MASON HAYES & CURRAN

Hedge Funds in Ireland

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1. Introduction

Over the last 25 years, Ireland has earned a reputation as a leading domicile for internationally focussed regulated investment funds. However in more recent years it has also grown to become the leading European jurisdiction for the establishment and servicing of alternative investment schemes and hedge funds in particular. Recent market statistics show that over 63% of European domiciled hedge funds currently use Irish legal structures while over 40% of global alternative investment funds (both Irish and non-Irish domiciled) are administered in Ireland.

The term “Hedge Fund” is not defined under Irish law and nor does it constitute a specific regulatory classification. Hedge funds are generally viewed as funds which pursue an alternative investment strategy, use leverage and avail of prime brokerage services. Accordingly they may be established in Ireland using any of a range of the legal and regulatory structures available, subject to the applicable requirements relevant in each case.

Investment funds in Ireland, including hedge funds, are authorised as regulated entities by the Central Bank of Ireland (the “Central Bank”), being the statutory regulator under Irish law. In terms of regulatory classifications, each regulated collective investment scheme (a “fund”) in Ireland is authorised as either a Non-UCITS or a UCITS and is subject to the Central Bank’s requirements, as set out in its Non-UCITS Notices or UCITS Notices (as appropriate) and Guidance Notes (collectively the “Notices”).

The essential difference between the two regulatory frameworks is that UCITS are authorised pursuant to European legislation, which applies standard investment and leverage restrictions. Non-UCITS funds, on the other hand, are authorised under indigenous Irish legislation. As such, they are not subject to the same level of restrictions but neither can they currently benefit from the pan-European “passport” available under the UCITS regime.

It can be noted, however, that the Alternative Investment Fund Managers Directive (Directive 2011/61/EU) (the “AIFMD”) will provide for the potential for Irish Non-UCITS funds to avail of a new European passport for alternative investment funds from 2013 and anticipation of these opportunities and the desire to “future proof” new funds has been a key factor in the growth in popularity of QIFs over the past two years in particular.

2. QIFS and other Non-UCITS

The target investor profile dictates the type of Non-UCITS fund to be used. The three available categories are:

- Qualifying Investor Funds (“QIFs”):
- Professional Investor Funds (“PIFs”); and
- Retail Investor funds.

The vast majority of hedge funds established in Ireland are authorised as QIFs and accordingly the other categories will not be considered further. QIFs comprise 70% of the total number of Irish Non-UCITS and hold 76% of the assets in such fundsi. There are currently around 1,350 QIFs in existence holding €175 billion in assets.

2.1 The QIF

QIFs can pursue aggressive investment strategies, including the use of leverage without restriction, and the applicable investment limits for other types of Irish funds either do not apply to QIFs or only apply to a very limited extent. Disclosure in the prospectus is required of the extent, if any, to which leverage will be used as well as a comprehensive, accurate and readily comprehensible description of the fund's investment objectives and policies. The investment restrictions that are applicable to QIFs relate to counterparty exposure and investments in other collective investment schemes, with a maximum of 50% of NAV being invested into any one unregulated fund.

2.2 Qualifying as a QIF

To be authorised as a QIF, a fund must;

- impose a minimum subscription requirement of at least €100,000 per investor (prior to October 2010 this requirement was €250,000). Institutions may not group amounts of less than €100,000 for individual investors;

- be marketed solely to the following qualifying investors:

a) an investor who is a professional client within the meaning of Annex II of Directive 2004/39/EC (Markets in Financial Instruments Directive) (primarily regulated entities, institutional investors and large undertakings, but certain individuals also); or

b) an investor who receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the scheme; or

c) an investor who certifies that they are an informed investor by providing confirmation (in writing) that:
   - the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or
   - the investor's business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the scheme.

The current minimum investment level brings the QIF broadly into line with that applicable to Cayman registered mutual funds. Exemptions from the qualifying criteria and minimum subscription requirements may be granted to the promoter (and its group companies), the investment manager, the management company or general partner and the directors and employees of such entities subject to certain conditions.

2.3 24 Hour Authorisation

QIFs enjoy a fast-track approval process whereby eligible funds can be approved in one day. This is available where the key parties have been pre-approved by the Central Bank, but if derogations or clarification from the Central Bank is required this must be addressed prior to the filing for approval.

2.4 Other Key Features of QIFs

Although Irish funds may not, in general, provide loans, QIFs may issue notes, on a private basis, to lending institutions to facilitate financing arrangements, provided that details of the note issue is clearly disclosed in the prospectus.
QIFs can issue a separate prospectus for a share class within a QIF or within a sub-fund of an umbrella QIF, provided the existence of other share classes is disclosed to investors. Shares or units in QIFs will generally have voting rights but classes of restricted voting shares or units are permitted provided investors have a right to convert to the equivalent voting class.

1 Source: Irish Funds Industry Association Statistics http://www.irishfunds.ie

3. UCITS

Alternative investment managers are increasingly exploring the structuring of their funds as UCITS as these are an ideal vehicle for managers seeking increased distribution and access to multiple markets. Ireland is renowned as a centre of excellence for UCITS products and is one of the leading domiciles for the establishment of cross-border or, internationally distributed, UCITS. Approximately 30% of all cross-border UCITS are domiciled in Irelandii.

3.1 What is a UCITS?

A UCITS is an “Undertaking for Collective Investment in Transferable Securities” and may be established in Ireland in a number of different legal forms. UCITS were designed as a pan-European mutual fund product, which, once authorised in one EU member state (a “Member State”), could be sold in all other Member States, without the need to be separately authorised in each target jurisdiction. To achieve this, UCITS are required to meet a common European standard in terms of authorisation, investment restrictions, risk diversification and investor protection. Accordingly their investment and borrowing restrictions are generally not negotiable.

In general terms, the basic investment requirement for UCITS is that at least 90% of its NAV must be invested in listed transferable securities, money market instruments or securities issued by sovereign states or their local authorities. UCITS can have no more than a 10% exposure to any one issuer (subject to certain exceptions), with the total number of securities held in issuers in which a UCITS invests more than 5% not, in aggregate, exceeding 40% of NAV. Borrowings are restricted to 10% of NAV, may only be made on a temporary basis and may not be used to achieve leverage. UCITS are limited to 100% leverage through the use of financial derivative instruments (“FDI”).

3.2 UCITS Updates and “Newcits”

In 2001, two new directives were successfully adopted which together are referred to as UCITS III. UCITS III significantly widened the range of investment possibilities for UCITS, facilitating the creation of alternative UCITS, the so-called “Newcits”. Since July 2011 UCITS have been established pursuant to Directive 2009/65/EC (generally known as “UCITS IV”) which was implemented in Ireland by means of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011 (S.I. 352 of 2011).

In summary, the authorisation of alternative funds as UCITS is now well established. Recent industry statistics show that in excess of 1,000 alternative UCITS have now been establishediii but interestingly over 65% of these were established post financial crisis so it is clear that this trend is increasing. At the same time the applicable investment, borrowing and leverage restrictions mean that UCITS will not be a suitable structure for every hedge fund strategy.

4. Global Distribution of Irish Funds

Irish funds are distributed in over 70 countries. 358 fund promoters, based in over 50 countries, have chosen to domicile their investment funds in Ireland, making it one of the world’s leading jurisdictions for the cross-border distribution of fundsiv.

Non-UCITS, including hedge funds structured as QIFs, are currently usually sold outside Ireland on a private placement basis or under exemptions applicable to institutional investors under local laws in the target country. In accordance with UCITS IV, the registration of UCITS for sale in other EU Member States is now a straightforward regulator-to-regulator notification, permitting marketing to proceed 10 business days after such notification.

5. Legal Structures of Irish Fund Vehicles

A choice of legal structures subject to different legal provisions is available under each of the regulatory categories of Non-UCITS and UCITS.

5.1 Variable Capital Investment Company

A variable capital investment company (“VCC”) can be established pursuant to the provisions of Part XIII of the Companies Act, 1990, as amended (for non-UCITS funds) or the UCITS Regulations (for UCITS). The VCC is the most common structure used for Irish-domiciled funds.

2 Source: Irish Funds Industry Association Statistics: http://www.irishfunds.ie

3 Source: Financial News, 7 October 2011

4 Source: Irish Fund Industry Association Statistics http://www.irishfunds.ie

A VCC is an incorporated entity with its own legal capacity as provided in its memorandum and articles of association. It has the capacity to enter into contracts and to sue and be sued. The day-to-day management and control is provided by a board of directors. The assets of a VCC are the property of the company in which the investors hold shares and those assets are held by a custodian.

A residual requirement (as a result of a quirk in Irish company law) is that in the case of a VCC (but not in the case of a unit trust), the prospectus must state that the VCC will at all times observe the principle of risk spreading. The Central Bank provides that it is the responsibility of the directors of the VCC to be satisfied in this regard.

It is a requirement of Irish company law that each VCC must have a minimum of two directors and the Central Bank requires they must have at least two Irish resident directors. Each director must be approved by the Central Bank in advance to ensure they satisfy its fitness and probity test.

5.2 Unit Trust

A unit trust can be established in Ireland pursuant to the Unit Trusts Act, 1990 (for non-UCITS funds) or pursuant to the UCITS Regulations (for UCITS funds).

A unit trust is a contractual type of vehicle and is constituted by a deed between the manager and the trustee. Both of these entities must be domiciled in Ireland. A unit trust does not have a separate legal existence, does not have the capacity to enter into contracts and cannot be sued.

The assets of a unit trust are held by its trustee (in its capacity as custodian) and are managed by a management company, which will, most often, delegate discretionary asset management to one or more investment managers. Contracts in relation to the management and administration of the unit trust are entered into by the manager, whereas the trustee will enter contracts in relation to the assets themselves such as bank deposits, security agreements etc. It is the manager and/or the trustee who may be sued in relation to the management, compliance or custody functions relating to the unit trust.

5.3 Common Contractual Fund

The common contractual fund (“CCF”) is a pooled contractual investment structure constituted either pursuant to the Investment Funds, Companies and Miscellaneous Provisions Act 2005 (for a non-UCITS) or the UCITS Regulations (for a UCITS). It does not have a separate legal personality.

Investors participate as co-owners of the assets of the fund, which is constituted by way of deed of constitution between the manager and the custodian. Such vehicles are completely tax transparent. CCFs may also avail of existing withholding tax exemptions available to other collective investment undertakings.

CCFs are established within a similar framework to that used for unit trusts and investment companies. The assets of the CCF are held by the custodian in the usual way, but the assets are under the common ownership of the investors, as tenants in common. As it is an unincorporated body, it cannot assume liabilities.

As with a unit trust, the manager and custodian enter the various agreements on behalf of the CCF.

Among the conditions attaching to the tax transparency of a CCF, are those requiring the CCF to:

- distribute all income annually;
- publish an annual breakdown of income by type and source;
- not have a redemption charge;
- not have meetings of unitholders; and
- not permit the transfer of holdings.

The benefits to pension funds and institutional investors of investing in CCFs will depend on how the tax transparency of the CCF is viewed by tax authorities of the investor’s own jurisdiction.

5.4 Investment Limited Partnership

An investment limited partnership (“LP”) may be established pursuant to the Investment Limited Partnerships Act, 1994 as a non-UCITS fund only. This structure has not proven popular in Ireland as the benefits it affords can also be obtained by a unit trust with less drawbacks.

5.5 Single and Umbrella Funds

Irish funds can be structured as single stand-alone funds or as umbrella funds and in the latter case the relevant legislation provides for segregated liability, for example for corporate structures, the Investment Funds, Companies and Miscellaneous Provisions Act 2005.

Both single and umbrella type funds can issue shares in one or more share classes which may provide, for example, for different fee levels, subscription amounts, currencies of denomination and/or distribution policies.

6. Hedge Fund Authorisation in Ireland

The Central Bank became the regulator of authorised investment funds in Ireland pursuant to the Central Bank Reform Act 2010. Prior to the commencement of this legislation in October 2010 this role was carried out by the Irish Financial Services Regulatory Authority, known as the "Financial Regulator". It operates an efficient authorisation process for Irish-domiciled funds. More detail on the authorisation procedure is set out below.

6.1 Promoter and Investment Manager Approval

The Central Bank requires that a promoter be initially identified to satisfy it that there is an entity of substance backing the project, although such an entity does not need to be contractually bound to a fund. Both the promoter and the investment manager (if different from the promoter) of the fund need to be approved by the Central Bank but the Central Bank may permit the approval processes to proceed in parallel. In the case of the promoter, the Central Bank will require confirmation that it has at least €635,000 in shareholders' funds.

There is no requirement for either the promoter or the investment manager to have physical operations in Ireland.

6.2 Fund Authorisation

An application for authorisation of an investment fund is made by lodging draft documentation with the Central Bank and it will usually respond with its initial comments within three weeks of receipt of an application. A typical fund should be capable of authorisation within five weeks, although QIFs enjoy a fast track approval process whereby eligible funds can be approved in one day.

6.3 Directors

The Central Bank must satisfy itself as to the reputation and experience of all directors by applying its fitness and probity test and directorship appointments must be approved in advance by the Central Bank. A minimum of two directors of the management company, general partner and the investment company must be Irish residents.

6.4 Service Providers

Irish domiciled funds are specifically required to have an Irish-based custodian which has been approved by the Central Bank. Where a fund appoints an Irish administrator certain minimum activities must either be carried out in Ireland or in accordance with the Central Bank's requirements on outsourcing. These include: NAV calculations; fund accounting; maintenance of members' register; and retention of backup documentation.

The fund must also have auditors, who will also be Irish based. There is no requirement for other service providers, such as distributors or investment advisers to be located in Ireland.

7. Hedge Funds Re-domiciling to Ireland

Specific legislation has been enacted, namely the Companies (Miscellaneous Provisions) Act 2009, and a streamlined procedure adopted by the Central Bank to provide a clear process to facilitate the re-domiciliation of unregulated funds to Ireland as a result of growing interest from fund managers to have their existing unregulated funds re-domiciled.

8. Management Companies

A unit trust and a CCF must have a management company, incorporated in Ireland, whereas a VCC may appoint a management company or alternatively can be 'self-managed' by its board of directors.

A management company typically does not perform discretionary investment management functions as this role is normally delegated to a dedicated investment manager or trading adviser, often located outside Ireland. Instead its role involves oversight, control and general organisation of the fund's activities. The Central Bank applies authorisation requirements on both UCITS and Non-UCITS management companies.

9. Liquidity

The recent financial crises focussed investor attention on liquidity issues as numerous funds applied gates or ceased redemptions entirely. A range of liquidity options are available for Irish Non-UCITS funds, which may be established as open ended, closed-ended or open-ended with limited liquidity.

UCITS are obliged to be open-ended with at least two redemption days a month and their liquidity has been one of the primary drivers for their growth in the alternative investment market. A 10% gate may be applied on redemption requests in respect of any given redemption date.

10. Appointment of Prime Brokers

The requirements of the Central Bank provide that all the assets of a fund must be entrusted to a third party trustee, or its sub-custodian, for safe-keeping. These requirements create potential issues in relation to the appointment of prime brokers to Irish authorised funds as they typically provide a range of services that involve possession of fund assets.

10.1 Central Bank Requirements

Guidance Note 2/11 “Professional collective investment schemes: Appointment of prime brokers and related issues” (the “Guidance Note”) was issued in July 2011 in order to address the appointment of prime brokers by certain Irish funds. Under the terms of the Guidance Note a QIF may select and enter into relationships with appropriate prime brokers whereby the prime broker may pledge, lend, rehypothecate or otherwise utilise for its own purposes fund assets transferred to it (“relevant assets”), without being appointed as a sub-custodian, subject to compliance with various conditions. Relationships with prime brokers must be fully disclosed in a fund’s prospectus, which must include a description of potential exposures arising from the relationship.

It can be noted that the Guidance Note does not apply to the appointment of prime brokers to UCITS so the generally applicable principles regarding the safeguarding of the assets of such funds continue to apply and accordingly, the prime broker may need to be appointed as a sub-custodian by the trustee.

10.3 OTC Counterparties

In addition to arrangements with prime brokers, a QIF may also seek to enter into collateral arrangements with over-the-counter (“OTC”) counterparties, including counterparties to OTC FDI, whereby assets of the fund are passed outside of the control of the trustee and which maybe pledged, lent or rehypothecated subject to the terms of the Guidance Note.There must be full disclosure in the fund’s prospectus of relationships with such counterparties as well as a description of the potential exposure arising from the relationship.

10.4 UCITS Counterparties

The general position is that the risk exposure of a UCITS to a counterparty to an OTC derivative may not exceed 5% of net assets. However, this limit is raised to 10% in the case of certain credit institutions. However, a combination of investments in transferable securities, money market instruments, deposits, and/or counterparty risk exposures arising from OTC derivatives transactions made or undertaken with the same body may not exceed 20% of net assets.

11. Taxation

Irish regulated funds benefit from the following attractive tax provisions:

- they are exempt from tax on their income and gains irrespective of an investor’s residency. This allows investors’ returns to roll up on a gross basis;
- no Irish withholding tax needs to be applied on income distributions or the redemption of units by a fund to a non-Irish resident investor;
- no Irish stamp duty is applied on the establishment, transfer or sale of units or shares in an Irish regulated fund;
- no on-going or yearly tax is charged on the NAV of the fund; and
- Ireland is not regarded as a tax haven.

11.1 Double Tax Treaties

Ireland has signed comprehensive double tax treaties with 65 countries, of which 56 are in effect. New treaties are continuously negotiated.

Dividends (if any) and interest which a fund receives from its non-Irish investments may be subject to local taxes, including withholding taxes. However, a structure can be put in place to benefit from Ireland's double tax treaty network to effectively avoid or reduce third county withholding taxes. The Irish fund can hold its interest in the foreign security through an Irish qualifying special purpose vehicle ("SPV") which avails of the provisions of Section 110 of the Taxes Consolidation Act 1997 ("TCA") to avail of Ireland's double tax treaty network to avoid or reduce such foreign withholding tax.

12. Continuing Obligations for Irish Funds

Following authorisation, Irish funds are required to comply with certain continuing obligations, as imposed by the Central Bank in the Notices and also under general Irish law, where applicable. The Central Bank is responsible for the on-going supervision of funds and (other than any requirements imposed by the Companies Acts, 1963-2009) all necessary filings are made with the Central Bank.

13. Listing on the Irish Stock Exchange

The Irish Stock Exchange (the "ISE"), is the world's leading exchange for listings of investment funds. There is no requirement for any fund to list on the exchange and it is available to both Irish and non-Irish funds.

However, there are a number of advantages to using an Irish fund when seeking to establish a fund listed on the ISE. For example, the ISE automatically accepts the suitability of service providers to a fund authorised by the Central Bank. QIFs may derogate from all ISE investment restrictions, save the prohibition on taking legal and management control of an issuer and limits on investment in commodities and real property.

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Mark Browne is a Partner in the Financial Services Department of Mason Hayes & Curran specialising in investment funds. Mark has over 10 years' experience in the funds industry and advises on all aspects of the structuring, establishment and on-going operation of investment funds in Ireland, as well as in regard to issues affecting service providers, including depositories and investment managers.

Mark has a keen focus on the alternative asset management sector and practiced as an Attorney-at-Law specialising in hedge funds in the funds practice of a leading firm in the Cayman Islands for four years. He advises on the redomiciliation of offshore funds to Ireland and the restructuring of hedge funds as UCITS.

About Mason Hayes & Curran

Mason Hayes & Curran is a full service, business law firm with 60 partners and over 290 employees specialising in Irish law. With offices in Dublin, London and New York the firm delivers sophisticated legal services to an extensive Irish and international client base. Our investment funds lawyers have a wealth of experience in the investment funds industry and have been involved in the development of policy and regulation in Ireland. We advise on the establishment and ongoing operation of Irish domiciled investment funds and our dedicated team of investment funds lawyers can also draw upon the expertise of specialist lawyers from our tax, corporate, banking, litigation, intellectual property, data protection, regulatory and compliance practices whenever required. For further information with regard to the topics covered in this Update, or Irish investment funds law generally, please see the contacts listed below: