A Guide to UCITS in Ireland
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Introduction
A GUIDE TO UCITS IN IRELAND

1. Introduction

Undertakings for Collective Investment in Transferable Securities, commonly referred to as UCITS, are collective investment schemes established and authorised under a harmonised European Union (EU) legal framework under which a UCITS established and authorised in one EU Member State can be sold cross border into other EU Member States without a requirement for an additional authorisation. This so-called “European passport” is central to the UCITS product and enables fund promoters to create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction by jurisdiction basis.

Originally introduced over twenty years ago, UCITS have become the gold standard EU investment fund product, recognised not only by the European financial services community but also further afield with many non-EU jurisdictions accepting UCITS as suitable for retail sale into their domestic markets. Whilst sold across the full spectrum of investor types, UCITS have been designed principally for the retail market as open-ended diversified, liquid products with their parameters - permitted asset classes and investment and borrowing restrictions - being enshrined in EU law.

Importantly, UCITS is not a product which has stood still, rather it has and continues to evolve, most recently with a significant broadening of permitted asset classes and more robust governance requirements being introduced in 2002 and clarified in 2007 and with a series of additional changes now envisaged under the UCITS IV proposal having as their aim a further simplification of the European passport process for UCITS, the use of master/feeder type structures, the creation of a framework for cross-border fund mergers and the replacement of the Simplified Prospectus. Underpinning UCITS and the proposed future evolutions of the product has been a common EU approach with involvement from securities regulators and industry participants across the European Union at each stage of the development process. Whilst at times the pace of change may be too fast for some and too slow for others, to date UCITS has generally achieved the right balance.

Ireland has become one of the leading EU “exporting” jurisdictions for UCITS having been pro-active in implementing the UCITS regime into domestic legislation in 1989, introducing a sensible investment funds focused fiscal regime and clear but prudent process for the authorisation and supervision of UCITS and relevant service providers. The result has been that promoters from all across the world have and continue to use Ireland as a domicile of choice for UCITS products seeking to access the European market place and, in many cases, further afield.
Legislative Basis for UCITS in Ireland
2. Legislative Basis for UCITS in Ireland

The legislative basis for UCITS in Ireland is founded on European law implemented domestically, expanded upon by UCITS related notices issued by the Irish Financial Regulator (the “UCITS Notices”) and with further clarification provided for in a series of Financial Regulator guidance notes (“Guidance Notes”) each of which – European and domestic legislation and the UCITS Notices and Guidance Notes – have evolved and been amended over time.

(i) European Legislation

The original UCITS Directive (Directive 85/611/EC) of 1985 established the UCITS product as a pan-European collective investment scheme which benefited from an EU-wide passport based on the concept of mutual recognition of Home State authorisation, setting down the legal forms which UCITS could take, their permitted investment and borrowing rules, liquidity requirements, prospectus disclosure rules and rules relating to annual and semi-annual reporting as well as rules relating to the role and duties of UCITS custodians/depositaries and their management companies.


UCITS III represented a major overhaul of UCITS in terms of what they could invest in, how they could be offered and sold and how they were to be managed.

Given the experience of the original UCITS regime and an often inconsistent, as between EU Member States, application of its terms, the introduction of UCITS III was followed by the creation of CESR, the Committee of European Securities Regulators, which was requested to advise on the interpretation of terms used within UCITS III with the aim of achieving a common agreed position on its interpretation and application. Following a series of consultations, CESR issued its final advices in January, 2006, followed in March, 2007 by a European Commission implementing Directive (Directive 2007/16/EC), referred to as the Eligible Assets Directive, which was in turn accompanied by CESR guidelines concerning UCITS eligible assets.

(ii) Irish Legislation

The original 1985 UCITS Directive (as amended) was implemented into domestic Irish law by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 1989 (the “1989 UCITS Regulations”).

Subsequently amended by S.I. No. 497/2003, by the Central Bank and Financial Services Authority Act, 2004 (introduction of a single regulator for financial services in Ireland), by the Investment Funds, Companies and Miscellaneous Provisions Act, 2005 (introduction of segregated liability for umbrella investment companies) and by S.I. No. 832/2007 (implementation of Eligible Assets Directive), the present legislative basis for UCITS in Ireland is encompassed in the 2003 UCITS Regulations (as amended).

(iii) UCITS Notices

The Irish Financial Regulator has issued a specific set of UCITS Notices which explain and clarify various aspects of the UCITS Regulators and which set down conditions not contained within the UCITS Regulations with which Irish UCITS are required to conform.

These UCITS Notices deal with:

- Supervisory requirements for UCITS authorised by the Financial Regulator and certain firms providing services to such UCITS – UCITS 2.
- Trustees – eligibility criteria – UCITS 3.
- Trustees – duties and conditions – UCITS 4.
- General conditions – UCITS 5.
- Prospectus – UCITS 6.
- Information to be included in the monthly returns – UCITS 7.
- Publication of annual and half-yearly reports – UCITS 8.
- Borrowing powers – UCITS 11.
- Techniques and Instruments including Repurchase/Reverse Repurchase and Stock lending for the purposes of efficient portfolio management – UCITS 12.
- Dealings by promoter, manager, trustee, investment adviser and group companies – UCITS 14.
- Supervisory requirements for UCITS authorised in another Member State intending to market their units in Ireland – UCITS 15.
(iv) Financial Regulator Guidance Notes and Policy Documents

The Financial Regulator has additionally issued a series of Guidance Notes which provide further clarification on the Financial Regulator’s approach on particular issues and has also issued a number of specific policy documents.

Certain Guidance Notes have application to all regulated fund types (both UCITS and Non-UCITS) such as those dealing with fund promoters, permitted markets for retail schemes, multi-adviser schemes, Money Market Funds, valuation rules, etc., with others having specific UCITS application such as those dealing with UCITS investing in other collective investment schemes, with UCITS investing in Financial Derivative Instruments, with the Simplified Prospectus, with UCITS investing in Financial Indices and with UCITS prospectus disclosures for Structured Products and Complex Trading Strategies.
Overview of UCITS
Permitted Asset Classes and Investment and Borrowing Restrictions
3. Overview of UCITS Permitted Asset Classes and Investment and Borrowing Restrictions

(i) Permitted Asset Classes

Whilst dealt with in greater detail in following sections, UCITS are in summary permitted to invest in:

- transferable securities and money market instruments which are either admitted to official listing on a stock exchange in an EU Member State or non-EU Member State or which are dealt on a market which is regulated, operating regularly recognised and open to the public;

- recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described above) within a year;

- money market instruments, other than those dealt in on a regulated market provided that the issue or the issuer is itself regulated for the purpose of protecting investors and savings;

- units of UCITS and units of non-UCITS collective investment schemes (CIS) (in certain cases);

- deposits with credit institutions; and

- financial derivative instruments that meet certain criteria; and

market instruments other than those referred to above (subject to a maximum aggregate limit of net asset value).

Given the increased investment opportunities granted under UCITS III and the subsequent clarification of the terms “transferable securities” and “money market instruments”, UCITS provide for a very broad spectrum of fund types and exposures, from relatively plain vanilla equity and bond products through to UCITS taking exposures to hedge fund and commodities indices, with UCITS fund of funds, money market and cash funds and index replicators also provided for.

(ii) Investment and Borrowing Restrictions

You will find the standard UCITS investment and borrowing restrictions set out in Appendix B. In the following sections further detail is given on the application of those investment and borrowing restrictions, taking account of how the Financial Regulator has interpreted and/or applies those restrictions, in the context of particular types of UCITS products.

In summary, however, it is important to note:

- that the principal UCITS focus is on portfolio diversification and liquidity;

- the general “5/10/40” rule requiring that no more than 10% of a UCITS net assets may be invested in transferable securities or money market instruments issued by the same body, with a further
aggregate limitation of 40% of net assets on exposures of greater than 5% to single issuers;

- that there are exceptions to the above for investments issued or guaranteed by governments, local authorities or certain public international or supra-national bodies;

- that index replicators can take exposures up to 20% of net assets to single issuers, with up to 35% to a single issuer in exceptional market conditions;

- that up to 100% of net assets can be invested in other collective investment schemes (CIS), provided no more than 20% invested in any one CIS, with an aggregate restriction of 30% of net assets applying to investment in non-UCITS CIS as well as strict rules applying to the nature of CIS in which a UCITS can invest, as well as limiting investment to a maximum of 25% of the units of the underlying CIS;

- that no more than 20% of net assets can be invested in cash deposits with any one credit institution as permitted by the Financial Regulator and up to 10% of net assets may be held for ancillary liquidity purposes with other credit institutions (which 10% limit is raised to 20% in the case of deposits made with the custodian/trustee);

- that investments in/through derivatives may be made/taken to assets in to which a UCITS can invest directly including financial instruments having one or several characteristics of those assets, and to financial indices, interest rates, FX rates and currencies;

- that the maximum exposure to a single OTC derivative counterparty is 5%, increasing to 10% for certain credit institutions;

- that various aggregations of the above restrictions apply (see Appendix B for further detail);

- that the maximum aggregate exposure to securities/instruments (other than CIS, derivatives and cash) not listed or traded on a recognised market is 10% of net assets;

- that additional general provisions apply including concentration limits, prohibitions on taking legal/management control of issuers, prohibitions on uncovered sales; and

- that borrowings are limited to 10% of net assets and can only be used for temporary purposes (for liquidity).

(iii) Efficient Portfolio Management Techniques and Instruments

UCITS are permitted to use techniques and instruments relating to transferable securities and money market instruments for efficient portfolio management (EPM) purposes which is taken to mean that they are economically appropriate and are entered into with the aim of reducing risk,
reducing cost or generating additional capital or income (with a level of risk consistent with the UCITS risk profile).

Derivatives used for EPM purposes must comply with normal rules for investment in financial derivative instruments.

Repos/Reverse Repos and stocklending are expressly permitted with strict rules regarding collateral including acceptable forms of collateral, level provided, valuation of collateral and how and where held and maintained. There are also strict rules as to counterparty credit rating (A2 or equivalent or deemed implied rating of A2) or indemnification.
4

Transferable Securities and Money Market Instruments
4. Transferable Securities and Money Market Instruments

As the UCITS acronym suggests, its original focus was on investment in “transferable securities” although as you will note from the following sections UCITS do offer far wider investment possibilities. Additionally a primary UCITS focus has been on “money market instruments”. Although the full definitions of both terms are set out in Appendix A, we have highlighted the key elements of both below, particularly given the clarifications provided in 2007 by the Eligible Assets Directive.

A. Transferable Securities

(i) UCITS III Definitions

Whilst not defined in the original 1985 UCITS Directive, the UCITS III Product Directive did introduce a definition of the term “transferable securities” as being:

- shares in companies and other securities equivalent to shares in companies (“shares”);
- bonds and other forms of securitised debt (“debt securities”);
- other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

other than the permitted UCITS efficient portfolio management (EPM) techniques and instruments.

(ii) Clarification by Eligible Asset Directive

In 2007 the Eligible Assets Directive clarified the above definition by providing that the reference to transferable securities “shall be understood as a reference to financial instruments which fulfil the following criteria”:

(a) the potential loss which the UCITS may incur with respect to holding those instruments is limited to the amount paid for them;

(b) their liquidity does not compromise the ability of the UCITS to comply with its obligation to provide at least fortnightly redemption facilities;

(c) reliable valuation is available for them as follows:

(ii) in the case of securities admitted to or dealt in on a regulated market in the form of accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from issuers;

(iii) in the case of other securities [i.e. the aggregate 10% that can be invested in transferable securities and money market instruments not specifically referred to in Article 19(1)], in the form of a valuation on a periodic basis which is derived
from information from the issuer of the security or from competent investment research;

(d) appropriate information is available for them as follows:

(i) in the case of securities admitted to or dealt in on a regulated market as referred to in subparagraphs (a) to (d) of Article 19(1), in the form of regular, accurate and comprehensive information to the market on the security or, where relevant, on the portfolio of the security;

(ii) in the case of other securities as referred to in Article 19(2), in the form of regular and accurate information to the UCITS on the security or, where relevant, on the portfolio of the security;

(e) they are negotiable;

(f) their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS;

(g) their risks are adequately captured by the risk management process of the UCITS.

It is worth noting that liquidity is a central requirement for UCITS portfolios and, accordingly, there are broad principles laid down regarding presumptions as to liquidity, assessment of liquidity risk where information is available which suggests redemption facilities could be compromised by a transferable security as well as principles regarding consideration of or presumption of negotiability.

(iii) Closed Ended Funds

The Eligible Assets Directive has made it clear that certain closed-ended funds will fall within the “transferable securities” definition and therefore be eligible for investment by UCITS where:

(i) they fulfil the criteria set out in “(ii) Clarification by Eligible Assets Directive” above;

(ii) they are subject to corporate governance mechanisms applied to companies or equivalent to those applied to companies;

(iii) they are managed by an entity which is (or where asset management activity is carried out by another entity on behalf of the closed ended fund, that entity is) subject to national regulation for the purpose of investor protection.

Appendix A sets out some of the principles used in considering the equivalence of corporate governance mechanisms for contractual type closed-ended funds.

A UCITS may not make investment in closed ended funds for the purposes of circumventing the normal UCITS investment limits.

(iv) Structured Financial Instruments

Structured financial instruments can also be eligible for investment as “transferable
securities” where they are financial instruments which:

(i) fulfil the criteria set out “(ii) Clarification by Eligible Assets Directive” above;

(ii) are backed by, or linked to the performance of, other assets, which may differ from those referred to in Article 19(1); provided that where a financial instrument covered by this subparagraph contains an embedded derivative component, the requirements regarding the derivatives risk management process, global exposure and aggregation of direct and indirect exposures shall apply to that component.

B. Money Market Instruments

The term “money market instruments” refers to instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time. UCITS can invest in money market instruments admitted to trading/dealt in on a regulated market and in money market instruments which are not admitted to or dealt in on a regulated market.

(i) Instruments normally dealt in on the Money Market

The reference to money market instruments as “instruments normally dealt in on the money market” shall be understood as a reference to financial instruments which fulfil one of the following criteria:

(i) they have a maturity of issuance of up to and including 397 days;

(ii) they have a residential maturity of up to and including 397 days;

(iii) they undergo regular yield adjustments in line with money market conditions at least every 397 days;

(iv) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in subparagraphs (i) or (ii), or are subject to a yield adjustment as referred to in subparagraph (iii).

(ii) Instruments which are liquid

The reference to money market instruments as “instruments which are liquid” shall be understood as a reference to financial instruments which can be sold at limited cost in an adequately short time frame, taking into account the obligation of the UCITS to repurchase or redeem its units at the request of any unit holder.

Appendix A sets down the factors to be taken into account at both the instrument and fund level in assessing liquidity.

(iii) Instruments which have a value which can be accurately determined at any time

The reference to “money market instruments as instruments which have a value which can be accurately determined at any time”
shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:

(a) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm’s length transaction;

(b) they are based either on market data or on valuation models including systems based on amortised costs.

With respect to the criterion “value which can be accurately determined at any time”, if the UCITS considers that an amortisation method can be used to assess the value of a money market instrument, it must ensure that this will not result in a discrepancy between the value of the money market instrument and the value calculated according to the amortisation method as set out in Guidance Note/08 UCITS: Valuation of assets of money market funds.

More detail on liquidity requirements and on governmental issues and issues by securitisation vehicles can be found in Appendix A.
UCITS Money Market Funds
5. UCITS Money Market Funds

Whilst many UCITS will invest principally in money market instruments and may consider themselves to be money market funds, there are only certain funds which are permitted by the Financial Regulator to refer to “money market funds” in its title and to follow an amortised cost valuation methodology. Such money market funds must be established as constant NAV Funds or accumulating NAV funds with the principal objective to preserve principal and maintain liquidity. Further, only those money market funds which have obtained a triple A rating from an internationally recognised rating agency together with a supplementary market risk rating (for example AAm by Standard & Poor's or Aaa/MR1+ by Moodys) or which have management companies/investment managers with demonstrable expertise in the operation of money market funds (which use amortised cost valuation) can use the term money market fund or UCITS money market fund in their title and follow an amortised cost valuation methodology.

Other types of money market funds may not use the term money market fund in their title and must value assets on a mark to market basis in accordance with the valuation rules set out by the Financial Regulator in its Guidance Note 1/00.

In this section we deal only with the former type of money market fund.

(i) Key Conditions

A number of conditions apply to money market funds which use the amortised cost valuation methodology as follows:

*Eligible Assets:* assets must be restricted to cash or high-quality money market instruments;

*Maturity:* assets are restricted to securities which comply with one of the following criteria:

(a) have a maturity at issuance of up to and including 397 days;

(b) have a residual maturity of up to and including 397 days; and

(c) undergo regular yield adjustments in line with money market conditions at least every 397 days; and/or

(d) the risk profile, including credit and interest rate risk, correspond to that of financial instruments which have such maturities or yield adjustments.

In the case of (c) and (d) above, the money market instruments invested in must also meet with the final maturity requirements of the relevant rating agency.

*WAM:* the weighted average maturity of the portfolio must not exceed 60 days;

*Mark to Market:* a weekly review of discrepancies between market value and amortised cost value of money market instruments must be carried out with escalation procedures being put in place to ensure that material discrepancies are brought to the attention of investment management personnel with discrepancies in excess of 0.1% being brought
to the attention of senior management within the management company or board of directors, the investment manager and trustee/custodian and if discrepancies in excess of 0.3% occur then a daily review must take place with the management company/directors notifying the Financial Regulator of the discrepancies and indicating what action, if any, will be taken to reduce the dilution.

**Stress Testing:** a monthly portfolio analysis is required to be carried out incorporating stress testing to examine portfolio returns under various market scenarios to determine if portfolio constituents are appropriate to meet predetermined levels of credit risk, interest rate risk, market risk and investor redemptions and this periodic analysis must be available for inspection by the Financial Regulator.

(ii) **ECB Reporting Requirements**

Money market funds are required to provide a variety of monthly and quarterly data through the Financial Regulator for the purpose of European Central Bank reporting requirements. Guidance Note GN2/99 sets out the relevant requirements into which money market funds the obligations apply.
Index Tracking UCITS
6. Index Tracking UCITS

One of the cornerstones of UCITS since the introduction of the original UCITS Directive in 1985 has been the imposition of strict risk spreading requirements. This has been enshrined in what is commonly known as the 5/10/40 rule which is that a UCITS may invest no more than 10% of its net assets in transferable securities or money market instruments issued by the same body, provided that the total value of transferable securities or money market instruments held in issuing bodies in each of which it can invest more than 5% is less than 40%.

This fundamental UCITS principle did create problems for UCITS which wished to track an index where the weighting of a constituent element of the index exceeded the 5% limit or where the relationship between two or more constituent elements of the index meant that they were considered to constitute a single issuer resulting in an aggregation of the exposure.

(i) 20% and 35% Rule

Since the introduction of a UCITS III, UCITS whose policy is to replicate an index is now permitted to invest up to 20% of net assets in shares and/or debt securities issued by the same body, with the 20% limit being raised up to 35% in the case of a single issuer where justified by exceptional market conditions. This flexibility is permitted where the relevant index is recognised by the Financial Regulator on the basis that it is sufficiently diversified, it represents an adequate benchmark for the market to which it refers and it is published in an appropriate manner.

(ii) Index Replication

The reference to “replication” of the composition of a shares or debt securities index is considered by the Financial Regulator to mean replication of the composition of the underlying assets of the index including the use of derivatives or other permitted UCITS efficient portfolio management techniques and instruments.

(iii) Sufficient Diversification

Although somewhat circular, reference to an index’s composition being diversified refers to an index which allows for a maximum weighting per issuer of 20% with a capacity for a single constituent to exceed 20% but not exceed 35% of the index.

(iv) Adequate Benchmark

The reference to the index representing an adequate benchmark for the market to which it refers is a reference to an index whose provider uses a recognised methodology which generally does not result in the exclusion of a major issuer of the market to which it refers.

(v) Publication

The requirement that the index be published in an appropriate manner is taken as a reference to an index which is accessible to the public and where the index provider is independent from the index replicating UCITS. Note, however, that this second requirement does not preclude index providers and the UCITS forming part of the same economic group provided that effective arrangements for the management of conflicts of interest are in place.
UCITS Investing in Other Collective Investment Schemes
7. UCITS Investing in Other Collective Investment Schemes

UCITS are permitted to invest up to 100% of their assets in other open-ended collective investment schemes ("CIS") where those CIS are:

- other UCITS; or

- other EU or non-EU CIS the sole object of which is the collective investment in transferable series and/or in other liquid financial assets of capital raised from the public and which operate on the principle of risk spreading and the units of which are at the request of holders, repurchased or redeemed, directly or indirectly out of those undertakings assets provided that:

  (a) such other CIS are authorised under laws which provide that they are subject to supervision considered by the Financial Regulator to be equivalent to that laid down in community law and that co-operation between authorities is sufficiently insured;

  (b) the level of protection for unitholders in the other CIS is equivalent to that provided for investors in a UCITS and in particular that the rules on assets segregation, borrowing, lending and uncovered sales of transferable securities and money market instruments are equivalent to the requirements of the UCITS;

(c) the business of the other CIS is reported in half-yearly and annual reports to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period; and

(d) no more than 10% of the UCITS or other CIS assets, whose acquisition is contemplated, can be, according to its rules or instruments of incorporation invested in aggregate in units of other UCITS or other open-ended CIS.

(i) Investment Restrictions

In addition to the restrictions on the types of non-UCITS CIS that a UCITS may invest in, there are four main investment restrictions which apply to UCITS investing in other CIS which are that:

- the maximum exposure to any one CIS may not exceed 20% of the net asset value of a UCITS (each sub-fund of an underlying umbrella CIS being regarded as a separate CIS for the purpose of applying this limit);

- the maximum aggregate investment in non-UCITS CIS may not exceed 30% of the net asset value of the UCITS;

- investment in a CIS which can itself invest more than 10% of net assets in other CIS is not permitted; and

- investment in a CIS must not result in the acquisition of more than 25% of the
units of any single CIS (or sub-fund of an umbrella CIS).

(ii) Acceptable Types of Non-UCITS CIS

In Guidance Note 2/03, the Financial Regulator has indicated it will permit investment by UCITS in the following categories of non-UCITS CIS:

- schemes established in Guernsey and authorised as Class A schemes;
- schemes established in Jersey as Recognised Funds;
- schemes established in the Isle of Man as Authorised Schemes;
- Non-UCITS Retail CIS authorised by the Financial Regulator itself provided such CIS comply in all material respects with the provisions of the UCITS Notices;
- non-UCITS CIS authorised in the Member State of the EEA, the United States, Guernsey or the Isle of Man and which comply, in all material respects with the provisions of the UCITS Notices.

(iii) Financial Regulator’s consideration of “in all material respects”

In this regard, the Financial Regulator’s consideration of “all material respects”, includes, inter alia, consideration of:

- the existence of an independent trustee/custodian with similar (to Irish trustee/custodians) duties and responsibilities in relation to both safekeeping and supervision;
- requirements for the spreading of investment risk, including concentration limits, ownership restrictions, leverage and borrowing restrictions, etc.;
- availability of pricing information and reporting requirements;
- redemption facilities and frequency;
- restrictions in relation to dealings by related parties.

(iv) Other Jurisdictions Tests

As you will note from the above, the Financial Regulator has indicated a number of jurisdictions and types of CIS which it considers to be acceptable for investment by a UCITS. Other jurisdictions and types of CIS may be considered by the Financial Regulator on submission to it and in assessing any such submissions, the Financial Regulator has indicated in its Guidance Note that it will have regard to memoranda of understanding (bi-lateral or multi-lateral), membership of an international organisation of regulators or other co-operative arrangements, (such as exchange of letters) to ensure satisfactory co-operation between the Financial Regulator and the competent authority of the relevant CIS:

- the management company of the target CIS, its rules and its choice of trustee
have been approved by its own regulator;

- the CIS is authorised in an OECD jurisdiction.

(v) Financial Regulator's consideration of “equivalence” for Non-UCITS CIS

As indicated above, in order for a non-UCITS to be an acceptable investment of a UCITS, the Financial Regulator needs to be satisfied that it is both authorised under a legislative regime which provides that it is subject to supervision considered by the Financial Regulator to be equivalent to that specified in community law and that the applicable regulatory regime is such that the level of protection for investors is equivalent to that provided for investors in a UCITS, that rules on segregation of assets, borrowing, lending and uncovered sales of transferable securities and money market instruments are equivalent to those laid down by the UCITS Directive.

In its Guidance Note 2/03, the Financial Regulator has indicated that it will use the following factors to guide its consideration as to whether such equivalence exists:

- rules guaranteeing the autonomy of the management of the CIS, and management in the exclusive interest of the unitholders;

- the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision. Where an independent trustee/custodian is not a requirement of local law, robust governance structures may provide a suitable alternative;

- availability of pricing information and reporting requirements;

- redemption facilities and frequency;

- restrictions in relation to dealings by related parties;

- the extent of asset segregation; and

- local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the CIS.

(vi) Fees/Charges and Disclosures

Where a UCITS intends to invest more than 20% of its net assets in other CIS, its prospectus must disclose the maximum level of management fees that may be charged to the UCITS itself and to the underlying CIS. In other words, the aggregate management fees at both levels have to be disclosed. In addition, actual aggregate management fees at both levels have to be disclosed in the UCITS annual report.

In addition, where a UCITS invests in a linked CIS (where both the UCITS and CIS are managed, directly or indirectly by delegation by the same management company or where the management
company of both the UCITS and underlying CIS are linked by common management or control or by a substantial direct or indirect holding), the manager of the underlying CIS is not permitted to charge subscription or redemption fees by account of the UCITS investment in it.

(vii) Cross Investment with umbrella Investment Companies

One sub-fund within a UCITS umbrella investment company type scheme is only permitted to invest in another sub-fund within the same umbrella where the umbrella scheme or its delegate (i.e. the administrator) has the systems capability to provide disclosure in relation to cross-holdings in accordance with industry adopted standards.

Where a sub-fund invests in one or more sub-funds of any umbrella UCITS, in addition to the requirements above in relation to investment by UCITS in a linked CIS, the investing sub-fund may not charge an annual management fee (or investment management fee) in respect of that portion of its assets invested in other sub-funds.

Additionally, investment may not be made in a sub-fund which itself holds units in other sub-funds within the same umbrella UCITS.
UCITS investing in Financial Derivative Instruments
8. UCITS investing in Financial Derivative Instruments

UCITS may invest in financial derivative instruments for investment purposes subject to a variety of conditions as outlined below relating to the nature of the exposures taken, the leverage generated through such positions, the process employed by the UCITS to manage the risks arising from derivatives investment as well as rules relating to OTC counterparty exposure and to the valuation of derivatives positions.

The Financial Regulator has prescribed in detail through its UCITS Notices and Guidance Notes the risk management conditions that must be met by Irish UCITS investing in derivatives.

Prior to the introduction of UCITS III, UCITS could only employ derivatives for efficient portfolio management (“EPM”) purposes. Regulation 45 of the UCITS Regulations now provides that UCITS may invest in exchange traded or over-the-counter derivative instruments for investment purposes, subject to certain conditions in particular those set down in:

- UCITS Notice 9 – which sets out investment restrictions applicable to UCITS including limits on counterparties and certain counterparty criteria;
- UCITS Notice 10 – which sets out high level derivatives rules including summary of permitted derivatives, cover requirements and risk management requirements; and
- Guidance Note 3/03 – which contains detailed provisions for the use of derivatives by UCITS.

(i) Conditions for the use of derivatives by UCITS

As outlined in UCITS Notice 10, UCITS may invest in any type of exchange traded or OTC derivative for investment purposes, subject to the following conditions:

- the underlying asset relates to UCITS eligible assets (i.e. transferable securities, money market instruments, CIS, deposits), financial instruments having one or several characteristics of these assets, financial indices, interest rates, foreign exchange rates or currencies;
- the counterparties to OTC derivative transactions are institutions subject to prudential supervision and belong to categories approved by the Financial Regulator (qualifying credit institutions, MIFID authorised investment firms or an entity subject to regulation as a Consolidated Supervised Entity by the US Securities and Exchange Commission) with a minimum credit rating (in the case of counterparties which are not credit institutions) of A2 or equivalent, or an implied rating of A2 or guaranteed by an entity with a rating of A2;
- the OTC derivatives are subject to reliable and verifiable valuation on a
daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the initiative of the UCITS.

Positions may create long or short exposure to the underlying asset and may result in leverage to the portfolio.

UCITS that use derivatives for investment (or for EPM) purposes must prepare a Risk Management Process and file it for approval with the Financial Regulator. In addition, adequate disclosure of derivative investments must be made in the UCITS’ prospectus. Specific provisions in this regard are outlined in Guidance Note 3/03.

(ii) Guidance Note 3/03

Guidance Note 3/03 was produced by the Financial Regulator to outline clearly the parameters for the use of derivatives by UCITS and to provide guidance on what the Financial Regulator expects in relation to the measurement and control of derivatives associated risk by UCITS.

Guidance Note 3/03 contains detailed requirements regarding the format and content of the Risk Management Process, the options for measuring and controlling risk exposure and sets out requirements and limits on position exposure, counterparty exposure as well as counterparty restrictions.

(iii) Risk Management Process

In order to monitor, measure and manage the risk profile of a UCITS, its investment manager must construct a formal Risk Management Process that is adapted to the complexity and sophistication of the derivatives used within the UCITS.

(iv) Sophisticated vs. Non-sophisticated UCITS

The rules for measuring global exposure and leverage differ depending on whether a UCITS is characterised as ‘sophisticated’ or ‘non-sophisticated’.

The Financial Regulator has not provided a formal definition of what constitutes a ‘sophisticated’ or ‘non-sophisticated’ UCITS, rather requiring the UCITS to classify itself as either ‘sophisticated’ or ‘non-sophisticated’ and provide a rationale for such classification.

Factors that may cause a UCITS to be considered ‘sophisticated’ include the following:

- where the use of derivatives forms a fundamental part of the UCITS’ investment objective and would be expected to be used in all market conditions;

- where the performance of the derivative is nonlinear in relation to the underlying assets or the performance is based on a reasonably complex mathematical formula;
where the use of cover for the derivative position is different from the underlying of the derivative.

The use of OTC derivatives might indicate the UCITS is more sophisticated but the complexity of the transaction should also be considered.

A ‘non-sophisticated’ UCITS will generally only use a limited number of simple derivative instruments for non-complex hedging or investment strategies.

(v) Measurement of Global Exposure and Leverage – Non-Sophisticated UCITS

Guidance Note 3/03 provides that the global exposure and leverage of a non-sophisticated UCITS should be measured using the commitment approach. A UCITS’ global exposure may not exceed its net asset value. Thus a leverage limit of 100% applies (leverage being global exposure divided by net asset value).

The commitment approach takes into account the following in seeking to ensure that risk is monitored in terms of any future commitments to which the UCITS may be obligated:

- the current value of the underlying assets the derivatives are based on (delta-adjusted in the case of options and warrants);
- counterparty risk;
- future market movements; and
- the time available to liquidate the position.

(vi) Measurement of Global Exposure and Leverage – Sophisticated UCITS

A sophisticated UCITS is required to use an advanced risk measurement methodology to measure global exposure. The Financial Regulator recommends the use of the Value-at-Risk (VaR) method and requires that the VaR model employed by the UCITS meets certain quantitative and qualitative criteria and be calculated using an acceptable proprietary or commercially available model.

Absolute VaR or Relative VaR may be applied. Absolute VaR is the VaR of the UCITS capped as a percentage of net asset value. Generally, the Financial Regulator will impose a limit on Absolute VaR of 5% of net asset value.

Relative VaR is the VaR of the UCITS divided by the VaR of a benchmark or a comparable, derivatives-free portfolio. Under Relative VaR, VaR is limited to twice the VaR on the benchmark or comparable, derivatives-free portfolio.

The VaR model used must adhere to the following requirements:

- the confidence level should be 99%;
- maximum holding period of one month;
minimum historical observation period of one year (less if justified, for example on the grounds of recent significant changes in price volatility);

stress tests carried out at least quarterly (to assess the likely impact of potential movements in interest rates, currencies and credit quality);

back testing of the VaR model (a formal statistical process to compare actual portfolio returns to the VaR predicted).

Details should also be disclosed of the following:

(i) software used

(ii) internal controls and internal audit of procedures;

(iii) additional risk measurement methods employed; and

(iv) profile and expertise of staff monitoring risk.

(vii) Netting/Hedging

Hedging positions may be offset and netting applied before calculating global exposure, counterparty exposure, position and cover requirements.

(viii) Netting

In the context of global exposure, position and cover requirements, purchased and sold derivatives positions may be netted subject to the following conditions:

both positions must relate to the same underlying asset/reference item or, in the case of derivatives on fixed income securities, they must bear a high degree of negative correlation in terms of price movement and both are cash settled with the same currency exposure;

the positions should be liquid and marked-to-market daily;

in the event that one of the positions is exercised, arrangements are such that the UCITS will have the cover necessary to fulfil its actual or potential obligations under the outstanding position.

In the context of counterparty exposure, purchased and sold derivatives positions may be netted provided there is a contractual netting agreement in place with the counterparty.

(ix) Hedging

In addition, hedging positions that reduce the overall risk profile of the UCITS will be permitted where the transaction exhibits a high negative correlation with an asset, rate or index of an underlying position in the portfolio.

(x) Position Exposure

Position exposure to the underlying assets of derivatives, when combined
with positions from direct investments, may not exceed general investment limits. This exposure is measured using the commitment approach (after netting of any long and short positions to the same issuer, if appropriate).

A combination of the following issued by, or made or undertaken with the same body may not exceed 20% of a UCITS’ net asset value:

- transferable securities or money market instruments;
- deposits;
- counterparty risk exposures from OTC derivative transactions; and/or
- position exposure to the underlying assets of derivatives.

There is no look through to underlying assets in respect of index derivatives, provided the index meets certain criteria.

(xii) Counterparty Exposure Limits

The counterparty exposure must include all exposures to the counterparty (i.e. exposure related to OTC derivatives and any other exposure to the counterparty). Exposure is limited to 5% of net asset value or 10% in the case of certain credit institutions as follows:

- a credit institution authorised in the EEA;
- a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1998; or
- a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand.

As indicated above, netting may be applied as appropriate before counterparty exposure is calculated. In addition, risk will be reduced where a counterparty provides acceptable collateral to the UCITS, in accordance with the Financial Regulator requirements.
Counterparties must agree to close out positions on request at fair value.

Exchange-traded derivatives that are marked to market daily and subject to margin requirements are deemed to be free of counterparty risk.

(xiii) Embedded Derivatives

Care also needs to be taken to examine the true nature of particular instruments to determine whether they “embed” derivatives. If a transferable security or money market instrument embeds a financial derivative instrument (FDI), then the global exposure, issuer concentration and leverage calculation rules referred to above apply to the embedded FDI element of the transferable security or money market instrument.

Consistent with CESR’s consideration of embedded FDI in its January 2006 advices, the Financial Regulator’s Guidance Note 3/03 provides that a transferable security and money market instrument will be considered to embed a FDI where it contains a component which fulfils the following criteria:

- by virtue of that component some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which functions as host contract can be modified according to a specified interest rate, financial instrument price, FX rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone FDI;
- its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and
- it has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

Both CESR and the Financial Regulator have noted that examples of structured financial instruments that may be assumed to embed a FDI are:

- credit linked notes;
- convertible or exchangeable bonds;
- structured financial instruments whose performance is linked to the performance of, for example, a basket of shares or a bond index, or structured financial instruments with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares with or without active management;
- collateralised debt obligations and asset backed securities that create leverage, i.e. the CDO is not a limited recourse vehicle and the investors’ loss can be higher than their initial investment or are not sufficiently diversified.
UCITS using UCITS structured financial instruments embedding FDI must respect the principles of the UCITS Directives and the Irish UCITS Regulations, and embedded FDI may not be used to circumvent those principles and rules.

UCITS using structured financial instruments embedding FDI should also refer to the Commission Recommendation on the use of FDI by UCITS in order to comply with the UCITS risk spreading rules as this Recommendation sets out how the underlying assets of FDI should be taken into account when assessing compliance with the risk limits set by the above-mentioned article.

Additionally, note that embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives to the UCITS.

It is the responsibility of the UCITS to check that investment in hybrid instruments embedding derivatives complies with these requirements. The nature, frequency and scope of checks performed will depend on the characteristics of the embedded derivatives and on their impact on the UCITS, taking into account it’s stated investment objective and risk profile.

(xiv) Format and Content of Risk Management Process

The Risk Management Process (RMP) must be prepared in accordance with the provisions of Guidance Note 3/03 and is subject to review and clearance by the Financial Regulator before being adopted.

The RMP should give information on the trading process employed by the investment manager and explain in detail the responsibilities and expertise of the personnel involved in the derivative trading activity of the UCITS. It should explain clearly the types of derivative instruments used by the UCITS and their specific purpose. The RMP must cover all derivatives used.

The RMP should also explain the following:

- how the various exposures (global exposure and leverage, counterparty exposure etc.) are measured;
- what limits apply to each such exposure;
- how these limits are monitored and enforced;
- how breaches of limits are reported and escalated.

A worked example of exposure calculations should also be provided. This should incorporate examples of each type of derivative and also demonstrate how hedging is used.
Any material amendments to the RMP must be addressed in a revised RMP filed with the Financial Regulator. Any non-material amendments or update (for example change of personnel or systems) should be included in the annual derivatives report.

(xiv) Annual Derivatives Report

UCITS Notice 10 requires that a UCITS must submit an annual report to the Financial Regulator on its derivative positions (an Annual FDI Report) so that the Financial Regulator may review the use of derivatives and any breaches of risk.

The Annual FDI Report should include details of the following:

- summary review on the use of derivatives by the UCITS during the year;
- instances of any breaches of global exposure during the year, with an explanation of remedial action taken and duration of the breaches;
- instances of any breaches of counterparty risk exposure during the year, with an explanation of remedial action taken and duration of the breaches;
- where relevant, a summary of non-material updates to the RMP. In this instance a revised RMP should be attached.

In the case of UCITS using VaR:

- year-end VaR number (expressed as a percentage of net asset value of the UCITS or as a percentage of the benchmark/comparable derivatives free portfolio, as appropriate);
- instances of any breaches in VaR limits during the year, with an explanation of remedial action and duration of breach;
- confirmation as to whether back-testing has been successful in accordance with the requirements and, if not, what actions the UCITS has taken to address the situation;
- confirmation that the UCITS does have a stress testing regime, an overview of the broad assumptions behind such testing and a commentary on the results of the stress testing and its applicability to the day to day use of the model.
UCITS investing in Derivatives on Financial Indices
9. UCITS investing in Derivatives on Financial Indices

There are specific UCITS rules relating to what will be acceptable as a permitted financial index underlying a financial derivative instrument. The requirements are that the index:

- must be sufficiently diversified;
- must represent an adequate benchmark for the market to which it refers;
- must be published in an appropriate manner; and
- must be managed independently from the management of the UCITS.

The Financial Regulator has issued a specific Guidance Note addressing those requirements in detail, as explained below.

(ii) Sufficiently Diversified

The general rule relating to diversification a UCITS portfolio is the 5/10/40 rule which refers to maximum permitted exposures per issuer. This is principally relevant to portfolios of transferable securities and money market instruments but does have relevance to UCITS which use commodity indices for risk diversification as opposed to trackers.

The UCITS III Product Directive did not explain how the general diversification rules would apply to indices based on non-eligible financial instruments such as commodity futures but this issue was addressed in the CESR advices of January 2006 where CESR noted that in the case of FDI on financial indices based on non-eligible assets that the rules be “adapted to the specific risk of such financial indices”. CESR suggested the following approach:

- where FDI on an index composed of non-eligible assets are used to track or gain strong exposure to the index, the index should be at least as diversified as set out under the diversification ratios of Article 22 (a) (the 20% weighting and 35% weighting);

- where FDI on an index composed of non-eligible assets are used for risk diversification purposes, provided the exposure on the individual commodity indices complies with the 5/10/40 ratios, there is no need to look at the individual components of these indices to ensure that they are sufficiently diversified.
That 20%/35% rule allows for a maximum exposure of 20% per issuer with capacity for the Financial Regulator to permit one holding to go above 20%, as high as 35% “where that proves to be justified by exceptional market conditions”. In other words, these higher limits will be available per commodity exposure for UCITS seeking to track or take a high exposure to a commodities futures index. In the January 2006 advices CESR stated that when assessing these diversification ratios, components which are highly correlated (i.e. futures on oil traded on different regulated markets) should be treated as giving exposure to the same commodity. This was not, however, repeated in the implementing Directive or Level 3 advices.

(iii) Adequate Benchmark

The relevant index must measure the performance of the group of assets it is purporting to represent and therefore, in the submission to the Financial Regulator on the relevant indices, there should be an explanation as to how each index meets that requirement.

Information to be included should include data on constituent selection criteria, constituent price collection procedures, asset allocation rules and guidelines etc. There is also an expectation that the index will be revised and rebalanced periodically to ensure that regulatory requirements with regard to allowed concentration limits are satisfied. Information must also be provided as to how the index calculation methodology is verified and on any fees embedded in the index.

(iv) Publication in an appropriate manner

The index must be published in an appropriate manner. This means that an investor should be able to access relevant material information on the index with ease, for example, via the internet. Index performance must be freely and continually available so that, to the extent permitted by the index provider, information on matters such as index constituents, calculation, rebalancing methodologies, etc. should be available. Information that an index provider considers to be of a proprietary and commercially sensitive nature is not expected to be published in a detailed manner.

(v) Independent Management

The index must be independently managed from the management of the UCITS and its performance must be calculated in an independent environment free from any external influences.

(vi) Hedge Fund Indices

Hedge fund indices may qualify as “financial indices” to which exposure can be taken through financial derivative instruments provided that they meet the index criteria indicated above and where:

- the index methodology has a set of predetermined rules and objective criteria for the selection and rebalancing of index components;
- the index provider does not accept payments from potential index providers.
components for the purpose of being included in the index; and

- back-filling (i.e. retrospective changes to previously published index values) is not permitted.

There are additional due diligence requirements imposed upon a UCITS which wishes to gain exposure to a hedge fund index which requires that a UCITS considers the quality of the relevant hedge fund index taking into account (at least) both the comprehensiveness of the index methodology and availability of information regarding the index and a UCITS must keep a record of these assessments.

In determining the comprehensiveness of the index methodology, the UCITS should consider whether the methodology contains an adequate explanation of matters such as the weighting and classification of components and the treatment of defunct components and whether the index represents an adequate benchmark for the kind of hedge funds to which it refers. In relation to the availability of information regarding the index, matters to be taken into account include whether there is a clear narrative description of what the index is seeking to represent, whether the index is subject to an independent audit and the scope of the audit as well as how frequently the index is published and whether that would affect the ability of the UCITS to accurately calculate its own NAV.

Consideration should also be given to the treatment of index components including the procedures by which the index provider carries out due diligence on the NAV calculation procedures of the underlying index components, the level of detail available regarding index components and their NAVs (including whether they are investable or non-investable and whether the number of components in the index achieves sufficient diversification).

Normal rules regarding OTC derivatives, in the case of exposure to an index by means of OTC derivatives, apply.
Available Legal Structures
10. Available Legal Structures

UCITS can be established in Ireland as variable capital investment companies, unit trusts, or as common contractual funds (*fixed capital investment companies are also available but not in practice used).

All three legal structures are subject to the standard UCITS investment and borrowing restrictions, the same authorization process and operating conditions and each must have as its sole object the collective investment in eligible assets of capital raised from the public and provide for at least fortnightly redemption facilities.

Each of the structures must have an Irish Administrator (responsible for calculation of the NAV, the accounting function and maintenance of books and records and usually incorporating the Transfer Agency function) and an Irish based Trustee/Custodian (responsible for safekeeping of assets and performance of certain fiduciary type duties). Most will appoint an Investment Manager (responsible for discretionary asset management of the UCITS portfolio) and many will appoint a Global Distributor or local Distributors.

Notwithstanding the above there are a number of distinctions between the three legal structures as summarised below.

(i) UCITS variable capital investment companies

UCITS variable capital investment companies or “VCCs” are public limited liability corporate vehicles with their own legal personality. In addition to the UCITS Regulations they are subject to Irish company law (with relevant exceptions) as it applies to public limited companies.

Their constitutive document is the Memorandum and Articles of Association and ultimate management authority resides with a board of directors, two of whom must be Irish resident. VCCs issue shares to investors which shares do not represent a legal or beneficial interest in the VCCs assets, those assets being legally held by the Custodian, beneficially by the VCC itself. Unlike both unit trusts and CCFs, VCCs are required to convene and hold an annual general meeting of shareholders and any changes to their Memorandum and Articles of Association require investor approval.

Self-managed VCCs require a minimum paid up capital of €300,000 before commencing operations and are also subject to the “substance” requirements applicable to Management Companies (see Section 11 below).
VCCs enter into contracts themselves as corporate entities, principally with the Investment Manager, Administrator and Distributor (or via the Management Company if not self-managed) and with the Custodian. VCCs who use a Management Company do not need to meet the “substance” or capital adequacy requirements for SMICs.

VCCs can be established as umbrella schemes and umbrella VCCs are subject to specific statutory provisions dealing with segregated liability between sub-funds.
(ii) **UCITS unit trusts**

Unit trusts are contractual arrangements created under a deed of trust (the “trust deed”) made between the Management Company and the Trustee. Unit trusts do not have their own legal personality and contracts are entered into in respect of unit trusts by the Management Company and, in certain cases, by the Trustee. The ultimate management authority rests with the Management Company which can act as Management Company for multiple collective investment schemes (UCITS and Non-UCITS; VCCs, unit trusts and CCFs). The Management Company must itself be authorised separately to the unit trust’s own UCITS authorisation and it must meet the “substance” and capital adequacy requirements outlined in Section 11 below.

Unit trusts issue units to investors and a unit represents an undivided beneficial interest in the assets of the unit trust. The assets are legally held by the Trustee.

Unit trusts are not required to hold annual investor meetings and, provided both the Management Company and Trustee certify that such changes do not prejudice the interests of investors, changes can be made to the trust deed without having to obtain prior investor approval.
(iii) UCITS Common Contractual Fund

The common contractual fund or CCF is a contractual arrangement similar to the FCP (Fonds Commun de Placement) structures in other European jurisdictions, notably Luxembourg and France, and the Dutch FGR (Fonds voor Gemene Rekening) enabling the assets held on behalf of investors to be managed through a single pool in proportion to the assets or cash subscribed to the pool.

A CCF is constituted under contract law by means of a deed of constitution ("deed") executed under seal by the Management Company. The deed provides for the safekeeping of assets of the CCF by a Custodian - who is also a party to the deed – and specifies the fiduciary responsibilities of the Custodian which are equivalent to those of custodians/trustees of other UCITS schemes. The deed also provides that the Custodian will be appointed on the terms of a custodian agreement to be entered into by the Management Company and Custodian.

Importantly, the CCF is an unincorporated body and does not have legal personality. Because a CCF does not have legal personality, it may act only through the Management Company (or investment manager, if authority is delegated to an investment manager).

Participants in the CCF hold their participation as co-owners and each participant holds an undivided co-ownership interest as “tenants in common” with other participants. A “tenancy in common” is a form of co-ownership in which the joint owner (the “tenant in common”) has a distinct but undivided interest or share in the property the subject of the co-ownership but with no right of survivorship (e.g. on death of one co-owner) in favour of any of the other joint owners (tenants in common). Investors do not have any beneficial entitlement to any particular asset, rather a proportional beneficial entitlement to an interest in the underlying pool of assets.

To assist in achieving tax transparency (these characteristics differentiate a CCF from an opaque corporate body), a CCF will normally have the following additional characteristics:

- income derived through the pooling vehicle should be distributed on a mandatory basis annually, pro rata to each participant’s investment in the CCF. This ensures that the income is both accounted for and taxed on an “arising”/current basis;

- the CCF participant should be provided with an annual breakdown of income on investments by type and source;

- no redemption charge should be levied on participants;

- no “investor” meetings (i.e. meetings similar to shareholder meetings) should be permitted;
the Irish tax authorities must view a CCF as a transparent vehicle for Irish tax purposes;

holdings/units in a CCF should not be freely transferable but are redeemable. It has, however, been accepted that units may be transferred in limited circumstances, i.e. with the prior consent of 100% of unitholders and the Management Company; and

assets should be jointly held by participants pro-rata to their investment.

(iv) Umbrellas, Sub-Funds and Classes

Whichever legal structure is chosen, UCITS can be established as single stand-alone funds and as umbrella funds, and can offer different unit or share classes within a fund, the normal differentiating factors being target audience (retail, professional, institutional), minimum subscription/holding requirements, designated currency and fees.

It is a fundamental principle, however, that assets/liabilities within a single fund are not allocated to individual classes, but may be “attributable” to classes in certain cases such as in the case of hedged currency classes where the gains/losses are attributed to the relevant classes, as well as other class liabilities such as fees.
UCITS Management Companies/SMICs
11. UCITS Management Companies/SMICs

UCITS established as unit trusts or as CCFs are required to have an Irish Management Company. This is because a unit trust is created by a Management Company and Trustee entering into a trust deed and, in the case of a CCF, it is constituted contractually by the Management Company unilaterally entering into a deed of constitution. UCITS established as investment companies have the option as to whether or not to appoint a management company. UCITS which do not appoint a management company are known as “self-managed investment companies” (“SMICs”).

(i) Management Company

In the fund management industry, particularly when dealing with collective investment schemes, the terms “Management Company” and “Investment Manager” have different meanings, different functions and different passports. These distinctions can at times become blurred, particularly since the introduction of the UCITS III Directives, but it is important to understand the difference as explained further below. (NOTE: The term “Manager” and “Management Company” are used interchangeably and refer to the same entity).

When we refer to a “Management Company” we are referring to the entity which has the ultimate responsibility for the management of a collective investment scheme. This overall management function encompasses overall control of the collective investment scheme, including the discretionary investment management function, the fund administration function and the distribution function.

If a Management Company is used for a collective investment scheme, the contractual arrangements are structured so that the Management Company is mandated to carry out investment management, fund administration and distribution in respect of the Irish domiciled collective investment scheme but the reality, in most cases, has been that the Irish Management Company delegates out fund administration to an Irish regulated entity, delegates out the distribution activity to a distributor in the jurisdiction where the UCITS is being distributed and delegates the investment management function to an appropriately regulated Investment Manager which, if it is a European entity, would be authorised in its Home EU Member State under the Markets in Financial Instruments Directive (“MiFID”).

A “self-managed” investment company or SMIC, as its name suggests, does not have an Irish Management Company and instead directly appoints the Administrator, the Custodian, the Investment Manager and Distributor.

(ii) Expansion of Opportunities for UCITS Management Companies

Since the introduction of the UCITS III Management Company Directive, UCITS Management Companies have been able to expand the range of services which they can provide, the types of clients to whom...
they can provide such services and have (albeit to a limited extent) obtained the capacity to passport their services cross-border within the EU.

A UCITS III Management Company can be authorised for collective portfolio management and, but not or, for individual portfolio management. This means that a UCITS III Management Company can act as Management Company to collective investment schemes and, if it wishes to expand its authorisation, it can also provide discretionary asset management services to other types of clients (i.e. clients which are not collective investment schemes) such as pension funds, corporates, insurance companies and retail investors.

See Appendix C for the full range of services and an explanation of the terms collective portfolio management and individual portfolio management as they apply to UCITS Management Companies.

(iii) Management Company Passport

Under the UCITS III Management Company Directive, Management Companies were granted a passport with the intention being that an Irish Management Company could, for example, act as Management Company of a Luxembourg corporate type fund (no passport was granted to act as Management Company of a foreign contractual type fund due to the legal nature of such funds). In practice the Management Company passport has not worked for the pure Management Company role, although Management Companies have been able to passport the investment management element of collective portfolio management as well as individual portfolio management, if authorised for that service.

The current position is, therefore, that a UCITS III type Management Company can be authorised to act as:

- Management Company to Irish domiciled corporate type funds and contractual type funds (both UCITS and non-UCITS); and
- Investment Manager to Irish funds and non-Irish funds (either directly or by sub-delegation);
- Investment Manager to other types of Irish and non-Irish clients (pension funds, insurance companies, individual managed accounts, etc.) on a direct or delegated basis (provided that it is authorised to carry out individual portfolio management).

During 2007 proposals were brought forward to address the implementation of the Management Company passport provisions from UCITS III as well as to address certain other UCITS structural issues, principally cross border mergers of UCITS and master feeder structures, these proposals being referred to as “UCITS IV”, as further described below.

At the request of the European Commission, CESR issued a call for
evidence on the Management Company passport issue. Further developments in this area are expected.

(iv) “Substance” Requirements

A UCITS III Management Company cannot be an “empty box”, must be managed by at least two persons and must perform the following eight key management functions:

- **Decision taking**: there must be clear responsibility and competence in relation to all material decisions affecting the operation and conduct of business of the Management Company. Generally speaking, the Financial Regulator considers that key strategic and material issues/decisions relating to the Management Company should be considered by its board of directors;

- **Monitoring compliance**: it must put in place procedures designed to ensure compliance with all applicable legal and regulatory requirements;

- **Risk Management**: it must put in place procedures designed to ensure that all applicable risks pertaining to the UCITS can be identified, monitored and managed at all times;

- **Monitoring of Investment Performance**: it must put in place procedures to ensure availability of up-to-date information on portfolio performance;

- **Financial Control**: it must put in place procedures to ensure all relevant accounting records are properly maintained and are readily available including production of annual and half-yearly financial statements;

- **Monitoring of Capital**: it must put in place procedures to ensure compliance with applicable capital adequacy requirements;

- **Internal Audit**: it must put in place procedures to ensure effective internal audit procedures; and

- **Supervision of Delegates**: it must have clear structures in place for the ongoing monitoring of work delegated to third parties.

It is important to note that both Management Companies and SMICs are required to demonstrate compliance with the above eight management requirements.

In advance of commencing operations, a Management Company must submit a detailed Application for Authorisation and a Business Plan to the Financial Regulator setting out how the above functions are going to be performed, by whom, where and what reporting lines are put in place. The eight functions have to be carried out by at least 2 people who can be:-

- employees based in Ireland (not abroad);
from an Irish third party engaged to provide the services in Ireland; or

board members who can carry out the 8 functions, provided that at least some of the functions are carried out by Irish resident directors.

(v) Capital Adequacy

The capital requirement for a UCITS Management Company is the higher of

(i) the initial capital requirement of €125,000 plus the own funds requirement (i.e. 0.02% of the amount of assets under management in excess of €250m); and

(ii) one quarter of its preceding year’s fixed overheads.

The aggregate of the initial capital requirement of €125,000 plus the own funds requirement to be maintained by a Management Company is subject to a maximum of €10 million.

The Financial regulator requires that a UCITS III Management Company maintain the higher of :-

(i) the initial capital requirement of €125,000; or

(ii) one quarter of its preceding year’s fixed overheads.

(i.e. the eligible assets requirement) in cash and/or liquid assets outside the Management Company’s Group.

The minimum capital requirement for a SMIC is €300,000 and it is not subject to the fixed overheads or the additional own funds requirements.

(vi) Authorisation Procedure

The application process for a UCITS III Management Company engaged in collective portfolio management only and which delegates out the fund administration, asset management and distribution functions to third parties is as set out below. An initial meeting with the Financial Regulator should be organised to introduce the parent group. This will be followed by preparation, completion and filing with the Financial Regulator of the following documents:

- formal Application for Authorisation (there is a specific application form for this purpose);

- detailed Business Plan setting out the legal nature of the Management Company, types of activities which it proposes carrying on, its organisational structure, how it will perform the eight oversight functions, three year financial projections, details of proposed capitalisation, overall group structure, sample of transaction flows for the type of transactions to which it will be engaged;

- Individual Questionnaires for each of its proposed Directors and senior management including Compliance Officer;
Code of Conduct, Anti-Money Laundering procedures, reporting lines etc;

Group structure details (considerable information may be required).

Following review of these documents the Financial Regulator will then enter into correspondence with the applicant which regularly takes the form of submitting additional documentation and providing clarifications where required. If individual portfolio management is also to be carried out, the Application and Business Plan become more like a MiFID type application.

For reasonably complete applications, the normal authorisation time is approximately four months.
12. UCITS IV

In March 2007, the European Commission published a number of papers outlining possible adjustments to the UCITS Directive. These papers included initial suggestions on how to address the non-implementation of the Management Company passport provisions from UCITS III as well as suggestions as to how to address certain other UCITS issues such as cross-border marketing of funds, fund mergers and asset pooling, improvement of product disclosures and strengthening supervisory cooperation mechanisms, these proposals collectively referred to as “UCITS IV”.

While there was wide agreement with regard to most of the Commission’s proposed changes, there was significant debate with regard to the Management Company passport proposal, with differing views as to whether a full or partial Management Company passport was the most appropriate way forward.

In July 2008, the European Commission issued an announcement advising how it intends to bring forward the UCITS IV proposals and setting out its intention to replace the existing Directives with a new single text. This proposal has been passed to the European Parliament and Council for consideration.

The proposed changes to the UCITS Directive will:

(i) Remove administrative barriers to the cross-border distribution of UCITS funds

Current cross-border notification procedures can take several months before completed (and entail unnecessary red-tape and administrative costs). The proposed new notification procedure will be reduced to a simple, electronic, regulator-to-regulator communication with the distribution immediately after such communication.

(ii) Create a framework for mergers between UCITS funds and allow the use of master-feeder structures

Fund mergers will be allowed, on both a domestic and a cross-border basis, and their authorisation procedure will be harmonised, as will the required level of information to be provided to investors. Subject to approval and the appropriate information of investors, a UCITS fund (feeder) will be allowed to fully invest its assets into another fund (master).

(iii) Replace the Simplified Prospectus by a Key Investor Information (KII)

The KII is to be contained in a short document conveying key facts to retail investors in a clear and understandable manner so as to assist them in making an informed investment decision.

(iv) Introduce further cooperation mechanisms between the national supervisors
As regards the Management Company passport, the Commission pointed out in their July 2008 announcement that the most recent consultation process revealed that there are a number of potential supervisory and investor protection concerns which need to be tackled. The Commission, therefore, decided to consult with CESR on these issues and to seek advice to assist the Commission to develop provisions permitting the introduction of a Management Company passport under conditions that are consistent with high level of investor protection. Following that advice, the Commission intends to bring forward an appropriate proposal in time to allow for its adoption during the current European Parliament’s term.
Taxation of UCITS in Ireland
13. Taxation of UCITS in Ireland

Ireland has a very favourable taxation regime for UCITS and indeed funds in general. All Irish funds (UCITS or Non-UCITS) whether they are constituted as corporate entities, unit trusts or investment limited partnerships are subject to the same taxation regime so long as they are designated as Investment Undertakings under Section 739B of the Taxes Consolidation Act 1997 (as amended) (the “TCA”).

Irish Direct Tax & Withholding Tax

Investment Undertakings (“funds”) are not subject to Irish taxation on any income or gains they may realise from their investments. In addition, there are no Irish withholding taxes in respect of a distribution of payments by funds to unitholders or any encashment, redemption, cancellation or transfer of units in respect of unitholders who are neither Irish resident nor ordinarily resident in Ireland and who have provided the fund with the appropriate relevant declaration of non-Irish residence or indeed in respect of certain categories of exempt Irish investors (e.g. approved pension schemes, charities, other investment undertakings, etc) who have also made the appropriate declaration to the fund.

When, however, a distribution is made by the fund to Irish resident unitholders (or an ordinarily Irish resident unitholder) who do not fall within any of the exempt Irish investor categories, or such a unitholder disposes of units and realises a gain, tax must be deducted by the fund at a rate of 20% on distributions (where payments are made annually or at more frequent intervals) or 23% (std rate plus 3%) on any other distribution or gain arising to the unitholder.

Stamp Duty

No stamp duty is payable in Ireland on the issue, transfer, repurchase or redemption of units in a fund. Furthermore, no stamp duty is payable by the fund on the conveyance or transfer of stock or marketable securities provided that the stock or marketable securities in question have not been issued by a company registered in Ireland and provided that the conveyance or transfer does not relate to any immovable property situated in Ireland or any right over or interest in such property or to any stocks or marketable securities of a company (other than a company which is an fund) which is registered in Ireland. Where any subscription for or redemption of units is satisfied by the in specie transfer of securities, property or other types of assets, consideration should be given to whether Irish stamp duty may arise on the transfer of such assets (in most cases it should not).

VAT

There are wide ranging VAT exemptions with regard to the provision of services to funds (e.g. administration, transfer agency, investment management, custodial, etc) and to the extent that a fund suffers Irish VAT on certain services it receives (e.g. audit and legal fees) the fund may recover this VAT based on its recovery rate. The recovery rate will be based on either (i) the extent that securities of the fund are invested outside the EU or (ii) the extent that the investors in the fund are located outside
the EU. The Irish Tax Authorities prefer to rule on the fund’s VAT recovery position by reference to where the securities of the fund are invested, rather than where the investors in the fund are located. Nevertheless, whichever basis is used, it must be applied consistently from one period to the next.

**Compliance requirements**

Funds have an obligation to register with the Irish Tax Authorities to obtain a tax reference number as each fund must file bi-annual tax returns with the Irish Tax Authorities. These tax returns should be accompanied by the payment of appropriate tax (if applicable) for the period in question. On the basis that there are no Irish resident or ordinarily resident unitholders (or such unitholders are exempt Irish investors) the appropriate tax should be nil.

Certain services received from abroad (e.g. the service of non-Irish lawyers or accountants) will require a fund to register and self account for VAT in Ireland. However, depending on the fund’s VAT recovery rate the fund may be able to recover some or all of this Irish VAT.
UCITS Authorisation Process
14. UCITS Authorisation Process

The authorisation process for UCITS has two parts, one dealing with the promoter of and service providers to the UCITS and the second dealing with the UCITS product itself.

A. Approval of Service Providers

In addition to the Management Company (as outlined above), the principal service providers to a UCITS are the Investment Manager, Administrator and the Trustee/Custodian. The entity promoting the UCITS must also be approved.

(i) Promoter

Before an application for authorisation of a UCITS can be considered, the Financial Regulator must be satisfied that the Promoter of the UCITS is acceptable to it. The Financial Regulator regards the Promoter as being the driving force behind the product (i.e. the entity without whom the UCITS would not be brought to the market). Promoters must be of good repute and should have a significant level of financial resources (at least €635,000) and a demonstrable and relevant track record in the promotion of funds. In considering the suitability of the Promoter of a UCITS, the Financial Regulator requires detailed information to enable it gain an appreciation of the Promoter and the nature of its business. Information to be provided includes:

- details of the main activities of the Promoter since its establishment;
- its experience and expertise in the promotion and management of collective investment schemes;
- ownership details;
- details of distribution networks;
- latest audited accounts in respect of the Promoter and its ultimate owners;
- confirmation that the Promoter is regulated in its home jurisdiction; and
- auditors’ confirmation that the Promoter has adequate financial resources.

(ii) Investment Manager

Where the asset management of a UCITS is, as is usual, delegated to a third party Investment Manager, the UCITS Directive imposes two principal requirements. Firstly, only Investment Manager, who are authorised or registered for the purpose of asset management and who are subject to prudential supervision may be appointed. Secondly, where a non-EU Investment Manager is appointed, there must be a form of co-operation in place between the Financial Regulator and the supervisory authorities of the third country Investment Manager.

If the Investment Manager is an entity authorised to carry out discretionary asset management under MiFID, the Financial Regulator will not apply a detailed review and approval process but rather will require confirmation from the Home State regulator.
that the Investment Manager has the appropriate regulatory status.

If the Investment Manager is not authorised to carry out discretionary asset management under MiFID (such as US, Japanese etc Investment Managers), the Financial Regulator will normally apply a detailed review and approval process. In both cases, a detailed application for approval needs to be submitted. Where a Promoter also acts as Investment Manager, a separate application for approval to act as Investment Manager is not required.

(iii) Administrator

The Administrator of a UCITS must be incorporated in Ireland and authorised by the Financial Regulator to provide administration services under the Investment Intermediaries Act, 1995 (as amended) and/or MiFID. There are certain “minimum activities” which must be carried out by the Administrator in Ireland, which cannot be delegated to an entity outside Ireland. Derogations from these minimum activities requirements may be sought on a case by case basis. The minimum activities rules may change in the event the Management Company passport is implemented.

(iv) Custodian/Trustee

The custodian of a UCITS must be a credit institution authorised in Ireland, an Irish branch of an EU credit institution or an Irish incorporated company which is wholly owned by an EU credit institution (or equivalent from a non-EU jurisdiction) provided that the liabilities of the Irish company are guaranteed by its parent.

A custodian/trustee of an Irish UCITS has a dual role (i) to “oversee” the manner in which the UCITS is managed and (ii) to safe-keep the assets of the UCITS, in each case in accordance with the requirements set down by the Financial Regulator.

B. UCITS Documentation Requirements

The following documents are required to be submitted to the Financial Regulator in support of an application for authorisation of a UCITS:

- Financial Regulator Application for Authorisation of a UCITS
- Business Plan
- Prospectus
- Memorandum and Articles of Association/Trust Deed/CCF Deed*
- Custodian Agreement*
- Administration Agreement
- Investment Management/Advisory Agreement
- Distribution Agreement (optional)
- Placing Agreement (optional)
The documentation required will vary depending on the structure of the UCITS i.e. if it is established as a variable capital investment company, a unit trust or CCF.

**The Simplified Prospectus is intended to provide investors with key elements of the Prospectus in a readily accessible form. Following first year of operation the Simplified Prospectus should also contain performance data, portfolio turnover rate and TER (total expense ratio) figures for the UCITS.**

Note that certain documentation for variable capital investment companies and if new, Management Companies will also need to be submitted to the Companies Registration Office.

**C. Timing**

On average it takes approximately 6-8 weeks from date of initial submission of an application to the Financial Regulator for authorisation of the UCITS to issue.

**D. Regulatory Fees**

The Financial Regulator imposes an annual industry funding levy on collective investment schemes. Rates (at time of writing) include an annual fee of €2,200 whether an umbrella or a single structure fund. Umbrella funds also pay a contribution of €550 per sub-fund on the first five sub-funds resulting in a maximum contribution for umbrella funds of €4,950.
Ongoing Supervision and General Regulatory Requirements
15. Ongoing Supervision and General Regulatory Requirements

Set out below is a summary of the principal ongoing supervision and general regulatory requirements for UCITS.

(i) Prospectus and Simplified Prospectus

A UCITS is required to publish a Simplified Prospectus and full Prospectus both of which must be dated and the essential elements of which must be kept up to date.

The Simplified Prospectus must be offered to investors free of charge before the conclusion of a contract, with the full Prospectus being supplied to investors free of charge upon request.

Both must contain sufficient information for investors to make an informed judgment of the investment proposed to them and in particular of the risks attached to that investment and the full Prospectus must include a clear and readily comprehensible explanation of the UCITS’ risk profile.

Additional requirements for Prospectuses are set out in UCITS 6.4. Guidance Note 1/05 deals further with the Simplified Prospectus, how its information should be laid out and what it should contain including performance data, TER data, portfolio turnover rate and general requirements as to keeping the Simplified Prospectus up to date.

(ii) Publication of Annual and Half-Yearly Reports

UCITS are required to publish an annual audited report for each financial year and an unaudited semi-annual or half-yearly report. The annual report must be published within four months of the year end, the semi-annual within two months of the period end and both must be sent to the Financial Regulator. Both must also be offered to investors free of charge before the conclusion of a contract and supplied to investors free of charge upon request.

There is also a requirement for monthly statistics to be provided to the Financial Regulator normally through the Administrator.

(iii) Related Party Dealings

The Financial Regulator has set out specific rules for related party dealings – transactions carried out with a UCITS by its promoter, management company, trustee, investment manager or by associated or group companies. The general principle is that these have to be carried out as if effected on normal commercial terms, negotiated at arm’s length and must be in the best interests of the investors. There are specific limitations imposed around such transactions.

(iv) Board Appointments

Board appointments to UCITS VCCs and to Management Companies require prior approval by the Financial Regulator.
Departures from the Board of Directors must be notified to the Financial Regulator immediately and there is a prohibition on common directors between the VCC/Management Company and the Board of Directors of the Trustee. Two directors must be Irish resident.

(v) Valuation Rules

The Financial Regulator has set out specific rules for the valuation of assets of UCITS in its UCITS Notices, with further clarification in its Guidance Notes.

(vi) Changes of Investment Objectives and Policies

Changes of investment objectives and material changes of investment policy are required to be approved in advance on the basis of a majority of votes cast at a general meeting of investors with a reasonable notification period being provided by the UCITS to allow investors redeem their holding prior to implementation of the changes. In this context, the term “material” is taken to mean, although not exclusively, “changes which would significantly alter the asset type, credit quality, borrowing limits or risk profile of the UCITS”.
Appendices
Appendix A

Transferable Securities and Money Market Instruments

A. Transferable Securities

(i) UCITS III Definitions

The term “transferable securities” is defined in the UCITS Product Directive as being:

- shares in companies and other securities equivalent to shares in companies (“shares”);
- bonds and other forms of securitised debt (“debt securities”);
- other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;

other than the permitted UCITS efficient portfolio management techniques and instruments.

(iii) Clarification by Eligible Asset Directive

In 2007 the Eligible Assets Directive clarified the above definition by providing that the reference to transferable securities “shall be understood as a reference to financial instruments” which fulfil the following criteria:

(a) the potential loss which the UCITS may incur with respect to holding those instruments is limited to the amount paid for them;

(b) their liquidity does not compromise the ability of the UCITS to comply with its obligation to provide at least fortnightly redemption facilities;

(c) reliable valuation is available for them as follows:

(i) in the case of securities admitted to or dealt in on a regulated market in the form of accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from issuers;

(ii) in the case of other securities (i.e. the aggregate 10% that can be invested in transferable securities and money market instruments not specifically referred to in Article 19(1)), in the form of a valuation on a periodic basis which is derived from information from the issuer of the security or from competent investment research;

(d) appropriate information is available for them as follows:

(i) in the case of securities admitted to or dealt in on a regulated market as referred to in subparagraphs (a) to (d) of Article 19(1), in the form of regular, accurate and comprehensive information to the market on the security or, where relevant, on the portfolio of the security;

(ii) in the case of other securities as referred to in Article 19(2), in the form of regular and accurate information to the UCITS on the security or, where relevant, on the portfolio of the security;
(e) they are negotiable;

(f) their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS;

(g) their risks and their contribution to the overall risk profile of the portfolio are adequately captured by the risk management process of the UCITS which must be assessed on an ongoing basis.

For the purpose of subparagraphs (b) and (e), and unless there is information available to the UCITS that would lead to a different determination, financial instruments which are admitted or dealt in on a regulated market in accordance with Article 19(1) shall be presumed not to compromise the ability of the UCITS to comply with its redemption facility requirements and shall also be presumed to be negotiable.

For the purposes of subparagraph (b) above, where information is available to the UCITS that would lead it to determine that a transferable security could compromise the ability of the UCITS to comply with its redemption facility requirements, the UCITS must assess its liquidity risk.

The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by its redemption facility requirements. In taking this prudent approach, the following are examples of the matters a UCITS may need to consider:

- the volume and turnover in the transferable security;

- if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy; also evaluation of the opportunity and timeframe to buy or sell;

- where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices;

- in assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.

In the case of transferable securities which are not admitted to trading on a regulated market, liquidity cannot automatically be presumed. A UCITS, therefore, needs to assess the liquidity of such securities where this is necessary to meet the requirements of its redemption facility rules.

In the case of transferable securities which are not admitted to trading on a regulated market, negotiability similarly cannot automatically be presumed. The
UCITS must assess the negotiability cannot automatically be presumed. The UCITS must assess the negotiability of securities held in the portfolio, with a view to ensuring compliance with the requirements of its redemption facility rules.

(iii) Closed Ended Funds as Transferable Securities

The Eligible Assets Directive has made it clear that certain closed-ended funds will fall within the “transferable securities” definition and therefore be eligible for investment by UCITS as the term “transferable securities” includes:

(a) units in closed-ended funds constituted as investment companies or as unit trusts, which fulfil the following criteria;

(i) they fulfil the criteria set out in Section (ii) above titled “Clarification by Eligible Assets Directive” above;

(ii) they are subject to corporate governance mechanisms applied to companies;

(iii) where asset management activity is carried out by another entity on behalf of the closed ended fund, that entity is subject to national regulation for the purpose of investor protection.

(b) units in closed-ended funds constituted under the law of contract which fulfil the following criteria:

(i) they fulfil the criteria set out in Section (ii) above titled “Clarification by Eligible Assets Directive” above;

(ii) they are subject to corporate governance mechanisms equivalent to those applied to companies as referred to in subparagraph (a)(ii) above;

(iii) they are managed by an entity which is subject to national regulation for the purpose of investor protection.

In assessing whether the corporate governance mechanisms for closed ended funds in contractual form are equivalent to investment companies, the following factors are stated by the Financial Regulator to be indicators which can be used as a guidance:

Unitholders’ rights. The contract on which the fund is based should provide for:

(i) right to vote of the unit holders in the essential decision making processes of the fund (including appointment and removal of asset management company, amendment to the contract which set up the fund, modification of investment policy, merger, liquidation);

(ii) right to control the investment policy of the fund through appropriate mechanisms.

Segregation of assets. The assets of the fund should be separate and distinct from that of the asset manager and the fund must be subject to liquidation rules adequately protecting the unit holders.
A UCITS may not make investment in closed ended funds for the purposes of circumventing the normal UCITS investment limits.

(iv) Structured Financial Instruments

“Transferable securities” also include financial instruments which:

(i) fulfil the criteria set out in Section (ii) titled “Clarification by Eligible Assets Directive” above;

(ii) are backed by, or linked to the performance of, other assets, which may differ from those referred to in Article 19(1); provided that where a financial instrument covered by this subparagraph contains an embedded derivative component, the requirements regarding the derivatives risk management process, global exposure and aggregation of direct and indirect exposures shall apply to that component.

B. Money Market Instruments

This term means “instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time”. These shall be understood by a reference to the following paragraphs:

(i) financial instruments which are admitted to trading or dealt in on a regulated market (in accordance with subparagraphs (a), (b) and (c) of Article 19);

(ii) financial instruments which are not admitted to trading.

The reference to money market instruments as “instruments normally dealt in on the money market” shall be understood as a reference to financial instruments which fulfil one of the following criteria:

(a) they have a maturity at issuance of up to and including 397 days;

(b) they have a residual maturity of up to and including 397 days;

(c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;

(d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in subparagraphs (a) or (b), or are subject to a yield adjustment as referred to in subparagraph (c).

The reference to money market instruments as “instruments which are liquid” shall be understood as a reference to financial instruments which can be sold at limited cost in an adequately short time frame, taking into account the obligation of the UCITS to repurchase or redeem its units at the request of any unit holder. When assessing the liquidity of a money market instrument, the following cumulative factors have to be taken into account:
At the instrument level:

(i) frequency of trades and quotes for the instrument in question;

(ii) number of dealers willing to purchase and sell the instrument, willingness of the dealers to make a market in the instrument in question, nature of market place trades (times needed to sell the instrument, method for soliciting offers and mechanics of transfer);

(iii) size of issuance/program;

(iv) possibility to repurchase, redeem or sell the money market instrument in a short period (e.g. seven business days), at limited cost, in terms of low fees and bid/offer prices and with very short settlement delay.

At the fund level, the following relevant factors should be considered in order to ensure that any individual money market instrument would not affect the liquidity of the UCITS at the fund level:

(i) unit holder structure and concentration of unit holders of the UCITS;

(ii) purpose of funding of unit holders;

(iii) quality of information on the fund’s cash flow patterns;

(iv) prospectuses’ guidelines on limiting withdrawals.

The fact that some of these conditions are not fulfilled does not automatically imply that the financial instruments should be considered as non-liquid. These elements must ensure that UCITS will have sufficient planning in the structuring of the portfolio and in foreseeing cash flows in order to match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands.

The reference to money market instruments as “instruments which have a value which can be accurately determined at any time” shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfil the following criteria, are available:

(a) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm’s length transaction;

(b) they are based either on market data or on valuation models including systems based on amortised costs.

With respect to the criterion “value which can be accurately determined at any time”, if the UCITS considers that an amortisation method can be used to assess the value of a money market instrument, it must ensure that this will not result in a discrepancy between the value of the money market instrument and the value calculated according to the amortisation method as set out in Guidance Note 1/08 UCITS: Valuation of assets of money market funds. The criteria referred to above regarding liquidity and a valuation which can be accurately
determined at any time shall be presumed to be fulfilled in the case of financial instruments which are normally dealt in on the money market and which are admitted to, or dealt in on, a regulated market in accordance with subparagraphs (a), (b) or (c) of Article 19, unless there is information available to the UCITS that would lead to a different determination. Where the presumption of “liquidity” and “accurate valuation” cannot be relied upon, the money market instrument should be subject to an appropriate assessment by the UCITS.

The reference in subparagraph (h) of Article 19 to money market instruments, other than those dealt in on a regulated market, provided that the issue or the issuer is itself regulated for the purpose of protecting investors and savings, shall be understood as a reference to financial instruments which fulfil the following criteria:

(a) they fulfil one of the criteria set out in above regarding “instruments normally dealt in on the money market” and all the criteria set out above regarding “instruments which are liquid” and “value which can be accurately determined at any time”;

(b) appropriate information is available for them, including information which allows an appropriate assessment of the credit risks related to the investment in such instruments, taking into account regulatory criteria applicable to transferable securities and money market instruments;

(c) they are freely transferable.

For money market instruments covered by sub-paragraphs (h)(ii) and (h)(iv) of Article 19 or for those which are issued by a local or regional authority of a Member State or by a public international body but are not guaranteed by a Member State or, in the case of a federal State which is a Member State, by one of the members making up the federation, appropriate information as referred to in paragraph (b) above shall consist of the following:

(a) information on both the issue or the issuance programme and the legal and financial situation of the issuer prior to the issue of the money market instrument;

(b) updates of the information referred to in subparagraph (a) on a regular basis and whenever a significant event occurs – CESR’s view is that regular updates should normally occur on an annual basis;

(c) the information referred to in subparagraph (a) verified by appropriately qualified third parties not subject to instructions from the issuer. Such third parties should specialise in the verification of legal or financial documentation and be composed of persons meeting professional standards of integrity;

(d) available and reliable statistics on the issue or the issuance programme.

For the money instruments covered by subparagraph (h)(iii) of Article 19, appropriate information as referred to in paragraph (b) above shall consist of the following:
(a) information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument;

(b) updates of the information referred to in subparagraph (a) on a regular basis and whenever a significant event occurs;

(c) available and reliable statistics on the issue or issuance programme or other data enabling an appropriate assessment of the credit risks related to the investment in such instruments.

For all the money market instruments covered by subparagraph (h)(i) of Article 19, except those referred to in the category above covered by sub-paragraphs (h)(ii) and (h)(iv) etc. and those issued by the European Central Bank or by a central bank from a Member State, appropriate information as referred to in paragraph (b) above shall consist of information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument.

The reference in subparagraph (h)(iii) of Article 19 to an establishment which is subject to and complies with prudential rules considered by the Financial Regulator to be at least as stringent as those laid down by Community law shall be understood as a reference to an issuer which is subject to and complies with prudential rules and fulfils one of the following criteria:

(a) it is located in the European Economic Area;

(b) it is located in the OECD countries belonging to the Group of Ten;

(c) it has at least investment grade rating;

(d) it can be demonstrated on the basis of an in-depth analysis of the issuer that the prudential rules applicable to that issuer are at least as stringent as those laid down by Community law.

The reference in subparagraph (h)(iv) of Article 19 to securitisation vehicles shall be understood as a reference to structures, whether in corporate, trust or contractual form, set up for the purpose of securitisation operations.

The reference in subparagraph (h)(iv) of Article 19 to banking liquidity lines shall be understood as a reference to banking facilities secured by a financial institution which itself complies with the subparagraph (h)(iii) of Article 19.
### Appendix B

**UCITS Investment and Borrowing Restrictions**

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<th>Permitted Investments</th>
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<td>Investments of a UCITS are confined to:</td>
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<tr>
<td><strong>1.1</strong></td>
<td>Transferable securities and money market instruments which are either admitted to official listing on a stock exchange in a Member State or non-Member State or which are dealt on a market which is regulated, operates regularly, is recognised and open to the public in a Member State or non-Member State.</td>
</tr>
<tr>
<td><strong>1.2</strong></td>
<td>Recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described above) within a year.</td>
</tr>
<tr>
<td><strong>1.3</strong></td>
<td>Money market instruments, as defined in the UCITS Notices, other than those dealt on a regulated market.</td>
</tr>
<tr>
<td><strong>1.4</strong></td>
<td>Units of UCITS.</td>
</tr>
<tr>
<td><strong>1.5</strong></td>
<td>Units of non-UCITS as set out in the Financial Regulator’s Guidance Note 2/03.</td>
</tr>
<tr>
<td><strong>1.6</strong></td>
<td>Deposits with credit institutions as prescribed in the UCITS Notices.</td>
</tr>
<tr>
<td><strong>1.7</strong></td>
<td>Financial derivative instruments as prescribed in the UCITS Notices.</td>
</tr>
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### Investment Restrictions

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<tbody>
<tr>
<td>2.1</td>
<td>A UCITS may invest no more than 10% of net assets in transferable securities and money market instruments other than those referred to in paragraph 1.</td>
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</table>
| 2.2 | A UCITS may invest no more than 10% of net assets in recently issued transferable securities which will be admitted to official listing on a stock exchange or other market (as described in paragraph 1.1) within a year. This restriction will not apply in relation to investment by the UCITS in certain US securities known as Rule 144A securities provided that:  

- the securities are issued with an undertaking to register with the US Securities and Exchanges Commission within one year of issue; and  

- the securities are not illiquid securities i.e. they may be realised by the UCITS within seven days at the price, or approximately at the price, at which they are valued by the UCITS. |

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<tr>
<td>2.3</td>
<td>A UCITS may invest no more than 10% of net assets in transferable securities or money market instruments issued by the same body provided that the total value of transferable securities and money market instruments held in the issuing bodies in each of which it invests more than 5% is less than 40%.</td>
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<tr>
<td>2.4</td>
<td>The limit of 10% (in 2.3) is raised to 35% if the transferable securities or money market instruments are issued or guaranteed by a Member State or its local authorities or by a non-Member State or public international body of which one or more Member States are members.</td>
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<tbody>
<tr>
<td>2.5</td>
<td>The transferable securities and money market instruments referred to in 2.4 shall not be taken into account for the purpose of applying the limit of 40% referred to in 2.3.</td>
</tr>
</tbody>
</table>
2.6 A UCITS may not invest more than 20% of net assets in deposits made with the same credit institution.

Deposits with any one credit institution, other than

- a credit institution authorised in the EEA;
- a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1988 (Switzerland, Canada, Japan, United States); or
- a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand

held as ancillary liquidity, must not exceed 10% of net assets.

This limit may be raised to 20% in the case of deposits made with the trustee/custodian.

2.7 The risk exposure of a UCITS to a counterparty to an OTC derivative may not exceed 5% of net assets.

This limit is raised to 10% in the case of a credit institution authorised in the EEA or a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1988; or a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand.

2.8 Notwithstanding paragraphs 2.3, 2.6 and 2.7 above, a combination of two or more of the following issued by, or made or undertaken with, the same body may not exceed 20% of net assets:

- investments in transferable securities or money market instruments;
- deposits, and/or
- risk exposures arising from OTC derivatives transactions.
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<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>2.9</td>
<td>The limits referred to in 2.3, 2.4, 2.6, 2.7 and 2.8 above may not be combined, so that exposure to a single body shall not exceed 35% of net assets.</td>
</tr>
<tr>
<td>2.10</td>
<td>Group companies are regarded as a single issuer for the purposes of 2.3, 2.4, 2.6, 2.7 and 2.8. However, a limit of 20% of net assets may be applied to investment in transferable securities and money market instruments within the same group.</td>
</tr>
<tr>
<td>2.11</td>
<td>A UCITS may invest up to 100% of net assets in different transferable securities and money market instruments issued or guaranteed by any Member State, its local authorities, non-Member States or public international body of which one or more Member States are members, any government of any OECD member country which is not a Member State where such securities are rated investment grade by an international rating agency, European Investment Bank, European Bank for Reconstruction and Development, International Finance Corporation, International Monetary Fund, Euratom, The Asian Development Bank, European Central Bank, Council of Europe, Eurofima, African Development Bank, International Bank for Reconstruction and Development (The World Bank), The Inter American Development Bank, European Union, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Government National Mortgage Association (Ginnie Mae), Student Loan Marketing Association (Sallie Mae), Federal Home Loan Bank, Federal Farm Credit Bank, Tennessee Valley Authority provided that if more than 35% of the assets of a Fund is invested in such securities, the Fund must hold securities from at least six different issues with securities from any one issue not exceeding 30% of the net assets.</td>
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</table>
### 3 Investment in Collective Investment Schemes (“CIS”)

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<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>3.1</td>
<td>A UCITS may not invest more than 20% of net assets in any one CIS.</td>
</tr>
<tr>
<td>3.2</td>
<td>Investment in non-UCITS may not, in aggregate, exceed 30% of net assets.</td>
</tr>
<tr>
<td>3.3</td>
<td>Investment in a CIS, which can itself invest more than 10% of net assets in other CIS, is not permitted.</td>
</tr>
<tr>
<td>3.4</td>
<td>When a UCITS invests in the units of other CIS that are managed, directly or by delegation, by the UCITS management company or by any other company with which the UCITS management company is linked by common management or control, or by a substantial direct or indirect holding, that management company or other company may not charge subscription, conversion or redemption fees on account of the UCITS investment in the units of such other CIS.</td>
</tr>
<tr>
<td>3.5</td>
<td>Where a commission (including a rebated commission) is received by the UCITS’ investment manager/investment adviser by virtue of an investment in the units of another CIS, this commission must be paid into the property of the UCITS.</td>
</tr>
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</table>

### 4 Index Tracking UCITS

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<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>4.1</td>
<td>A UCITS may invest up to 20% of net assets in shares and/or debt securities issued by the same body where the investment policy of the Fund is to replicate an index which satisfies the criteria set out in the UCITS Notices and is recognised by the Financial Regulator.</td>
</tr>
<tr>
<td>4.2</td>
<td>The limit in 4.1 may be raised to 35%, and applied to a single issuer, where this is justified by exceptional market conditions.</td>
</tr>
</tbody>
</table>
## General Provisions

### 5.1
An investment company, or management company acting in connection with all of the CIS it manages, may not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body.

### 5.2
A UCITS may acquire no more than:

(i) 10% of the non-voting shares of any single issuing body;

(ii) 10% of the debt securities of any single issuing body;

(iii) 25% of the units of any single CIS;

(iv) 10% of the money market instruments of any single issuing body.

**NOTE:** The limits laid down in (ii), (iii) and (iv) above may be disregarded at the time of acquisition if at that time the gross amount of the debt securities or of the money market instruments, or the net amount of the securities in issue cannot be calculated.

### 5.3
5.1 and 5.2 shall not be applicable to:

(i) transferable securities and money market instruments issued or guaranteed by a Member State or its local authorities;

(ii) transferable securities and money market instruments issued or guaranteed by a non-Member State;

(iii) transferable securities and money market instruments issued by public international bodies of which one or more Member States are members;

(iv) shares held by a UCITS in the capital of a company incorporated in a non-member State which invests its assets mainly in the securities of issuing bodies having their registered offices in that State, where under the legislation of that State such a holding represents the only way in which the UCITS can invest in the securities of issuing bodies of that State. This waiver is applicable
## General Provisions

### 5.3

only if in its investment policies the company from the non-Member State complies with the limits laid down in 2.3 to 2.10, 3.1, 3.2, 5.1, 5.2, 5.4, 5.5 and 5.6, and provided that where these limits are exceeded, paragraphs 5.5 and 5.6 below are observed.

(v) Shares held by an investment company or investment companies in the capital of subsidiary companies carrying on only the business of management, advice or marketing in the country where the subsidiary is located, in regard to the repurchase of units at unit-holders’ request exclusively on their behalf.

### 5.4

A UCITS need not comply with the investment restrictions herein when exercising subscription rights attaching to transferable securities or money market instruments which form part of their assets.

### 5.5

The Financial Regulator may allow recently authorised UCITS to derogate from the provisions of 2.3 to 2.11, 3.1, 3.2, 4.1 and 4.2 for six months following the date of their authorisation, provided they observe the principle of risk spreading.

### 5.6

If the limits laid down herein are exceeded for reasons beyond the control of a UCITS, or as a result of the exercise of subscription rights, the UCITS must adopt as a priority objective for its sales transactions the remedying of that situation, taking due account of the interests of its shareholders.

### 5.7

Neither an investment company, nor a management company or a trustee acting on behalf of a unit trust or a management company of a common contractual fund, may carry out uncovered sales of:

- transferable securities;
- money market instruments;
- units of CIS; or
- financial derivative instruments.
5 General Provisions

5.8 A UCITS may hold ancillary liquid assets.

6 Financial Derivative Instruments ('FDIs')

6.1 A UCITS’s global exposure (as prescribed in the UCITS Notices) relating to FDI must not exceed its total net asset value.

6.2 Position exposure to the underlying assets of FDI, including embedded FDI in transferable securities or money market instruments, when combined where relevant with positions resulting from direct investments, may not exceed the investment limits set out in the UCITS Notices. (This provision does not apply in the case of index based FDI provided the underlying index is one which meets with the criteria set out in the UCITS Notices.)

6.3 A UCITS may invest in FDIs dealt in over-the-counter (OTC) provided that the counterparties to over-the-counter transactions (OTCs) are institutions subject to prudential supervision and belonging to categories approved by the Financial Regulator.

6.4 Investment in FDIs are subject to the conditions and limits laid down by the Financial Regulator.

7 Restrictions on Borrowing and Lending

(a) A UCITS may borrow up to 10% of its Net Asset Value provided such borrowing is on a temporary basis. A UCITS may charge its assets as security for such borrowings.
A UCITS may acquire foreign currency by means of a “back to back” loan agreement. Foreign currency obtained in this manner is not classified as borrowing for the purposes of the borrowing restrictions set out at (a) above provided that the offsetting deposit:

(i) is denominated in the base currency of the UCITS; and

(ii) equals or exceeds the value of the foreign currency loan outstanding.
Appendix C

Management Company Authorisation Options

Management Companies authorised under the UCITS III Management Company Directive are able to carry out the following activities:

2.1 the management of unit trusts/common funds and of investment companies (collective portfolio management). This includes:

- Investment management
- Administration
  - legal and fund management accounting services
  - customer enquiries
  - valuation and pricing (including tax returns)
  - regulatory compliance monitoring
  - maintenance of unit-holder register
  - distribution of income
  - unit issues and redemptions
  - contract settlements (including certificate dispatch)
  - record keeping

2.2 (a) management of portfolios of investments, including those owned by pension funds in accordance with mandates given by investors on a discretionary client-by-client basis (individual portfolio management), where such portfolios including one or more of the instruments listed in Section B of the Annex to the Investment Services Directive;

2.3 (b) as non-core services:

- investment advice concerning one or more of the instruments listed in Section B of the Annex to the Investment Services Directive
- safekeeping and administration in relation to units of collective investment undertakings

It is important to note however that Management Company may not be authorised solely to provide the services referred to in 2.2 (a) or (b) and, furthermore, may only be authorised to provide the non-core services referred to in 2.2 (b) where they are authorised for activity 2.2 (a).
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