Impact of the recent regulatory changes on the UCITS CTA market

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1. Executive Summary

Despite the restriction on commodity investments imposed by the UCITS Directive, commodity trading advisers (CTAs), also known as managed futures managers, using a UCITS structure have witnessed strong growth in assets in recent years.

Part of this success can be explained by the relative ease of implementing their strategy in a UCITS format via the creation of bespoke indices replicating the original CTA allocation.

In July 2012 the European Securities and Markets Authority (ESMA) published a consultation paper[1] proposing changes which will make using indices replicating the CTA allocation a much more complex task. This will significantly impact the funds using this replication technique.

In this paper we provide an overview of the UCITS CTA market and explain the changes in regulation, assessing the consequences for managers using an index structure. Finally we examine various options available in order to comply with the proposed new regulatory framework.

At this stage the recommendations have not yet been transposed into national laws and it is only when implemented that the full impact on the UCITS CTA market can be assessed. While not covered in this paper, it is important to note that these changes also affect other strategies using a replication structure, such as UCITS commodity funds.

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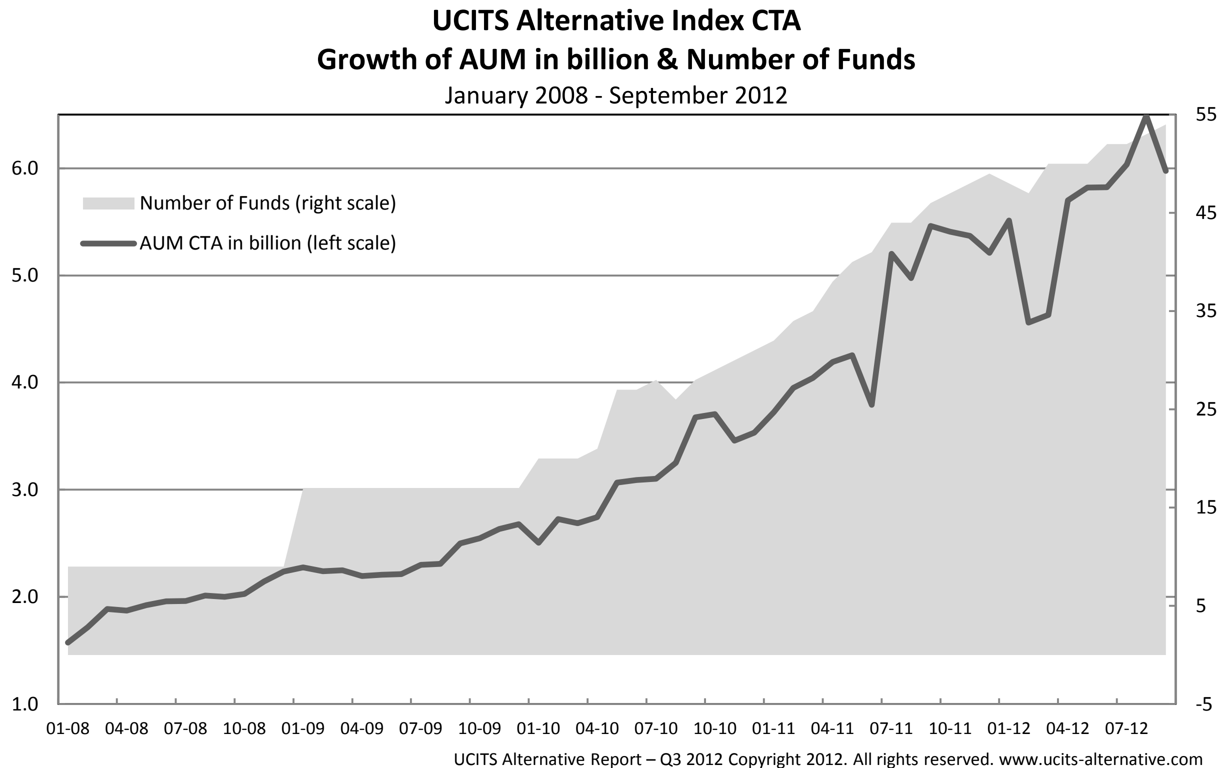
[1] http://www.esma.europa.eu/system/files/2012-474.pdf

2. UCITS CTA Market Overview

UCITS CTA funds have experienced exponential growth over the last four years. The number of funds has grown from 9 to 55 funds from January 2008 to September 2012. The assets managed have surged from EUR 1.57 billion to EUR 6.09 billion over the same period[2]. The graph below illustrates the progression of both the number of funds and assets managed by CTA managers in UCITS format.



The first UCITS CTA funds were mainly launched by European based managers advising onshore vehicles. It was only after the summer of 2009 that the market really started to pick-up, with large offshore CTA managers coming into play[3]. Since then the assets under management have more than doubled.

[2] Source: UCITS Alternative Index Quarterly Industry Report Q3 2012, http://www.ucits-alternative.com/page-report.html
[3] The first CTA funds launched by a major offshore CTA manager was the Man AHL Trend fund launched in July 2009.

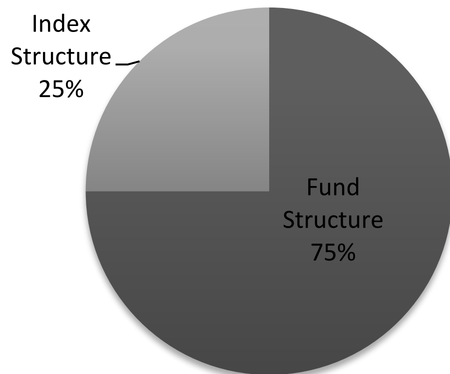
The graph below illustrates the portion of funds using index structures versus fund structures in terms of both number of funds and assets managed (as of September 2012). Although the funds using the index structure represent only one quarter of all funds, they account for about half of all the assets managed in the strategy. Out of the 10 largest UCITS CTA managers, 7 are using the index structure[4].

This can be explained by the fact that the leading and oldest CTA managers all favour the index structure. While the recent regulatory changes may only concern a handful managers, they affect the largest and most well known CTA managers.

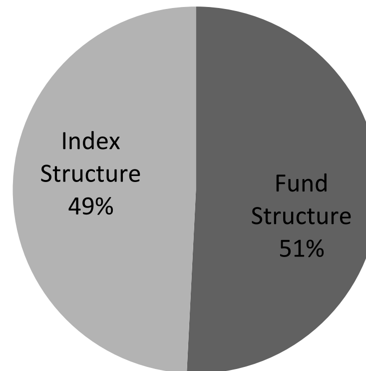
Breakdown of UCITS CTA funds using Index versus Fund structure

September 2012

Percentage of UCITS CTA Funds using Index versus Fund structure



Percentage of assets managed by UCITS CTA funds using Index versus Fund



Source: Alix Capital / UCITS Alternative Index - www.ucits-alternative.com

[4] As of October 2012. Source: UCITS Alternative Index.

3. Index Based Approach versus Direct Approach

Since its introduction in 1985, the UCITS Directive has banned investments in physical commodities or products linked to commodities, such as commodities derivatives. For this reason the first UCITS CTA funds launched have no allocation to single commodities instruments.

CTA managers have therefore explored other routes to implement their strategy while maintaining exposure to commodities. The solution found was to use the index section of the Directive rather than the fund one. UCITS indices are indeed governed by different rules than funds and the current rules governing indices are relatively simple and flexible enough to accommodate most CTA strategies. In order to be eligible an index had to meet the following criteria:

- be sufficiently diversified;
- be representative of an adequate benchmark for the market to which it refers;
- be published in an appropriate manner; and
- be independently managed from the management of the UCITS.

In practice, an index replicating the original strategy is created. The performance of this index is then replicated into the UCITS vehicle via a total return swap.

The use of this structure offers several advantages. Firstly in terms of portfolio management it allows allocation into commodities instruments as well as higher concentration limits[5]. It also enables managers to handle only one pool of assets that can be then replicated in various different investment formats (offshore funds, UCITS, managed accounts, etc.). Finally it makes it possible to replicate the existing strategy without any tracking error.

Nonetheless, using an index has a number of drawbacks. The performance replication comes at a cost and introduces an additional counterparty – the swap provider – adding an extra layer of risk.

For many market participants the rules governing UCITS indices were too loose and perceived as a loophole in the regulation that could eventually damage the Directive's reputation. UCITS index rules had been made as flexible as possible to accommodate most financial indices but they have not been thought up as a way to circumvent the Directive's spirit by authorizing investment in otherwise non-eligible assets such as commodities. This is what pushed ESMA to review and strengthen the rules governing indices.

[5] The current Directive authorizes an index to hold up to 20% to any single constituents with the possibility to have up to 35% in one constituent under certain conditions.

4. ESMA New Regulation Proposal - UCITS Eligible Indices

In the Report and Consultation Paper published on July 25th 2012, entitled "Guidelines on ETFs and other UCITS issues: Consultation on recallability of repo and reverse repo arrangements", ESMA[6] introduces new guidelines governing the implementation on UCITS eligible indices. While the scope of the paper covers numerous issues, some directly impact UCITS CTAs using the index structure. ESMA's view is that an index shall be transparent and replicable if it is to qualify as UCITS-compliant and therefore benefit from the strong UCITS' brand attached to the framework.

Specific sections of the paper have a direct impact on the use of this structure for CTA managers[7].

1. **Rebalancing frequency**

   ESMA declares that*: "A UCITS should not invest in a financial index whose rebalancing frequency prevents investors from being able to replicate the financial index."* Indices which are rebalanced on an intra-day or daily basis will not be acceptable in UCITS funds. This means that CTA managers that are rebalancing their portfolio more frequently than weekly will no longer be able to use this approach.

   While for some long term trend follower CTA managers weekly rebalancing may be acceptable, most are employing shorter term strategies that require more frequent rebalancing, and are therefore directly impacted by the new regulation. The consultation paper does specify that technical adjustments can be made intraweek and shall not be considered as rebalancing. Each regulator will have to determine what constitutes technical rebalancing.

2. **Transparency**

   a. Calculation methodology

   ESMA states *"UCITS should not invest in financial indices for which the full calculation methodology to, inter alia, enable investors to replicate the financial index is not disclosed by the index provider."* The text further specifies that this includes "*providing detailed information on index constituents, index calculation, re-balancing methodologies and index changes*" and that this information should be easily accessible, free of charge, by investors and prospective investors.

   This point is the most controversial one from a manager perspective as it concerns their intellectual property and competitive edge. CTA managers are investing enormous resources to develop and maintain their trading models. If the result is made directly available to everyone, they will think twice before choosing an implementation technique that obliges them to disclose their models.

   b. Index constituents

[6] http://www.esma.europa.eu/system/files/2012-474.pdf
[7] Sections 51; 52 and 53.

ESMA says that: *"A UCITS should not invest in financial indices that do not publish their constituents together with their respective weightings."* Again the text specifies that the information should be easily accessible, free of charge, for investors and prospective investors. ESMA however adds that the weightings may be published after each rebalancing on a retrospective basis.

This is also a problematic issue for CTA managers. They have raised concerns that competitors could re-engineer their models by analysing the positions. For others, disclosing their position would expose them to front running issues from other market participants and potentially severely impact their returns.

5. Possible Outcomes

At this stage, a number of technical issues still need to be clarified and each regulator may have a slightly different interpretation on how to implement the proposed changes. In any case CTA managers face a choice when these changes will be implemented. Their options are as follows:

Keep the Index approach:

Keeping the index approach means accepting the constraints described above. Managers will have to fully disclose both methodology and positions and limit the rebalancing frequency to weekly. While this last point might turn out to be less restrictive in its application, the issue of transparency will prove difficult for CTA managers to navigate. The only possible solution, in our view, would be if the regulator accepts a broad strategy description, rather than a comprehensive one, and if the frequency at which managers can disclose the index methodology is not too frequent, and occurs with sufficient delay.

If that is the case, some managers could continue to use the index section of the Directive. At this stage it is difficult to know if and how many funds will continue to use this structure. All CTA managers we have discussed the proposals with - representing 50% of the CTA funds using the index approach - have stated that they could not accommodate the proposal as it is currently drafted.

Use the fund approach and abandon commodity exposure:

A number of CTA managers have built up competitive products and raised substantial assets without exposure to commodities. However, this is not applicable to all managers and investment approaches as it largely depends on the relative contribution of commodities to the overall strategy. For some with little exposure to commodities, this might be an acceptable solution. Some are already working on models excluding commodities and will therefore adapt to the constraint. However, for most managers this option is not realistic given the level of allocation to commodities or their unique characteristics in terms of diversification and decorrelation. For those who abandon the commodity

exposure it could take some time to convince investors that they can effectively run their strategy without exposure to this asset class.

Use the fund approach and maintain commodity exposure:

Over the last two years the development of new structured financial instruments such as certificates has allowed some CTA funds to gain exposure to commodities while using the fund section of the UCITS Directive. Certificates are debt instruments which fall within the categorization of transferable securities and are used to either replicate the performance of the commodities exposure only, or of the entire portfolio. They are bound to the same restriction as any other investment in a UCITS funds and cannot represent more than 10% of the fund allocation.

The composition of the certificate is however not governed by the UCITS rules and it can therefore invest in non-eligible assets such as commodity derivatives. However the regulator requires a certain level of diversification of the assets held. Certificates also have to meet specific constraints in terms of independent valuation and liquidity. They require approval by the regulator and this is done on a case by case basis.

Certificates are not ideal solutions, as for any structured instruments they introduce an additional layer of costs for the UCITS and as well as additional risks.

In our view a large portion of UCITS CTA managers with commodities exposure will select this route in the future, despite its drawbacks. Using certificates allow the manager to maintain the desired commodity exposure while not having to comply with all the upcoming index constraints.

6. Conclusion

While it is difficult to draw any final conclusion concerning the ultimate interpretation of the ESMA guidelines, it seems clear to us that the majority of CTA funds using the index structure will have to rethink the way they implement their strategy.

The use of certificates seems to be the most obvious option to gain commodity exposure. It will however be interesting to see the ESMA's position if all CTA managers start to use this approach. We believe the reasons for banning commodities in UCITS products are outdated. Commodities are an important asset class which helps investors achieve diversification. A number of market participants are lobbying for their inclusion among the list of UCITS eligible assets. For example the Alternative Investment Management Association (AIMA) recently published a position paper about UCITS V[8] that advocates the inclusion of commodities instruments in UCITS. Among other issues AIMA believes that the current treatment of commodity derivatives appears to be "*outdated and in contradiction with the investor protection concerns and the interest of investors in general*". These restrictions are having a contrary effect to the spirit of the law.

Solutions for CTA managers to retain commodity exposure in the UCITS framework do exist, however it is not beneficial to force managers to use complex procedures to gain exposure to a highly regulated, liquid and commonly used asset class.

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[8] AIMA Position paper UCITS V - http://www.aima.org/objects_store/ucits_v_-_position_paper.pdf