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CHAPTER 16

Investment Companies

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16.1 Introduction

16.1.1 The Review Group recognises the importance of the international investment funds industry to the Irish economy. The Group also acknowledges the complexity of the legislation and regulation under which the industry operates, as outlined below, and, perhaps most importantly, the need to ensure a timely and regular review of the legal and regulatory regime in the light of market and other developments. Such review will assist in maintaining Ireland's competitive position *vis-á-vis* other jurisdictions. In addition, the Group considered whether the Companies Acts represents the best home for the law relating to investment companies in particular and funds in general. In recognition of these factors, the Review Group sets out a number of recommendations in this chapter dealing specifically with investment companies.

16.2 The international investment funds industry in Ireland

16.2.1 The development of the international funds industry in Ireland began in 1989, with the implementation of the EU UCITS Directive.[1] This was followed shortly afterwards by the enactment of a number of legislative initiatives which were designed to ensure that the full range of fund products familiar to international promoters was available in Ireland. In 1989, also, a special tax regime for International Financial Services Centre (IFSC)[2] funds was introduced. This regime provided for exemption from corporation tax of Irish-authorised investment funds subject to the conditions that (i) the fund was managed by a company with an IFSC certificate and (ii) Irish tax residents would not be permitted to invest in the fund. The first of these requirements was usually satisfied either by the establishment by a fund promoter of its own IFSC management company or by the appointment of a third party fund administrator in Dublin which held an IFSC certificate. In some cases, fund promoters set up their own stand-alone operations in Ireland.[3]

16.2.2 The initiatives described above have resulted in the development of Ireland as a significant international centre for the establishment of investment funds. There are 925 investment funds authorised in Ireland. Of these, approximately two-thirds are investment companies. The bulk of the remainder are unit trusts, with only two investment limited partnerships currently authorised. At 30 September 2001, the total net asset value of Irish funds was €243.6 billion.[4] There are, approximately, 9,000 people employed, whether directly or indirectly, in the investment funds industry in Ireland. From this point of view alone, the development of the international funds industry is generally regarded as one of the key successes of the IFSC.

16.3 Investment funds – structure and regulation

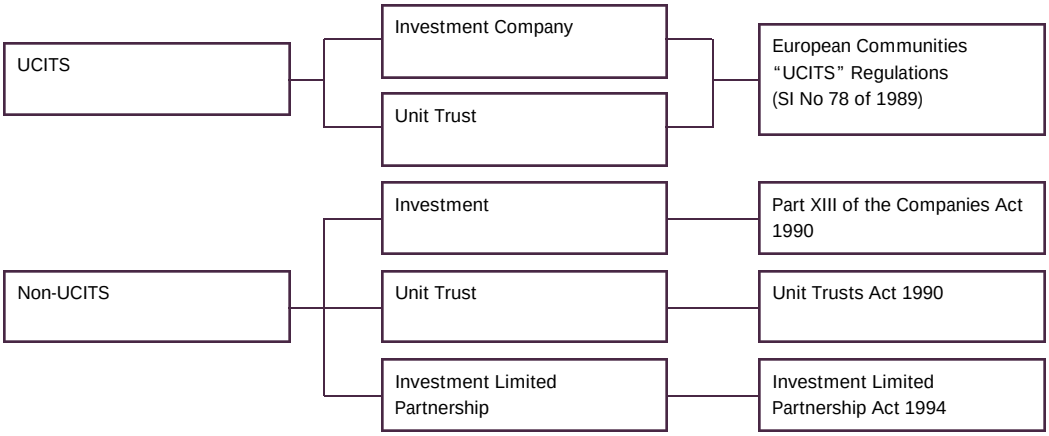
16.3.1 The bulk of Irish investment funds are established as investment companies. The choice of legal structure for a fund can depend on a number of factors, including promoter and investor preference. The principal enactments governing investment companies ("investment funds in Ireland") are set out in the diagram below:

1 European Communities (Undertakings for Collective Investment in Transferable Securities) Directive 85/611/EEC, implemented in Ireland by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 1989 (SI No 78 of 1989).

2 The IFSC was set up in 1987 in a designated area around the Custom House Docks in Dublin. A special low rate of tax, 10%, applied to companies in the designated area offering financial services to international clients. Such companies were granted a tax certificate, commonly referred to as an "IFSC certificate". This concession generally applies until 2005.

3 The Irish Government reached agreement in 1998 with the EU Commission that the IFSC certification regime would be phased out, with the last certificates being issued in 1999. Companies holding IFSC certificates will generally continue to enjoy the 10% corporate tax rate until 2005. The Government also attained Commission approval that the standard rate of corporate tax would be gradually reduced over four years, leading to a standard rate of 12.5% effective January 2003. Companies would no longer be required to locate in the IFSC or fulfil any of the other "IFSC" requirements to benefit from the reduced rate of tax.

4 Source: Central Bank of Ireland.



16.3.2 Because investment funds constituted as companies generally have very distinct forms of company organisation and objectives, it is often inappropriate to treat them in the same way as the generality of companies. The most notable distinction is, perhaps, the fact that investment companies have a variable capital, which has resulted in the relaxation of the normal capital maintenance rules. Sections of the Companies Acts have frequently been disapplied from investment companies. Other provisions, notably Part XIII of the 1990 Act and certain provisions of the UCITS Regulations, apply only to such companies.

16.3.3 In addition to different legal structures, investment funds in Ireland may be established under different provisions of the Companies Acts depending on whether or not they come within the scope of the EU UCITS Directive. (Investment funds not coming within the UCITS Directive are generally known as "non-UCITS"). UCITS are governed by the UCITS Directive, which was implemented in Ireland by the UCITS Regulations, and may be established as either investment companies or unit trusts. Non-UCITS may be established as investment companies (under Part XIII of the 1990 Act), unit trusts (under the Unit Trusts Act 1990) or investment limited partnerships (under the Investment Limited Partnerships Act, 1994).

16.3.4 Under all of these enactments, the Central Bank of Ireland (the "Central Bank") is designated as the regulator.[5] The primary concern of the Central Bank in its capacity as regulator is investor protection and to ensure compliance with relevant law. All investment funds established in Ireland must be authorised by the Central Bank and the investment manager of the fund must be approved as such by the Central Bank. In addition, the other service providers to the fund, notably the fund administrator and custodian, must be based in Ireland and must be approved by the Central Bank to act as such.

16.3.5 Pursuant to the legislation, the Central Bank has power to make regulations relating to the initial authorisation and ongoing supervision of investment funds. In this regard, the Central Bank has issued a series of "Notices" for both UCITS and non-UCITS funds and, in addition, periodically issues guidance notes. It is interesting that the Central Bank's Notices and guidance notes do not distinguish between the different legal forms of investment funds except where the context specifically requires.

16.3.6 The Central Bank Notices cover issues relating to the detailed operation of authorised investment funds, such as investment and borrowing restrictions, prospectus contents and reporting requirements.[6] In the case of non-UCITS, the nature of the requirements depends on the category of authorisation being sought, i.e. whether the fund will be marketed to retail or "sophisticated" investors. Because non-UCITS are not subject to the constraints of an EU Directive, they allow for a much wider and more flexible range of investment and borrowing strategies than are permitted under the UCITS Regulations.

5 In February 2001 the Government decided on the establishment of a unified regulator of financial services, the Irish Financial Services Regulatory Authority (IFSRA), operating under a proposed new Central Bank of Ireland and Financial Services Authority Board. IFSRA will be responsible for the licensing and prudential regulation of all financial services providers.

6 See www.centralbank.ie/supervision.html.

16.4 Undertakings for collective investment in transferable securities ("UCITS")

16.4.1 The term "UCITS" is used to describe funds authorised by the UCITS Directive. The intention behind the UCITS Directive was to have an investment product subject to the same regulation in each EU Member State. The product could, once authorised in one Member State, be sold to the public in each Member State without further authorisation. All that is required is registration with the local regulator, which cannot refuse permission to market once a fund is duly authorised in another Member State and complies with the local marketing rules. The types of fund which can be established under the UCITS Directive are relatively limited and the reality of a pan-European market for investment funds has fallen short of the vision. The EU Council of Finance Ministers, in December 2001, adopted two further Directives which will amend the original UCITS Directive both by extending the range of investment products available and introducing specific rules pertaining to the infrastructure and capitalisation of UCITS. The Review Group understands that the Irish Government intends to proceed with the early implementation of these Directives.

16.5 Investment companies

16.5.1 For the purposes of this report, the Review Group is concerned only with investment companies, i.e. companies operating under either Part XIII of the 1990 Act or the UCITS Regulations. The UCITS Regulations introduced a new type of company, the variable capital company. Section 252 of the 1990 Act introduced a similar form of company for non-UCITS. This form applies only to companies incorporated in accordance with one or other of those enactments and regulated by the Central Bank. Such companies are structured to facilitate the periodic repurchase of the shares of the company at the option of the shareholder and are generally known as open-ended companies. (Section 80 of the Investment Intermediaries Act 1995 extended many of the provisions of Part XIII of the 1990 Act to closed-ended investment companies, i.e. investment funds in which shareholders do not have an automatic right to redeem their shares).

16.5.2 Investment companies must be established as PLCs. The provisions of Part XIII of the 1990 Act apply to an *investment company,* defined at s 253(2) of the 1990 Act as:

> …a company limited by shares (not being a company to which the UCITS Regulations apply)-
>
> (a) the sole object of which is stated in its memorandum to be the collective investment of its funds in property with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds; and
> (b) the articles or memorandum of which provide-
> (i) that the actual value of the paid up share capital of the company shall be at all times equal to the value of the assets of any kind of the company after the deduction of its liabilities, and
> (ii) that the shares of the company shall, at the request of any of the holders thereof, be purchased by the company directly or indirectly out of the company's assets.

16.5.3 The definition was further amended by the Investment Intermediaries Act 1995 and, subsequently, by the 1999 (No 2) Act. Section 253(2A) now reads:

> Notwithstanding subsection (2)(b)(ii), this Part shall also apply to a company to which subsection (2) otherwise applies, the articles or memorandum of which do not provide that the shares of the company shall, at the request of any holders thereof, be purchased in the manner therein provided, to the extent as may be approved and subject to such conditions as may be applied by the [Central] Bank.

16.6 The IFSC Funds Group

16.6.1 As part of the Government's policy to promote international financial services in Ireland, a number of working groups, which incorporate both industry and State experts, operate under the aegis of the Department of the

Taoiseach. The purpose of these groups is to advise the Government on policy and technical (legal/regulatory/tax) matters designed to ensure the continuing competitiveness of Ireland as an international centre for financial services. In this context, the IFSC Funds Group has identified a number of legislative provisions, relating to both UCITS and non-UCITS, which it considers are impeding the efficient operation of Irish-authorised investment funds, and has made proposals for amendments relating thereto. These are largely of a technical nature and are designed to facilitate the efficient operation of investment funds in Ireland and, in some cases, to streamline the law relating to UCITS with that for non-UCITS. This law has, in certain respects, become inconsistent, primarily because the two types of funds operate under different legislative provisions. The overriding objective is to ensure that Ireland remains competitive with other jurisdictions within its commitments under European company law and fund law Directives, while providing appropriate investor protection.

16.6.2 The Review Group has examined the proposals of the IFSC Funds Group in the particular context of company law principles as established over the years. The Review Group accepts the proposals of this expert group and recommends that they be implemented as part of the implementation of the overall recommendations contained in this report.

16.7 Complexity of the situation and principal proposals

16.7.1 An important issue with regard to investment companies is whether the Companies Acts are the most appropriate means of facilitating the operation of such companies or whether they should, together with unit trusts and investment limited partnerships, operate under a separate legislative code.

16.7.2 A clear case can be made for the retention of provisions governing the activities of particular companies in the Companies Acts. This is the reason why, in the first place, such legislation was made part of the Companies Acts. On the other hand, however, investment companies have very particular needs which will frequently be very different to the needs of so-called "ordinary" companies. Changes have been required to the general companies' legislation as applies to all companies, in order to facilitate a tiny number of companies that are, however, hugely important to the economy.[7] The piecemeal amendment of the general companies' legislation in order to facilitate developments in the international practice of investment companies has the result that the general law is made more complex and wordy. Such an approach is certainly not conducive to simplification of company law.

16.7.3 The Review Group considers that there is a stronger argument for a separate legislative code for investment funds, particularly given the extent of regulation of such entities by the Central Bank. Such a code would govern the establishment and operation of investment funds, irrespective of legal form and of whether they are UCITS or non-UCITS, and would facilitate the operation and regulation of such different entities in a consistent manner. The Group recommends, therefore, that the establishment and operation of all forms of investment funds (whether investment companies, unit trusts or investment limited partnerships and whether UCITS or non-UCITS) should be provided for by means of a Collective Investment Schemes Bill. The Group recognises, however, that, pending a commitment to draft and enact such a dedicated Bill, to the extent to which the Companies Acts apply to investment companies, a number of changes are required to be made. The principal amendments that have been proposed by the IFSC Funds Group, which are endorsed by the Review Group, are outlined in 16.8 below.

16.7.4 In restructuring the Companies Acts so as to create the paradigm envisaged at 3.7.3, Part XIII of the 1990 Act would be placed within a Part of Group B of the consolidated Companies Act. The Group sees considerable merit in the hiving-off of that Part into a stand-alone piece of legislation. To the extent that it is possible, the Review Group recommends that the pre-consolidation Bill (which will be necessary to create the legislative infrastructure required to give effect to the Group's recommendations on the restructuring of the Companies Acts) would facilitate this hive-off and achieve two resulting Bills: the consolidated Companies Bill and the Collective Investment Schemes Bill.

7 See, for example, s 93 of the 2001 Act which amends s 213 of the 1963 Act, dealing with the winding-up of companies.

16.8 Other proposals for amendment to the Companies Acts

UCITS Regulations

16.8.1 The Department of Enterprise, Trade and Employment is currently working on the implementation of a number of amendments to the UCITS Regulations recommended by the IFSC Funds Group. There may, however, be a serious legal difficulty in implementing some of these amendments by way of Regulations under the EC Act, as is the intention, if the amendments proposed cannot be seen to be specifically required for the purpose of implementation of the UCITS Directive. In such circumstances, it will be necessary to give effect to the amendments by means of primary legislation, and the Review Group recommends that any such amendments be included in the Bill which will give effect to the overall recommendations contained in this report.

Limited duration companies

16.8.2 Currently, under s 251(1)(a) of the 1963 Act, even where a period has been fixed in a company's articles of association for the duration of the company, a shareholders' resolution is still required for the company to be wound up on a voluntary basis. This requirement creates certain foreign tax inefficiencies in the context of investment funds. In particular, the requirement to have a resolution to effect the termination of a company brings Irish funds outside certain preferential tax treatment in the USA. The removal of the requirement for the passing of a resolution overcomes these tax inefficiencies and it is recommended, accordingly, that s 251(1)(a) be amended to allow for what is known in the international funds industry as "limited duration companies".

16.8.3 Certain consequential amendments flow from this amendment as a voluntary winding-up process is predicated on the assumption of a shareholders' meeting at which a resolution is passed to wind up the company. In the present context, it is envisaged that a shareholders' resolution would solely be required to approve the appointment of a liquidator. Sections 252(1), 253, 256(2) and 266(1) of the 1963 Act clearly envisage a meeting of shareholders being held for the purpose of passing a resolution to wind up and these sections, at least, will also have to be amended, insofar as they relate to investment companies, to facilitate limited duration investment companies.

1986 Act

16.8.4 A number of provisions of the 1986 Act relating to the format and content of company accounts are not appropriate for investment companies. For example, the format of company accounts prescribed in the 1986 Act is not suitable for umbrella funds,[8] where each share class or "sub-fund" effectively operates as a separate fund.

16.8.5 The Fourth Directive, on which the 1986 Act is based, permitted Member States to exempt open-ended investment companies from the requirements of the Directive. (Closed-ended investment companies must, however, comply with these requirements.) The 1986 Act, in implementing the Directive, did not, however, allow for the exemption.

16.8.6 The fact of open-ended investment companies being made subject to the requirements of the Directive may mean that such companies are at a disadvantage *vis-á-vis* not only Irish unit trusts and investment limited partnerships but also funds established in other EU Member States which have availed of the Fourth Directive exemption. Given the development of the investment funds industry in Ireland and in view, also, of the fact that the Central Bank prescribes the contents of accounts for all investment funds, the Review Group recommends that open-ended investment companies be exempted from the 1986 Act.

Section 53 of the 1990 Act

16.8.7 Section 53 of the 1990 Act requires directors who acquire shares in a company to notify the company secretary within five days of the relevant acquisition; a failure to notify resulting in the shares losing their voting rights.

8 An umbrella investment company is a company that can issue shares of different classes, each of which relates to a separate pool of assets, which can be described as a "sub-fund" or a "portfolio". A company prescribes a separate investment objective and policy for each sub-fund and the assets held in that portfolio are professionally managed with the aim of meeting this objective.

This section was specifically disapplied from UCITS investment companies by s 55 of the 1990 Act and, the Review Group recommends, should similarly be disapplied from non-UCITS investment companies.

16.9 Cross-investment by umbrella investment companies

16.9.1 The funds industry is currently seeking to have certain sections of the UCITS Regulations and of Part XIII of the 1990 Act amended in order to allow for cross-investment between sub-funds of both UCITS and non-UCITS umbrella investment companies. There is a wide range of circumstances where it can be beneficial for a sub-fund to invest in another sub-fund rather than take investment exposure directly. For example, a sub-fund could use cross-investing to take exposure to smaller asset classes in order to create efficiencies in the portfolio management, portfolio operations and fund accounting areas. It is not possible at present for investment companies to do this because of the interpretation of ss 254 and 255 of the 1990 Act (although it is possible in a unit trust).

16.9.2 The IFSC Funds Group is currently examining this issue to identify the amendments which need to be made to the Companies Acts to facilitate cross-investment and a specific study has been commenced to examine and report on any potential conflicts with EU law or generic principles of domestic company law. In the interest, again, of ensuring that Ireland remains competitive *vis-á-vis* other investment funds jurisdictions, where cross-investment is generally permitted, the Review Group recommends that the amendments proposed be given priority attention.

16.10 Protected cell companies

16.10.1 Investment funds may be established in the form of umbrella funds, under which a number of sub-funds are created within a single corporate entity. This is a popular and efficient type of investment vehicle. Generally, however, the company is legally liable for all of the debts of the company, including debts occurring at sub-fund level. A number of amendments would be required to Irish company law to allow the creation of umbrella investment companies where the liabilities of the individual sub-funds is limited, through the creation of individual cells. From a prudential viewpoint, such structures have merit and are important for the protection of investors. Whilst the likelihood that the individual sub-funds could fail to meet their liabilities is remote in the context of retail funds (where borrowing is limited), there are other funds, particularly those investing in derivatives and using leverage, where such eventualities could arise.

16.10.2 The key feature of a protected cell company ("PCC") is that although the company remains a single legal entity, it has separate and distinct "cells". The assets and liabilities of each cell are segregated and protected from those of the other cells. They are also separate and distinct from a PCC's non-cellular assets.

16.10.3 The objective is to ensure that the assets of one cell are only available to those creditors of the company who are creditors in respect of that cell and that the assets of one cell are protected from the creditors of the company who are not creditors in respect of that cell and who accordingly are not entitled to have recourse to the assets of that cell. A PCC enables assets to be ring-fenced within the company's individual cells pursuant to a statutory framework.

16.10.4 One method of dealing with the issue of cross liability between sub-funds is for the company to establish separate trading subsidiaries for each sub-fund, thus isolating liability at the level of the subsidiary. This is, however, a cumbersome structure to create and to operate.

16.10.5 Segregation of liability between sub-funds is possible in a unit trust. It is also possible in a number of other jurisdictions where special protected cell legislation has been introduced. The absence of this facility for investment companies puts Ireland at a disadvantage *vis-á-vis* its competitors. This is an issue that requires further examination.

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16.11 Summary of Recommendations

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- The establishment and operation of all forms of investment funds (whether investment companies, unit trusts or investment limited partnerships and whether UCITS or non-UCITS) should be provided for by means of a Collective Investment Schemes Bill. **(16.7.3)**

- In restructuring the Companies Acts so as to create the paradigm envisaged at 3.7.3, Part XIII of the 1990 Act should be placed within a Part of Group B of the consolidated Companies Act. To the extent that it is possible, the pre-consolidation Bill (which will be necessary to create the legislative infrastructure required to give effect to the Group's recommendations on the restructuring of the Companies Acts) would facilitate this hive-off and achieve two resulting Bills: the consolidated Companies Bill and the Collective Investment Schemes Bill. **(16.7.4)**

- If the amendments to the UCITS Regulations recommended by the IFSC Funds Group cannot be effected by secondary legislation, they should be included in the Bill which will give effect to the overall recommendations contained in this report. **(16.8.1)**

- Sections 252(1), 253, 256(2) and 266(1) of the 1963 Act should be modified in their application to investment companies so as to dispense with the requirement for a shareholders' resolution in the voluntary winding-up of an investment company and to facilitate limited duration investment companies. **(16.8.3)**

- Open-ended investment companies should be exempted from the 1986 Act. **(16.8.6)**

- The disapplication of s 53 of the 1990 by s 55 of the 1990 Act in the case of UCITS investment companies should be extended to non-UCITS investment companies. **(16.8.7)**

- In the interests of ensuring that Ireland remains competitive vis-á-vis other investment funds jurisdictions where cross-investment is generally permitted, amendments proposed by the IFSC Funds Group should be given priority attention. **(16.9.2)**