ABOUT CARNE

Carne is the premier global provider of Fund Management Solutions to the asset management industry. We are experts in AIFMD and UCITS funds and provide governance services for regulated and offshore funds in various jurisdictions both within and outside the EU.

Carne has offices in Ireland, Luxembourg, London, Cayman, Channel Islands, Chicago, New York, Lisbon and Switzerland.

Our Independent Fund Management Solutions Include:

- UCITS & AIFM Management Companies;
- UCITS & AIFM Fund Platforms;
- Non-EU AIFM Management Company;
- CORR Technology Solutions
- Fund Directors;
- UCITS & AIFM Risk Management Services;
- UCITS & AIFM Designated Person/Conducting Officer Services;
- Distribution Support Services;
- Distributor Due Diligence;
- Fund Foreign Registrations;
- MLRO & AMLCO Services;
- Company Secretarial Services;
- Compliance Officer Services;
- Investment Manager Due Diligence;
- KIID Services;
- Annex IV Reporting (AIFMD).
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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 continued progression of the UCITS project and the latest iteration of the directive in UCITS V, we at Carne have seen yet more interest from 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. With the uncertainty which Brexit has brought, flexible solutions which maintain access to the EU’s single market will be important to UK managers.

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.
WHAT ARE UCITS FUNDS?

A BRIEF OVERVIEW

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 Economic Area (EEA) based on its authorization in one EU member state. UCITS also enjoy a high level of recognition in many non-EEA 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 €10 trillion at the end of September 2018.

• 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.
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 (particularly regarding the use of derivatives and the ability to employ leverage). 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.)

UCITS IV which was agreed by the EU in 2009 took effect on 1 July 2011. The key changes introduced by UCITS IV included the introduction of a management company passport, enhanced governance requirements for UCITS management companies, notification procedures for cross-border marketing within the EU, UCITS master-feeder structures, a framework for fund mergers and the key investor information document (“KIID”), a 2-page “key features” type document. The UCITS IV Directive was complemented by a variety of detailed implementing measures (“Level II”) and implementation advice from committees of regulators (“Level III”), specifying further the regulatory requirements and setting technical standards for the key measures and other areas such as ETFs, index-tracking funds, index eligibility rules, risk management framework, repos/securities lending and collateral rules.

The next iteration of the UCITS Directive, Directive 2014/91/EU commonly referred to as UCITS V came into force on 18 March 2016. UCITS V comprised the following key elements:

A. REMUNERATION PROVISIONS

The UCITS V Directive, which came into force on 18th March 2016, imposed a requirement on all UCITS management companies and self-managed UCITS to establish and apply remuneration policies and practices that are consistent with, and promote, sound and effective risk management, and do not encourage risk-taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS it manages nor impair compliance with the UCITS Management company’s duty to act in the best interests of the UCITS.

While the provisions of the Directive in this regard are relatively broad and are based on the principles of the EU’s Alternative Investment Fund Managers Directive (“AIFMD”), they have been supplemented by detailed requirements set out in ESMA’s “Guidelines on Sound Remuneration Policies under the UCITS Directive” (2016/ESMA/575).

The remuneration provisions set out in the Directive and detailed in the ESMA guidelines apply in relation to the remuneration policies and practices of “Identified Staff” of the UCITS Management Company (or self-managed UCITS), which comprises members of the Board (both executive and non-executive), senior management and officers and staff whose activities may have a material impact on the risk profile of the UCITS Management Company, as well as staff whose total remuneration package brings them into the same category as senior management.
In addition to the individuals identified within the UCITS Management Company, the definition of Identified Staff also includes persons within the entities to which portfolio management and risk management for a specific UCITS fund have been delegated, whose job functions and responsibilities may have a material impact on the risk profile of that particular UCITS fund (i.e. CIOs, CEOs, CFOs, risk officers, portfolio managers, traders, etc.).

Where portfolio management or risk management activities have been delegated, the UCITS Management Company must ensure that:

a) the entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under these guidelines; or

b) appropriate contractual arrangements, to cover any payments made to the delegates’ identified staff, as compensation for the performance of portfolio or risk management activities on behalf of the UCITS, are put in place with entities to which portfolio management or risk management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules.

The ESMA guidelines provide a definition of total remuneration that covers both fixed and variable components of remuneration as well as other additional benefits (pension, company cars, etc.). In addition, the ESMA guidelines set out a number of detailed requirements including conditions for how the variable portion of remuneration should be paid, the type/nature of such compensation and its proportionality with any fixed remuneration, the appropriateness of performance assessment periods, vesting of payments, clawback/malus arrangements, restrictions around “golden parachutes” or guaranteed discretionary payments, etc.

Where appropriate to the nature, type and complexity of the UCITS funds under management, the UCITS Management Company should consider the establishment of a remuneration committee and there must be adequate disclosure in appropriate UCITS documentation (such as financial statements) regarding both qualitative and quantitative aspects of the UCITS’ remuneration arrangements.

It is important that identified staff are assessed for the materiality of their influence over the UCITS’ risk profile through an analysis of:

• whether that person's role has significant impact on the UCITS Management Company's results and/or balance sheet;

• whether that person's role has significant impact on the performance of the UCITS under management;

• the risk taking profile of particular business units.

There is a certain element of proportionality that can be applied to the implementation of the remuneration provisions of the Directive and the ESMA Guidelines. A number of EU regulatory authorities have issued consultations or guidance papers on their interpretation and implementation of certain aspects of the ESMA Guidelines, most notably the UK’s FCA.

Ultimately it is the Board of the UCITS Management Company that is responsible for ensuring that the goal of having sound and prudent remuneration policies and structures is not improperly circumvented and that remuneration procedures are aligned to the requirements of the Directive and the ESMA Guidelines.
**B. DEPOSITARIES**

**Depositary Eligibility**

UCITS V requires the appointment of a single depositary to a UCITS and specifies the categories of entity that shall be eligible to act as a depositary. The permitted categories are national central banks, credit institutions, and other legal entities authorised under the law of Member States to carry out depositary activities under the UCITS V Directive, which are subject to prudential supervision and capital adequacy requirements.

**Depositary Obligations**

Similar to AIFMD, UCITS V sets out the obligations of depositaries in detail in order to achieve a high level of harmonisation within the EU. This includes duties regarding oversight over delegates, subscriptions and redemptions, valuation of units, carrying out the UCITS' instructions, timely settlement of transactions, UCITS income distributions, cash monitoring, due diligence and the segregation of assets. UCITS V also details the particulars to be included in depositary contracts, the requirements for delegating safekeeping obligations to third parties and other requirements.

**Depositary Liability**

The depositary's liability is similar to the standard of liability of a depositary under AIFMD, albeit that the contractual discharge of liability possible under AIFMD is not possible under UCITS. The depositary will only be able to avoid liability where it can prove that the loss of assets is due to an "external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary". This represents a higher standard than currently applied under the AIFMD.

**C. SANCTIONS**

UCITS V 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.
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.

A. WHAT DO FUND PROMOTERS / MANAGERS / DISTRIBUTORS WANT?

1. 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. Some managers have made use of white label platforms to access retail opportunities not available to unregulated funds.

Once approved in the “home” Member State (i.e. the country of the fund’s domicile), registration in other EEA jurisdictions will be granted subject to a registration process in the “host” Member State. UCITS also enjoy a high level of recognition by regulators and investors alike in many non-EEA countries or regions such as Switzerland, South Africa, Asia, and South America, and the process of registration in these countries is a well-trodden path.

Another advantage, from an investor’s viewpoint, is that 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 are subject to higher risk management requirements than non-UCITS funds. This reduced onus on due diligence benefits promoters and distributors of UCITS funds.
2. Fees

Management fees would typically be in the range of 0.50% to 2.00% of net asset value (albeit fees for money market funds and ETFs would usually be lower).

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, subject to high watermark and/or hurdle rates, are acceptable.

Distributors can charge an additional ad valorem distribution fee or can, depending on the jurisdiction, 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, up-front sales charges and redemption charges);
- Different currencies;
- Currency-hedged and unhedged share classes;
- Distributing and accumulating share classes.

ESMA issued an opinion paper in January 2017 on this topic proposing a common EU framework for share classes of UCITS based on some high-level principles. In particular, ESMA is of the view that hedging arrangements at share class level (with the exception of currency risk hedging) are not compatible with the core principle of having a “Common Investment Objective” across all share classes in a UCITS.

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

3. 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) for investment purposes and also to employ leverage (using derivatives) as well as allowing short exposures through the use of derivatives. Most “alternative” strategies can be established within a UCITS framework although some will not be suitable and others will have to be toned down in order to be acceptable for retail distribution. See below in Section 5 for more details on the types of UCITS strategies that can work in UCITS.

4. 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.

5. “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.
B. WHAT DO INVESTORS WANT?

1. 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 after the dealing cut off. 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 Net Asset Value (“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 pay out 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, as defined in the fund’s documentation, to ensure the UCITS can liquidate positions in order to meet large redemption requests in an orderly fashion. UCITS are not allowed to borrow except for temporary cash flow mismatches up to a limit of 10% of Net Asset Value. This mechanism is thus designed to protect the interests of the remaining shareholders in the case of large redemptions.

Liquidity risk management is an increasing focus for regulators. In Luxembourg, the Risk Management Process (“RMP”) must contain details on liquidity risk management including stress tests. Ireland has similar requirements under CP86 (see details in Section 7 A 6. below on CP86). Additionally, Irish UCITS regulation (S.I. 420) imposes increased requirements on UCITS funds and management companies to document and assess the liquidity of instruments in the fund. UCITS funds are an attractive investment type for European insurance companies under Solvency II due to more favourable capital treatment relative to alternative funds. UCITS administrators have also developed reporting products for insurance company investors to satisfy Solvency II compliance.

2. Security of Assets

A UCITS fund must appoint an independent depositary to hold fund assets. Such assets (excluding cash, derivatives and investment funds) must be held in segregated custody accounts with the relevant depositary (i.e. the assets must be segregated from the balance sheet of the depositary). Depositaries 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. Depositaries have, in addition, certain oversight responsibilities in relation to aspects of the UCITS’ management and administration functions. UCITS V contains a number of significant enhancements to the security of assets held in custody similar to the AIFM directive. These include: (i) capital and regulatory criteria applying to depositaries, (ii) rules applying to depositary oversight (such as cash flow monitoring and oversight of manager adherence to UCITS investment limits) (iii) appointment and oversight of sub-custodians and (iv) strict liability applying to assets held in custody.

3. 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 Management Companies (and self-managed UCITS) must draft and
have approved by the home regulator an RMP which covers all UCITS under management. In Ireland, this document 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, the UCITS directives require a UCITS Management Company to consider and document the management of all relevant (material) risks to the UCITS under management, including liquidity risk and operational risks (i.e. a holistic risk management approach). Some jurisdictions (including Luxembourg) require these other risks to be included in the RMP, others allow them to be documented in other ways. In Ireland, this must be documented in a Risk Framework according to CP86 (See section 7A6 below on CP86).

For UCITS that avail of the management company passport 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, the EU created the European Securities and Markets Authority, ESMA. ESMA is continually strengthening the regulatory robustness of UCITS, which is of benefit to investors in UCITS schemes. The home Member State regulator of the UCITS fund, or of 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 State regulator including prudential capital requirements (and, where established in a third country outside the EU, that a cooperation agreement is in place between the proposed regulator of the UCITS and that of the investment manager). The regulations applying to UCITS funds also include detailed guidance on valuation rules, eligible collateral and minimum standards for counterparties.

All UCITS must have a depositary, administrator and independent auditor. The assets held on behalf of the UCITS are separated from the assets of the depositary (with the exception of cash) which means there is no counterparty risk to the 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 that are based in the domicile of the UCITS are subject to ongoing supervision by the home regulator.

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 governance, risk and control 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.
4. 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. 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:

a) 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 (subject to certain correlation criteria). Global exposure/leverage up to 100%, i.e. a total gross market exposure of 200% of NAV, is permitted under the commitment approach.

b) Value at Risk: A UCITS may alternatively choose to measure leverage based on an Advanced Risk Methodology such as 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.
5. Documentation / Transparency

UCITS funds must publish a prospectus which contains inter alia detailed risk warnings. Besides the prospectus itself, the fund must publish the so-called KIID which provides the investor on two pages with information on the essential elements of the fund and specifies 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.

6. 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). 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. 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. Some European countries have introduced tax incentives which make UCITS products more attractive relative to offshore fund products. Please also refer to other sections below on taxation (note that this UCITS guide does not purport to provide tax advice).
UCITS funds accounted for assets of **€10 trillion** at Sept 2018
The following is a non-exhaustive list of product types that can be structured within a UCITS. Many alternative strategies have been launched as UCITS. The product opportunities in the alternative UCITS space are continuing to evolve. On the other hand we note that some proposed regulations (e.g. on money market funds) 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:

a) Traditional (long only) strategies (equity/bond/money market/funds of funds);

b) Exchange-traded funds;

c) Structured products (index/structured/guaranteed funds);

d) Alternative strategies (equity/credit/macro/relative value/multi-strategy/event driven);

e) Funds of alternative UCITS funds (see below).

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 or using listed notes) which have been approved by the regulators. These techniques can be used to link a strategy which may not work directly in a UCITS but which may become possible in a UCITS via a structuring technique.

### Possible in UCITS funds

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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 and as a consequence a range of such funds has been launched.

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 across strategies. The product can be sold as “best of breed”. There are also certain tax advantages to individual investors versus an unregulated fund of funds. For example, in respect of the UK 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 of most relevance 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% of NAV;
- A UCITS cannot own in excess of 25% of the shares or units of another single fund (applied at sub-fund level).

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

** Non-UCITS funds must have investor protection measures and regulation equivalent to UCITS and must issue half-yearly and annual reports.

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.
HOW TO LAUNCH A UCITS FUND

A. 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 service providers such as administrators, depositaries, law firms, auditors, management companies 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 also have a cross border fund business. In this guide we concentrate on Ireland 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 next:

1. 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.

2. 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 Luxembourg regulator, the Commission de Surveillance du Secteur Financier (“CSSF”) in English, French or German. All business in Ireland is conducted in English.

3. Service Providers

Both Luxembourg and Ireland are very well served by administrators and depositaries. 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.

4. Taxe d’abonnement

Luxembourg has a tax on fund assets at 5 bp of 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.
5. Independent Directors / Conducting Officers / Management Company

In principle, UCITS can be established either as self-managed funds or by using a management company. Where a management company is used, the substance in the form of conducting officers / designated persons and management is established at the level of the management company whereas a self-managed fund creates substance directly by appointing directors and conducting officers / designated persons.

In practice few new self-managed funds are being launched due to the very high time commitments required of designated persons / conducting officers by the regulators. Our experience is that most directors are not willing to assume these roles. For these reasons most new UCITS are established by appointing a management company.

In Luxembourg, none of the directors needs to be Luxembourg resident although there is usually at least one Luxembourg-based director.

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 18/698 (replacing Circular 12/546) outlines the significant expectations of the CSSF in relation to governance and substance for UCITS Management Companies (and self-managed 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.). A minimum of three full-time equivalent Luxembourg resident staff are required in the UCITS management company.

The UCITS management company/fund also needs to have its own bricks and mortar office – i.e. simply a registered address is not sufficient.

In addition to 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 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. Some foreign regulators have refused the registration of self-managed Luxembourg UCITS for public distribution. 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).

As mentioned above, 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. 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.

In Ireland, the management company and fund (if in corporate form) must appoint a minimum of two Irish resident directors. In addition to the directors, management company or the self-managed fund must appoint so-called designated persons to assume day-to-day responsibility for a number of managerial functions as defined by the Central Bank of Ireland (“CBI”).
Guidance Note
The CBI entitled “Fund Management Companies – Guidance” (or “CP86”, a reference to the Central Bank’s consultation paper 86 which preceded the guidance) imposes the following additional conditions on the residency of directors and designated persons for Irish management companies (and self – managed funds):

Where a management company or fund has a PRISM impact rating of -

a) Medium Low or above, the management company shall have at least:

• 3 directors resident in the State or, at least, 2 directors resident in the State and one designated person resident in State,

• half of its directors resident in the EEA, and

• half of its managerial functions performed by at least 2 designated persons resident in the EEA, or

b) Low, the management company shall have at least:

• 2 directors resident in the State,

• half of its directors resident in the EEA, and

• half of its managerial functions performed by at least 2 designated persons resident in the EEA*.

* In the context of Brexit, the Central Bank has said that it would consider the UK to having equivalent requirements to an EEA jurisdiction for the purposes of these residency rules. CP86 became effective on 1 July 2018.

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 “comply or explain” rulebook.

In addition to the residency requirements of directors and designated persons as noted above, CP86 which was issued by the CBI in its final form in December 2016, contains guidance around the corporate governance of Irish management companies and self – managed funds including delegate oversight, organisational effectiveness (including conflicts management), directors’ time commitments, supervision of managerial functions and operational issues (including document retention policy).

Statutory Instrument 420 (“S.I. 420”) which places the UCITS regulation on a statutory footing in Ireland introduced the concept of a “Responsible Person”. The Responsible Person is the Management Company for UCITS that have appointed a Management Company and the Board of the UCITS for “Self-managed” UCITS. The Responsible Person is responsible under S.I. 420 for ensuring compliance with the UCITS regulations (except for a number of topics that are the responsibility of the Depositary). S.I. 420 together with CP86, significantly increased the level of governance and oversight required for the Management Company/UCITS. Given the level of oversight required, it may be more practical for Irish UCITS to follow the traditional Luxembourg model of appointing a local Management Company to ensure compliance with all the relevant laws and regulations applying.

Furthermore, the Central Bank of Ireland operates a fitness and probity regime which places obligations on a management company and fund 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 management.
companies or funds. This regime forms part of an Irish framework for investor protection. The CSSF has a similar approval process for the approval of directors and conducting officers (as noted in CSSF 18/698). This process includes the completion of a “Declaration of Honour”. Both regulators also look closely at the existing time commitments of directors and conducting officers/designated persons and their capacity to assume additional mandates.
B. AUTHORISATION PROCESS

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/CBI:

| **Directors** | All directors appointed to a UCITS fund or management company will need to be authorized and approved by the CSSF/CBI. 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 together with time commitments must be submitted. In Ireland, there is a detailed online questionnaire which requires disclosure of the director's time commitments which must be completed including the provision of supporting information such as CV and details of third-level education as well as professional qualifications. See Section 16 for services that Carne can provide. |
| **Investment Manager** | The CSSF/CBI will request details of the investment management company. If the investment manager is already a regulated entity in a recognised jurisdiction then approval is usually a formality. |
| **Administrator** | 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 that the administrator should be 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. |
| **Depositary** | A UCITS fund or management company must appoint a regulated depositary in the country of domicile of the UCITS. Normally the depositary will appoint a global sub-custodian who may be based in another country. The depositary has a duty of oversight over any appointed sub-custodians and various other duties of oversight (as expanded under UCITS V). See section 9 for options on using prime brokers for UCITS funds. |
| **Management Company / Conducting Officers / Designated Persons** | A UCITS must either appoint a management company or, as noted above, must appoint a minimum of two local designated persons / conducting officers (plus an “administrative centre” for a Luxembourg self–managed UCITS).

*See Section 16 for solutions that Carne can provide.*
The other parties to a UCITS fund who are appointed but are not required to be authorised by the CSSF/ CBI include:

<table>
<thead>
<tr>
<th>Product Structuring Services</th>
<th>See section 16 below for services that Carne can provide.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Advisors</td>
<td>A law firm in Luxembourg or Ireland will be appointed. The law firm will draft the prospectus and prepare/review all legal documentation for the establishment.</td>
</tr>
<tr>
<td>Auditors</td>
<td>An annual audit is required in both jurisdictions.</td>
</tr>
<tr>
<td>Distributor(s)</td>
<td>The party or parties appointed to distribute/ market the fund in different countries.</td>
</tr>
<tr>
<td>Company Secretary / Domiciliary Agent / Registered Office</td>
<td>Required for corporate structures to keep company minute book, arrange board meetings, organise general meetings etc.</td>
</tr>
<tr>
<td>Listing Agent</td>
<td>If the fund is to be listed on a Stock Exchange, it is usually necessary to appoint a local listing agent.</td>
</tr>
<tr>
<td>Foreign Registration Service - Foreign Lawyers / Tax Advisors / Paying Agents</td>
<td>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 tax requirements (to ensure that investors can avail of the most favourable tax treatment regarding their investment).</td>
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### Legal Documentation

The process of launching a UCITS fund involves drafting a number of legal and other documents some of which will be reviewed and commented upon by the CSSF/CBI:

<table>
<thead>
<tr>
<th>Prospectus</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key Investor Information Document (KIID)</td>
<td>As described above, the KIID is designed to provide investors with essential information on each UCITS (either for each share class or for a representative share class) in a prescribed format on two pages in simple language. The KIID will be replaced by a new “KID” in 2020 following the introduction of “PRIIPS” (Packaged Retail and Insurance-Based Investment Products) regulation.</td>
</tr>
<tr>
<td>Risk Management Process Statement/ Risk Management Framework</td>
<td></td>
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<td>-------------------------------------------------------------</td>
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<tr>
<td>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 (&quot;RMP&quot;) must be submitted to the CSSF/CBI although the CSSF and the CBI deal with the requirements in different ways. The CBI continues to require a standalone document called the RMP for the use of derivatives and the management of related risks. 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 CBI 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 asset cover. It also deals with aspects such as netting and use of collateral.</td>
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</tr>
<tr>
<td>Separately to the RMP which must be submitted to the CBI, and similar to the CSSF's requirements in Luxembourg, the CBI's CP86 guidance (see 7A6 above re CP86) specifies that a management company/UCITS must have an adequate &quot;risk management framework&quot; which:</td>
<td></td>
</tr>
<tr>
<td>• Identifies applicable risks</td>
<td></td>
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<tr>
<td>• Confirms the risk appetite</td>
<td></td>
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<tr>
<td>• Identifies appropriate risk mitigants</td>
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<tr>
<td>• Incorporates policies for measurement, management and monitoring of risk including risk mitigants</td>
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<tr>
<td>This is a more comprehensive risk document to the derivatives focused RMP, and should encompass all material fund risks.</td>
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</tbody>
</table>

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<tr>
<th>Business Plan/Substance Application</th>
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<tr>
<td>The “Business Plan&quot; 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, which deals with the Luxembourg &quot;substance&quot; 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.</td>
</tr>
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</table>
Policies, Procedures, Service Level Agreements ("SLAs")

Adequate documentation and procedures must be in place for the operation of the management company/fund office and to ensure that delegate arrangements are appropriately managed and supervised. Example policies would include Valuation Policies, Anti Money Laundering, Conflicts of Interest policies and Designated Person / Conduction Officer procedures. SLAs should be put in place with the main delegates to the management company/ self – managed fund.

Constitutional Documentation

Depending on the legal structure (company, SICAV, ICAV, 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 management company agreement, administration agreement, depositary agreement and investment management agreement. There may also be a distribution agreements if a distributor is appointed. Some of these agreements are reviewed by and require approval from the CSSF/CBI.

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. These documents are not reviewed by the regulator.

Application Form / Letter

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

The approval process with the regulator can take 6 - 12+ weeks from the date of the first submission to the regulator with first drafts of the prospectus and other documentation.

C. 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, depending on the country there will be costs associated with the registration process involving, for example, legal fees, tax advice and translation costs. Carne 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.
Global Brand

UCITS are widely sold outside of the EU in Switzerland, Asia, South America and South Africa
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 continue to be the preference of a large number of professional investors across EU jurisdictions and globally, including insurance companies, 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.

Setting up a fund as a UCITS can also bring benefits from the cultural 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 have withdrawn their private placement regimes) and uncertainty surrounding the rules on the distribution of unregulated funds in various jurisdictions means that any marketing of unregulated funds can incur 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 contains an EU passport for non-UCITS funds. The AIFMD does not compete directly with the UCITS brand due to the more stringent diversification rules and eligible assets criteria of UCITS. Where the AIFMD applies, an AIF manager needs to comply with similar organisational / governance requirements as a UCITS.

Finally, the UK’s decision to leave the EU (“Brexit”) means that UK based fund managers and distributors will need to assess how their funds will continue to access the European market post-Brexit. Solutions include the establishment or appointment of EU based entities who can support distribution activity.
Examples of Distribution Opportunities for UCITS not available to unregulated funds

• Retail distribution;

• Pensions, insurance and institutional 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). This is subject to a look through approach for insurance companies who under Solvency II must look through to the investments underlying the UCITS. Consequently UCITS can often demand a higher allocation from those investors;

• 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 for a UCITS fund is well trodden path;

• 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.

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, similar to how Cayman funds are currently sold. 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 AIFMD and it may be problematic to rely upon reverse solicitation as it could be difficult to prove that no marketing has taken place.

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 European Economic Area countries (EEA). The registration process under EU law involves a regulator to regulator notification which is supposed to take no more than two weeks once all of the required documentation has been provided to the host regulator. 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 tax registration and reporting may be required (for the investors to receive the most beneficial tax treatment).
The requirements for providing translations of documents have also been standardised 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-EEA countries does not benefit from the EU passport and there is therefore no automatic entitlement for a UCITS fund to register in a non-EEA country. However, many non-EEA 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. UCITS funds are sold in over 70 countries worldwide.
A. CHOICE OF SERVICE PROVIDER

Luxembourg and Ireland are both very well serviced with administrators and depositaries. Most of the large international administrators/depositaries are based in both locations as well as a number of local companies. Only the depositary 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. |
| Fees | 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. |
| Service | 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. |
### Operating Considerations

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.

The ability of service providers to offer certain middle office services and other value added services (particularly for more complex strategies or those using derivatives) such as:

- Risk reporting (including value at risk);
- Post trade compliance monitoring;
- Performance attribution;
- Collateral management;
- Trade matching;
- Cash management;
- FX services including currency hedging;
- Securities lending;
- Tax services (e.g. FATCA, Common Reporting Standards, VAT, Payroll (Irish director fees));
- PRIIPS and MiFID reporting
- Solvency II reporting

It might be beneficial for promoters operating in various EU member states to centralise certain aspects of fund servicing with one service provider, e.g. the administrator. On the other hand, some promoters prefer to use a number of service providers in order to gauge the services provided against one another.
B. DEPOSITARY/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 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 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. The choice of model will depend on what works best for the investment manager and broker.

C. PRIME BROKER APPOINTED AS OTC COUNTERPARTY

In this model the depositary holds all of the assets of the fund (excluding derivatives). The fund independently engages 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 or due to the size of the UCITS and the broader relationship that may include non-UCITS funds. 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 depositary/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.

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% of NAV (or 10% of 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.
Most alternative strategies can work within the UCITS rules.
A. IRELAND

For new UCITS funds that have appointed a UCITS Management Company, there is no requirement to submit a Business Plan to the CBI as the Management Company will have an existing Business Plan in place which has been already approved. For a UCITS which is self-managed, the business plan must be submitted and approved by the CBI. This sets out the governance regime in place for the fund. 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:

<table>
<thead>
<tr>
<th>Function</th>
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<tbody>
<tr>
<td>Fund Risk Management*</td>
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<tr>
<td>Operational Risk Management*</td>
</tr>
<tr>
<td>Investment Management*</td>
</tr>
<tr>
<td>Regulatory Compliance</td>
</tr>
<tr>
<td>Distribution</td>
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<tr>
<td>Capital and Financial Management</td>
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<tr>
<td>Organisational Effectiveness**</td>
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* Fund risk management and operational risk management cannot be undertaken by the same person who is responsible for investment management

** Organisational effectiveness is not a managerial function per se but it’s a role that must be carried out by an independent director who could be the chairman
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.

Depending on the size and complexity of funds under management, it may be possible to structure the UCITS management company/fund with the designated directors/persons acting on a part time basis. 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.

As noted above in Section 7, the CBI has issued guidance on corporate governance (“CP86”) which proposes more prescriptive rules on the oversight required by management companies/designated persons and directors. This has significantly increased the time commitment of designated persons/directors in the oversight of self-managed UCITS and may encourage fund promoters to consider the appointment of a management company. This coincides with the introduction of S.I. 420 and the concept of the “Responsible Person” who has responsibility for compliance with the majority of the provisions of the UCITS regulations. The Responsible Person is the management company where the UCITS has appointed a management company or the Board of directors for a self-managed fund. Under CP86, where a director performs a designated oversight role, the CBI requires the UCITS Management Company/fund to have a separate contract for the oversight role in addition to the Director’s engagement letter. The contract must include inter alia the amount of time the individual will devote to the designated oversight role. The board must ascertain and be satisfied that the individual has the relevant skills, experience and expertise to carry out the oversight of the particular functions that they are agreeing to oversee – for example where the individual is responsible for overseeing risk management they must have relevant experience of acting in a risk management role.

B. 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. In Luxembourg, it is difficult to obtain approval for a self-managed fund and consequently close to every fund is established using a management company.
If a UCITS fund appoints a management company in Luxembourg, then the management company must comply with the various substance requirements as set out in the CSSF’s Circular 18/698. Self-managed funds (“SIAGs”) are also possible but are much less common. The management company or the SIAG must comply with Circular 18/698, the principal requirements being:

• There must be two Luxembourg resident conducting officers/dirigeants who are responsible for all of the activities of the UCITS management company/SIAG. The activities are:

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<th>Activities</th>
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<tr>
<td>Investment Management</td>
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<td>Risk Management</td>
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<td>Administration of the UCIs</td>
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<td>Handling complaints and claims</td>
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<tr>
<td>Fight against money laundering and counter terrorist financing (AML/CTF)</td>
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<td>Valuation</td>
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<td>IT Function</td>
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<td>Accounting Function</td>
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The conducting officers will need to demonstrate that they have appropriate resources/support to carry out their functions. There must be three Luxembourg resident full-time equivalent staff in the Management Company;

• The division of these functions between the conducting persons must avoid conflicts of interest. So for example, the functions of risk taking and the control of these risks cannot be assumed by the same person. The conducting person in charge of internal audit or risk management cannot assume the role of Compliance Officer, nor the role with responsibility for AML / CTF;

• 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;

• For the directors, the number of hours per annum devoted to their professional activities cannot exceed 1920 and the number of mandates in regulated entities and operating companies cannot exceed 20;

• 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, anti-money laundering/counter terrorism financing, conflicts of interest, complaints handling, voting, business continuity planning etc.
Sections 4B and 7B above refer to the Risk Management Process ("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 a holistic approach is expected by regulators; i.e. the UCITS Management Company / fund needs to identify and 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., the Management Company / fund also needs to have an adequate liquidity risk management process in place and fully consider operational risks. As outlined in the sections mentioned above, the RMP in Ireland is focused on the use of derivatives and the related risks while the risk framework as prescribed under CP86 must encompass all fund risks. The RMP in Luxembourg covers all risks of the fund and management company.

In relation to portfolio risks there is in particular a need to be clear on 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 4B, there are limitations on the amount of global exposure or leverage in a UCITS fund measured either under the "commitment approach" or under VaR;

**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 provided the index is UCITS compliant;

**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.

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 or group (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;

• **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.
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 (See Section 7A4 above). Investments in special institutional money market cash funds, special pension funds (including pension pooling vehicles) and funds investing in other funds which are already subject to subscription tax are exempt from subscription tax. The same applies to micro finance investment vehicles and exchange traded funds.

The Common Reporting Standard (“CRS”) is a FATCA style initiative to combat tax evasion on a global basis. Effectively replacing the European Savings Directive (“EUSD”), over 100 countries are applying CRS. Investment funds report certain information in relation to non-resident investors to the local tax authorities which will then be passed on to the tax authorities of the investors’ country of residence.

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 which can allow for reduced levels of withholding taxes on dividend / coupon payments.

There are other taxes that may apply in certain markets on securities transactions such as stamp duty (UK) and capital gains tax (for 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 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. Some countries have more favourable capital gains tax regimes for investments in UCITS funds versus other offshore funds. 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 some of these countries.

Some fund structures allow for tax transparency which can be advantageous for funds targeting tax exempt investors such as pension funds and US tax exempt investors. In Ireland, the ICAV is a new corporate vehicle that has the possibility to “check the box” under US tax rules. The Luxembourg SICAV also benefits from this feature. The Irish CCF is a tax transparent contractual structure sometimes favoured by large pension fund investors. Luxembourg has a similar structure, the “FCP”. 
Luxembourg and Ireland are the main domiciles for UCITS distributed cross-border.
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 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.

Under Irish law, there are only six countries (Bermuda, BVI, Cayman Islands, Guernsey, Jersey and Isle of Man) where a corporate vehicle can be re-registered as an Irish company whilst preserving its legal identity. Luxembourg is less prescriptive on this.

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

a) **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.
b) 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;
- Investments 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.

c) 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;
- The practicalities of novating trading arrangements (e.g. ISDAs) would need to be looked at;
- 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.

d) Performance History

Performance history should be transferred if possible. It will be necessary to demonstrate that post re-organisation, there will be no change to the fund’s investment policies and objectives and expenses will be equivalent.

e) 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, some 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 more complex to make equalisation adjustments at the level of the shareholder and 2) some sub-distributors and nominees cannot process equalisation adjustments.

f) 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
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). If the conversion to UCITS is effected within the existing legal structure then there should be no tax issues for investors.

**g) 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/CBI for review and comments will be issued. For self–managed funds, a Risk Management Process and a Business Plan/Substance Application Questionnaire 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 depositary and sub-custodian charges.

**h) 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 (management company, investment manager, administrator, depository, directors, etc). Additionally, the Risk Management Process and Business Plan/Substance Application Questionnaire (for self-managed funds) will need to be written/ completed. Once the documents have been submitted to the CSSF/CBI 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 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 management company, investment manager (and also the 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/distributors/nominees 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 transition timeline will necessarily be impacted by the need to register the UCITS fund in those same domiciles where the merging or transitioning fund is registered or offered prior to any transition event.

• If there is a change to the fund’s administrator/transfer agent, the new administrator/transfer agent will likely seek to review all existing AML/KYC documentation. This may result in further shareholder materials being requested to comply with the administrator’s policies. This remediation exercise may impact the ability for certain investors to trade (or receive redemption proceeds) until such time as they have supplied the required materials to the administrator.
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.

The EU directive governing all non-UCITS funds with an EU footprint, with very few exceptions, is the Alternative Investment Fund Managers Directive (AIFMD). The ability to opt out of the AIFMD for non-UCITS funds is very limited and any fund that does not meet opt-out requirements with a footprint in the EU, no matter how small a footprint, will be caught by its provisions.

The AIFMD allows for qualifying investor and retail investor funds to be established under its rules. For the latter, the investor protection provisions are similar to those of UCITS but the investment restrictions are less stringent.

The AIFMD regulates the manager rather than the fund directly. There are different fund types in both Ireland and Luxembourg (some regulated and some not regulated e.g. the Luxembourg Reserve Alternative Investment Fund or “RAiF” which is very popular) which are available to fund promoters and managers. If you have questions on this topic, please contact Carne for further information.
70-80% of publicly sold funds in Asia are UCITS
A. UCITS VI

UCITS VI has been considered but it does not seem to be a current priority for the EU lawmakers. When it was last considered, a number of topics were examined including:

- 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;

- Considerations for a number of improvements to UCITS 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.

B. MONEY MARKET FUNDS (“MMFS”)

Reforms of MMFs were published in 2017 and come into effect in 2019 for existing MMFs and for newly authorized MMFs from mid-2018. The reforms include a new Public Debt CNAV MMF and a Low Volatility NAV MMF. The new regulations contain requirements in relation to inter alia liquidity, diversification, eligible assets, securitisations, credit assessment, risk management and stress testing, the prohibition on external support, disclosures and regulatory reporting. ESMA has issued a final report on draft technical advice, implementing technical standards and guidelines under the MMF regulation.
Carne is the premier global provider of Fund Management Solutions to the 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 Luxembourg, Ireland and the UK and a non-EU AIFM management company in the Channel Islands. In addition, Carne has offices in, London, Cayman Islands, Channel Islands, Chicago, New York, Lisbon and Switzerland.

We have a broad range of services to support asset managers and their funds including:

- **Tailored Services:**
  - Fund launch project management;
  - Selection of Service Providers;
  - Cross border consultancy (fund launches, mergers, liquidations);
  - Secondees (part/full time);
  - Management Company structuring, set up and support.

For further details on Carne’s services, please contact your local Carne office (contact details on the back page).

- **Fund Management Solutions for AIFMD and UCITS funds:**
  - UCITS & AIFM Management Companies;
  - UCITS & AIFM Fund Platforms;
  - UK AIFM and Collective Portfolio Manager (ACD / ACM / ACS Operator);
  - Non-EU AIFM Management Company;
  - Fund Directors;
  - UCITS & AIFM Risk Management Services;
  - UCITS & AIFM Designated Person/ Conducting Officer Services;
  - Distribution Support Services;
  - Fund Foreign Registrations (passporting);
  - MLRO Services;
  - Company Secretarial Services;
  - Compliance Officer Services;
  - KIID Services;
  - Annex IV Reporting (AIFMD).
Given the level of oversight required under UCITS regulations, the most practical solution for a UCITS is to appoint a local Management Company.
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. ESMA has issued further technical standards, e.g. on risk management, to assure a high degree of harmonisation across the EU. There are fewer differences now in how certain rules are applied but some rules can 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:

a) Eligible assets
b) Eligible markets
c) Liquidity rules
d) Risk spreading rules
e) Rules relating to derivatives
f) Rules relating to efficient portfolio management

APPENDIX 1:
UCITS INVESTMENT RULES

The eligible assets categories in UCITS are as follows:

1. Transferable securities
2. Money market instruments
3. Transferable securities and money market instruments embedding a derivative element
4. Financial derivative instruments (“derivatives” or “FDIs”)
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.

b) 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.

c) 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 and added 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 in Luxembourg. 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.

• In Ireland, a UCITS fund must:

  - Assess and document in writing liquidity risk where investment in a transferable security could compromise liquidity of fund;
  - Assess and document in writing liquidity risk of a transferable security when investing in a transferable security (at a minimum including volume and turnover of the transferable security, issue size and portion of issue to buy, opportunity/timeframe to buy or sell the transferable security, assessment of secondary market activity, intermediaries and market makers);
  - Assess and document in writing liquidity and negotiability of the transferable security in the fund where the transferable security is not traded on regulated markets.

d) 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.

**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 approved 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,
• Max 20% with 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, this limit is applied at the sub-fund 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/(reverse) repos/stock lending
  - Position exposure of assets underlying derivatives;
  - Exposures created through the reinvestment of collateral.

• Max 20% of NAV in respect of all exposures to issuing bodies within the same corporate group;

• Issuers from same corporate group are considered the same issuer for the purposes of the risk spreading rules except that investment up to 20% is allowed for transferable securities and money market instruments issued by the same issuer/group;

• 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);

• Exposure from reinvestment of collateral must be included for purposes of risk spreading limits.

**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;

• Foreign currency borrowings exceeding back to back deposits must be treated as borrowings.

**e) Rules Relating to Derivatives:**

• General criteria: To invest in a derivative one needs to assure that the underlying is permissible according to the UCITS rules (look through principle)

• Underlyings must 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.
Total Return Swaps:

- Underlying assets must comply with investment objectives and investment limits of the UCITS;

- Prospectus disclosure required:
  - Information on underlying strategy and composition;
  - Information on counterparties;
  - Risk of counterparty default;
  - Extent of counterparty’s discretion in managing exposures/underlyings or if counterparty approval is required for a transaction;

- Possible requirement for counterparty to be disclosed as an investment manager (if a counterparty has discretion over the composition or management of the underlying of the FDI).

Collateral:

- Counterparty risk can be reduced by eligible collateral which meets the following criteria:
  - Liquidity;
  - Valuation;
  - Issuer credit quality;
  - Correlation;
  - Collateral diversification - diversify on country markets and issuers;
  - Risks identified in RMP;
  - Held at custodian or agent (with conditions);
  - Enforceable/immediately available;

- Non-cash collateral cannot be sold, pledged or re-invested;

- Cash collateral can only be invested as follows:
  - Deposits with certain institutions, high quality gov bonds, reverse repos (with conditions), short term money market funds;
  - Must be diversified as above;
  - Can’t place cash collateral on deposit with counterparty or affiliate;

- If more than 30% of AUM received as collateral, UCITS must perform stress tests on the collateral under normal and exceptional liquidity conditions and have a stress testing policy;

- UCITS must have a collateral haircut policy;

- Investors must be informed of the collateral policy in prospectus.

Global Exposure - Commitment approach:

- A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net asset value of its portfolio. The UCITS may not therefore be leveraged in excess of 100% of net asset value.

- 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;

- A currency derivative involving 2 legs not in the base currency must aggregate both legs;

* 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 business 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 expected leverage in the prospectus together with a statement on the possibility of higher leverage;
  - Disclose the actual leverage of the period in the annual report together with VaR utilization (min, max, average);
  - 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 qualifying 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;

- UCITS should establish whether its exposure is to an OTC counterparty, broker or clearing house;

- Any exposures relating to repos, reverse repos or stock lending must also be included within the 5%/10% counterparty risk limits;

- When assessing counterparty exposure, UCITS have to take into account margin paid to the counterparty or margin due from the counterparty where the margin is not subject to client money rules.
Cover requirements:

• A UCITS must at all times be capable of meeting its payment and delivery obligations for FDIs;

• Cover for a FDI must be:
  - Liquid assets for cash settled FDI;
  - For FDIs requiring physical delivery, UCITS must hold the underlying or hold liquid assets where:
    - Underlying is highly liquid fixed income security and/or UCITS considers that the exposure is adequately covered without holding the underlying, risks are captured in the RMP and details are included in the prospectus.

e) 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;

• UCITS must consider implications for liquidity risk management re meeting redemptions;

• Need to assess credit rating of counterparty if existing or, if counterparty is downgraded below A-2, a new credit assessment must be carried out;

• Collateral may be posted;

• ESMA has published rules on collateral including rules on credit quality, diversification, liquidity, valuation, reinvestment of collateral;

• Security repo'd or lent (or cash for reverse repo) must be instantly recallable or UCITS must be able to terminate agreement;

• UCITS must be able to terminate a reverserepo on an accrued or MTM basis (if on an MTM basis then this must be used in the NAV);

• Various disclosures required in annual report (exposures, revenues, counterparties, collateral).
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