

**Hedge Funds and
Funds of Hedge Funds
in the
International
Financial Services Centre
Dublin**

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1. Introduction

Despite the downturn in the global economy, the Irish funds industry and, in particular, the hedge funds industry has continued to grow from strength to strength. Investors demanding greater diversity of investment opportunities in the late 90's brought about huge change in the financial marketplace and the momentum has spilled over into the 21st century. A consequence of this change was the increased acceptance by the traditional funds industry of the potential offered by the hedge fund product as an alternative investment offering. Interest in alternative investment products had been increasing and the need for a regulated product to meet investor demand was unquestioned. Industry analysts identified the European Market as offering huge potential in terms of hedge fund penetration and Ireland, via the Dublin Funds Industry and its regulator, the Central Bank of Ireland, has now established itself as a key domicile for such products.

The jurisdictions in which hedge funds were traditionally domiciled were the Cayman Islands, Bermuda, Mauritius and the British Virgin Islands which meant that hedge funds were seen as less regulated products. In addition, hedge funds were often viewed as high risk because they were operated by investment managers who employed unusual investment techniques which demanded a lot by way of flexibility and little or nothing by way of regulation. However, with the growth of interest in alternative investments, Ireland has put itself forward as a reputable and regulated environment offering greater opportunities to make the hedge fund product available to a wider array of investor. This in turn has thrown down new challenges not only for the hedge fund manager but also for the service providers.

2. What is a Hedge Fund?

While hedge funds currently represent one of the fastest growing areas of the investment management universe, the term does not lend itself easily to definition. There is certainly no legal definition of the term and despite what the name suggests, a hedge fund has little or nothing to do with hedging techniques. On the contrary, the traditional definition is that a hedge fund is an investment vehicle established and marketed in offshore jurisdictions which uses leveraging and shorting as investment techniques and which provides limited protection by way of regulation to investors. In modern terms, almost every non-traditional alternative investment strategy tends to be referred to as a hedge fund strategy.

Most would agree that the following are the characteristics that differentiate the hedge fund from a traditional long only fund:

- A hedge fund manager will utilise differing degrees of leverage to increase exposure (and potential gains) to its given investment strategy. Hedge funds often use leverage to achieve higher returns and short positions to produce profits even in falling markets;
- Flexibility in the methods of compensation of the hedge fund manager and typically performance fees are high;
- The hedge fund manager is given great flexibility as to the products that may be traded and investment objectives and policies of the hedge fund;

- An absolute return performance objective. The hedge fund manager seeks to make absolute returns even in a falling market;
- A prime broker is often used.

3. Why are certain investors attracted to Hedge Funds?

Many investors are attracted to hedge funds as they are considered highly speculative investments suitable only for the wealthy private institutional investor. The risks can often be far greater than traditional long only funds and consequently the returns are perceived to be high. Also, because hedge fund managers frequently have a significant personal stake in the fund, investors may feel that the hedge fund manager stands to lose along with the investor should the fund perform badly.

From an investment manager's perspective, the advantages are indeed great: apart from the attraction of start-ups not having to share the management fee within a large institution, hedge fund managers also charge generous performance fees, essentially a share in the profits generated by the fund. Statistics indicate that these can vary from 20% in the UK to as much as 45% of the absolute return achieved by a hedge fund in the more mature US market.

4. The use of a Prime Broker

Since hedge funds traditionally developed in 'unregulated' jurisdictions, a requirement to employ the services of an independent custodian was not traditionally imposed. Instead, funds in these jurisdictions relied on one main broker through which they would buy and sell securities, and to provide custody facilities as part of its broker service. This broker became to be known as the prime broker. To the extent that the hedge fund required to borrow or to take short positions, the prime broker would be able to provide financing and lend securities to the fund. As the prime broker had custody of the fund's assets, it had security for the securities the fund had borrowed from it. This type of relationship was generally only possible in unregulated jurisdictions, since most regulators would not permit unlimited access by a prime broker to a fund's assets because of the risk of loss to the fund should the prime broker become insolvent. Loss could arise if the prime broker effectively treated the funds' assets as its own, rendering them indistinguishable from its own assets to a liquidator.

When considering the possibility of allowing hedge funds to be established in Ireland, the Central Bank took the view that the taking of title to a hedge fund's assets by a prime broker was incompatible with a custody relationship. Where a prime broker is appointed, the trustee/custodian is essentially replacing its own sub-custody network with the prime broker and its network of agent banks. The assets transferred are no longer owned by the hedge fund and the hedge fund merely has a contractual right against the prime broker for the return of equivalent investments or, if the prime broker is insolvent, a debt owed to it equal to the value of the investments transferred. In addition, where only one prime broker is engaged by a hedge fund, the risks associated with single counterparty exposure arise.

The Central Bank's difficulty with the use of a prime broker lay in the requirements imposed by the Central Bank on Irish custodians in the interest of protecting investors. In summary, a trustee/custodian of a non-UCITS fund (UCITS vehicles are not allowed to be established as hedge funds) is required to exercise due care and diligence in the discharge of its duties and will

be liable for any loss arising from the negligence, fraud, bad faith, wilful default or recklessness of the trustee/custodian in the performance of those duties. In addition, a custodian/trustee of an Irish fund must ensure that the assets of those funds are held within the custodian/trustee's custody network so that in the event of the insolvency of the safekeeping agent the assets are available to the fund. Furthermore, non-cash assets of the fund must be readily identifiable and segregated from the assets of the safekeeping agent.

The Central Bank needed to be satisfied that the appointment of a prime broker still allowed the trustee/custodian of a hedge fund to meet those requirements. Much industry discussion culminated in an important move by the Central Bank in permitting the use of prime brokers for funds authorised by the Central Bank as "professional" and "qualifying" investor funds on certain conditions.

The rationale and requirements worked through by the Central Bank and the industry in achieving this breakthrough have now been embodied in a draft Guidance Note issued by the Central Bank in April 2000. A summary of the Central Bank's current position as set out in the draft Guidance Note is as follows:

- any entity, including prime brokers, to whom the assets of a hedge fund are entrusted must be appointed as a sub-custodian by the trustee/custodian;
- the prime broker, or its parent company, must have a minimum credit rating of A1/P1;
- the prime broker must be regulated as a broker by a recognised regulatory authority and it, or its parent company, must have shareholders' funds in excess of Euro 200 million (or its equivalent in another currency);
- the Central Bank accepts that there are circumstances in which assets of the hedge fund may be transferred out of the control of the trustee/custodian. Where a hedge fund's assets are passed outside the custody network to a prime broker (whether to secure borrowings or for any other reason whatsoever), the Central Bank has set out requirements that must be complied with;
 - (a) the value of assets passed to the prime broker must not exceed the level of the hedge fund's indebtedness to the prime broker;
 - (b) the arrangement must incorporate a procedure to mark positions to market daily in order to monitor the use of assets on an ongoing basis;
 - (c) the prime broker must agree to return the same or equivalent assets to the hedge fund;
 - (d) the arrangement must incorporate a legally enforceable right of set off enabling the hedge fund to set off the value of assets held by the prime broker against the liabilities owed by the hedge fund to the prime broker. The rationale is that in the event of the prime broker's insolvency, the hedge fund should not be left in a position whereby it is in debt to the prime broker and is left to prove as an unsecured creditor for the return of assets used by the prime broker.
- there must be clear disclosure in the hedge fund's promotional/fund-raising documentation

of its proposed relationship with the prime broker.

In addition, the Central Bank has confirmed that the prime broker may take a charge over the assets of the hedge fund held by the prime broker in its capacity as sub-custodian to the hedge fund.

It is worth noting that while the Guidance Note remains in draft format when it is eventually formally issued by the Central Bank amendments to these requirements may be made. However, the above is a clear example of how the Central Bank together with the Dublin funds industry has taken a quantum leap in favour of facilitating the hedge funds industry in Ireland. This solution offers to fund promoters for the first time the possibility of utilising a prime broker for a regulated Irish fund while still allowing the prime broker to use a limited amount of the fund's assets. It is not, however, without its difficulties. For instance, it is unclear what is meant by the Central Bank referring to the hedge fund's "indebtedness" to the prime broker. On the whole, however, it has been broadly welcomed by the industry.

5. Retail, Professional and Qualifying Investor Categories

The "retail", "professional" and "qualifying investor" categories of non-UCITS schemes can be broken down as follows:-

(a) Retail Scheme

If a fund has no minimum subscription or, if it imposes a minimum subscription of less than Euro 125,000, it will be considered to be a "retail" scheme. This type of fund is regularly used where the principal target market is retail investors outside the EU although it can of course be used within the EU but will not benefit from any European UCITS visa.

Even though its investment and borrowing restrictions are quite stringent (quite similar to UCITS), it is a very popular vehicle. A retail scheme's investment restrictions generally prohibit it investing more than 10% of NAV in securities which are not listed or traded on an approved market, more than 10% of NAV in the securities of any one issuer, no more than 10% of NAV in any class of security issued by a single issuer and borrowings cannot exceed 25% of NAV.

The Central Bank has recently approved the creation of retail funds of hedge funds. See further below.

(b) Professional Scheme

If a minimum subscription requirement of at least Euro 125,000 per investor is imposed, a fund will be considered to be a "professional" scheme. That means that the standard investment and borrowing restrictions which we have just mentioned can be disapplied to the extent agreed with the Central Bank.

Currently the Central Bank will allow investment in listed and unlisted securities subject to a general maximum of 20% of NAV in any one issuer. However, it is a case by case approach.

Once appropriate security is put in place a professional scheme can be leveraged to about 1:1 and, its debt securities can be listed on the Irish Stock Exchange, if guaranteed or virtually guaranteed.

(c) *Qualifying Investor Scheme*

To be a qualifying investor scheme, a fund must:

- (i) impose a minimum subscription requirement of Euro 250,000 per investor;
- (ii) be marketed solely to the following qualifying investors:
 - (a) any institution which owns or invests on a discretionary basis at least Euro 25 million or;
 - (b) any individual with a minimum net worth in excess of Euro 1.25 million.

Institutions may not group amounts of less than Euro 250,000 for individual investors unless pursuant to a fully discretionary investment mandate. Qualifying investors must self certify that they meet these minimum criteria, that they are aware of the risk involved in the proposed investment and of the fact that, inherent in such investments, is the potential to lose all of the sum invested.

This structure gives promoters the opportunity to use Dublin vehicles for a complete range of different fund types depending on the requirements of their targeted investors. The Central Bank disappplies its general investment restrictions and borrowing limits for qualifying investor funds. This type of fund also enjoys a similar derogation from the Irish Stock Exchange where again in virtually all cases the Exchange disappplies its investment restrictions.

6. What are the advantages of establishing a Hedge Fund in Ireland?

Given Ireland's position as a highly regulated jurisdiction it is attracting those hedge funds which are suitable in terms of their investment strategies and investor base away from their traditional jurisdictions. A distinct benefit of establishing a hedge fund in Ireland is the strict approval and supervision process relative to those in less regulated jurisdictions. Accordingly, fund promoters are attracted by the prospect of offering a regulated hedge fund product while fund managers, who are already established in Dublin, are familiar with the legislative framework, and have solid relationships with their service providers. Indeed, the established centres are re-inventing themselves. Custodians/trustees have had to deal with the issues arising out of the Central Bank Guidance Note in relation to prime brokers, the appointment of prime brokers as sub-custodians and the charging of funds assets. Administrators have had to deal with more complex valuations, equalisation and performance fee calculations and multi-class structures with differing currency classifications. It is from this established footing rather than from any start-up operation that the growth in Dublin authorised hedge funds will come.

7. Fund of hedge funds – the Way Forward?

As hedge funds move from the alternative to the mainstream, it is projected that the growth in directly invested hedge funds will, to a large extent, be matched by the growth in fund of hedge funds. In the US, sophisticated investors such as pension funds, banks, insurance companies,

high net worth individuals and indeed families often invest in fund of hedge funds taking in different strategies, enhancing their returns and minimising the risks. They are therefore, seen as a popular method of gaining exposure to alternative investment products but what is the position in Ireland in respect of fund of hedge funds?

8. The Central Bank's position on Funds of Hedge Fund schemes

The Central Bank's position in respect of the schemes in which fund of funds schemes can invest is set out in NU 1 of the non-UCITS Notices.

NU 1 (Paragraph 1) provides *inter alia* that a scheme in which an Irish fund of funds scheme can invest must be:

- authorised in Ireland or in another jurisdiction by a supervisory authority established in order to ensure the protection of unit-holders and which in the opinion of the Central Bank, provides an equivalent level of investor protection to that provided under Irish laws, regulations and conditions governing Irish funds; or alternatively
- the management/trustee and custodial arrangements, constitution and investment objectives of any scheme in which it is intended that an investment should be made must provide an equivalent level of investor protection as that provided by schemes authorised under Irish laws and regulations governing Irish funds.

Retail schemes are obliged to comply with the requirements of NU 1 (Paragraph 1) but *professional investor funds* ("PIF") may be granted a derogation on application to the Central Bank. In the case of *qualifying investor funds* ("QIF") on the other hand, the requirements of NU 1 (paragraph 1) are automatically disapplied.

From a fund of hedge funds perspective, this means that an Irish domiciled PIF/QIF fund of hedge funds can invest in hedge funds which are unregulated such as the majority of hedge funds established in the British Virgin Islands and the Cayman Islands where most hedge funds are domiciled. Certain conditions apply however, which include the requirement that where the PIF or QIF proposes to invest in underlying funds which are unregulated this fact should be clearly disclosed in the prospectus and, where appropriate, should include a warning to the effect that the scheme may invest in underlying funds which are unregulated and which will not provide an equivalent level of investor protection to schemes authorised by the Irish Central Bank.

In order to address concerns in relation to inappropriate investment by Irish fund of funds (and feeder) schemes in unregulated schemes, the Central Bank has made a number of amendments to its NU series of notices and in particular, NU 1. The amendments are set out in the Central Bank's Guidance Note 1/01 entitled "Collective investment schemes other than UCITS – Feeder Schemes and Fund of Fund Schemes: Acceptable Investments and Related Issues" which was issued by the Central Bank in December, 2001. The main amendment for our purposes is that a PIF fund of funds scheme is now allowed to invest up to 100% in unregulated schemes, subject to a maximum of 20% in any one such unregulated scheme whereas a QIF fund of funds scheme may now invest up to 100% in unregulated schemes, subject to a maximum of 40% in any one such unregulated scheme.

The diversification requirement of 20% in any one such unregulated scheme in respect of PIFs

seems to correspond to most hedge fund managers diversification needs. This seems, therefore, to herald the way forward for PIF fund of funds schemes being the vehicle that hedge fund managers will adopt in the future for fund of hedge funds in Ireland. Similarly, QIF fund of hedge funds schemes may also become popular with hedge fund managers but it is likely that to achieve sufficient diversification only a maximum of 20% will be invested in any one scheme despite the fact that a maximum of 40% is permitted by the Central Bank.

Other points of interest to note in respect of Guidance Note 1/01 are as follows:

- *Fund of funds schemes investing in other fund of funds schemes (NU 1, paragraph 4)* – This paragraph prohibits a retail fund of funds scheme from investing in another fund of funds scheme. A PIF scheme is permitted to derogate from the requirement provided investment in other fund of funds does not exceed 10% of net assets. The requirement is disapplied in the case of a QIF. Therefore, a PIF or QIF fund of hedge funds investing in another fund of hedge funds may be permitted although the Central Bank requires that any such proposed investment should be clearly disclosed. In this regard, disclosure should focus on the implications of the policy regarding increased costs to investors (i.e. the fact that fees will arise at three levels – the Irish scheme, the underlying fund of funds and the underlying funds in which the fund of funds invests) and the resultant lack of transparency in investments.
- *Fund of funds schemes investing in feeder fund schemes* – Guidance Note 1/01 stipulates that a Retail/PIF fund of funds proposing to invest in a feeder fund is not permitted but is so permitted in the case of a QIF. Accordingly, a QIF fund of hedge funds may invest in a feeder scheme where suitable disclosure regarding increased costs and lack of transparency is provided.

9. Retail Funds of Hedge Funds

In December 2002 the Central Bank issued a new non-UCITS Notice (NU 25) on "Funds of unregulated fund schemes" which followed consultation with members of the funds industry. This Notice permits the authorisation of so-called "funds of hedge funds" which can be sold to retail investors. It is anticipated that the introduction of this new fund variation will serve to further boost Ireland's growing hedge fund industry. It is expected that the new Irish fund of hedge funds will be popular with retail investors seeking higher returns than those generated by traditional long only funds.

Funds of regulated funds schemes will continue to be authorised under NU 1 and are permitted to invest up to 10 per cent. of net asset value in unregulated underlying collective investment schemes. Such unregulated funds schemes are those which fall outside the scope of Annex 2 to the Central Bank's Guidance Note 1/01 which sets out acceptable investments in respect of fund of regulated funds schemes.

NU 25 now provides that a scheme may invest more than 10 per cent. of net asset value in unregulated schemes, such as hedge funds and other alternative investment funds, subject to certain rules.

In relation to a fund of unregulated funds scheme, it may not invest more than 5 per cent. of net asset value in any one unregulated scheme or more than 10 per cent. of net asset value in schemes managed by the same management company, which definition includes related

companies or institutions. Further, these limits may be raised to 10 per cent. and 20 per cent. respectively, if the management company of the underlying scheme(s) is authorised to provide investment management services in an OECD jurisdiction.

The underlying unregulated schemes must be subject to independent audit and must have arrangements in place whereby all assets are held by a party/parties independent of the manager of the underlying schemes.

Although NU 25 relates to "retail" collective investment schemes, there is a minimum subscription requirement of Euro 12,500. However, this requirement may be disapplied where acceptable arrangements are in place to provide full protection to the capital subscribed by investors.

Specific additional disclosure in a scheme's prospectus is the main thrust of NU 25. The Notice sets out additional risk warning wording which must be included in a prominent position in the offering document. The prospectus must also provide information on:-

1. the investment policies of underlying schemes in which the scheme proposes to invest and any risks associated therewith;
2. the levels of leverage employed by the underlying schemes;
3. the expected impact of all fees charged on overall performance;
4. the cumulative effect of any performance fees;
5. potential liquidity problems;
6. potential valuation difficulties.

There is also a requirement that the periodic reports of the fund of funds provide certain additional information on the underlying schemes.

The prospectus must provide a clear explanation of the alternative investment strategies that the underlying schemes may employ. It must also describe the diversification policies of the scheme and provide information on the extent to which the scheme may invest in underlying schemes that have demonstrated a high volatility of return.

Before the Central Bank will authorise a scheme under NU 25 it must be satisfied that the management of the scheme and its delegates, where applicable, demonstrate appropriate experience and expertise in relation to alternative investment schemes. To satisfy the Bank's requirement, detailed information must be submitted to show that appropriate controls and systems are in place to monitor the activities and overall leverage of the underlying schemes, their managers and any risk assessment procedures, on a continuing basis. Any submission should include information on the extent to which the management of the scheme (and its delegates) will review the background, expertise and experience of the underlying managers, the risks of the underlying schemes and the strategies being employed by them.

As provided for in NU 1, a fund of unregulated funds scheme may not invest in units of another fund of funds scheme, whether authorised under NU 1 or NU 25 or established outside Ireland.

Similarly, where a scheme invests in units of a collective investment scheme managed by the same management company or by an associated or related company, the manager of the scheme in which the investment is being made must waive any preliminary/initial/redemption fee that it would normally charge. Further, where a commission is received by the manager of a scheme by virtue of an investment in units of another collective investment scheme, this commission must be paid into the property of the fund of funds scheme.

Where the fund of unregulated funds scheme is open-ended it must provide at least one dealing day per month to facilitate redemptions. The scheme may, however, retain up to 10% of redemption proceeds, where this reflects the redemption policy of the underlying scheme, until such time as the full redemption proceeds from the underlying scheme are received. The Central Bank recognise that there may be circumstances where the underlying scheme may not permit holdings to be redeemed on as frequent a basis as that applying to the fund of unregulated funds and as a result the fund of unregulated funds cannot accurately determine its net asset value. In such circumstances the scheme could calculate an estimated net asset value which would be subject to adjustment once the redemption proceeds from the underlying scheme had been received and a final net asset value is calculated. If the scheme adopts such a redemption policy there must be full disclosure in the prospectus with the time limits for payment of redemption proceeds clearly set out. The maximum interval permitted between submission of a redemption request and payment of settlement proceeds must not, however, exceed 95 calendar days.

The publication of NU 25 has been welcomed by the industry as a reflection of the Central Bank's willingness to respond quickly to market requirements and indeed is a sign of the Central Bank's growing sense of comfort with the hedge fund product generally. Ireland's position as a regulated jurisdiction has now been established and it is attracting hedge funds away from their traditional jurisdictions. It is projected that the growth in directly invested hedge funds will, to a large extent, be matched by the growth in funds of hedge funds.

10. Conclusion

The regulatory environment in Ireland, in the context of hedge funds and funds of hedge funds generally, is central to the future development of the funds industry as a whole. Pragmatic regulation of hedge funds is essential if alternative investment products are to thrive in the flexible environment in which they must operate to attain their objectives. The Central Bank, as regulator, has facilitated the development of the Irish funds industry and the success of the IFSC has undoubtedly been due primarily to the legal and regulatory framework that is in place and the reputation and integrity of the Central Bank. With this in mind, it must be remembered that the secret of good regulation is to strike a balance between protecting the investor and giving fund managers sufficient discretion and flexibility to do their job effectively.

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