



Regulatory
Outlook for the
Funds Industry
2007

DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

REGULATORY OUTLOOK FOR THE FUNDS INDUSTRY 2007

Introduction

Given the contributing role regulation may have on the competitiveness of the funds industry in Ireland and consequently its reputation, what is the regulatory outlook for 2007 and can we expect a measured approach from the Financial Regulator resulting in a positive impact on the Irish funds industry?

Irish Regulatory Outlook

In November 2006, the Financial Regulator issued its Strategic Plan which is a roadmap for Irish financial services regulation until 2009.

The Financial Regulator referred to aspirations shared by it and industry for a financially stable growing economy and a culture which promotes best international standards and the protection of consumers. To achieve this, the Financial Regulator set out its expectations of industry to implement good governance and sound risk management procedures, to willingly engage with it as regulator and most importantly to commit to protect consumers' interests. Equally the Financial Regulator undertook to strive for proportionate regulation based on extensive consultation and regulatory impact analysis, allow time for industry to adjust to regulatory changes and enforce compliance in a reasonable way.

The Financial Regulator expressed confidence that these expectations would be met given the mutual trust between it and its stakeholders to date. Indeed the Financial Regulator's fitness and probity regime which became effective as of the 1st January 2007 for directors and managers of financial services firms is an important cornerstone of this approach.

The Financial Regulator confirmed its approach to the supervision of regulated financial service providers, including managers, administrators and custodians of collective investment schemes, is risk focused, based on the nature of the risks inherent in the business of each financial service provider. Consequently the Financial Regulator utilises greater resources in the areas of greatest risk, for example financial service providers providing services to consumers in the State or holding client money in a fiduciary capacity.

This approach is evidenced by the Consumer Protection Code which was introduced by the Financial Regulator in August 2006 to ensure such financial service providers comply with conduct of business rules when dealing with consumers and by the Minimum Competency Requirements which became effective as of the 1st January 2007 whereby individuals acting on behalf of such financial service providers are required to hold minimum qualifications and to undertake a programme of continuing professional development.

On a positive note, the Financial Regulator also confirmed its approach to regulation will where possible continue to be principles based acknowledging that many regulatory requirements derive from European Directives which are unavoidably rules based e.g. MiFID, CRD, the Transparency Directive, etc.

Separate to regulatory developments, is 2007 the year we can expect the introduction of directors' compliance statements and audit committees?

The Companies (Auditing & Accounting) Act 2003 (the "2003 Act") provided for the introduction of directors' compliance statements and audit committees in relation to public limited companies and certain private limited companies that exceeded certain balance sheet and turnover thresholds. These provisions have yet to be commenced and it is expected that collective investment schemes will be exempted from such provisions. However it is expected that these provisions once commenced will apply to service providers that exceed the thresholds applicable to private limited companies.

In relation to directors' compliance statements, the Government has agreed to take forward the recommendations of the Company Law Review Group and it is expected that this revised model will be given effect in the Company Law Consolidation & Reform Bill which is expected to be published in 2007.

Separately, the Financial Regulator proposes to complete in 2007 its consultation on directors' compliance statements for regulated financial service providers as provided for in the Central Bank and Financial Services Authority of Ireland Act 2004.

In relation to audit committees, it is expected that these will be introduced in 2007 given the Office of the Director of Corporate Enforcement recently issued guidance on the issue.

EU Regulatory Outlook

2007 will see the implementation of the following remaining directives in the EU Financial Services Action Plan:-

The Third EU Money Laundering Directive (2005/60/EC), which is applicable to Irish authorised collective investment schemes and their managers and administrators, must be transposed into Irish law by the 15th December 2007. The Directive allows for client identification procedures to be carried out on a "risk-sensitive" basis, which is a welcome development for the funds industry.

Listed closed ended collective investment schemes need to be mindful of the Transparency Directive (2004/109/EC) which is due to be implemented into Irish law by 20th January 2007. The aim of the Directive is to increase investor protection and market efficiency by improving information made available to all investors of listed issuers. Although primary legislation to implement the Directive has been enacted, secondary legislation, although at an advanced stage, is yet to be introduced. However, implementation of the Directive may have to be delayed as the Level 2 implementing measures, which will apply in addition to the Directive, have yet to be formally adopted by the EU Commission.

Market in Financial Instruments Directive 2004/39/EC ("MiFID") is due to be transposed into Irish law by 31st January 2007 with a proposed effective date of 1st November 2007.

MiFID exempts collective investment undertakings, their managers and trustees and therefore MiFID will not directly affect Irish authorised collective investment schemes. However MiFID will apply to UCITS management companies authorised to carry out individual portfolio management under Article 5(3) of the UCITS Directive.

Fund service providers, such as non-UCITS management companies, administrators, distributors, etc that are authorised under the Investment Intermediaries Act 1995 to carry out any of the core investment services detailed in Section A of Annex 1 of MiFID will also come within the ambit of MiFID.

The Capital Requirements Directive, comprising Directives 2006/48/EC and 2006/49/EC (collectively known as the "CRD") presents a revised capital adequacy framework applicable to credit institutions, investment firms authorised under the Investment Intermediaries Act 1995 and any stockbroker authorised under the Stock Exchange Act 1995. It was transposed into Irish law with effect from the 1st January 2007 by the EC (Capital Adequacy

of Investment Firms) Regulations 2006 and EC (Capital Adequacy of Credit Institutions) Regulations 2006.

Despite implementation of the CRD, investment firms have the option of remaining under many of the existing CAD requirements until the 31st December 2007 provided notification is given as soon as possible to the Financial Regulator of their intended switch over date.

Worldwide Regulatory Outlook

Hedge fund managers will be aware of the decision in the 2006 U.S. case *Goldstein v SEC*, in which the SEC's Hedge Fund Advisor Registration Rule was vacated.

The main effect of the Hedge Fund Advisor Registration Rule was to narrow significantly the Private Advisor Exemption under the Investment Advisors Act of 1940 by redefining the meaning of "client", whereby private fund advisors were required to look through each fund and count the number of investors in the fund as clients.

On the 27th December 2006, the SEC published two proposals in order to address the *Goldstein* decision.

The proposed anti-fraud rule clarifies that the SEC is authorised to take action against investment advisors to hedge funds and other pooled investment vehicles that mislead or defraud investors whether or not the advisors are registered with the SEC.

The second proposed rule published by the SEC proposes amendments to the private offering rules under the US Securities Act 1933 which would define a new category of an accredited investor that would apply to the offer and sale of securities issued by hedge funds and other private investment pools to individuals. The proposed definition would include any natural person who meets either the net worth test or income test specified by the existing SEC rules, and owns at least US\$2.5 million in investments.

The proposed rules as published are currently subject to public comment and will be subject to a further vote of the SEC Commissioners before coming into force.

Conclusion

Given the depth of regulatory changes to be introduced in 2007, it remains to be seen whether the Financial Regulator will be successful in adopting a proportionate approach by striking a balance between the benefits of regulation and the constraints it imposes on service providers within the funds industry.

However there have been positive developments already in 2007 with the Financial Regulator agreeing to revise the current process for authorisation of qualifying investor funds (“QIFs”), such that a QIF will now be capable of being authorised by the Financial Regulator on a filing only basis. Although one of the recommendations in the Government’s strategy document ‘Building on Success’ for the International Financial Services Industry in Ireland, it indicates the Financial Regulator’s intent in pursuing a proportionate approach to regulation in order to realise the shared aspiration of a competitive financial services industry. A very welcome development indeed!

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Author: Brian Kelliher

 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
39th 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
website: 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.

Brian Kelliher

e-mail: brian.kelliher@dilloneustace.ie
Tel : +353 1 667 0022
Fax: + 353 1 667 0042

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DILLON  EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

33 Sir John Rogerson's Quay, Dublin 2, Ireland.
www.dilloneustace.ie

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