THE EVOLVING INVESTMENT STRATEGIES OF UCITS

EFAMA report on the so-called "Newcits" phenomenon

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EXECUTIVE SUMMARY

There is a clear trend to use a wider range of instruments and in different ways in UCITS investment strategies, within the constraints of UCITS III. This is the result of an evolutionary process which was initiated by the UCITS III Directive of 2001[1], grew in reaction to investors' demands following the financial market crisis, and was further spurred by the market entrance of new players as a result of the debate on the AIFMD.

For many years, the best practices and innovative implementation of strategies and portfolio management techniques have been cross-fertilized between the hedge fund and traditional, long-only investment management communities to meet the evolving needs of clients. In particular, there is clear investor desire to achieve yield uplift relative to the low returns on deposit accounts. At the same time there is a demand from investors for capital security. These desires can be in conflict and different strategies are needed in order to meet them.

The current UCITS legislation provides a robust framework with strong retail investor protection and is about to be enhanced with the UCITS IV requirements. The so-called "Newcits" are neither new products nor a new category of funds. "Newcits" are UCITS that can be described as aiming actively to manage the risk-return trade-off. They are subject to and are managed in compliance with the UCITS framework. As such they offer the same level of investor protection as other UCITS.

The "Newcits" label was coined by the media and should not be adopted by the industry or regulators. We do not believe that it is necessary or beneficial to have a specific label for these funds. The universe of UCITS is evolving but this is encompassed by the UCITS regulatory framework. Moreover, the regulatory requirements and supervisory tools are being developed, especially under the UCITS IV framework, which enters into force on 1 July 2011.

EFAMA strongly welcomes the creation of ESMA and encourages it to strengthen the Single Market in investment management by developing a more harmonised reading of the UCITS rules. EFAMA has full confidence that ESMA and the national regulators will continue to enforce the UCITS requirements to all UCITS managers in an adequate manner and thereby maintain a level playing field for all UCITS managers to operate and to develop products that suit their customers' needs while at the same time providing a high level of investor protection.

[1] Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002

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Introduction

Traditionally, UCITS funds have been regarded worldwide as plain vanilla investment funds which only employ traditional investment strategies. However, as allowed by the UCITS III Directive of 2001, there are nowadays more and more UCITS funds that use a wider range of techniques and instruments with the aim of managing the trade-off between risk and return. One of the main examples is using derivative techniques to generate "absolute" returns to the investors. The investor demand for this kind of products has significantly increased since the financial markets crisis. The media has made this a topic of attention and coined the label "Newcits".

Some regulators have expressed reservations as to the nature of this type of UCITS product. Many of these reservations relate to the extent of derivative use and the sophistication of investment strategies employed. Conscious of the importance of protecting the integrity of the UCITS brand worldwide, a working group was convened by EFAMA to examine the nature of those reservations and concerns. The aim of the work was objectively to evaluate whether such concerns are valid. If valid, the group would consider whether they were being addressed within the current regulatory environment or were about to be addressed through the impending implementation of key legislation, notably UCITS IV. Concerns that were valid and were not being addressed would be followed up through suggested courses of action and recommendations put forward by the working group.

1. What is "Newcits"?[2]

To analyse the "Newcits" phenomenon it has first to be defined what "Newcits" are. According to Strategic Insight[3], the universe of "Newcits" is composed of around 1,000 funds with assets of €114 billion. Other providers, such as the Absolute UCITS database (Hedge Fund Intelligence), were counting at the end of June 2010 more than 600 "Newcits" funds and only €34 billion of assets.

The "Newcits" definitions used to date cover different types of products and managers. For example:

1. For some, "Newcits" are simply UCITS that take advantage of certain investment techniques permitted by the UCITS III Directive, which enables UCITS to pursue strategies that were previously more common in the alternative investment fund sector – in particular, the hedge fund sector. The investment performance objectives of "Newcits" are not usually driven by the traditional benchmarks or indices. They tend, instead, to invest in a range of financial derivative instruments and use such instruments to have both long and synthetic short exposures, and some may also use a certain degree of leverage.

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[2] Annex 1 describes in more details the different sub-categories within these products.

[3] "*Alternative and Hedge Fund UCITS in the Next Decade*" (2010): report published by Strategic Insight and commissioned by the Association of the Luxembourg Fund Industry (ALFI) with the support of Luxembourg for Finance (LFF). The report is available at http://www.alfi.lu/publications-statements/publications/alternative-and-hedge-fund-ucits-next-decade

2. Some commentators use the term “Newcits” to refer specifically to “absolute return” funds replicating an existing hedge fund strategy, whereas others apply the term to UCITS that are either absolute return funds or long-only funds using UCITS III investment powers and which do not have an "offshore" equivalent.

3. Others use the term “Newcits” to refer to UCITS falling within both 1 and 2; and some use it as a marketing name and include within it non-UCITS hedge funds whose investment strategies could fit within the UCITS III investment powers as well as UCITS.

These differences illustrate the difficulty for market players to identify what is really a “Newcits”. Indeed, many of these funds are not new at all. “Absolute return” funds, for example, have existed for a long time but are considered as “Newcits” or not depending on the provider. In fact, “Newcits” is not a new category of funds. All UCITS are subject to the same detailed rules set down in European legislation. **“Newcits” are UCITS.**

Therefore, in EFAMA’s view, the term “Newcits” is not helpful and should not be used. In fact, as a result of various developments in the EU regulatory framework and market developments, there exists a growing universe of UCITS that are difficult to capture within one umbrella definition. The universe of these funds is made of UCITS that are not purely “long only”. This universe is however a patchwork of different types of strategies, including: strategies created by UCITS asset managers that have entered the “absolute return” market; and new strategies created by hedge fund managers for the sake of diversification or hedge funds that have been more or less adapted to the UCITS world.

The focus of this EFAMA report is therefore to analyse the reasons behind the evolving investment strategies of UCITS, what possible challenges this development poses on the different parts of the UCITS value chain, and how the UCITS regulatory framework meets these challenges.

2. The evolution of UCITS

The original 1985 UCITS Directive allowed UCITS to invest only in transferable securities covering equities and bonds. Prior to UCITS III, UCITS funds were permitted to use derivative instruments only for efficient portfolio management purposes. This essentially meant that they could be used only with the aim of the reduction of risk, reduction of cost or the “generation of additional capital or income for the UCITS with an appropriate level of risk”. This definition meant that, in practice, funds could use derivatives only in a small number of defined instances, although there was some variation in Member States’ interpretations of the requirements.

It was recognised in the 1990s that there was significant demand for the use of derivatives within a retail fund. The benefits of the use of derivatives were highlighted as their liquidity, their low costs and the reduced interference in the stock picking process by using derivatives for tactical asset allocation. In order to ensure that the UCITS brand continued to best serve the needs of the mainstream investor market, it was recognised that the permitted use of derivatives would have to be broadened. The UCITS III Directive of 2001, among other things, therefore permitted derivatives to be used for investment purposes. In deciding to extend UCITS investment powers, legislators recognised the potential increased risks derivatives posed and, as a counter balance, required a sufficient risk management process to be put in place to monitor their use within prescribed limits.

The Commission Recommendation on the use of derivatives in 2004 further clarified how "exposure" was to be calculated and it also introduced the concept of "sophisticated UCITS", which led to the realisation of the widened opportunities that the 2001 Directive offered. The 2007 Eligible Assets Directive provided further clarity and harmonisation between different national regulators' interpretations of UCITS III as regards the permitted asset types that could be held within a UCITS. In particular, it included a definition of a financial index that allowed investment in an index based on non-eligible assets – such as commodities and hedge fund indices. This clarified the possibility of a wider range of assets and strategies within UCITS.

As intended, the UCITS III framework provides investors with an investment with strong liquidity, transparency, risk management and governance, but which is flexible enough, through the controlled use of derivatives, to facilitate the creation of more than just long-only products. UCITS funds are able to offer their investors investment strategies that are similar to what would traditionally be regarded as alternative investment strategies (for example, equity long/short, tactical trading and global macro), but within a highly regulated framework. This has broadened the market considerably and met investor demand for the ability to obtain funds with an absolute return focus within a UCITS structure.

It is clear that there is a wide variation in the use of derivatives for investment purposes but, regardless of its extent, such derivative use is geared towards achieving enhanced or specific types of returns for investors. Some investment strategies rely more heavily on derivatives than others, with the spectrum of funds ranging from (i) those that aim to provide a similar strategy to an "alternative strategy" within a more controlled environment (for example, through total return swaps) to (ii) funds that aim to produce positive returns by taking direct long and short positions using derivatives and financial instruments permitted under the UCITS Directive. The reality is that derivative use to achieve the best return for investors, as well as to provide for the reduction of risk, is now common place because it is much sought after by investors.

3. Response to investor demand for risk reduction and return enhancement

3.1 Why use the UCITS framework?

The expanding universe of types of UCITS is the consequence of different factors and evolutions within investment management. First and foremost, it is a response to investor demand and is a global trend. Many investors want to be, at least partly, immune from the betas of global markets, ie to limit their market risk, after having experienced within one decade two major global financial markets shocks – the bursting of the dot-com bubble and the most recent crisis of 2008.

Secondly, UCITS enjoy a very high level of recognition in Europe and beyond. UCITS has become a global brand of a well-regulated and risk-diversified investment fund that can be marketed to retail investors. The advantages of this framework and brand have also attracted a large number of institutional investors. UCITS has proven to be a great success story not only in Europe but also outside, particularly in Asia. Indeed, more than 40% of UCITS sales take place outside Europe nowadays. It is therefore an attractive business proposition to structure a product as a UCITS when aiming for a Europe-wide or even global distribution.

Thirdly, some institutional investors in certain countries are not allowed to invest and/or they face constraints in investing in unregulated products that are not explicitly compliant with local regulation. Regulations often foresee that UCITS are eligible investments for such investors, but hedge funds are not generally automatically eligible investments. Especially since the financial market crisis in 2008, hedge funds managers have been entering the UCITS space as there has been rising demand from their institutional clients towards products which are well-regulated and provide a high level of liquidity.

Another, more recent reason is linked to the changing regulatory environment. In particular, the then uncertainty around the final content of the Alternative Investment Fund Managers Directive (AIFMD) increased the interest of hedge funds managers in the UCITS framework. They realised that the UCITS investment and borrowing powers accommodated many of their strategies within a framework that already provides a European passport to market these funds cross-border and to achieve therefore scale efficiencies in their management.

Taken together, all these factors have prompted several hedge fund managers to pursue a wide range of investment management strategies within the UCITS framework. The UCITS Directive offers such opportunities while at the same time imposing high standards in terms of risk, liquidity and conflicts of interest management. By entering the UCITS market, these fund managers submit themselves to the full range of the UCITS requirements and hence demonstrate their willingness to apply the operational standards of UCITS management aimed at mitigating the risks involved. It has to be noted that it is to the benefit of the clients that these products are offered in a regulated UCITS framework where all parties in the value chain are subject to regulation.

All this was confirmed in a recent report prepared for ALFI by Strategic Insight[4], in which respondents to a survey "*identified liquidity, a strong regulatory framework, transparency, and the UCITS brand as the four most important factors supporting the growth of alternative UCITS.*"

3.2 The robust requirements of the UCITS framework

All UCITS are regulated and are subject to the same requirements and constraints. These constraints limit the types (and the extent) of hedge fund like strategies that can be delivered within the UCITS framework. The UCITS structure imposes on the UCITS manager constraints and risk management requirements linked to the nature of assets held in the UCITS portfolio and the investment techniques employed. This requires the management company to have an adequate operational framework.

[4] Strategic Insight, "Alternative and Hedge Fund UCITS in the Next Decade, 2010, p.7

Unlike any other EU financial services regulation, the UCITS Directive imposes a very detailed set of requirements on the characteristics of the investment fund, thereby regulating the investment product itself. It is to be noted that this differentiates UCITS from all other financial services products, which are only indirectly affected by regulation of the service provider, for example the credit institution issuing a structured note or the insurance company issuing a unit-linked life insurance policy.

This robust product regulation is at the heart of the high level of investor protection UCITS provide. The key UCITS investment limits and requirements are listed below:

- There are strict limits in relation to the global exposure of a UCITS, cover for investment in derivatives, and counterparty risk. There is a limit on absolute VAR: monthly 99 % confidence, limit 20 %

- Relative VAR: with the same confidence levels VAR has to be less than 2 times that of the benchmark.

- Liquidity: redemption possibility and NAV publication at least twice a month.

- Eligible assets constraints: no direct investment in precious metals or other commodities or other non-financial assets.

- Limits to concentration risk: the "5/10/20/40" diversification rule applies.

- Uncovered short selling is prohibited.

- Disclosure requirements: annual and semi-annual report, simplified prospectus (to be replaced by key investor information document, the KIID, under UCITS IV) and a prospectus for the fund need to be published.

Also, the UCITS requirements impose detailed responsibilities on management companies in relation to risk management and risk measurement, in terms of both their organisation and procedures and in the way that funds are monitored. Senior management is responsible for approving and reviewing the risk management policy and arrangements, and the processes and techniques for implementing the risk management policy. UCITS management companies must establish a permanent risk management function, which must be functionally and hierarchically independent from other departments within the management company, and which is responsible for implementing the risk management policy and procedures. Managers are required to measure and manage at any time the risks to which the fund is or might be exposed, and must ensure compliance with the UCITS limits concerning global exposure and counterparty risk.

It should therefore be emphasised that risk management in UCITS is already state-of-the art, and will be enhanced even further by the entry into force of the UCITS IV Directive on 1 July 2011. These new rules include many, even more detailed provisions on internal control mechanisms for the UCITS management company. The rules cover the risk management, compliance and internal audit functions, risk management policies, risk measurement, counterparty risk and issuer concentration risk calculation, as well as procedures to value OTC derivatives.

3.3 How closely can a hedge fund strategy be implemented in a UCITS?

Given the UCITS requirements described above, investors in a UCITS should not expect, or be led to expect, an identical outcome to that of a hedge fund. As compared to hedge funds, the implementation of absolute return strategies within UCITS is constrained by, for example:

- A tight limit on leverage;
- Fewer available asset classes;
- Strong liquidity constraints;
- Investment and concentration limits; and
- Necessity to diversify counterparty risk.

The above require specific and robust risk management and control systems that differentiate UCITS from hedge funds. Moreover, UCITS management companies are subject to a number of other requirements designed to provide retail investor protection, such as governance requirements, the appointment of a depositary, organizational requirements, capital requirements, and so on.

All these requirements impose additional costs and constraints for UCITS, which make strict implementation under UCITS format of a hedge fund portfolio and return difficult to achieve. It is important for customer communications to be clear on these aspects.

4. Products that use derivatives for investment purposes are not necessarily more risky products

UCITS that use a wider range of investment strategies, techniques or instruments, are not necessarily more risky for the investor than other UCITS. In fact, such UCITS aim to limit the market risk of the fund's investments in order to deliver returns even in difficult market conditions, whereas long-only strategies provide more linear market exposure to investors. A UCITS that invests in emerging market smaller companies, for example, can be far more risky for the investor that many of the funds that use derivatives.

All UCITS are exposed to a range of risks. Managing those risks is one of the tasks of the UCITS manager for which it is rewarded by the investor through the management fee. As discussed above, UCITS risk management is already very advanced, but will be further enhanced by the entry into force of UCITS IV, which includes many, even more detailed provisions on internal control mechanisms for the UCITS management company.

For any UCITS, the risk profile is dependent on the investment strategy followed, the types of assets and the geographical markets invested in. Liquidity, counterparty, valuation and operational risks exist for all UCITS and have to be appropriately monitored and managed. The risk management process of the manager must be fit for purpose considering the nature of the UCITS managed.

UCITS that use derivatives systematically or extensively can be exposed, in particular, to *counterparty risks*. The UCITS manager has therefore to pay particular attention to the management of counterparty risks, especially in those UCITS where performance swaps are used to implement hedge fund strategies. The manager therefore is required to have appropriate risk management processes. Also, the valuation or pricing function must have appropriately sophisticated systems and controls. CESR has recently given more guidance on the management of counterparty risk (CESR 2010/788). It is worth mentioning that the safety of the OTC derivatives trading in the EU is being improved by the move to central clearing with the proposed European Market Infrastructure Regulation (EMIR), which is currently being negotiated by the European Parliament and Council.

The use of *leverage* is confined within the global exposure limits that are set by the Directive for all UCITS. Global exposure is defined as a measure designed to limit either the incremental leverage generated by a UCITS through the use of financial derivative instruments (commitment approach: the incremental exposure cannot exceed the total NAV), or the market risk of the UCITS portfolio (probabilistic approach – standardised limits and requirements are set on the calculation of Value at Risk). UCITS IV further harmonises practices between Member States and brings in a series of enhancements in respect of the use of Value at Risk methodologies, stress testing and back testing, beyond the qualitative (organisational) requirements.

UCITS that employ a wide range of investment strategies, techniques or instruments may, in turn, be exposed to a wider range of, or heightened, *operational risks*. It is therefore essential that the operation and oversight of such UCITS follows best practice as regards their risk management systems and processes. In particular, for such UCITS, the manager needs to identify, monitor and manage both investment exposure risks arising from the instruments and strategies used, and the operational risks related to those instruments and strategies.

The specificity of some strategies necessitates those investment managers to strengthen their risk management tools by implementing specific systems in order adequately to measure global exposure. Lastly, the use of leverage and possible positioning on less liquid securities/ asset classes forces the investment manager to focus more on liquidity risk.

5. The role of UCITS "Platforms"

The development of a wider range of UCITS structures has been facilitated by the platform services offered by investment banks (or existing UCITS management companies) to hedge funds, enabling them to convert hedge funds strategies into the UCITS framework. There are different types of "platform" services. One common structure is that a bank (or asset manager) uses or sets up its own UCITS management company, which in turn establishes a UCITS umbrella fund. The portfolio management function of each sub-fund is usually delegated to a different fund manager. These fund managers are thus in charge of the investment strategy of UCITS without having to set up their own UCITS management company. In some Member States such arrangements have been common for many years for more traditional UCITS.

From the legal point of view, the responsibility for ensuring compliance of a UCITS with all requirements arising from EU legislation and national regulations rests exclusively with the UCITS management company providing "platform" services. Specifically, the UCITS Directive requires that the management company (the "platform") retains responsibility for its delegate, which must be authorised or registered to carry out asset management, subject to prudential supervision, and cannot prevent the platform from acting or the UCITS being managed in the best interest of the investors.

This structure provides:

- Technical support to small asset managers: Through the UCITS "platform", investment banks (and for some services, asset management companies) can offer technical support to niche hedge fund houses and other small asset managers focusing on a wider range of investment strategies and techniques. Such technical support involves in particular: depositary services, provision of derivative instruments (swaps, notably), funding requirements (seed money), compliance and risk management functions. Funds established by platforms therefore benefit from a professional and regulated infrastructure, adequately equipped to deal with the UCITS requirements.

- Dedicated distribution network: The platform also provides access to retail and institutional distribution networks to small asset managers and non-EU hedge fund managers, who would otherwise not have an adequate European distribution base.

- Operational oversight of asset managers by the platform, in addition to the oversight required by the UCITS Depositary.

6. The role of the depositary

There was a general view among depositaries consulted by the EFAMA working group that their responsibilities and duties have not changed with the evolving UCITS universe and that the standards applicable to UCITS fully apply to all types of UCITS. In other words, custody services and oversight duties are identical with regards to authorised financial instruments, and are independent of their use by the UCITS. The depositaries also presented the view that the evolution of the UCITS universe has been happening for many years and is not a new phenomenon.

In particular, it was recognised that dealing with non-standardised OTC instruments requires specific attention and processes. Depositaries therefore need to be especially vigilant as regards:

- Quality of collateral and collateral management rules
- Integrity and accuracy of the manager's valuation process
- Efficiency of the margin calls on the OTC contracts

Depositaries, as for any other actors in the value chain, have to have the capacity to handle the full range of instruments, techniques and investment strategies used by the UCITS, to which they act as depositaries.

7. Transparency towards investors and distribution issues

All UCITS are subject to the same detailed disclosure requirements - including prospectus, simplified prospectus and, in the future, the KIID - as all UCITS. It is important that there is transparency for investors as to the instruments the fund uses or may use, and how they impact the overall risk profile of the fund. In this respect, information on the investment strategy and risk and reward profile of the UCITS provided in its KIID and prospectus must be composed with particular care by the UCITS manager.

The specificities and characteristics of the investment strategy of the UCITS and the relevant risks involved should be adequately explained in the disclosure documents (as amended by UCITS IV). In particular, adequate information should be provided to help investors to understand the quality of protection or guarantee (if any) against identified risks. The UCITS framework provides enough tools to inform investors in an adequate way via the disclosure documents and this is the responsibility of the management companies.

As regards distribution, the regulatory classification of a UCITS is the same regardless of the underlying assets or strategy. In selling them a distributor needs to consider appropriateness and suitability in accordance with the general rules of MiFID. Promoters launching such products have a role to play defining the target client segments and informing the product features (such as minimum investments for example) appropriate to that target segment.

8. New market entrants and the role of the regulators

The current UCITS legislation provides a robust framework with strong retail investor protection and is about to be enhanced with the UCITS IV requirements. All UCITS are subject to and are managed in compliance with the UCITS framework. As such, all UCITS offer the same level of investor protection.

It is essential that all new entrants to the UCITS market have a thorough understanding not only of the UCITS investment and borrowing restrictions but also of the full breadth of the UCITS requirements - governance structure, transparency, risk, liquidity and conflicts of interest management, the role of the depositary, and so on - and that those new entrants will have to adhere to the letter and spirit of those rules.

It is recognised that in authorising these types of UCITS, regulators will wish to ensure they have correctly understood the proposed structure, and to consider whether, in their view, the investment and risk managers, as well as any relevant services providers, are adequately equipped to monitor and manage the strategies and risks associated with the product.

EFAMA strongly welcomes the creation of ESMA and encourages it to strengthen the Single Market in investment management by continuing to develop a harmonised reading of the UCITS rules, which has evolved under CESR’s stewardship since 2004. EFAMA has full confidence in that ESMA and the national regulators will continue to enforce the UCITS requirements to all UCITS managers in an adequate manner and thereby maintain a level playing field for all UCITS managers to operate and develop products that suit their customers’ needs while at the same time providing a high level of investor protection. EFAMA is willing and able to play its part in the ongoing evolution of the UCITS regulatory framework. UCITS is a European success story and should remain so.

9. Conclusions

There is a clear trend to use more derivatives in different ways in UCITS investment strategies, within the constraints of UCITS III. This is the result of an evolutionary process which was initiated by the adoption of the UCITS III Directive in 2001 and further spurred by the market entrance of new players following the financial market crisis and the debate on the AIFMD. For many years, the best practices and innovative implementation of strategies and portfolio management techniques have been cross-fertilized between the hedge fund and traditional, long-only asset management communities to meet the needs of institutional clients. In recent years this convergence has also been taking place within UCITS. Investors want products which aim to provide reduced risks and enhanced returns.

"Newcits" are neither new products nor a new category of funds. **"Newcits" might be described as UCITS which aim to manage the risk/return trade-off by the use of a wide range of strategies and instruments.** Such funds do not comprise a new brand or a specific and novel sub-category of UCITS. They operate under the one and the same regulatory framework as any other type of UCITS does. The "Newcits" label was coined by the media and should not be adopted by others. We do not believe that it is necessary or beneficial to have a specific label for these funds. Labeling in such a way a universe of diverse strategies will only distract investors, regulators and other stakeholders from the real issues. The universe of UCITS is evolving but this is encompassed by the UCITS regulatory framework. Moreover, the regulatory requirements and supervisory tools are being further developed and articulated, especially under the UCITS IV framework, which enters into force on 1 July 2011.

The enforcement of the existing regulatory framework is of key importance. EFAMA has full confidence in that ESMA and the national regulators will continue to enforce the UCITS requirements for all UCITS managers in an adequate manner and thereby maintain a level playing field for all UCITS managers to operate and develop products that suit their customers' needs while at the same time providing a high level of investor protection.

Conclusions:

1. The universe and strategies of UCITS are evolving due to investor demand for risk reduction and return enhancement, which is a global trend.

2. This evolution is encompassed by the UCITS regulatory framework. Moreover, the regulatory requirements and supervisory tools are being further developed and articulated especially under the UCITS IV framework, which enters into force on 1 July 2011.

3. The term “Newcits” incorrectly indicates the creation of a new type of product or a legal sub-category that is clearly defined and quite different from other UCITS. This is not the case, and the term should be avoided.

4. All UCITS and UCITS management companies are subject to the same detailed regulatory framework and must comply with it. The key issue is proper enforcement of the rules.

5. EFAMA has full confidence in that ESMA and the national regulators will continue to enforce the UCITS requirements to all UCITS managers in an adequate manner and thereby maintain a level playing field for all UCITS managers to operate and develop products that suit their customers' needs while at the same time providing a high level of investor protection.

6. EFAMA is willing and able to play its part in the ongoing evolution of the UCITS regulatory framework.

ANNEX 1: Overview of Universe of UCITS using a wide range of instruments and techniques

This Annex provides a brief analysis of the evolving universe of UCITS that use a wide range of instruments and techniques to support particular types of investment strategies. It seeks to determine (i) the size of the market and (ii) the funds' countries of domiciliation, and to examine (iii) their evolution in recent years and (iii) the different strategies that these funds employ.

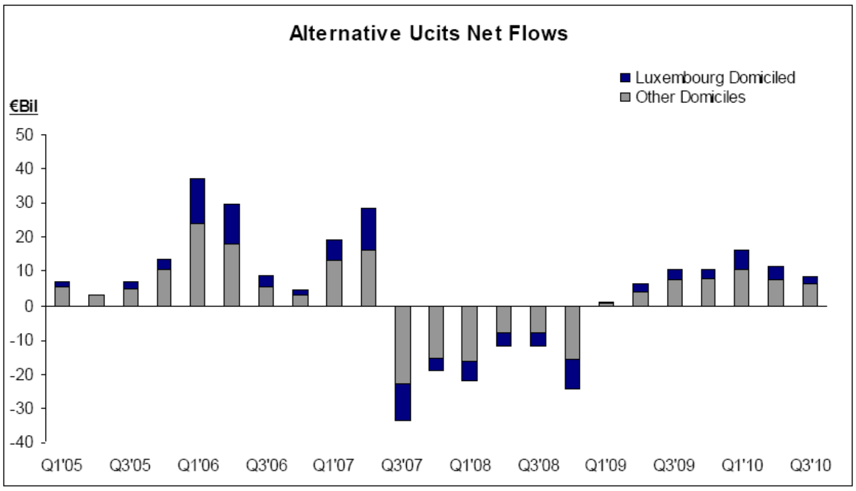
1. Market Data

- According to Strategic Insight[5] the universe of "alternative" investment strategies within UCITS funds is composed of 1,000 UCITS with assets of €114 billion ($156 billion) including fund of funds (€105 billion excluding fund of funds), as of September 2010.

- This represents 4% of the assets in all long-tem UCITS (excluding money market and liquidity funds).

2. Domiciliation

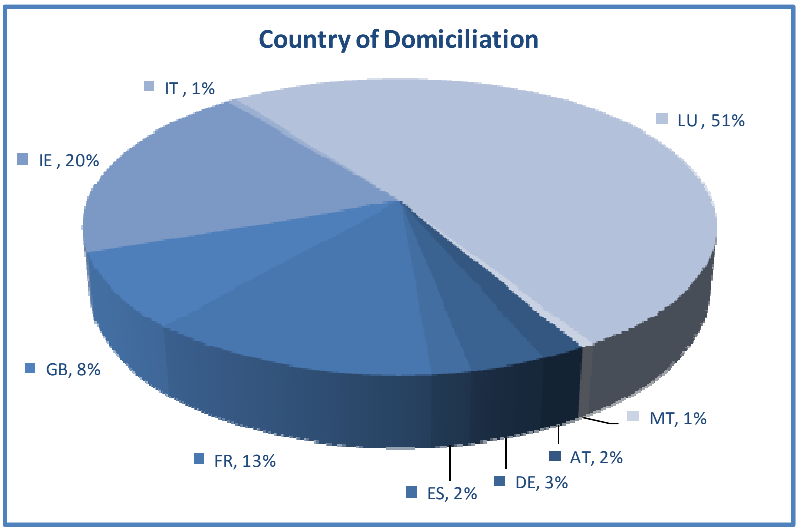
Luxembourg-domiciled funds accounted for almost half (49%) of such UCITS assets and flows in 2010, and 45% of the number of funds.



Source: Strategic Insight Simfund Global

Regarding the country of domiciliation, an analysis of the Citywire's database shows that there is clear trend to domicile these funds in Luxembourg and Ireland with 51% and 19% of funds domiciled in these countries respectively.

[5] "Alternative and Hedge Fund UCITS though the Next Decade" report from Strategic Insight commissioned by ALFI.



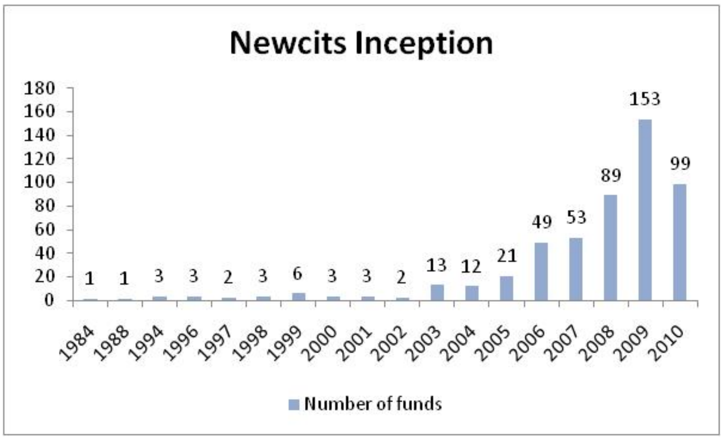
There are many types of strategies that may be implemented using the UCITS framework, including: Managed futures/ Commodity Trading Advisor (CTA), Commodities, Currency, Global macro, Event driven, Convertible arbitrage, Volatility arbitrage, Credit fund, Emerging markets, Long/short (including 130/30) and Equity market neutral, Multi-strategy.

The table below illustrates the split between different types of strategies in relation to the country of domiciliation of the Citywire's database:

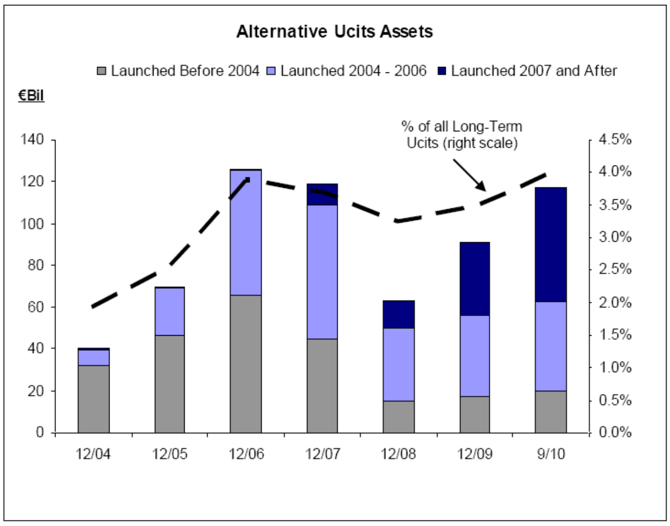
	COUNTRY OF DOMICILIATION									
CATEGORY	AT	DE	ES	FR	GB	IE	IT	LU	MT	Total
COMMODITIES	1				1	6		17		25
CONVERTIBLES				1		3		1		5
CREDIT STRATEGIES	1	2		13	10	20		35		81
CURRENCY		1		1		12		22		36
EMERGING MARKET EQUITY						11		16		27
EVENT DRIVEN	2	3		3				3		11
FUND OF FUNDS		2	2	6	4	4		18		36
GLOBAL MACRO	1		1		5	9	1	13	3	33
L/S EQUITY	1	1	2	18	19	18		60		119
MANAGED FUTURES	2	2		1		3		20		28
MARKET NEUTRAL	1		1	8		5	1	27		43
MUTISTRATEGY	1	4	3	3	3	11	1	26		52
VOLATILITY TRADING		2		12				7		21
Total	10	17	9	66	42	102	3	265	3	517

3. Track record

Looking at the date of inception, and according to the Citywire's database, it is evident that a clear proliferation of these funds has occurred since 2006, representing 85% of the total. However, such UCITS existed before then and some of them have an important track record, as shown in the graph below.



According to Strategic Insight, funds launched after 2007 captured nearly 70% of net new flows in 2010. Funds launched prior to the financial crisis naturally suffered outflows and asset declines during the downturn. Both segments are now expanding, but the newer products are clearly growing faster.



Source: Strategic Insight Simfund Global