

Investment  
Funds:  
“Hot Topics”  
Roundtable

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

## ▣ INVESTMENT FUNDS – “HOT TOPIC” ROUNDTABLE: BURNING ISSUES AFFECTING INVESTMENT FUNDS IN IRELAND

### Introduction

This paper, whilst addressing a number of recent product development issues specific to the Irish funds regulatory regime for real estate funds and CCFs, has as its focus on what I consider to be the main issue facing the Irish and broader European funds industry; cross border distribution.

Although principally considering the position for UCITS, I have also touched on the most recent proposals put forward as a solution to the fragmented state of the European hedge funds industry.

By way of background, it is thought that UCITS represent approximately 70% of the Euro 5 trillion managed by the European funds industry, with in excess of 30,000 UCITS having being notified for sale in at least one other EU Member State and with over 5,000 UCITS on offer in five or more Member States. These statistics hide the fact that fund promoters continue to experience frustration in effecting the notifications required to passport a UCITS cross border.

For hedge funds, there has never been a harmonized regime with the result being a significant divergence of structures, authorization processes and marketing rules across Europe. Latest industry recommendations, however, are for the removal of barriers to cross border distribution, at least for the more sophisticated investor market.

As one of the leading European domiciles for both UCITS and hedge funds, Ireland is keenly interested in any developments in these areas, with any removal of barriers being seen as having only positive benefits for the Irish funds industry.

The last few months have seen publication of a number of important reports and guidelines on cross border distribution, with an expected White Paper on investment funds to be issued by European Commission later this year.

## Cross-Border Distribution of UCITS – The Way Forward Remains Unclear

For "exporting" jurisdictions such as Ireland, the process, timing and costs involved in completing the notifications required to market a UCITS from one EU Member State into another remains one of the hottest funds related issues. It is worth noting that of the Euro 633 billion in Irish domiciled schemes as at end June, 2006, 79% or Euro 503 billion is invested in UCITS products. Accordingly, whilst very much a broad European issue, the various outputs on the issue over the last 4 months have been of major relevance to Ireland.

In summary, following a two-stage consultation process, the CESR deliberations finalized in June, 2006 with the issue of a set of guidelines which unfortunately represent a failure to make any real progress in this area. This disappointment was, however, followed by the July, 2006 Expert Group Report on Market Efficiency which represented a breath of fresh air on the topic and made a series of simple but hugely pragmatic recommendations which, if ever implemented, would make a significant leap forward in creating a true single market for European investment funds.

At the European Commission Hearing on Investment Funds (UCITS) in Brussels in October 2005, Charlie McCreevy, the European Commissioner for Internal Markets and Services made clear the need to take steps to ensure that the core objectives of the UCITS Directive are actually implemented stating "Making existing rules deliver is a must. But it must not blind us to some big questions about the longer-term challenges. Financial markets have not stood still since 1985 or indeed 2001. Regulation needs to respond to these changes; to work with the grain of the markets. Otherwise, UCITS law risks becoming a straight-jacket rather than a facilitator."

Such sentiments may result in a positive reception for the Expert Group's report at Commission level, but based on past experience I am not holding my breath.

### **Background**

The 1985 UCITS Directive (85/611/EEC) introduced the pan-European passport regime for what are referred to as "harmonized" undertakings for collective investment in transferable securities ("UCITS"). 2001 saw an overhaul of the UCITS regime, with new product and expanded management company opportunities being introduced by what are known as the UCITS III Directives.

The passporting or cross border sales regime has as its foundation the concept of mutual recognition whereby a UCITS is only required to be authorized in one Member State (its "*home Member State*"), with the UCITS then being capable of being marketed into other EU Member States ("*host Member States*") without having to seek further authorization in those host Member States, provided certain notification requirements to the host Member State are fulfilled.

Article 46 of the UCITS Directive requires a UCITS which wishes to market into another Member State to effect a *notification* to that host Member State which includes filing the following documentation with that notification:

- an attestation by the home Member State authority to the effect that the UCITS fulfils the conditions imposed by the Directive
- the UCITS fund rules or its instruments of incorporation
- its full and simplified prospectus
- where appropriate, its latest annual report and any subsequent half-yearly report, and
- details of the arrangements made for the marketing of its units/shares in that other Member State.

Additionally, Article 44 of the UCITS Directive provides that a UCITS which markets its units in another Member State must comply with the laws, regulations and administrative provisions in force in that State *which do not fall within the field governed by the Directive*. Essentially, this means that all of the requirements in relation to the authorization of UCITS, compliance with investment and leverage restrictions, corporate governance and ongoing supervision are exclusively within the remit of the home Member State whereas the principal item not governed by the Directive, marketing, is left with host Member State.

### **The Frustrating Reality**

On the face of it, these notification and compliance with local marketing rules requirements seen relatively straight forward but in practice they have proved to be quite the opposite.

Different rules apply in different jurisdictions as to the content of the notification, the translation of documentation into local languages, the filing process itself, the process to be followed in the case of umbrella schemes where not all sub-funds are to be sold cross-border and the layout of the annual/semi-annual accounts where not all sub-funds are being sold cross-border, as well as the reality of queries from certain host Member States competent authorities on the UCITS structure itself (despite being a matter which is outside the host Member States competency) and even on the form of the attestation from the home

Member State competent authorities. Additionally, the local marketing requirements differ from jurisdiction to jurisdiction.

What was originally intended to be a process which would take no more than 2 months to complete has become for many fund groups a much more drawn out process, often taking 6 months and sometimes even longer. When multiplied by the number of jurisdictions into which a UCITS may wish to sell (it is not uncommon for a fund to wish to register in three or more Member States), one can appreciate the delays, costs and mounting frustration that promoters suffer in simply trying to get what is in itself a highly regulated product to market.

### **CESR Guidelines – A Lost Opportunity**

Following earlier failed attempts to overhaul the original UCITS regime, the UCITS III Directives significantly extended the investment strategies that could be pursued by UCITS and the authorisation capacity and passporting for their management companies. Unfortunately, the process for effecting cross-border notifications was not materially amended and all the ambiguities and potential for delays remain in place.

Following the introduction of UCITS III, the initial areas of focus for the industry and regulators were the actual conversion process itself (the requirement to convert all existing UCITS I product to the new UCITS III regime) and, in the face of objections by certain EU Member States to new UCITS III products approved by other Member States (despite not being an area within their competency), the achievement of a common understanding of the meanings and new capacities provided by the UCITS III Product Directive. Since these issues have now largely been addressed, the most recent focus has been on the UCITS passport itself (for the fund, not the management company).

Following a two step consultation process ending in May of this year, the Committee of European Securities Regulators (CESR) issued a set of guidelines entitled "CESR's Guidelines to Simplify the Notification Procedure of a UCITS". In summary, the CESR Guidelines recommended as follows:

- (i) *Notification Letter*: CESR recommended a standardized notification letter which could be submitted *in a language common in the sphere of international finance* or in the or one of the official languages of the host Member State, if not contrary to the domestic legislation or regulations of the host Member State. CESR members also agreed to facilitate electronic filing of documents.

On the face of it, this appeared positive but where local legal or regulatory provisions would require to be amended to facilitate such a standardized notification letter or the language in which it issues, the benefits of this recommendation are lost. No positive action is required.

- (ii) *Areas of Competency:* CESR has restated the principle that a host Member State cannot use any reasons other than non-compliance of marketing arrangements to refuse the passporting notification made. In other words, divergent interpretations as to whether a UCITS complies with the Directive in the first place cannot be used as a blocking mechanism.

This, unfortunately, has not stopped certain Member States blocking notifications on grounds which do not relate to marketing arrangements, although it is recognised that the CESR deliberations on the UCITS Product Directive have reduced the likelihood of this remaining a significant issue.

- (iii) *The Two-Month Period:* This is essentially a restatement of what is in the Directive, namely that a UCITS can begin marketing in the host Member State two months after it has completed the notification, unless the host Member State establishes in a *reasoned decision* taken before the expiry of that two month period that the marketing arrangements do not comply with the provisions of the Directive.

However, the two month period only starts when the host authority has received what it considers a *complete notification*. CESR has indicated that the notification should be considered complete if all the information and documents provided for in the Directive and in CESR's Guidelines have been received and CESR further recommended that if the notification itself is incomplete, the host authority should be required to inform the UCITS regarding the incompleteness and missing information list from documents as soon as possible and in any case within one month from the date of receipt of the incomplete notification.

Unfortunately, this does not represent any real positive development as not only are the documentation requirements and determination as to what represents a complete notification open to significant local interpretation, there is no legal obligation on the host Member State to take any action at any time prior to the expiry of the two month period. In other words, the fundamental flaw of giving a role to the host Member States continues.

- (iv) *Shortening/Managing the Two Month Period:* CESR stated that the two month period should be the maximum period available for the host Member State to check the notification and that period should be shortened whenever possible. If by the end of the two month period, the host Member State has not established by way of a *reasoned decision* that the arrangements made for marketing do not comply, then CESR has restated the Directive position, namely that the UCITS can commence marketing its units.

Whilst a number of well intentioned additional clarifications are provided by CESR, the key problem is that the Directive does not explain what would constitute or would not constitute a *reasoned decision*. Again, no real progress.

- (v) *Certification of Documents:* CESR has restated the Directive position, namely that certification by the home Member State of the UCITS is no longer required, rather self-certification by the UCITS is acceptable. This is positive as is the agreement of the CESR members not to require the use of the Hague-Apostille for certification of documents.
- (vi) *Translation of Documents:* The documents which have to be submitted to the host Member State authority must be sent in the original language *and translated into the or one of the official language of the host State except for the UCITS attestation which can be in English*. The recommendation on translation indicates that to facilitate transparency of the language requirements, CESR members will provide information on their web sites on the documents that must be translated as well as on the languages. Given previous experience, it is likely that this information, if actually published, would be in the language of the host Member State which would mean that further translation would have to be effected.

The rationale behind requiring a significant number of documents to be translated into the local language seems flawed – I would argue that all that should be required is a local translation of the simplified prospectus. Unfortunately, CESR has failed to accept such a recommendation and promoters are left with having to translate many sizeable documents which most investors are unlikely ever to read, and thereafter keep them updated in those local languages.

- (vii) *Umbrella Funds:* The CESR Guidelines recommend that if a UCITS intends to market actively only some of the sub-funds of an umbrella (i.e. not all) in the host State, only those sub-funds proposed to be marketed actively have to be notified. Again, failing to grasp the issue, if new sub-funds are added to the umbrella at a

later date after the original notification and those sub-funds are proposed to be marketed in the host State, the notification procedure triggers the two month period again. It really should be much much shorter. CESR does indicate, in an aspirational manner, that the host authority should be in a position to very quickly consider the notification in a timeframe significantly less than the regular two month period but this again is left to the various Member States to apply.

(viii) *Content of the Notification File:* The documents that have to be provided under the Directive are restated in the CESR Guideline, namely:

- valid home authority original attestation (can be in English);
- standard form notification letter;
- fund articles/instruments of incorporation;
- latest up-to-date full and simplified prospectuses;
- latest published annual report and half-yearly reports;
- details of the arrangements made for marketing.

Interestingly, whilst CESR indicates that these are the only documents that can be sought and that UCITS should not be obliged to send any other documents or information, it also recognizes that its hands are tied by the provisions of the Directive which does allow for local rules which could require additional documents to be filed. Accordingly, not only do UCITS have a long list of documents to provide, have translated and kept up-to-date but they may also be subject to other local documentation requirements.

(ix) *National Marketing Rules/Other Specific National Regulations:* The various Member States authorities are expected to complete a standard form document and publish it on their web sites setting out their national marketing rules and all other specific national regulations.

This in itself is a further indication of how the passport is undermined and the single market frustrated through application of a myriad of local unharmonised rules.

Whilst CESR was undoubtedly restrained by the provisions of the Directive itself, its recommendations were not seen as positive or forward looking.

## Report of the Expert Group on Investment Fund Market Efficiency

As outlined in the May, 2005 EU Commission's Green Paper on Enhancing the EU Framework for Investment Funds, an industry expert group was established to consider rationalization of the investment fund value chain. One of the issues that was considered by the Expert Group, which issued its report in July, 2006, was the UCITS notification process with the Expert Group providing a set of logical and welcome recommendations on reducing the administrative delays in getting UCITS to market.

The Report recognized that although UCITS are in direct competition with a variety of other investment products (such as unit-linked life products, investment certificates and structured products as well as non-UCITS collective investment schemes) compared to many of those other products, the UCITS framework adds significant additional cost issues and procedures which result in delays in bringing the product to market. Without repeating the background to the various issues outlined above in the context of the CESR recommendations, the Expert Group Report recognized that the notification procedure "has become a by-word for bureaucratic interference and hassle", that the need to comply with different Member State's requirements and to translate documents into other languages "is a costly burden on the shoulders of the fund industry and its investors" and further recognized that "both uncertainty and long delays seriously handicap the fund industry when competing with other financial products offering similar features".

The recommendations of the Expert Group go right to the heart of the issue proposing that the UCITS Directive be amended as follows:

- (i) by introducing a maximum initial home state authorization of 20 business days together with material changes to their authorisation (which includes adding additional sub-funds to an umbrella structure) subject to a 10 day maximum;
- (ii) by replacing the current requirement for cross border notification to be effected by the the UCITS itself with a simple regulator to regulator notification and by limiting the documents to be filed to a regulatory certificate;
- (iii) by ending use of a simplified prospectus, replacing it instead with a "summary prospectus" which would be a simple short document acting as a detachable part of the full prospectus which would be used as a marketing document satisfying all product disclosure requirements to the end investor so that "its use as a marketing document switches off host state marketing rules";

- (iv) the requirement to translate fund documentation, other than the summary prospectus, should be dispensed with.

If these provisions were implemented, it would represent a fundamental and extremely positive development. Firstly, it would accelerate the initial process of authorization for UCITS vehicles. Secondly, subsequent changes would again be subject to a true fast track process and, most importantly, the whole area of consideration of a notification by the host Member State would be removed and could be carried out within 3 days from a request.

Equally importantly, following on from the Prospectus Directive example, the summary prospectus concept which would provide brief non-technical language conveying the essential characteristics of the fund structure and each relevant sub-fund and would remove the wholly unnecessary application of local marketing rules.

#### **What will happen next?**

The Expert Group's report, as well as reactions to it, is to be taken into account by the European Commission when assessing the options to improve the UCITS framework. The expectation is that the Commission will publish the results of its assessment in November, 2006, and at the same time issue a White Paper on the actions that it intends to take.

## **Expert Group Report on Cross Border Marketing of Hedge Funds – Industry Aspirations**

As a possible pointer to future developments, July 2006 also saw the publication of the European Commission sponsored Report of the Alternative Investment Expert Group on Managing, Servicing and Marketing Hedge Funds in Europe.

Noting that the European hedge funds industry has seen significant growth in recent years, with 1,250 hedge funds domiciled or managed from the European Union representing approximately USD 325 billion of AUM at the beginning of 2006, the Expert Group examined the multiplicity of regulatory regimes, the differing investor entry requirements/thresholds and the negative impact that cross border marketing restrictions are having in restraining the development of the European hedge funds industry, the key recommendations of the Expert Group included:

- to allow provision of investment services in respect of a full range of hedge funds by MiFID authorised firms without imposing additional restrictions or formalities at the level of its fund, its manager or other participants

- that regulators should not seek to control sales and distribution through product regulation or regulation. Instead focus should be on minimum investment thresholds and conduct of business rules for intermediaries/sales channels
- to give effect to mutual recognition of nationally regulated retail – oriented hedge fund products
- that regulation of investment strategies would be misguided
- to remove absolute or arbitrary quantitative restrictions on institutional investors
- to remove requirements to appoint a domestic custodian to European hedge funds
- no regulatory restrictions on re-hypothecation limits.

This Report is intended to feed into the investment fund strategy paper to be published later this year by the Commission and nothing in the report would cause difficulty for the current Irish framework, outlined below, which operates very much in line with the Report's recommendations.

### **Irish Legal Structures**

Hedge funds and FoHF can be established in Ireland as open-ended, limited liquidity or closed-ended variable capital investment companies, unit trusts, investment limited partnerships and common contractual funds. Each of these vehicles is available as an umbrella structure with segregated liability between sub-funds.

These vehicles are generally exempt from Irish taxes and are often structured with an underlying trading Irish SPV to improve treaty access.

### **Irish Hedge Fund Regulatory Categories**

The Irish regulatory framework operates in two ways – firstly by imposing common rules regarding fund participants and secondly by setting different investment and leverage limits depending on the investor profile.

#### *(i) Fund Participants*

Before it can establish an Irish hedge fund, the promoter must be approved by the Irish Financial Regulator. The principal requirements are that the promoter must be regulated, have shareholders funds of not less than Euro 635,000 and must have relevant experience in fund management/distribution.

Additionally, a regulated Irish administrator and a regulated Irish (or foreign branch) custodian must be appointed to the fund and the fund manager must be a regulated entity in its home jurisdiction for asset management business. Specific rules relating to the prime broker are set out below.

*(ii) QIF, PIF and Retail FoHF*

There are three available Irish regulatory categories of hedge funds designed to accommodate all investment strategies and investor types.

The Qualifying Investor Fund (QIF) is designed for high net worth individuals and institutional investors and, though a fully regulated fund in all other respects, has no investment or leverage restrictions other than that it must generally deal with highly rated entities when transacting OTC and can generally not invest on a master-feeder basis into an unregulated fund. QIFs may be established as single or multi-strategy hedge funds, practically without limitation. QIFs carry a minimum initial investment requirement of Euro 250,000 per investor and investment is confined to individuals with a minimum net worth in excess of Euro 1.25 million, institutions which own or invest on a discretionary basis not less than Euro 25 million and persons and companies involved in the investment management of the Fund's assets who might not otherwise qualify to invest.

The Professional Investor Fund ("PIF") carries a minimum initial investment requirement of Euro 125,000, has broad investment diversification and concentration requirements and a leverage restriction of 2:1. Within these constraints, PIFs can be established as single or multi-strategy funds.

Hedge Funds are not available to the retail market other than through the Retail Funds of Hedge Funds which carries no minimum investment requirement and just one principal investment restriction which requires that no more than 20% of net assets may be invested in a single underlying hedge fund. Additional rules apply to the underlying schemes of a Retail FoHF and there are a series of specific risk disclosures to be inserted into the prospectus as well as requirements to satisfy the Financial Regulator regarding controls the fund manager has to monitor the activities of the underlying schemes.

## Prime Brokers

The Financial Regulator's rules in relation to prime brokers are, in summary, as follows:

- the fund's relationship with the prime broker must be disclosed in the fund's offering document, and it must include a description of potential exposures arising from the relationship;
- in the case of a QIF, there is no limit on the extent to which assets may be passed to the prime broker;
- for PIFs, assets passed to the fund's prime broker may not exceed 140% of the level of the fund indebtedness to the prime broker;
- a prime broker must be regulated to provide prime brokerage services by a recognised regulatory authority, and it, or its parent company, must have shareholders' funds in excess of €200m (or its equivalent in another currency). In addition, the prime broker, or its parent company, must have a minimum credit rating of A1/P1;
- the prime brokerage agreement must incorporate a procedure to mark positions to market daily, in order to meet the exposure requirements on an ongoing basis;
- the prime broker must agree to return the same or equivalent securities to the fund;
- the agreement must incorporate a legally enforceable right of set-off for the fund.

The Financial Regulator no longer reviews prime brokerage documentation, subject to confirmation from the fund's legal advisers that the documentation is consistent with its rules regarding appointment of prime brokers.

Whilst Ireland is recognised as one of the leading administration centres for hedge funds and funds of hedge funds ("FoHF") globally, with some commentators estimating that almost 30% of all hedge funds are now administered in Ireland, Ireland is also one of the key European locations for domiciling hedge fund and fund of hedge fund products.

Over the next 12 months, we expect to see Ireland increase its share of the global domicile market as the likelihood increases of some harmonisation of Europe's private placement

rules for hedge fund products and, with most institutions looking to have some exposure to hedge funds, demand continues unabated for a regulated hedge fund product.

## Expansion in CCF Opportunities

In this section I have outlined two key changes to the CCF structure during the last year which open up significant additional uses for the structure as well as highlighting potential future interaction between CCFs and pan European pension funds or institution for occupational retirement provision (*iorp*).

### **New Non-UCITS CCF**

The European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 ("UCITS Regulations") enabled the establishment of a new structure known as a "CCF" or "Common Contractual Fund" as a recognized pension pooling structure. The CCF structure enables the assets held on behalf of such investors to be centralised through a single vehicle, in proportion to the assets or cash subscribed to the CCF structure. A CCF is a tax-transparent contractual arrangement similar to the FCP structures in other European jurisdictions, notably Luxembourg and France.

Originally available as a UCITS vehicle only, the Investment Funds, Companies and Miscellaneous Provisions Act, 2005 expanded the CCF possibilities by enabling CCFs to be established as Non-UCITS. This has opened up far greater investment structuring possibilities such as private equity, real estate and other alternative strategies which can now avail of the CCF tax transparency benefits.

### **Finance Act 2005**

Equally important, whilst CCFs were originally restricted to investment by pension funds, the Finance Act, 2005 has extended the tax transparent treatment of CCFs to all investor categories other than individuals or trustees/custodians holding units on behalf of individuals.

This makes a CCF an attractive tax transparent vehicle for use not only by multi-national companies which operate pension schemes in a number of different jurisdictions but by other fund promoters seeking to market to institutional investors.

## Future Interaction with EU Pension Schemes

Consideration has been given by Irish funds industry participants recently to the potential for interaction between regulated pooled investment funds and the new pan European pension fund vehicles introduced by the EU Pensions Directive. The Directive creates a legal framework which will allow the free movement of financial contributions from an employer in one EU Member State to a pensions vehicle sponsored by that employer in another Member State.

It creates a legal right for an iorps established under the laws of one Member State to receive financial contributions from an employer operating in another Member State for the sole purpose of providing retirement benefits for persons employed by that employer.

Ireland has transposed the EU Pensions Directive. As a matter of Irish law, favourable tax treatment attaches to the sponsorship of occupational pension schemes, pension assets under management and payment out of benefits to members and beneficiaries. A regulatory framework has been created in Ireland whereby trust based Irish iorps can be established in an effective manner to receive contributions from employers established in other EU Member States. Any decision by an EU employer to sponsor a cross border pensions vehicle under the flexible Irish regulatory regime for iorps will depend on whether its Member State has transposed the EU Pensions Directive and has adopted workable processes for the regulatory supervision of social, labour and tax law obligations.

In the belief that, going forward, synergies may be drawn through the use by employers and cross border pension vehicles of existing investment pooling technology, consideration is being given as to how a cross border iorp, once established by an EU employer, might inter-relate with, for example, an Irish investment pooling vehicle.

It seems unnecessary to have to set up completely new investment structures within or for iorps when regulated pooled tax transparent structures are currently available which can be utilized by cross border iorps once they have been established to receive sponsorship from employers established in other Member States.

The Irish CCF is an efficient pooling vehicle which is transparent for Irish tax purposes with no chargeable events and has received a number of successful confirmations of transparency in a number of jurisdictions from investor and investment perspectives.

Where an Irish cross border iorp would utilize a CCF as a pooling vehicle, the underlying investor would be the trustee of the scheme. No Irish withholding tax, VAT, NAV tax or capital duty attaches to it. Income and gains arise and accrue to the investor.

### **Iorps still a long way off**

Until the EU Pensions Directive is fully implemented by all Member States, it will not be possible for multinational employers to consider fully the benefits which might flow from the directive.

Even if the Directive is effectively transposed by all Member States, it still fails to lay down harmonizing rules for the application of national social and labour laws to the activities of cross border iorps in relation to the pension assets of employees. In making cross border financial contributions into an iorp established in another Member State, EU employers must continue to adhere to the national social and labour law obligations attaching to the contract of employment between them and their employees in the Member State where they are established. It is reasonable to assume that such social and labour law obligations may directly or indirectly influence the investment activities of a sponsored iorp.

Additionally, more fundamental challenges still face cross border occupational pension vehicles in the new regime. National taxation rules regarding the sponsorship of pension schemes, assets under management and payment of benefits do not come within the scope of the EU Pensions Directive. Without tax issues being fully addressed in a coherent manner, the real benefits of the EU Pensions Directive are a long way off.

## **Positive Developments for Irish Real Estate Funds**

Set out below are the key changes negotiated with the Irish Financial Regulator over the last number of months which will lead to a much brighter future for the development of regulated real estate funds in Ireland.

Please note, however, that what is detailed below applies for the moment only to qualifying investor funds ("QIFs") and not to professional investor funds or retail funds.

The principal changes are as follows:

### **Property and Property Related Assets**

The definitions of "Property" and "Property Related Assets" in the Financial Regulator's current property notice (NU18.3) will not apply to QIFs and, instead, far broader definitions can be given with no limitation on tenure, on minimum unexpired lease term or on the type of interest in land or building that can be acquired. Property derivatives will be allowed (provided appropriately explained/disclosed) and exposures taken via companies, partnerships, trusts or other forms of collective investment scheme, regulated or unregulated etc can be provided for.

### **Loans by Real Estate Funds**

In the past, it was only permissible for funds to make loans to wholly owned subsidiaries. The Financial Regulator has now clarified its position and is now willing to permit loans made as an investment provided linked to some element of equity investment (for tax or other structuring reasons, including for exit purposes). The Financial Regulator will not consider such loan investment to breach the general prohibition on funds making loans.

### **Joint Venture and Co-Investor Arrangements**

The Financial Regulator has made it clear that it has no objection to joint venture arrangements, co-investment arrangements or any other form of investment where the Fund invests along with or side by side with other investors in a particular investment (i.e. where it does not hold 100% of either the investing vehicle or of the investment). However, the Regulator will treat such an investment in the same manner as if the Fund were investing in an unregulated collective investment scheme so that, while there is no aggregate limit on the exposure to such joint ventures or co-investment or other types of investment scheme/arrangement, the maximum exposure to any one such joint venture or co-investment arrangement etc will be 40% of net assets. You should note that we have objected to the figure being based on net assets given the leverage employed in such products and we expect that this will be reconsidered by the Regulator in due course.

### **Relaxation of Legal/Management Control Rules**

The Financial Regulator has reconfirmed that it will not apply the prohibition on taking legal/management control of issuing bodies to investments in intermediate vehicles such as companies, partnerships or trusts etc that are simply intermediate vehicles through which investment has been made (whether wholly owned or not). More importantly, it has confirmed that it will disapply the general rule prohibiting the taking of legal/management

control in the case of a property fund investing in property companies provided that it would be a generally passive investment and would not involve the Fund itself in running the day to day management of such property companies.

### **Layering of SPVs**

In relation to the use of wholly owned intermediate vehicles (e.g. wholly owned subsidiaries, wholly owned SPVs, trusts, limited partnerships etc) the Financial Regulator formerly impose a limit that there could only be one layer of subsidiary below the Fund. The Financial Regulator has now confirmed that you can have as many layers as you wish and that the Regulator will not impose any limit on the numbers of layers of subsidiary vehicles a QIF can invest through, the key requirement being one of disclosure (i.e. disclosing the fact that there may be layers of subsidiaries, the fact that there might be additional costs involved and that this may lead to a less transparent investment structure). This will allow for, for example, investment by an Irish fund through an Irish wholly owned subsidiary into the shares of a Swedish company which in turn invests into a Luxembourg company which in turn invests into a Bulgarian holding company and then into a Bulgarian property. Additionally, prior approval for the use of such wholly owned vehicles will not be required. The Financial Regulator will set out a series of principles to follow and once followed, no prior approval will be needed.

### **Development Land Restriction Clarifications**

Whilst the restriction of 50% of gross assets in "development land" remains, the Financial Regulator has clarified that this relates to green field sites and development significant redevelopment projects and does not include the holding of vacant buildings or general refurbishment. We are of the view that, whilst we would like this restriction fully removed, it is something which can be overcome by the vast majority of funds (other than those which wish to be exclusively exposed to speculative opportunities).

### **Independent Valuer Disclosure Changes**

Details of the independent valuer no longer have to be disclosed in the prospectus provided that there is an appropriate disclosure in the periodic reports (semi-annual/annual reports). One can have more than one independent valuer per portfolio.

### **Title to Real Estate Assets – Key Change**

The key change has been in relation to the holding of title to property assets. Up until very recently the requirement has been, as is the case for all Irish domiciled regulated collective investment schemes, that title to property assets had to be held in the name of the custodian or within its sub-custody network. This raised legitimate concerns for trustees/custodians due to their perception of potential liability for environmental, asbestos related and public liability claims in certain circumstances where the liability was in excess of the value of the Fund/its insurance cover. The Financial Regulator has now confirmed that it is willing to allow the title to property to be held in the name of the Fund itself or in the name of an SPV (including on a layered basis) provided that either

- (i) a restriction be imposed on the title (i.e. to the effect that title cannot be disposed of without the prior consent of the Custodian); or
- (ii) a caution be registered on the title (i.e. to give notice to the Custodian of a proposed dealing in the property/to warn prospective purchasers that the prior consent of the Custodian would be required);or
- (iii) if neither (i) nor (ii) are possible, the Fund must undertake that it will not invest in real estate assets unless the Custodian is satisfied (x) that the property cannot be disposed of without its prior consent or (y) that arrangements equivalent to those set out in (i) or (ii) above are in place.

In relation to (iii) above, this is intended to include (but not be limited to) a situation where the Custodian is satisfied that, because it/its sub-custodian/lawyers etc hold the physical title deeds, the property cannot be disposed of without its consent.

This is a significant development as not only does it create flexibility but it also sets out clear parameters which we feel is better than other jurisdictions where they only allude to title arrangements in their rules leaving uncertainty/ambiguity.

### **Information Memorandum/Prospectus Directive**

The final point negotiated is a clear position adopted by both the Financial Regulator and by the Irish Department of Enterprise Trade & Employment (the government department responsible for the implementation of the Prospectus Directive), that the Irish Regulator will be willing to authorise as regulated collective investment schemes true closed-ended collective investment schemes which can and do avail of one or more of the exemptions

(from the requirement to issue a prospectus) under the Prospectus Directive. Instead of issuing a prospectus, such funds will be required to issue an Information Memorandum. The Financial Regulator will apply its rules on the information which it requires for a prospectus to an Information Memorandum thereby giving it comfort that it can actually regulate the offering made by such a vehicle and therefore allow it to remain within the regulated collective investment scheme regime.

## Investments in Unit-Linked Life Insurance Products

The Financial Regulator has recently issued guidelines in relation to investment by non-UCITS collective investment schemes in unit-linked investment products of insurance companies. The Financial Regulator has pointed out two main issues arising from such investment;

- ▣ the entering into a life assurance contract; and
- ▣ the investment in an underlying investment vehicle which is not subject to specific product regulation.

The Financial Regulator's guidelines provide that investment can only be made in such products in accordance with restrictions which apply to investment in unregulated schemes. In addition, as the assets within the unit-linked investment product are owned by the insurer, limits which apply to individual issuers are also relevant for consideration.

The Financial Regulator has stated the following:

- ▣ a non-UCITS scheme may invest in unit-linked investment products issued by insurance companies authorised within the European Economic Area;
- ▣ no more than 20% of the net assets of the non-UCITS scheme may be invested in the unit-linked investment product(s) of any one insurer;
- ▣ no more than 10% of net asset value may be invested in securities issued by the same institution;
- ▣ a combination of investments in securities and unit-linked products of a single insurer must not exceed 20% of net asset value; and

- ▣ this can rise to 40% of net asset value in the case of a QIF.

Any proposal to invest in unit-linked investment products must be explained in the prospectus and the underlying assets to which the fund will be exposed must be outlined in detail.

**Date:** September, 2006

**Author:** Andrew Bates

## CONTACT US

### Our Offices

#### Dublin

33 Sir John Rogerson's Quay,  
Dublin 2,  
Ireland.  
Tel: +353 1 667 0022  
Fax.: +353 1 667 0042

#### Cork

8 Webworks Cork,  
Eglinton Street,  
Cork, Ireland.  
Tel: +353 21 425 0630  
Fax: +353 21 425 0632

#### Boston

26th Floor,  
225 Franklin Street,  
Boston, MA 02110,  
United States of America.  
Tel: +1 617 217 2866  
Fax: +1 617 217 2566

#### New York

245 Park Avenue  
39<sup>th</sup> Floor  
New York, NY 10167  
United States  
Tel: +1 212 792 4166  
Fax: +1 212 792 4167

#### Tokyo

12th Floor,  
Yurakucho Itocia Building  
2-7-1 Yurakucho, Chiyoda-ku  
Tokyo 100-0006, Japan  
Tel: +813 6860 4885  
Fax: +813 6860 4501

e-mail: [enquiries@dilloneustace.ie](mailto:enquiries@dilloneustace.ie)  
website: [www.dilloneustace.ie](http://www.dilloneustace.ie)

### Contact Points

*For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.*

#### Andrew Bates

**e-mail: [andrew.bates@dilloneustace.ie](mailto:andrew.bates@dilloneustace.ie)**  
**Tel : +353 1 667 0022**  
**Fax: + 353 1 667 0042**

#### DISCLAIMER:

This document is for information purposes only and does not purport to represent legal advice. If you have any queries or would like further information relating to any of the above matters, please refer to the contacts above or your usual contact in Dillon Eustace.

#### Copyright Notice:

© 2009 Dillon Eustace. All rights reserved.  
This article was first presented at the International Bar Association Conference in Chicago in 2006.

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

33 Sir John Rogerson's Quay, Dublin 2, Ireland.  
[www.dilloneustace.ie](http://www.dilloneustace.ie)

In alliance with Arendt & Medernach