

New EU Hedge  
Fund, Private  
Equity and  
Derivative  
Proposals

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## NEW EU HEDGE FUND, PRIVATE EQUITY AND DERIVATIVE PROPOSALS

### A New EU Framework for Hedge Funds, Private Equity and Derivatives?

On 18 December, 2008 the European Commission issued a formal consultation document on hedge funds. The consultation document<sup>1</sup> sets out a series of targeted questions to be considered by all EU citizens and organisations but contributions are particularly sought from investors, the hedge fund industry, other financial institutions, public authorities and listed companies. It follows the policy announcements made to the EMAC<sup>2</sup> on 1 December, 2008 by Charlie McCreevy, Commissioner for the Internal Market and Services, on wider segments of the alternative investment market including private equity and derivatives.

Pursuant to this policy, the European Commission is examining, in line with relevant authorities in many other global markets, whether a new architecture for financial markets is required following the current economic crisis. It follows the wider statements from leaders of the G20 on 15 November, 2008 that "*all financial markets, products and participants should be regulated or subject to oversight, as appropriate to their circumstances*".

As the EU has only recently completed the implementation of a large-scale financial services reform pursuant to its Financial Services Action Plan<sup>3</sup>, it is hoped that further regulation will be not be overly restrictive, but rather will build on the existing regulation of EU market participants and help stimulate recovery by introducing targeted measures to restore market confidence. In this regard, it is positive to note that Commissioner McCreevy has categorised himself as a market liberal and has historically been sympathetic to the alternative investment community.

Indeed a previous analysis by the European Commission of the risks presented by hedge funds to the European financial and economic system suggested that all significant risks were adequately addressed by a combination of EU legislative measures, Member State national regulation and self regulatory codes.

However, the markets have now changed, the Commissioner has acknowledged that he recognises the value of good and appropriate regulation and, perhaps above all, the political will from many EU Member States is moving towards imposing some form of harmonised prudential supervision and further control on the alternative investment sector. In this regard, the hedge fund consultations follow recent EU proposals in the areas of banking capital adequacy, regulation of credit rating agencies, accounting reforms for EU financial

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<sup>1</sup> The consultation document is available for download – see Note 1 to this publication.

<sup>2</sup> Economic and Monetary Affairs Committee of the European Parliament.

<sup>3</sup> [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm)

institutions and amendments to the deposit guarantee scheme directive raising the minimum level of deposit guarantees throughout the EU.

## Hedge Funds

While the benefits hedge funds bring to the financial markets have been recognised, one of the main concerns expressed in the consultation is with regard to the impact highly-leveraged funds may have the stability of the financial system; and also to a perceived lack of transparency of hedge funds vis-à-vis regulators and other financial market actors.

These concerns have been further elaborated under five main headings:

- ▣ Applicable Scope – The Commission proposes to specifically identify the group of participants in the alternative investment markets which will fall within the scope of any future regulation, e.g. creating an EU harmonised definition of a “hedge fund”.
- ▣ Systemic Risk – A previous view was that hedge funds were considered of little systemic risk as their losses would largely be borne by investors and, to the extent such risks did arise, they were indirectly regulated via supervision of their managers and counterparties. However, the growth of the industry, the exposure of regulated investment banks (prime brokers), the large volume of trading by hedge funds, their derivative exposure and borrowing has prompted a need to re-examine this area.
- ▣ Market Efficiency And Integrity – The Commission proposes to examine the effect of hedge funds on market transparency and has specifically identified short-selling with an emphasis on the abuse of otherwise legitimate techniques, e.g. “naked” shorting or market manipulation.
- ▣ Management of Micro-Prudential Risks – How should the internal processes of hedge funds be improved, particularly with respect to risk management; and how should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?
- ▣ Transparency Towards Investors and Investor Protection – The Commission has proposed an examination of hedge fund reporting and transparency towards their investors. It is envisaged that this will apply to all investor classes but in particular to retail investors, who in recent years have gained greater exposure to the alternative markets.

*The areas of Private Equity and Derivatives were identified in Commissioner McCreevy’s policy speech to the EMAC but not specifically included in the hedge fund consultation documents. However, the consultation is noted as being applicable to a wider area and further specific consultations on these areas may issue.*

## Private Policy

The current view expressed by Commissioner McCreevy is that the private equity industry may need less regulation or reform than the hedge fund industry and the Commissioner notes that, it has been identified as a lesser risk area to overall financial stability. However, certain features of private equity have been singled out as raising concerns – particularly corporate governance, transparency, reporting and over-leveraging.

The Commission has engaged in a dialogue with the industry along the lines suggested by the *Lehne Report* (covering the above noted areas and also notification thresholds, investment policy disclosure and identification of shareholders) and shall report this to the European Parliament within the next three months at the latest. It was also noted that in reviewing the Basel 2 framework the appropriateness of the methodologies used to determine risk weightings applied to private equity deals needs to be critically looked at.

## Derivatives

As many observers will be aware, the Commission has already begun working towards moving Credit Default Swaps onto central clearing systems<sup>4</sup>.

Now, in coordination with the hedge fund and private equity consultations, a wider review of all derivatives will be undertaken to see if further measures are necessary to remove any risks to financial stability.

## Impact on Ireland

Until the final proposals are issued it is not certain as to what effect that they will have in Ireland, other EU Member States or on non-EU entities offering affected products into the EU.

However, if we try to take a positive view for Irish participants, the Irish alternative investment industry has long championed the use of regulated structures to replicate the hedge fund strategies employed in traditional low-regulation or unregulated offshore centres. As a result, the majority of Irish hedge funds and a large number of private equity vehicles use Irish authorised fund structures – some UCITS models but more typically Non-UCITS professional investor funds (PIFs) or qualifying investor fund (QIFs). These structures are

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<sup>4</sup> See

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/679&format=HTML&aged=0&language=EN&guiLanguage=en>

already regulated and meet the general criteria set out in self-regulatory models identified by Commissioner McCreevy<sup>5</sup> and the G20 as a possible source for any new framework.

Irish funds of this type are authorised by the Irish Financial Regulator (an EU recognised supervisory authority and a member of the Committee of European Securities Regulators) pursuant to Irish corporate, trust, contractual or partnership law and subject to regulatory Notices and Guidance Notes<sup>6</sup>. As a top-level summary, they have independent trustee and administration requirements, annual audit requirements, robust disclosure in offering documents, transparency requirements and conflicts of interest provisions. The promoters, managements and service providers must all be of good standing and pre-approved by the Irish Financial Regulator. PIFs and QIFs also have flexible segregated global custody, prime brokerage and counterparty controls and diversification limits aimed at protecting against counterparty risk.

As a result, Irish rules impose greater prudential substance than the majority of models sold from traditional offshore centres and also those of some EU domiciled competitors, e.g. the Luxembourg SIF. This substance may mean that they are affected to a lesser extent by any reforms.

This may mean that Irish funds will meet, or can be readily adapted to meet, restrictions on cross-border sales if the Commission decided to create a registration system or restrictions on distribution.

However, while Irish authorised funds are established under Irish laws, the derivative documentation they use is often governed by US or UK legal systems (being the most widely accepted legal standards in the market) and as a result any update of EU principles may have a direct impact on Irish parties.

## Timetable and Consultations

The public consultation has invited contributions from stakeholders by 31 January, 2009. The results will be discussed at a high-level conference to be held in Brussels in February, 2009. The intention is that the Commission's consultation should be completed so as to feed into the overall EU response to the G20 review. The work underway in the *de Larosiere*<sup>7</sup> group has also been identified as an important element in helping to shape the EU response to the crisis.

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<sup>5</sup> For example the President's Working Group on Financial Markets best practices for the hedge fund industry in the US and the proposals issued by the Hedge Fund Working Group in the UK.

<sup>6</sup> See the Financial Regulators UCITS and Non-UCITS Notices and Series of Guidance Notes.

<sup>7</sup> Jacques de Larosière has been charged by the Commission with a wide ranging review of the recent financial crisis. As well as supervision Mr de Larosière will review current regulatory and crisis prevention measures.

The G20 has decided that by 31 March, 2009 private sector bodies that have developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices.

**Date:**           **December 2008**

o       **Notes:**

1. The Consultation Document and further information can be view or downloaded at:  
[http://ec.europa.eu/internal\\_market/consultations/2008/hedge\\_funds\\_en.htm](http://ec.europa.eu/internal_market/consultations/2008/hedge_funds_en.htm)
2. The full text of Commissioner McCreevy's speech can be obtained via the following link:  
<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/665&format=HTML&aged=0&language=EN&guiLanguage=en>
3. Dillon Eustace publications giving greater detail on background to the Commissioner's speech, Irish hedge funds, private equity and derivatives can be obtained on request or by download from  
<http://www.dilloneustace.ie/publications>

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