

Hedge Funds and Alternative Investment in Ireland

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1. Introduction

The downturn in the global economy has resulted in increased interest in hedge funds and alternative investment products. Investors, seeking returns in falling or stagnant markets, are increasingly turning away from traditional investment strategies and seeking access to short-selling, leveraged and derivative techniques. This rapid growth and the desire to offer alternative investment products to new classes of investor has thrown down new challenges for regulators, hedge fund managers and service providers. Across the financial sector reforms are being considered and new regulation introduced.

Over the past 15 years Ireland has emerged as a favoured fund domicile in Europe for alternative investment funds. Recent industry data suggests that in excess of €200 billion¹ in “alternative investment²” assets are administered in Ireland, primarily in Dublin. While the industry has developed at an impressive rate, it is fair to say that, not unusually, law and regulation has struggled to keep a pace.

The explosion in the growth and popularity of hedge funds has occurred against a backdrop of increased activity by global regulators. Recent corporate scandals and the entry of non-sophisticated investors into the hedge funds sector have prompted regulators to examine the alternative investment markets with greater scrutiny than ever before.

The purpose of this memorandum is to give an overview of the Irish alternative investment regime and the regulatory framework. It will examine the legal structures and investor categories which are available, the use of prime brokers, establishment of funds of funds and feeder fund schemes. It also addresses proposed developments to the Irish legal and regulatory regime to cope with the current market demands, including increases in counterparty exposure limits for securities lending, related issues such as the adoption of PRIMA³ and the impact of the EU Financial Services Action Plan.

2. The New Regulatory Environment

“In the end the responsibility is the industry’s, whether it is investment funds or any other sector. In the new environment, financial institutions, will not thrive unless they set high ethical and governance standards and stick to them. Otherwise, sooner or later, the markets will punish them to the relic of history.”⁴

All participants in the alternative investment market and especially hedge fund managers and fund promoters need to be aware of the impact that current and proposed regulation will have on their activities. As the industry succeeds in attracting mainstream investors, both institutional and retail, it appears that it will also have to pay increasing attention to compliance with regulatory requirements, which only a couple of years ago would have been unimaginable. Indeed some might argue that the concept of “regulation” is anathema to the hedge fund arena dominated as it is by the free-spirited entrepreneur⁵.

On a global level, the impact of the SEC hedge fund sweep, the US Patriot Act, Sarbanes-Oxley Act and the European Commission’s Financial Services Action Plan (“FSAP”)⁶ is already being felt. For

1 Source: Dublin Funds Industry Association Survey, June 2003.

2 “Alternative Investments” were defined in the DFIA survey to include hedge funds, fund of funds, private equity funds and “other forms of alternative investment strategies”.

3 Place of the Relevant Intermediary Approach. This concept is further discussed in Section 13

4 Director General Alexander Schaub, Director General of DG Internal Market FEFSI Fund Forum, Brussels, 19 September 2003.

5 See Hedge Funds: Law and Regulation, Iain Cullen and Helen Parry: Regulator, Creep and Convergence Hedge Funds and The Regulators by Dick Frase, Dechert. Sweet & Maxwell, 2001, Chapter 2.

6 The FSAP is a series of policy objectives and specific measures to improve the European Single Market for financial

European participants the FSAP brings mixed blessings. Its aim of creating a real single European market for financial services will enable capital and financial services to flow freely throughout the EU. Economic research conducted for the European Commission predicted that the integration of EU financial markets pursuant to the FSAP will bring significant benefits to industry, investors and consumers. Estimates from the research forecast a direct increase in EU-wide real GDP by 1.1% (€130 billion in 2002 prices) over a decade or so. Research also predicted an increase in total employment by 0.5%. Among the benefits highlighted were a reduction in the cost of equity capital by 0.5% and a 0.4% decrease in the cost of corporate bond finance is expected to follow⁷.

However, at the same time its constituent legislative measures impose prudential safeguards and increased investor protection as is evident from new EC Directives on market abuse and insider dealing, on the supervision of pension funds and EU harmonised prospecti⁸.

On the hedge fund front a UK MEP, John Purvis, has recently produced a working document on hedge funds and derivatives, which was presented to the European Parliament's Committee on Economic and Monetary Affairs with a view to opening a discussion on the possible introduction of a harmonised European hedge fund for sale cross-border within the European Union⁹. Recent experience on the introduction of the new UCITS Directives¹⁰ would suggest that this is a very ambitious objective indeed.

Other developments at EU level have seen the issue of an Action Plan on Corporate Governance and Company Law in May 2003¹¹ (issued in response to recent corporate scandals on both sides of the Atlantic) and a proposal to create a new financial services committee organisational structure in the banking, insurance and investment funds sectors, similar to that established in the EU securities market under the FSAP¹². This would see the establishment of four new committees¹³ to assist the Commission in the implementation and function of new Directives in these areas.

The financial reporting obligations of institutions are also being upgraded and an EU Regulation requiring all EU companies listed on a regulated market to prepare their accounts in accordance with international accounting standards (IAS) from 2005¹⁴ has been adopted.

Ireland, like all EU Member States, will be required to implement these measures into its domestic law and, as an open-economy, it will feel the impact of US and other foreign regulation. It also has its own

services over a five years period. The European Commission adopted it on 11 May 1999. The FSAP sets out priorities and time-scales for legislative and other measures to tackle specific strategic objectives, including completing a single wholesale financial market, developing open and secure markets for retail financial services and ensuring the continued stability of EU financial markets. The Action Plan also addressed broader issues concerning the European financial market, including the elimination of tax obstacles and creating an efficient and transparent legal system for corporate governance.

7 As published in the European Commission's Seventh Report on the FSAP on 2 December 2002. Sources: LE study for DG Internal Market and IVIE

8 Directives 2003/6/EC, and 2003/41/EC and 2003/71/EC respectively

9 European Parliament Working Document on Hedge Funds and Derivatives dated 5 August 2003. Committee on Economic and Monetary Affairs. Rapporteur: John Purvis.

10 Directives 2001/107/EC and 2001/108/EC

11 COM (2003) 284(01) from the European Commission to the Council and the Parliament Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward

12 See European Commission Press Releases IP/02/195 and IP/03/1507

13 The first two, the European Banking Committee (EBC) and European Insurance and Occupational Pensions Committee (EIOPC) will assist the Commission in adopting implementing measures for EU Directives. In addition, responsibility for overseeing the implementation of EU laws on UCITS would be transferred from the UCITS Contact Committee to the existing European Securities Committee (ESC) and Committee of European Securities Regulators (CESR). Finally, the package would also establish two committees bringing together national supervisors, the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Similar to the CESR for securities Directives, these new entities would aim to improve the practical implementation of EU law in their respective fields in the Member States.

14 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards

domestic rules in relation to hedge funds and alternative investment, most of which are set down by the Irish Financial Services Regulatory Authority (“IFSRA”). Regulation is undoubtedly making itself felt.

3. Ireland as a Hedge Funds Centre

As an international fund domicile, Ireland presents itself amongst the most flexible and advantageous in the world due in no small part to the wide variety of fund vehicles which may be established under the Irish legal and regulatory system. While this status is not in doubt the case (particularly when IFSRA is compared to many of its peers) there is a strong case to be made for even greater flexibility.

A perceived 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 IFSRA’s Guidance Note in relation to the use of prime brokerage services, the appointment of prime brokers as sub-custodians and the creation of security over fund assets. Administrators have had to deal with more complex valuations, equalisation and performance fee calculations and multi-class structures with differing currency classifications.

Ireland has already pioneered some of the most radical changes to the European alternative investment market, which for years had lagged behind its more developed counterpart in the United States. At present it is possible to establish a variety of hedge funds schemes, to use prime brokers, to use derivative products and other alternative investment strategies and to establish funds of funds and feeder fund structures. The marketplace has been opened to retail investors, who may gain exposure to hedge funds through fund of funds. Recent developments include changes to exposure limits when using prime brokers, allowing a scheme to post excess collateral to a counterparty in order to secure its obligations, rather than simply being able to post collateral up to the level of the scheme's indebtedness. In addition, the implementation in Ireland of UCITS III¹⁵ accommodates the use of some hedge fund strategies by EU harmonised funds (i.e. funds which are permitted to market their units across the EU on the basis of authorisation in their “home” Member State).

Ireland’s position in the mutual funds area may also be attributed to:

- the successful establishment of the International Financial Services Centre in Dublin which has encouraged some of the world’s leading financial institutions to locate to Ireland;
- both these institutions and the Irish regulatory authorities have accumulated a number of years of experience in dealing with hedge funds. Therefore, there is a familiarity and acceptance of more complex investment strategies utilized by hedge fund managers;
- the existence of a developed national infrastructure and skilled workforce;
- under Irish tax laws collective investment schemes and their investors will not be liable to tax on income or gains unless the scheme has Irish resident or ordinarily resident unitholders, although even if that is the case there are some exemptions depending on the nature of the unitholders. Further, in most cases stamp duty and gift/inheritance tax is not payable on the transfer of units in a scheme;
- management companies, general partners or trustees/custodians etc are entitled to a 12.5% tax rate on profits;
- the willingness of the Irish regulatory authorities, notably IFSRA, to adapt and develop its regulation to keep pace with developments in the mutual funds industry; and

¹⁵ UCITS III is the common name of the EC Product and Management Company Directives, which were implemented in Ireland by European Communities (Undertakings for Collective Investment in Transferable Securities) (Amendment) Regulations, 2003 and European Communities (Undertakings for Collective Investment in Transferable Securities) (Amendment)(No.2) Regulations, 2003.

- strong Government support including early implementation of relevant EU Directives and the introduction of legislation supporting the funds industry.

4. Hedge Funds - Legal Structures

The starting point for any discussion on Irish hedge funds are the legal structures available to fund promoters. Ireland has a specific legal framework for investment funds, which is made up of domestic Irish legislation, EU regulations and implemented directives and the rules of IFSRA¹⁶.

Hedge funds in Ireland are usually established in the form of either a unit trust or an investment company with variable capital. These schemes may in turn be established as single or umbrella funds. The choice of structure will largely depend on taxation and marketing issues in the country where it is proposed to market the fund. In addition, the use of leverage and the necessity to segregate the assets of sub-funds in an umbrella structure is an important consideration, as further discussed below.

4.1 Unit Trusts

A unit trust is an unincorporated fund constituted by a trust deed made between a management company and a trustee/custodian. They are established in Ireland under the Unit Trusts Act, 1990 (as amended). In addition to this legislation, IFSRA imposes its own set of regulatory notices, the NU (Non-UCITS) Notices¹⁷ and Guidance Notes, which must be observed.

The actual rules of the fund and the rights of the investors are set out in the trust deed. As a unit trust does not have a separate legal existence, it does not have the capacity to contract and cannot sue or be sued. The assets of the fund are held in the name of the trustee/custodian but are at all times beneficially owned by the unitholders. Unitholders are entitled to an undivided share in the assets but are not entitled to claim ownership of any specific asset. The trust is managed by a management company, which may in turn delegate its responsibilities to various service providers, e.g. investment managers, administrators or distributors. An Irish based administrator must carry out the day-to-day administration of the fund in Ireland. Custody of all assets and cash must be provided by an Irish based custodian who will in turn enter into global/sub-custody arrangements for non-Irish investments.

A distinct advantage of the unit trust scheme is that, in an umbrella structure (which is further considered below) it is possible to provide for segregation of the assets and liabilities of each sub-fund from those of every other sub-fund within the umbrella. Such segregation is not as clear for sub-funds within an umbrella type investment company. However, it is difficult to clearly establish that an Irish authorised unit trust is actually tax resident in Ireland. Most of Ireland's double tax treaty counterparties consider unit trusts as being tax transparent and, therefore, may regard the residency of the unitholders as being the relevant criterion. Authorised unit trusts are not subject to tax in Ireland.

4.2 Investment Companies

Investment companies are incorporated entities with their own legal capacity as provided in their memoranda of association. The principle piece of Irish legislation governing these structures is Part XIII of the Irish Companies Act, 1990 (as amended). They are also regulated by IFSRA and are required to adhere to the applicable Notices and Guidance Notes.

Investment companies have the capacity to enter into contracts and to sue and be sued. A board of

¹⁶ This legislation includes, the UCITS Regulations, 1989 (as amended and consolidated in 2003 Regulations), the Unit Trusts Act 1990 (as amended), Part XIII of the Companies Act 1990 (as amended), the Investment Limited Partnerships Act 1994 (as amended) and the IFSRA's UCITS Notices, NU Notices and Guidance Notes

¹⁷ At present hedge funds cannot be established under the UCITS Regulations. However, UCITS III funds may accommodate some hedge fund strategies as further discussed in Section 5.3.

directors provides their day-to-day management and control with ultimate control resting with shareholders. The day-to-day administration of investment companies must be carried out in Ireland by the investment company itself or by an Irish based administrator. Custody of all assets and cash of the investment company must be provided by an Irish based custodian who will in turn enter into global/sub-custody arrangements for non-Irish investments.

Sub-funds within an umbrella type investment company are constituted as share classes and as a result the investment company as a whole is in theory liable to third parties for outstanding debts. There is, therefore, potential for a creditor of one sub-fund, where that sub-fund is unable to discharge its liabilities to that creditor, seeking recourse against the assets of another sub-fund within the company. Whilst this is not normally an issue in un-leveraged umbrella investment company structures, it is very much an issue where one or more sub-funds are engaging in leverage as part of their investment policy whether this is through straight borrowings (loans, note issues etc) or through leveraging the portfolio using derivative instruments. This cross-liability issue can be overcome by employing non-recourse documentation and, to a lesser extent, by structuring the leverage through a subsidiary of the relevant sub-fund, although the latter approach should be viewed sceptically¹⁸.

Authorised investment companies are not subject to tax in Ireland.

4.3 Single or Umbrella Fund?

Both unit trusts and investment funds may be established as either single funds or as umbrella funds. An umbrella fund is, essentially, one in which there is an overall “parent” structure with a number of sub-funds hanging from the parent with shares/units being issued in each of the sub-funds. The rationale behind using an umbrella structure is to be able to offer investors a variety of different products within one structure while at the same time benefiting from significant reductions in set-up timing and set-up cost. Each sub-fund of an umbrella fund must comply with the laws, regulations and conditions governing mutual funds and the prior approval of IFSRA must be obtained for the creation of any new sub-fund.

It is possible to establish an unlimited number of sub-funds within an umbrella scheme and umbrella schemes are probably now the most frequently used schemes.

4.4 Funds of Funds and Feeder Funds

Funds which feed into either another collective investment scheme (feeder funds) or several other schemes (fund of funds) can also be established in Ireland. These structures can offer significant flexibility. The collective investment scheme into which a feeder fund feeds may be established in Ireland or in another jurisdiction where, for example, there are foreign ownership restrictions in the other jurisdiction which can be overcome by investing through a local scheme. It is currently possible to establish retail funds of funds in Ireland, as well as those targeting more sophisticated investors.

The precise rules applicable to funds of funds and feeder fund schemes are set out below in sections 9, 10 and 11.

5. Investor Categories – Retail, Professional and Qualifying Investors

Once the appropriate legal structure has been chosen, consideration must be given to the target investor. Under the Irish regime, investment and borrowing restrictions are largely dependent upon the type of investor. Very few restrictions (if any) are placed upon funds targeting sophisticated investors, while increasing restriction is imposed where unsophisticated or retail investors are chosen. IFSRA has long recognised the demand for alternative investment products, which can be sold to sophisticated investors

¹⁸ Legislative changes are currently being formulated to provide for protected cells and to allow cross-investment by sub-funds within investment companies.

and allow greater flexibility in relation to investment restrictions and borrowings. As a result, specific investor categories were created and hedge funds may be established in Ireland as professional investor funds (“PIFs”) or qualifying investor funds (“QIFs”). PIFs and QIFs afford a considerable deal of flexibility with regard to investment strategies, leveraging and transactions involving derivative instruments.

To date, IFSRA has not permitted the establishment of retail hedge funds, however, it does permit retail funds of hedge funds¹⁹. Therefore, it is possible under current regulation for retail investors to have at least indirect access to alternative investment products.

5.1 Retail Schemes

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 are retail investors outside the EU. Even though its investment and borrowing restrictions are quite stringent, 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.

There are currently two primary ways in which retail investors can gain access to alternative investment strategies. Retail funds of hedge funds may be established in accordance with IFSRA Notice NU 25, which is further discussed in Section 10. Secondly, the implementation in Ireland of UCITS III accommodates some alternative investment strategies for EU harmonised funds. The principle advantage of such harmonised funds is that they may market their units across the EU on the basis of their “home” state authorisation without having to apply for separate authorisation in each Member State. However, the usefulness of this “European marketing passport” is somewhat curtailed by the stringent investment restrictions applicable to UCITS schemes.

The UCITS III Product Directive²⁰ significantly widens the range of investment possibilities for UCITS Funds. Under the previous UCITS regime (“UCITS I”)²¹, investment in financial derivative instruments was only permitted for the purpose of efficient portfolio management or currency hedging. Under UCITS III a harmonised UCITS may invest in financial derivative instruments as part of its investment policy.

However, a UCITS may only invest in a derivative where the underlying assets consist of transferable securities, units in other collective investment schemes, deposits, money market instruments, financial indices, interest rates, foreign exchange rates or currencies. Investment in the underlying assets must be specifically provided for in the investment objectives of the UCITS. Thus, harmonised UCITS may not make an investment through a financial derivative instrument, which it would be prohibited from making directly.

Investment in derivative instruments, which are traded on a regulated market as well as those dealt over the counter, will be permitted. However, specific conditions are set out regarding investment in OTC derivatives. The fund’s “global exposure” relating to derivatives must not exceed the total net asset value of the UCITS. This exposure is calculated in relation to the value of the underlying assets, the counterparty risk, future market movements and time available to liquidate the positions. The difficulty in calculating global exposure in relation to these criteria has already been identified as being open to different interpretations which are currently being debated by EU Member State authorities.

¹⁹ The Dublin Funds Industry Association is currently formulating proposals for a retail hedge fund.

²⁰ EC Directive 2001/108/EC implemented in Ireland by European Communities (Undertakings for Collective Investment in Transferable Securities) (Amendment) Regulations 2003

²¹ The first attempt to reform the UCITS Directives (so called “UCITS II”) failed.

In the case of OTC derivatives, the counterparties must be institutions subject to prudential supervision, the OTC derivatives must be subject to a reliable and verifiable valuation on a daily basis and must be capable of being sold, liquidated or closed by an offsetting transaction at any time at their fair value and there must be no more than a 5% exposure to a single counterparty which can be increased to 10% if the counterparty is a bank. How exposure to a single counterparty is to be calculated has not yet been determined. Equally, where the line will be drawn in relation to the type of instrument which will be permitted has yet to be determined.

A UCITS investing in financial derivatives as an asset class must maintain adequate risk management systems. Where relevant the prospectus must disclose that the use of derivatives is permitted; the aim of the derivatives strategy and where the UCITS will primarily use derivatives to achieve its investment objectives this must be prominently disclosed along with the possible impact of use of derivatives on the risk profile and volatility of return of the UCITS.

5.2 Professional Investor Schemes²²

The conditions and restrictions set out in IFSRA's Notices, in particular those related to investment and borrowing, may be disapplied in the case of schemes marketing their units to professional investors only. Notices may be disapplied in whole or in part on a case-by-case basis.

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. The aggregate of an investor's investments in the sub-funds of an umbrella scheme can be taken into account for the purposes of determining this requirement. The amounts of subsequent subscriptions from investors who have already subscribed the minimum subscription of Euro 125,000 are unrestricted. There are limited exceptions to this subscription requirement where the investor is the management company, general partner, provides investment management/advice or is a qualifying director or employee or one of those entities.

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

Once appropriate security is put in place a professional scheme can be leveraged to about 1:1.

The prospectus of the scheme must contain appropriate risk disclosures and quantitative parameters which limit the extent of leverage which will be engaged in by the scheme and the extent to which the investments of the scheme will be concentrated in a single or narrow range of exposures. These limits should be relevant to the investment policies of the scheme. Where the scheme may employ more than one investment policy different limits may apply to each such policy.

5.3 Qualifying Investor Scheme²³

The conditions and restrictions related to investment objectives and policies and leverage set out in IFSRA's Notices, are disapplied in full in respect of schemes marketing solely to qualifying investors. All provisions contained in Notices which do not relate to investment objectives, investment policies or to the level of leverage employed apply in full to these schemes, unless specific derogations are granted by IFSRA.

QIFs, which are structured as investment companies, must comply with the principle of spreading investment risk as required under section 253(2)(a) of the Companies Act, 1990 Part XIII. This restriction does not apply to unit trust schemes. In practice a minimal level of risk spreading may meet this requirement.

²² Ref IFSRA Notice NU 12.

²³ Ref IFSRA Notice NU 24.

To qualify as a QIF, a scheme 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.

As in the case of PIFs there are some limited exceptions to these criteria where the investor is the management company, general partner, provides investment management/advice or is a qualifying director or employee or one of those entities. 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 Irish vehicles for a complete range of different fund types depending on the requirements of their targeted investors. IFSRA disappplies its general investment restrictions and borrowing limits for QIFs. This type of fund also enjoys a similar derogation from the Irish Stock Exchange requirements where again in virtually all cases the Exchange disappplies its investment restrictions.

6. The use of a Prime Broker

Since hedge funds have 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 brokerage service. This broker came 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 became insolvent. Loss could arise if the prime broker effectively treated the funds' assets as its own, rendering them indistinguishable from its own assets.

When considering the possibility of allowing hedge funds to be established in Ireland, IFSRA 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.

IFSRA's difficulty with the use of a prime broker lay in the requirements imposed by IFSRA on Irish custodians. In summary, a trustee/custodian of a fund 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.

IFSRA 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 IFSRA in permitting the use of prime brokers for funds authorised by IFSRA as PIFs and QIFs on certain conditions.

IFSRA recently issued a revised draft Guidance Note in relation to prime brokers and other financing counterparties to Irish domiciled alternative investment schemes and hedge funds. The new draft Guidance Note replaces existing rules (as set out in draft Guidance Note 2/00²⁴) and is the result of extensive negotiations between the Dublin Funds Industry Association and IFSRA. The focus of the new rules is to facilitate trading strategies by permitting increased exposure to a counterparty and to speed up the approval process. IFSRA have confirmed that the new draft Guidance Note is now the accepted basis of the rules governing use of primebrokers. Notwithstanding this, negotiations between the Dublin Funds Industry Association and IFSRA continue on issues relating to prime brokers and the finalisation of the Guidance Note.

A summary of IFSRA 's current position as set out in the draft Guidance Note is as follows:

A PIF or QIF may enter into relationships with prime brokers where the scheme can meet with the following requirements:

- (a) A PIF and a QIF may pass assets of the scheme to a prime broker which assets the prime broker may pledge, lend, rehypothecate or otherwise utilise for its own purposes under the following conditions:
 - (i) In the case of a PIF, the assets so passed shall not exceed 140% of the level of the PIF's indebtedness to the prime broker. For the purposes of this limitation, "assets so passed" will include cash on deposit with the prime broker;
In the case of a QIF there is no limit on the extent to which assets may be passed to the prime broker, but the extent to which assets are available to the prime broker must be fully disclosed in the prospectus issued by the QIF;
 - (ii) The arrangement incorporates a procedure to mark positions to market daily, in order to meet the above requirements on an ongoing basis;
 - (iii) The prime broker must agree to return the same or equivalent securities to the scheme;
 - (iv) The arrangement incorporates a legally enforceable right of set-off for the scheme.
- (b) Where the prime broker will hold assets of the scheme, other than as provided for above, the prime broker must be appointed as a sub-custodian by the trustee. While the prime broker may take a charge over those asset , the assets must be held in accordance with the provisions of paragraphs 15-17 of IFSRA Notice NU 7 which require the assets to be held in segregated custody on a fiduciary basis (where recognised) and be clearly identifiable as assets of the fund.
- (c) The prime broker must be regulated to provide prime broker services by a recognised regulatory authority, and it, or its parent company, must have shareholders' funds in excess of €200 million (or its equivalent in another currency). In addition, the prime broker, or its parent company, must have a minimum credit rating of A1/P1.

Where a prime broker is appointed by a PIF or QIF or in the case of an OTC counterparty risk exposure in excess of 40% of net assets, the trustee should confirm that at a minimum it will:

- (i) receive daily reports from the prime broker on assets held by the prime broker outside the

²⁴ The rules set out in Guidance Note (2/00) had formed the basis on which IFSRA permitted the appointment of prime brokers to Irish funds since its issue in April 2000.

- custody network and valuations for those positions;
- (ii) reconcile those positions with its own records, on a nominal basis;
 - (iii) on each valuation point, reconcile assets on a valuation basis. Where the period between valuation points exceeds two weeks, the valuations received from the PB should be independently verified;
 - (iv) any discrepancies arising from the reconciliation, which cannot be satisfactorily resolved with the PB, should be reported to the management of the PIF or QIF requesting the scheme to take remedial action;
 - (v) request confirmation from the prime broker that it does not hold assets other than in accordance with the requirements of the draft Guidance Note and the provisions of the sub-custody agreement.

There must be clear disclosure in the hedge fund's promotional/fund-raising documentation of its proposed relationship with the prime broker. In the case of a QIF, this description must mention that the normal restriction of 140% of indebtedness does not apply and provide the extent to which exposure will or will not be limited.

IFSRA will no longer formally review prime brokerage documentation, subject to confirmation from the fund's legal advisers that the documentation incorporates IFSRA's rules regarding appointment of prime brokers and that the agreement does not conflict with the provisions of the Guidance Note.

7. Permitted Investment Instruments and Applicable Restrictions

As noted above, the investment and borrowing restrictions applicable to hedge funds are dependent upon the relevant investor category. Most standard restrictions are disapplied for PIFs and completely disapplied for QIF schemes. Thus such schemes are permitted to invest in a wide range of instruments including derivatives, futures and options, units of other collective investment schemes etc.

Indeed, schemes can invest in one particular type of instrument or adopt a hybrid investment strategy, investing in other funds, futures and options and use leverage and derivatives. In many cases IFSRA has adopted specific Notices to accommodate such investment strategies, including:

- Fund of Funds Schemes (IFSRA Notice NU 1)
- Futures and Options Schemes – Capital Protected (IFSRA Notice NU 20)
- Leveraged Futures and Options Schemes (IFSRA Notice NU 21);
- Feeder Schemes (IFSRA Notice NU 22);
- Multi-Advisor Schemes (Guidance Note 1/97)

Where a directly investing scheme is authorised with mixed investment objectives, investment limits applicable to a particular type of scheme are calculated by reference to that portion of the scheme's overall net asset value invested in that fashion. However, where a principal objective is, and/or the investment policies provides for, a significant investment in other collective investment schemes, as set out below, investment limits may be calculated by reference to the net asset value of the scheme rather than on a pro-rata basis.

Once appropriate disclosure regarding the use of these instruments is made in the prospectus and the constitutive documents of the fund grant the power to the fund to engage in such instruments, a QIF (or a PIF scheme provided suitable derogations have been granted) will be able to trade in these investments on an almost unlimited basis.

The most significant problem facing funds in utilising such instruments is the limit imposed on the posting of collateral to counterparties in the context of OTC transactions. This issue has been addressed

in Section 6 in relation to the use of prime brokers and similar restrictions apply to a fund entering into swaps, e.g. pursuant to ISDA agreements²⁵. The main concerns relate to the restrictions on the holding of assets as security outside the custodian network (as is usually required) and the limits on posting excess collateral.

Currently, IFSRA will permit excess collateral to be posted to a counterparty as security for a fund's obligations provided appropriate disclosure is made in the prospectus and the exact limits will be imposed on a case-by-case basis. However, as discussed below, there are moves to solve this problem and establish more flexible rules.

8. Prime Brokers, OTC Transactions and other Developments

The restrictions imposed on funds and their market counterparties (e.g. prime brokers and derivatives counterparties) on the posting of collateral have also been addressed in the new draft Guidance Note.

A summary of IFSRA's current position as set out in the draft Guidance Note is as follows:

A PIF or QIF may enter into arrangements with other counterparties, including counterparties to OTC financial derivative instruments, provided that:

- (a) The counterparty has a minimum credit rating of A2/P2;
- (b) In the case of a PIF, risk exposure to the counterparty must not exceed 20% of net asset value. This limit may be raised to 30% in the case of a credit institution which falls under one of the following categories:
 - a credit institution authorised in the European Economic Area (EEA);
 - a credit institution authorised within a signatory state, other than a Member State of the EEA, to the Basle Capital Convergence Agreement of July 1988 (Switzerland, Canada, Japan, United States);
 - a credit institution authorised in Australia, Guernsey, Isle of Man, Jersey or New Zealand.
- (c) These limits are not applicable to QIFs, but transactions by QIFs with counterparties, which may give rise to counterparty risk exposure in excess of 40% of net asset value must be made in accordance with the conditions applicable to the appointment of prime brokers.

Counterparty risk exposure must be measured on an aggregate basis and will include, for example, exposures arising from investments in securities issued by the counterparty, amounts held on deposit and OTC derivative positions.

As in the case of prime brokers, full disclosure of the arrangement between the fund and other financing counterparties must be made in the prospectus.

9. Funds of Hedge Fund Schemes

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 funds 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?

The specific conditions and limits, which IFSRA imposes in respect fund of funds schemes, are set out IFSRA Notice NU 1 (Fund of Funds schemes). The conditions and limits applicable to all collective

²⁵ International Swaps and Derivatives Association, Inc.

investment schemes, as set out in the other IFSRA NU Notices, also apply to fund of funds schemes except insofar as they are effectively disapplied by IFSRA Notice NU 1. Fund of Funds may be established as retail (subject to the specific rules set down by IFSRA Notice NU 25 see section 10), PIFs or QIFs. In accordance with IFSRA standard policy many of the restrictions imposed by IFSRA Notice NU 1 can be disapplied in the case of a PIF and are not applicable for QIFs. However, a PIF or QIF will be required to disclose in its prospectus that the restrictions of IFSRA Notice NU 1 do not apply and include appropriate risk warnings.

IFSRA Notice NU 1 is supplemented by IFSRA's Guidance Note 1/01²⁶, which was initially issued by IFSRA in December 2001²⁷.

Investments in other Regulated Schemes

Where a principal objective is, and/or the investment policies provide for, a significant investment in other schemes, as set out below, investment limits may be calculated by reference to the net asset value of the scheme rather than on a pro-rata basis. These exceptions are permissible in the context that the investments of the underlying scheme will be diversified.

- In the case of retail schemes, IFSRA Notice NU 1 provides for an investment limit of 20% in the units of any one underlying scheme. This can be increased to 30% for one of the underlying schemes.
- By way of derogation from the limit set down in IFSRA Notice NU 1, a PIF is generally permitted to invest up to 40% in any one scheme. A provision to allow increased investment in any one scheme is not applied in the case of a PIF. Any proposed investment in another scheme greater than 40% will be regarded as a feeder type investment.
- A QIF is not subject to paragraph 2 of IFSRA Notice NU 1 but any proposed investment in another scheme greater than 40% will be regarded as a feeder type investment with subsequent disclosure requirements.

Investment in Unregulated Schemes

IFSRA Notice NU 1 provides that, subject to a maximum of 10% of net assets in unregulated schemes, 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 IFSRA, provides an equivalent level of investor protection to that provided under Irish laws, regulations and conditions governing Irish funds. Retail schemes are obliged to comply with the requirements of IFSRA Notice NU 1 (Paragraph 1) but PIFs may be granted a derogation on application to IFSRA. In the case of a QIF, the requirements of IFSRA Notice NU 1 are automatically disapplied.

- For retail schemes (other than retail funds of hedge funds authorised under IFSRA Notice NU 25) investment in unregulated underlying schemes is restricted to 10% of net assets;
- A PIF which is a fund of funds scheme may invest up to 100% in unregulated schemes, subject to a maximum of 20% in any one such unregulated scheme;
- A QIF, which is a fund of funds scheme, may invest up to 100% in unregulated schemes, subject to a maximum of 40% in any one unregulated scheme.

Investment in underlying schemes should not be made if this would affect a scheme's ability to provide normal redemption facilities to investors within usual time frames. Open-ended PIFs and QIFs may provide for dealing on a quarterly basis. IFSRA requires that the time between submission of a

²⁶ Guidance Note 1/01 entitled "Collective investment schemes other than UCITS – Feeder Schemes and Fund of Fund Schemes: Acceptable Investments and Related Issues"

²⁷ IFSRA Notice NU 1 and IFSRA's Guidance Note 1/01 have both been amended to reflect the revised provisions of NU 25 relating to retail funds of hedge funds.

redemption request and payment of settlement proceeds must not exceed 90 calendar days. This period can however be extended to 95 calendar days in the context of a retail fund of hedge funds authorised under IFSRA Notice NU 25 (see section 10 below), a feeder or fund of funds scheme which provides for dealing on a more frequent basis (e.g. monthly, weekly, etc.) Furthermore, a retail fund of hedge funds authorised under IFSRA Notice NU 25, a PIF or QIF can retain up to 10% of redemption proceeds, where this reflects the redemption policy of the underlying scheme and until such time as the full redemption proceeds from the underlying scheme are received.

From a fund of hedge funds perspective, this means that an Irish domiciled fund of hedge funds can invest in hedge funds which are unregulated such as hedge funds established in the British Virgin Islands and the Cayman Islands. Certain conditions apply however, which include the requirement that where the fund 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 IFSRA.

The diversification requirement of 20% in any one such unregulated scheme in respect of retail funds of hedge funds authorised under IFSRA Notice NU 25 and PIFs seems to correspond to most hedge fund managers diversification needs. This seems, therefore, to herald the way forward for retail and PIF fund of funds schemes being the vehicles 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 IFSRA.

Other points of interest to note in respect of fund of funds are as follows:

- A PIF or QIF may invest in underlying schemes with lock-up periods. This is subject to the frequency in which its units may be redeemed by investors (investment must not affect this), the duration of the lock-up period and the amount invested in the underlying scheme.
- A fund of funds scheme may not invest in units of another fund of funds scheme. A PIF may derogate from this provided investment does not exceed 10% of net asset value. The restriction is disapplied in the case of a QIF.
- Investment in feeder funds is prohibited for retail fund of funds. However, a PIF may make such an investment on a limited basis, including where the feeder fund provides the only means of investing in an underlying scheme. A QIF may invest in a feeder scheme once suitable disclosure regarding increased costs (i.e. costs at each fund level) and lack of transparency is provided.
- Where the 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 the preliminary/initial/redemption charge which it normally charge. Where a commission is received by the manager of the scheme by virtue of an investment in the units of another collective investment scheme, this commission must be paid into the property of the scheme.
- The prospectus must disclose, and quantify to the extent possible, the types of charges and other costs relating to the underlying collective investment schemes which will be borne by the scheme, the jurisdiction in which such schemes are domiciled and their regulatory status.
- Where a fund of funds invests in an umbrella structure, the investment restrictions apply in respect of investment in the individual sub-funds.

10. Retail Funds of Hedge Funds

IFSRA recently issued a revised IFSRA Notice NU 25 on “Funds of Unregulated Fund Schemes” replacing the version issued in December 2002. This 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 seeking higher returns than those generated by traditional long only funds. The revised IFSRA Notice NU 25 amends the diversification requirements to require simply that not more than 20% of the net assets of the fund are invested in any one scheme, and disappplies the minimum subscription requirement previously imposed by IFSRA Notice NU 25.

Funds of funds schemes, authorised pursuant to the provisions of IFSRA Notice NU 1, may invest no more than 10% of their net asset value in unregulated schemes. IFSRA Notice NU 25 provides that a scheme may invest more than 10% net asset value in unregulated schemes, such as hedge funds and other alternative investment funds, subject to certain rules. The rules (as set out below) are in addition to the general rules for all collective investment schemes, which are not disapplied.

Diversification Requirements

The scheme may not invest more than 20% of net assets in the units of any one scheme²⁸;

Permitted Underlying Schemes

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.

Subscription Requirements

The minimum investment requirement of €12,500 previously imposed by IFSRA Notice NU25 has now been removed, thus permitting “retail” funds of unregulated funds with no minimum subscription requirements.

Disclosure Requirements

Specific additional disclosure in a scheme's prospectus is the main thrust of IFSRA Notice 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:

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

Management Requirements

²⁸ NU 25 previously required that the scheme may not invest more than 5% of its net assets in the units of any one scheme or more than 10% in the units of schemes managed by the same manager.

Before IFSRA will authorise a scheme under IFSRA Notice 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.

Where a fund of unregulated funds scheme invests more than 40% of its net assets in schemes managed by the same manager, or by an associated or related company, the management of the scheme must make a quarterly report to IFSRA on the extent to which the underlying schemes diversified between strategies.

The scheme may not invest in units of another fund of funds scheme or of a feeder scheme, whether authorised by IFSRA 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. IFSRA recognises 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.

11. Feeder Funds

A feeder fund is a fund whose principle object is investment in a single underlying collective investment scheme. However, this is not a strict rule. As noted above in relation to funds of funds, IFSRA rules for feeder funds can also apply where a fund makes mixed investments but its investment in an underlying scheme exceeds the applicable investment limits, e.g. more than 40% investment for a QIF.

IFSRA Notice NU 22 sets out the restrictions applicable to such schemes. In general, IFSRA's requirements for feeder funds are stricter than in relation to fund of funds. Again PIF schemes may seek derogations from these rules, however, in the case of a QIF there are fewer automatic derogations than normally granted for other schemes.

Investment in Underlying Schemes

The underlying scheme must either be authorised in Ireland or in another jurisdiction which in the opinion of IFSRA provides an equivalent level of investor protection to that provided under Irish laws and regulations governing collective investment schemes. In the case of feeder funds which are PIFs or QIFs, the underlying scheme must comply "in all material respects" with IFSRA's requirements for such schemes.

As such IFSRA will only authorise an Irish feeder scheme where it is satisfied that the underlying scheme offers a level of investor protection comparable to that which applies to an equivalent Irish authorised scheme. IFSRA has set out in detail its approach to specific jurisdictions and types of underlying scheme, which it will permit in the context of a feeder scheme and the specific application procedure which should be adopted.

Guidance Note 1/01 provides that QIF feeder funds may obtain a derogation from the above requirements and invest in an unregulated scheme in certain circumstances i.e. where the underlying scheme is managed within the promoter's group, where the group involved is a large institution with a proven relevant track record and where the group provides adequate comfort to IFSRA in relation to its control and supervision of the unregulated scheme. Features which would provide such comfort include the unregulated scheme having independent custody arrangements, being subject to an annual audit and any sub-manager being subject to a detailed due diligence test before appointment. There is also a list of requirements relating to the ability of the manager of the underlying scheme to monitor its underlying positions, which IFSRA would require the manager to have on an ongoing basis.

Feeder schemes into funds of funds

A feeder scheme investing in a fund of funds must comply with the following requirements:

- the underlying fund of funds must be authorised in Ireland or in another jurisdiction which in the opinion of IFSRA provides an equivalent level of investor protection to that provided under Irish laws and regulations governing collective investment schemes;
- a prominent risk warning must be included in the prospectus to alert investors to the fact that they will be subject to higher fees arising from the layered investment structure;
- where a feeder scheme invests in a fund of funds 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 may not charge subscription or redemption fees on account of the investment. Commission or rebates received by the manager of the feeder scheme, by virtue of the investment into the fund of funds scheme, must be paid into the property of the feeder scheme;
- IFSRA will not be disposed to accepting applications where high annual management fees are proposed (i.e. greater than 1% of the net asset value of the feeder scheme). To ensure that unitholders understand the fees that will arise, from their investment in the feeder, the prospectus must disclose, preferably in tabular form, the fees arising at the level of (i) the feeder, (ii) the funds of funds, and (iii) the underlying SCHEME into which the fund of funds invests, to the extent known (and at least an indication of these).

Feeder schemes into feeders

A feeder scheme which proposes to invest in another feeder is not acceptable.

Other Requirements

The prospectus of a feeder fund must contain sufficient information relating to the underlying scheme to enable investors make an informed judgement of the investment proposed to them. The periodic reports of the underlying scheme must be attached to the periodic reports of the feeder scheme. The scheme must make appropriate disclosures in its prospectus regarding the relationship between it and the underlying scheme including comprehensive information relating to charges and expenses in respect of the underlying scheme.

The manager of the underlying scheme must waive the preliminary/initial charge which it is entitled to charge for its own account in relation to the acquisition of units by the feeder scheme. Where a commission is received by the manager of the scheme by virtue of an investment in the units of the underlying scheme, this commission must be paid into the property of the scheme.

12. Securities Lending

An important element of any alternative investment framework is a robust system for securities lending. Counterparties to lending transactions have to consider numerous risk factors, including systemic, insolvency and legal risk. The proper evaluation of such risks has proved difficult where there are cross-border issues owing to the differing laws of EU Member States and indeed the absence of a global consensus on principles such as the determination of the *lex situs* of secured assets. In the absence of clarifying legislation, lenders have had to rely upon legal opinions issued by specialist lawyers for comfort on matters such as the effectiveness of contractual netting provisions in the event of the insolvency of the borrower. However, this situation is changing and the existing Irish securities lending framework is being reinforced by adoption of new domestic legislation and the implementation of EC Directives, e.g. the Collateral Directive²⁹.

Although it is beyond the scope of this article to examine the numerous provisions which impact on the regulation of securities lending in detail, we have noted some of the key provisions of the current Irish framework below. These include:

- **The Netting of Financial Contracts Act 1995** (the “Netting Act”) and **Netting of Financial Contracts Act, 1995 (Designation of Financial Contracts) Regulations 2000**³⁰. The Netting Act provides protection on insolvency for certain bilateral netting, set-off, guarantee and collateral arrangements and, subject to certain exceptions (e.g. fraud), provides that netting agreements in relation to “financial contracts”³¹ are enforceable against a party to the netting agreement (or a guarantor or other person providing security) notwithstanding any rule of law relating to bankruptcy, insolvency or receivership;
- **UCITS/Non-UCITS Regulations and IFSRA Notices** issued thereunder. IFSRA permits securities lending by mutual funds, on the terms and conditions laid down by it under its Notices and in accordance with applicable laws.
- **The European Communities (Finality of Settlement in Payment and Securities Settlement Systems) Regulations, 1998**. The 1998 Regulations provide that where payments or securities settlement systems are based on netting, transfer orders and netting arrangements within a payment system they will be legally enforceable and binding on members of the payment system and third parties in the event of insolvency of a member, where the relevant transfer orders were entered into the payment system before the insolvency proceedings were initiated. The provisions of these Regulations are however limited to certain participants and defined “payment systems”;
- **Revenue Commissioners statement of practice for stocklending/sale and repurchase transactions post-6th April 1999**. As noted above the principle provision was to recognise the substance of securities lending transactions rather than the strict legal form. Where parties can comply with the provisions set out in the statement, securities lending will be viewed as a loan rather than a transfer, thus avoiding potential liability to corporation tax, capital gains and stamp duty.
- **Stamp Duties Consolidation Act 1997**, as amended. Section 87 of the Stamp Duties Consolidation Act 1999 as amended by the Finance Act, 2000 gave statutory effect to the stamp duty exemption noted in Revenue Notice.

²⁹ EC Directive 2002/47/EC on Financial Collateral Arrangements

³⁰ The Netting Regulations added new definitions of “financial contracts”, thereby extending the protection afforded by the Netting Act to a greater number of transactions

³¹ Financial contracts are defined in the Netting Act, as amended by Regulations issued in 2000, and include “equities lending and equities borrowing contracts”

- **The Finance Act 2000** gave further statutory footing to many of the taxation provisions noted in the Revenue Notice.
- **The European Communities (Financial Collateral Arrangements) Regulations 2004** which implement Directive 2002/47/EC on financial collateral arrangements. The aim of the Directive is to create a Community-wide regime for the provision of financial instruments (mainly securities) and cash (not banknotes, but rather money credited to an account) as collateral and where possession or control of the collateral passes to the collateral taker. The Regulations apply to both title transfer financial collateral arrangements (including repurchase agreements or “repos”) and security financial collateral arrangements. However, it does not apply to non-financial forms of collateral, such as real estate, plant and machinery, book debts etc. The Regulations also contain a number of key provisions to encourage the provision of collateral as security, reduce costs and other administrative burdens. They disapply certain provisions of insolvency law to specified types of financial collateral arrangement; in particular, those that would inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques, such as bilateral close-out netting, the provision of additional collateral in the form of top-up collateral and the substitution of collateral. In addition, they provide that the validity of financial collateral arrangements or provision of financial collateral will not depend on formal acts such as registration of security interests etc. Finally, they also apply the “PRIMA” principle to qualifying transactions as discussed below.

PRIMA

A topic very much related to the enforcement of security interests when dealing with transfers and charging of collateral is the determination of the *lex situs* of assets held by counterparties. Securities lenders had identified that the security they created over collateralized assets was susceptible to being held invalid due to conflict of laws cross-border, e.g. non-compliance with the laws of the jurisdiction in which the securities were held. This legal risk became greater with the development of complex sub-custodial arrangements and the increased holding of dematerialized securities in clearing systems, e.g. Clearstream or Euroclear.

In Ireland, the general rule is that the law governing the proprietary effect and perfection of the interest will be determined by the *lex situs* of the secured assets. However, it is not always clear whether the Irish courts will use the “look through” approach or “place of the relevant intermediary approach” (PRIMA) to determine the *lex situs*. The look through approach involves looking through a chain of intermediaries to either the jurisdiction of incorporation of the issuer of securities, location of the security register or the location of the actual security certificates. Obviously, such an approach is very difficult when dealing with a diverse portfolio of securities (multiple issuers and therefore multiple jurisdictions) and indeed different jurisdictions rely on either place of incorporation, place of the register or certificates to determine *lex situs*, again leading to multiple jurisdictions. The PRIMA approach has been heralded as the solution to many of these complications and has received widespread global backing, culminating in the recent agreement of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary³². PRIMA provides a uniform conflict of laws rule for securities held through intermediaries and looks to the law of the location where the intermediary maintaining the account to which the securities are being credited as the *lex situs*.

Ireland has begun tackling the above-mentioned concerns of market participants by the adoption of PRIMA into its laws. This is being accomplished on a phased approach:

³² The Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary (the “PRIMA Convention”) was finalised on 13 December 2002. Proposed signatory States are discussing some final issues and Ireland is expected to formally ratify the Convention in the next few months

- (a) narrow introduction into Irish law pursuant to the Settlement Finality Regulations, 1998³³, which have been briefly discussed above. Under the Regulations, the application of PRIMA is restricted to members of payment systems and Central Banks, including the European Central Bank. A condition for the application of PRIMA is that securities (including rights in securities) are provided as collateral security to members of payment systems or to central banks of the Member States or to the European Central Bank;
- (b) the implementation in Ireland of Directive 2002/47/EC on financial collateral arrangements by the European Communities (Financial Collateral Arrangements) Regulations 2004, applies PRIMA as a general rule to all situations where securities held through indirect holding systems are provided as collateral. Article 9 of the Directive, deals with conflicts of laws and provides that any question with respect to specified matters³⁴ in relation to book entry securities collateral³⁵ shall be governed by the law of the country in which the relevant account is maintained. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country; an
- (c) the Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary (the “PRIMA Convention”), provides a uniform conflict of laws rule for securities held through intermediaries. The European Commission has recently proposed that the PRIMA Convention should be ratified at Community level. Article 4(1) provides that the parties may expressly agree a law to cover issues in respect of securities held with an intermediary (as are fully set out in Article 2). This freedom to choose is limited by the “reality test” which in summary provides that (i) the relevant intermediary must have, at the time of the agreement, an office in that State and (ii) that office must either alone or together with other offices of the relevant intermediary, or with other persons acting for the relevant intermediary, engage in a business or other regular activity of maintaining securities accounts. Article 4(2) contains a black list of activities, which by themselves do not qualify as elements of maintaining securities accounts. Article 5(1) contains fallback rules which provide that if the applicable law is not determined under Article 4, but there is a written account agreement that “expressly and unambiguously” states that the relevant intermediary entered into the account agreement through a particular office, the applicable law is the law of the location of that office, once the “reality test” is fulfilled. Finally if this test also provides no answer, the Convention looks, as a fallback, to the law of the place of incorporation or organisation of the relevant intermediary.

13. 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. IFSRA, as regulator, has facilitated the development of the Irish funds industry. However with the plethora of regulations, it must continue to strike a balance between protecting the investor and giving fund managers sufficient discretion and flexibility to do their job effectively

33 European Communities (Finality of Settlement in Payment and Securities Settlement Systems) Regulations, 1998 (S.I. No. 539 of 1998) (the “Regulations”) which implemented Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 (the “Settlement Finality Directive”)

34 These are set out under Article 9 (2) and include the legal nature and proprietary effects of book entry securities collateral; the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and more generally the completion of the steps necessary to render such an arrangement and provision effective against third parties; whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest, or a good faith acquisition has occurred; and also the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

35 Defined as financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary

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