, are prohibited from engaging in any principal transaction, or any joint enterprise or other joint arrangement, with a RIC. This prohibition includes: selling securities or other property to, or buying securities or other property from, the RIC; borrowing money from the RIC; receiving any compensation for acting as an agent of a RIC in connection with the purchase or sale of any property for the RIC (other than usual and customary compensation for acting as a broker for the RIC); using the RIC’s brokerage commissions to obtain any benefit that is outside of the safe harbor provided in Section 28(e) of the US Securities Exchange Act of 1934; participating in or effecting any transaction in connection with any joint enterprise or joint arrangement or profit-sharing plan in which the RIC is a participant; and underwriting any securities which are being sold to the RIC, except in accordance with certain conditions.

By way of comparison, there are no particular prohibitions on UCITS transactions with affiliated persons. Permitted UCITS investments include: listed transferable securities and money market

instruments, and recently issued transferable securities that will be admitted to listing within a year; money market instruments, other than those on a regulated market, if the issue or the issuer is itself regulated for the purpose of protecting investors and savings; units of UCITS and units of certain non-UCITS funds; deposits with credit institutions; financial derivative instruments where either the underlying asset would be eligible as a direct investment or it is a financial index meeting certain criteria (and a UCITS using derivatives must implement and document an appropriate derivatives risk management process that is appropriate for the risk and complexity of the strategy being adopted); and transferable securities and money market instruments other than those referred to above, subject to a maximum aggregate limit of 10% of net asset value.

Permitted levels of leverage are similar for both UCITS and RICs. A RIC may be classified as either open-ended or closed-ended with respect to its liquidity requirements. An open-ended RIC may not issue preferred stock or debt securities of any kind, nor may it borrow from any entity other than a bank and the RIC must maintain 300% asset coverage for all borrowings and investments in instruments which create leverage.

A closed-ended RIC has somewhat greater flexibility. These RICs may issue three classes of securities and, with respect to any preferred stock issuances, are only subject to a 200% asset coverage requirement. In order for a RIC to enter into certain types of transactions where the fund may be liable for an amount greater than the investment (such as the sale of options, the purchase and sale of futures contracts, forward contracts, short sales and over-the-counter derivatives), the RIC must segregate liquid assets on its books in an amount equal in value (marked-to-market daily) to the amount of the RIC’s potential liability. Although these restrictions may prevent hedge fund managers from using certain types of strategies, it may be possible to create a similar investment exposure within the applicable constraints by using swaps and other derivative instruments that are not subject to the segregation requirement.

A UCITS established under the UCITS III regime may also leverage its portfolio, but only by the use of derivative instruments. The usual leverage limit is a gross exposure limit of 200% of the net assets of the UCITS. However, where a UCITS is classified as “sophisticated” by its regulatory authority (based on the risk-management processes it employs), then the leverage limit may instead be set in terms of VaR (Value at Risk), and, for many strategies this can be quite liberating.

Consequences of Regulation

As regulated vehicles, both UCITS funds and RICs are subject to a number of rules regarding regulatory oversight, investor liquidity, fund governance and reporting obligations (among other things).

Regulatory Oversight: Both the UCITS and RICs require each of the relevant fund and investment manager/adviser to be registered – in the case of a UCITS, with the relevant national regulator and, in the case of a RIC, with the SEC. Generally, the investment manager of a UCITS must be established with the EU. However, national regulators may apply a dispensation to this rule, and approve an investment manager that is regulated by an appropriate regulator outside the EU (which may include the SEC). Any non-US manager of a RIC must be registered with the SEC.

In exchange for this regulatory oversight, UCITS funds and RICs may be marketed to retail investors throughout the EU and the US, respectively. However, a UCITS fund offers a significant advantage over a RIC in that, in order for the manager to charge performance-based compensation to a RIC, the RIC must only be sold to “qualified clients” (generally persons with a net worth of over \$1.5 million or who have at least \$750,000 invested with the manager of the RIC). By contrast, a UCITS may, if desired, charge performance-based compensation and still be marketed to retail investors.

Investor liquidity: As described above, a RIC may elect to be classified as either open-ended or closed-ended. An open-ended RIC must offer daily investor liquidity, which will be challenging, if not impossible as a practical matter, for most hedge fund managers. A closed-ended RIC offers investment units that are not redeemable at the option of investors (but may still create investor liquidity by listing on a stock exchange or, more commonly, by providing quarterly, semi-annual or annual offers to repurchase units), and will generally be more appropriate for hedge fund strategies, which require greater control over cash outflow from the fund. By contrast, a UCITS must permit redemptions at least twice per month, and redemption limitations such as “gates” are restricted, other than in certain exceptional circumstances.

Fund Governance: UCITS fund governance requirements depend on the precise legal form and jurisdiction of the fund vehicle, but are broadly similar to those applicable to RICs. A RIC must have a board of directors (or trustees, as appropriate), at least 40% of whom must be independent – although industry best practice and conditions for

relying upon certain relevant exemptive orders result in many fund boards being comprised of at least 75% independent directors. The board will typically meet on a quarterly basis. The board must have an audit committee, which is charged with the annual approval of retention of the RIC's independent accountants. A RIC must also adopt a compliance policy and a code of ethics for the fund, and appoint a chief compliance officer (CCO). The RIC may, however, "outsource" the CCO function to an external compliance consulting firm.

Reporting Obligations: As with fund governance, the precise reporting obligations on a UCITS depend on the jurisdiction of the fund vehicle. However, all UCITS funds must, in addition to nationally-imposed reporting requirements, provide annual and semi-annual reports to investors setting out the financial position of the scheme, charges and a three year comparative history. Reporting obligations on a RIC will generally be similar. The US registered fund must send audited annual reports and unaudited semi-annual reports to investors, and must also file with the SEC: semi-annual reports showing its investment holdings; semi-annual and annual reports showing basic data regarding the RIC and its operations; and annual reports showing how the RIC's shares have been voted in proxy solicitations related to portfolio holdings. All reports filed with the SEC are publicly available.

Conclusion

The use of RICs for hedge fund-like investment strategies has thus far been relatively limited. However, for hedge fund managers willing to accept the additional regulatory burden and investment restrictions, a RIC may, like a UCITS fund, offer considerable advantages, particularly in accessing investor capital. The close similarities between the RIC structure and the UCITS structure suggest that, as with the burgeoning UCITS hedge fund sector in Europe, the recent interest in hedge fund-type RICs may presage the development of a significant new market. **THFJ**

ABOUT THE AUTHORS

Barry Y. Greenberg is a Partner based in Dallas, Texas, Samuel T. Brooks is an Associate based in London. Both are in the Investment Funds & Private Equity Group at Akin Gump Strauss Hauer & Feld LLP. Mr. Greenberg and Mr. Brooks provide advice to investment advisers, private domestic and offshore alternative investment funds and UCITS III and U.S. registered funds. They counsel clients on a wide range of issues, including entity formation, governance and regulatory compliance matters.