Continued Evolution of Ireland's Funds Industry

Andrew Bates

Building on both European and domestic initiatives, Ireland is continuing to witness significant growth in the number of funds being established within both the UCITS – *the European harmonised fund product which can be sold cross border within the European Union on a passporting basis based on single EU Member State authorisation* – and Non-UCITS product ranges, with the most notable development being the increasing use within UCITS of strategies formerly the preserve of the alternative industry.

Latest available statistics from the Irish Funds Industry Association show the NAV of Irish domiciled funds of over US$ 1.2 trillion (November 2007), with most growth being seen on UCITS III products and non-UCITS alternative funds using the QIF fast track process.

UCITS III DEVELOPMENTS

Ireland is now seeing many UCITS taking advantage of the new structuring possibilities under UCITS III, particularly for long/short type products, total return swap type arrangements and portfolios made up of derivatives on baskets of securities and on financial indices including hedge fund and commodities indices. This has led to increasing complexity within UCITS products, a greater focus on valuation issues, on collateral issues and more generally as to what does and does not qualify as an eligible asset for UCITS.

(i) Eligible Assets Directive

Additional clarification on that latter point was provided in March 2007 by the European Commission's implementing Directive on eligible assets which gives some room for flexibility in interpreting what may or may not fall within the UCITS concepts of "money market instruments" and "transferable securities" as well as clarifying the parameters for UCITS investing into other asset types including closed-ended funds and derivatives on financial indices.

In our view, this Directive opens up new opportunities, one example being the possibility of permitting UCITS to invest more than 10% of net assets into loan type investments (such as loan assignments) and another being the broader use of the term "financial instruments" to describe assets which may be deemed to qualify as "transferable securities".

(ii) Physical Short Sales

Probably the most interesting Irish development in the UCITS area over the last six months has been the Irish Financial Regulator's Policy Note which will allow UCITS engage in covered physical short sales thereby pursuing direct long/short and 130/30 strategies without being required to replicate

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synthetically through derivatives. To date, promoters of UCITS funds have only been able to pursue a synthetic 130/30 strategy through the use of derivatives. The revised policy provides that where stock is borrowed before entering into a physical short sale of that stock, the stock borrowing arrangement will be considered to constitute cover for the short sale. The principal conditions are that

(a) short sales are covered through a stock borrowing at the outset,
(b) the stock borrowing arrangement must be in accordance with the Financial Regulator's requirements and the assets used by the UCITS fund to support the stock borrowing cannot be passed to the stock lender (although a charge over such assets may be given by the fund's trustee/custodian);
(c) general leverage limits are not exceeded;
(d) the strategy is adequately disclosed in the UCITS fund's prospectus and risk management Process.

The prospectus must disclose a clear description of the covered short sale strategy including how the cover is provided, relevant risk factors and an indication of the expected level of leverage.

NON-UCITS DEVELOPMENTS

Whilst UCITS operate under a pan-European regime, the Irish non-UCITS structures are domestic products which do not avail of a European passport and are generally sold on a private placement type basis only. They have been extremely popular for structuring alternative type funds, in particular hedge funds, fund of hedge funds, real estate funds, private equity/venture capital type funds and master feeder type structures and can be established as open-ended, closed-ended or as limited liquidity type schemes with significant flexibility in product design.

The investment and borrowing restrictions that apply to non-UCITS structures are set on the basis of the type of investor being targeted – retail, professional or qualifying investor – with most interest and most development being seen with in the qualifying investor (QIF) product. QIFs impose a minimum subscription requirement per investor of Euro 250,000 (or equivalent) and can be sold only to qualifying investors – individuals with a minimum net worth of Euro 1.25 million (excluding principal private residence/contents) or institutions who own or invest on a discretionary basis at least Euro 25 million (or are themselves owned by qualifying investors).

(i) QIF Fast Track

The most important development to the QIF product of the last few years has been the new fast track authorisation process introduced in February 2007. Initially slow to take off, this development has now been seen as a resounding success with large volumes of QIF funds being launched using the new process by end December 2007.

The new process provides that, subject to meeting pre-agreed parameters, a QIF will be capable of being authorised by the Financial Regulator on a filing only basis so that once a complete application for authorisation is received by the Financial Regulator before 3.00pm on Day X, a letter of authorisation for the QIF can be issued by the Financial Regulator on Day X +1. There is no longer a prior review process.

(ii) Future Developments

2008 should see further clarification on the Financial Regulator's position on QIFs seeking to avail of a derogation to allow investment on a master-feeder basis into what, from an Irish regulatory perspective, are considered to be "unregulated funds".

We are also hopeful that 2008 will see finalisation of the QIF prime brokerage rules [which are currently being negotiated between the industry and the Financial Regulator], as well as further clarification on matters such as custody of real estate assets [building on 2006 developments], the use of side pockets as well as the possible removal of certain company law provisions which are seen as having little relevance to the funds industry. ■

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