



Hedge Fund
Developments
in 2006

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HEDGE FUND DEVELOPMENTS IN 2006

Introduction

There have been a number of significant international developments since last year including the publication in July, 2006 of the Report of the Alternative Investment Expert Group (the “Expert Group’s Report”) under the auspices of the European Commission as envisaged by its Green Paper on the Enhancement of the EU framework for Investment Funds published in July, 2005, the decision of a U.S. federal appeals court to strike down the SEC’s Rule 203(b)(3)-1(d) containing the “hedge fund amendments” to the Investment Advisors Act, 1940, and recent market data released showing the state of health of the hedge fund industry as a whole.

Development in the EU

The European Commission asked the Expert Group in 2005 to report how it sees the future development of the European hedge fund industry and what obstacles could be removed or steps taken to make the business more efficient. While it remains to be seen how many of the Expert Group’s proposals will be taken on board by the Commission, as a possible pointer to future developments, the Expert Group has agreed with past public statements from the Commission itself, in so far as it suggests that the European hedge fund industry is developing in such a way that does not give rise to a need for targeted legislation at European level and that any such legislation, to the extent that it impinges on hedge funds’ unrestricted freedom to invest or their business models, is likely to fail. The Report recommended that it was premature to consider broadening the investment restrictions of the existing UCITS framework so as to accommodate a broader range of hedge fund strategies. The Report recommended moving towards mutual recognition of a nationally regulated retail-oriented hedge fund product outside of the UCITS framework by firstly imposing a minimum investment threshold of €50,000 on such hedge funds and secondly by ensuring that those who sell the products are appropriately regulated and supervised and observe the appropriate conduct of business rules and duties of care to the end-investor (as, it suggests, would be the case under proposed MiFID standards). The regulatory capital requirements of regulated institutional investors, under Basel II and the soon to be in force Capital Requirements Directive, should be carefully examined, the Report urges, such that arbitrary restrictions on hedge fund investment by such regulated institutions be removed. The Report also suggested that in order to make the market for custody services more

efficient, that hedge funds not be required to appoint a local custodian. It will be interesting to see how the latter proposal is treated by the Commission as most European hedge funds, including Ireland's, are created under regulations based on the UCITS model and have as their cornerstone the independent functions of custody and management as well as management oversight by a locally based custodian.

The Commission has said it will publish an investment fund strategy paper later this quarter, which will outline the actions it proposes to take in this regard. outlining the actions it proposes to take in this regard.

Market Developments

Data published in the May 2006 semi-annual HFMWeek Fund Administrator Survey (the "HFMWeek Survey") made interesting reading for those who continue to predict the doom of the hedge fund industry, and was timely, as it coincided with the call from the Expert Group to the European Commission to rationalise European hedge fund servicing and distribution in order to make Europe more attractive to the growing hedge fund market.

The HFMWeek Survey suggests an increase in both single manager hedge funds and funds of hedge funds but a slow-down in the growth of funds of hedge funds. The Report indicates that global single manager hedge fund assets are valued at US\$1.77 trillion or just over 69% of total hedge fund assets, only two years after first breaking the US\$1 trillion mark, according to the same report. Fund of hedge funds are reported to be valued at US\$781 billion, or 30.6% of the total value of hedge fund assets, with single manager funds enjoying a higher rate of growth in the previous 6 months at 45% compared to the 10% growth in funds of hedge fund assets. According to the report, Europe's share of the world's hedge fund assets is currently at 24%, while the U.S. has over 50%, showing little change from the corresponding HFMWeek survey carried out in November, 2005.

The move to on-shore or regulated offshore jurisdictions due to the increased institutional, and particularly, traditionally more risk-sensitive, regulated institutional investor-base, is borne out by the hedge fund domicile statistics of the HFMWeek Report which identifies a decrease in the traditional strangle-hold Cayman and the British Virgin Islands held over the domicile industry and an increase in the share of global onshore and European offshore jurisdictions. It reports that Cayman's share of the hedge fund domicile business decreased from 44% in November 2005 to 39% in May, 2006 with onshore and other offshore jurisdictions in some instances doubling their count of hedge funds over the same six month period.

It is not certain from the available statistics whether this has resulted to any great extent from a fall off in the numbers of Cayman hedge funds being created or a relative increase in hedge fund creation in other domiciles. It should be borne in mind that reliable statistics in this area are hard to come by; for example, whereas surveys such as that undertaken by International Financial Services, London as of the end of 2005 based on Hennessee Group data suggest that approximately 55% of the world's hedge funds are based in offshore jurisdictions, according to recent official data released in Cayman, more than 80% of the world's hedge funds are based in Cayman alone.

Greater regulation of the industry world-wide and increased harmonisation in the European market is bound to be positive for Ireland and other regulated domiciles on a number of fronts - greater regulation and legal certainty may spur greater investment by more risk adverse investors, such as pension funds and life insurance companies –an overall increase in the size of the industry will obviously benefit the industry in Ireland assuming it can consolidate or increase its share of the market. There is room in Ireland for significant growth within the hedge fund administration market – for example, relative to the US, Cayman and Luxembourg, and considering Ireland's hedge fund assets under administration, Ireland continues to have a relatively concentrated pool of hedge fund administrators (39 according to the most recently available Dublin Funds Industry Association statistics). This, together with other factors, such as the growth of European hedge funds and European hedge fund management, the global growth of hedge fund assets, and the other traditional factors which make Ireland an attractive base, such as very low corporate tax and availability of experienced and expert staff, may lead to new entrants in the medium term, as recently witnessed by the establishment of Quintillion. Ireland's fund domicile business is also likely to benefit as more and more hedge funds begin to be established in regulated jurisdictions such as Ireland rather than in traditional unregulated jurisdictions such as Cayman and the British Virgin Islands.

Development in the U.S.

In the U.S. July, 2006 also saw a U.S. federal court of appeal striking down the SEC's October 2004 requirement for advisors or managers to "private funds" having more than 14 U.S. person investors, to register with the SEC as investment advisors under the Investment Advisors Act, 1940.

Many legal commentators in the U.S. were surprised by the decision of the Court and felt that it would not have been upheld if the case made its way to the U.S. Supreme Court,

however, the SEC has decided not to appeal the decision and is, at the time of writing, preparing a revised set of rules to govern this area. The difficulty for the non-U.S hedge fund management industry is likely to continue to be that the SEC's rule will probably not be restricted territorially. In this regard, the Expert Group's Report recommended among other things that European Union and national regulators enter into negotiations with the SEC with a view towards securing exemption from the registration requirements for European hedge fund managers which are already registered with an EU Member State.

Development in Ireland

In domestic developments in Ireland, the Irish Financial Services Regulatory Authority issued an explanatory guide to rules made under Guidance Note 1/01 (the "Guidance Note"), which provide for the ability of Irish Qualifying Investor Funds ("QIF") to invest on a master-feeder basis into an "unregulated fund". An unregulated fund is one which does not fall within the scope of Annex 1 or Annex 2 to the Guidance Note. A fund domiciled in Cayman, for example, would be considered an unregulated fund for this purpose. As a policy-driven measure introduced by the Regulator in 2000, normally an Irish QIF can invest no more than 40% of its net asset value in a single unregulated fund. The exception to the general rule, which only applies to QIFs, and is obtained by way of a written derogation request to the Regulator, is found in Section D of Annex 1 the Guidance Note and applies in circumstances where the underlying fund is managed within the Irish feeder's promoter's group, the group involved is a large institution with a proven, relevant track record and the group provides adequate comfort to the Regulator in relation to its control and supervision of the unregulated fund. The Regulator indicated in its letter of 2 June, 2006 to the Dublin Funds Industry Association, that this means that the promoter must have significant shareholders funds and significant assets under management (for example it is expected that the promoter will have a minimum capital of approximately €100m and assets under management in the region of €4 billion) and must have carried out asset management activity for a minimum of 10 years. With regard to what constitutes "adequate comfort", the unregulated scheme must have independent custody arrangements, the unregulated scheme must be subject to annual audit, any sub-manager must be subject to a detailed due diligence test before appointment, on an ongoing basis, the manager of the unregulated scheme must have the ability at any time upon notice to close the account of any or all sub-managers, or to instruct a lending counterparty to close out particular positions or to stop accepting instructions from individual managers, independently monitor positions taken in the scheme from a risk perspective, receive daily reports from brokers or lending counterparties, have real time access to all trades and positions through the broker accounts, monitor on a daily basis the market risk and other factors associated with the

activities of each underlying manager, require that off-exchange contracts be subject to normal market rules (ISDA or equivalent), apply daily stress and scenario tests and monitor overall leverage of the underlying fund. Where some of these are not practical because the unregulated scheme invests directly in other schemes, the Regulator has indicated that it may be willing to accept the proposal on the basis of extensive diversification of investments. In its letter of 2nd June, 2007, the Regulator indicated that derogation requests must be submitted and approved in advance of submitting a formal application for authorisation under the relevant legislation, the provisions of the derogation request in relation to control over the underlying scheme should be made by the investment manager of the proposed feeder scheme and must address each of the points in Section D and a copy of the offering memorandum for the proposed underlying scheme should be submitted to the Regulator.

Summary

With effect from 1 September, 2005, the Regulator, in association with the Dublin Funds Industry Association, has streamlined its fund authorisation and documentation amendment approval process such that from that date the Regulator no longer reviews Memorandum and Articles of Association, Management, Administration, Transfer Agency, Investment Management, Investment Advisory, Distribution, Paying Agency or Representative Agency Agreements in advance of fund authorisation or sub-fund approval, and instead relies on certifications as to their compliance with applicable regulations by representatives of the Fund involved. Over time this is expected to significantly reduce the timing of fund authorisations and the processing of post-authorisation changes to fund documentation.

For the coming year, we see the position of European offshore domiciled hedge funds continuing to grow to the detriment of their non-European offshore counterparts. We would expect Ireland's position as Europe's leading fund domicile and administration centre to continue to grow and we expect to see European hedge fund domiciles generally to increase their share of the global domicile market as the harmonisation of Europe's private placement rules and the elimination of discriminatory tax practices between Member States become serious considerations for sponsors when choosing a fund domicile.

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