



FINANCIAL REGULATOR
Rialtóir Airgeadais

Collective investment schemes: exchange rate hedging; valuation of OTC derivatives

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Consultation Paper | **CP27**

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Exchange rate hedging:

Guidance Note 3/99 (Share classes - hedging against exchange rate movements) permits authorised collective investment schemes (CIS) to engage in currency hedging transactions at share class level. Conditions imposed include the stipulation that a currency share class must not be leveraged as a result of hedging transactions, i.e. the share class must not be over-hedged.

The Financial Regulator accepts that over-hedged (and under-hedged) positions may be unavoidable from time to time due to market movements. Accordingly it is proposed to amend Guidance Note 3/99 to provide some additional flexibility in relation to the hedging policy, subject to appropriate disclosure in the prospectus.

In the case of CIS which market to retail and professional investors, a limit of 105% of net asset value is proposed in relation to over-hedged positions, subject to a monthly review and an undertaking that over-hedged positions will not be carried forward from month to month.

CIS which market solely to qualifying investors are not subject to this limit but should outline hedging strategies and limits as appropriate in the prospectus.

Valuation of OTC derivatives:

CIS are permitted to invest in OTC derivatives provided that the CIS is satisfied that the counterparty will value the transaction, at least daily in the case of UCITS and at least weekly in the case of non-UCITS, and will close out the transaction at the request of the CIS at fair value. *Ref: Notices UCITS 10 (paragraph 3(iv)) and NU 16 (paragraph 13 (v)).*

The Notices provisions are supplemented by the following provisions in Guidance Note 1/00 (Valuation of Assets of Collective Investment Schemes):

"Off-exchange derivative contracts:

- ◆ *The Financial Regulator's Notices (NU 16, NU 20, NU 21) require that the counterparty must be prepared to value off-exchange derivative contracts at least weekly. In the case of UCITS, a daily valuation is required (UCITS 10). On application the Financial Regulator may accept monthly valuations from the counterparty in the case of closed-ended and certain professional and qualifying investor schemes with not less than monthly valuation policies.*
- ◆ *The valuation of the position is that supplied by the counterparty provided that such valuation is approved or verified, at least monthly, by a party who is approved for the purpose by the trustee and who is independent of the counterparty. In the case of UCITS the valuation must be approved or verified by the independent party at least weekly.*
- ◆ *Where valuations provided by different counterparties (or by the independent party(ies) referred to above) in respect of the same or similar derivatives positions differ significantly these should be promptly investigated and reconciled."*

The Financial Regulator has received a number of submissions in relation to the accuracy and timeliness of valuations provided by counterparties.

The principal points made were that:

- ◆ A counterparty valuation may not necessarily be indicative of the value that the counterparty might actually transact;
- ◆ Counterparties may resist committing contractually to providing valuations on an ongoing basis and may not provide these in a timely manner;
- ◆ Valuations are model driven and, particularly in the case of more complex instruments, the models may be inaccurate on occasions.

The Financial Regulator is also cognisant of the draft European Commission Directive on the clarification of definitions related to eligible assets for UCITS. Article 8(4) of the draft Directive provides for the valuation of OTC derivatives. The text refers to:

"valuation , by the UCITS corresponding to the fair value ...which does not only rely on market quotations by the counterparty and which fulfils the following criteria:

(a) the basis for the valuation is either a reliable up-to-date market value of the instrument, or, if such a value is not available, a pricing model using an adequate recognised methodology;

(b) verification of the valuation is carried out by one of the following:

(i) an appropriate third party which is independent from the counterparty of the OTC derivative, at an adequate frequency and in such a way that the UCITS is able to check it;

(ii) a unit within the UCITS which is independent from the department in charge of managing the assets and which is adequately equipped for such purpose."

"Fair value" in this context is a reference to the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction, (Article 8(3)).

The Financial Regulator accepts the validity of the submissions and is prepared to consider some amendments to the relevant provisions of Guidance Note 1/00. However, given the bi-lateral nature of the instruments involved, it is considered that the valuation provided by the counterparty must have primacy in the valuation process.

The proposed amendments to the Guidance Note will allow CIS to exercise discretion in relation to the value of the OTC derivatives for the purposes of the Net Asset Value calculation, provided that valuations provided from another source(s) are reconciled with the counterparty valuation.

The Financial Regulator is also prepared to introduce additional flexibility in relation to independent verification of counterparty valuations. In particular the Financial Regulator will permit that "independent" in this case can include a party related to the counterparty where the related party is an independent unit within the counterparty's group which does not rely on the same pricing models employed by the counterparty.

However, in many cases CIS enter into a single OTC derivative and receive collateral from the counterparty to limit the exposure. Frequently, and particularly in the case of CIS with structured returns, the counterparty and the management of the CIS are related parties. The Financial Regulator has concerns that in such circumstances, where the return to the CIS is based solely on the performance of a single instrument, there is an increased need for independent valuation. Accordingly it is proposed that in the case of UCITS and non-UCITS retail CIS investing in OTC derivatives where exposure to the counterparty can, through the provision of collateral, exceed the limits laid down in the UCITS Regulations or the NU Series of Notices and verification of the counterparty valuation is carried out by a related party, the valuation of the OTC derivative will, additionally, be subject to further independent review, on a six monthly basis, by an unrelated party.

Amendments to Guidance Notes

The proposed amendments to Guidance Note 3/99 (Share classes - hedging against exchange rate movements) and Guidance Note 1/00 (Valuation of Assets of Collective Investment Schemes) are set out in the Annex.

The Financial Regulator invites all interested parties to provide comments or make a submission on the matters set out in this consultation paper.

Comments should be submitted no later than 30 March 2007 to:

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Or via e-mail to fifapolicy@financialregulator.ie

**Financial Institutions and Funds Authorisation
28 February 2007**

Annex

Guidance Note 3/99

Share classes - hedging against exchange rate movements

In this text the following terminology will be used

'CIS' shall refer to a single pool collective investment scheme¹ or, in the case of an umbrella scheme, a sub-fund;

'share class' shall refer to classes of units or shares created within a CIS;

'base currency' shall refer to currency of denomination of the CIS;

'currency share class' shall refer to a share class denominated in a currency other than the base currency;

'class currency' shall refer to the currency of denomination of the share class;

'unhedged currency share class' shall refer to a currency share class where, typically, shares may be subscribed for, and the redemption proceeds can be obtained in, the class currency rather than the base currency. However, currency conversion will be conducted at prevailing spot currency exchange rates;

'hedged currency share class' shall refer to a currency share class in respect of which the CIS will conduct currency hedging transactions, the benefit and cost of which will accrue solely to the investors in that class.

The Irish Financial Services Regulatory Authority's ("the Financial Regulator") approach to the creation of more than one share class within a CIS is as follows:

- each CIS must consist of a single common pool of assets;*
- assets may not be allocated to individual share classes;*

¹ An investment limited partnership may not be formed as an umbrella CIS and may not provide for different classes of limited partnership interests.

- *the capital gains/losses and income arising from that pool of assets must be distributed and/or must accrue equally to each shareholder relative to their participation in the CIS;*
- *subject to the overriding principles outlined above, share classes may be established. These are generally differentiated on the basis of subscription /redemption procedures, distribution policies or charging structures.*

A sample pricing methodology which ensures equity of treatment between shareholders is contained at Appendix 1.

Hedging against exchange rate movements at class level

The Financial Regulator has always permitted unhedged currency share classes. Historically, however, the Financial Regulator has not permitted the creation of hedged currency share classes. The principal concern has been that the application of the costs/benefits of the hedge to the share class, rather than to the pool of assets as a whole, would infringe on the principle of equity of treatment of all shareholders in a CIS, specifically that all shareholders must share equally in the gains/losses and income arising from the central pool of assets.

The Financial Regulator received a number of submissions from the industry proposing that currency hedging transactions at share class level be permitted. These contended that investors' interests were best served by permitting such hedging transactions and that permitting currency share classes without associated hedging strategies could mislead investors in certain circumstances. It was also contended that the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 ['the Regulations'] permits such a strategy. The submissions noted that these techniques are permitted in at least one other European jurisdiction and that the administrative procedures to cope with the techniques are available and well developed. Finally it was noted that other structures, (the provision of separate individual currency hedging facilities for investors or the creation of

separate sub-funds), would result in unnecessary extra expense and/or complications for investors who require such protection.

Following detailed consideration of these submissions the Financial Regulator accepts that, subject to a) clear disclosure in the prospectus and b) unambiguous valuation and allocation provisions in the constitutional document of the CIS, the creation of a hedged currency share class -

- may be viewed as an acceptable efficient portfolio management technique and not an investment asset of the CIS;
- creates positive benefits to shareholders;
- does not prejudice holders of other share classes; and
- is not contrary to any provision of the Unit Trusts Act, 1990, Part XIII of the Companies Act, 1990, the Investment Funds, Companies and Miscellaneous Provisions Act, 2005 or the Regulations.

Consequently, and subject to the rules and disclosure requirements set out below, the Financial Regulator will permit the establishment of hedged currency share classes.

Constitutional document

A share class may not be created unless this has been specifically provided for in the constitutional documents of the CIS, i.e. the trust deed, deed of constitution or articles of association. In the case of umbrella CIS particular care must be taken to ensure that provisions for the creation of classes within sub-funds are clear and unambiguous. Moreover it should be clear whether it is intended to create hedged and/or unhedged currency share classes.

Where it is proposed or envisaged that hedged currency share classes will be created the constitutional documents should, in respect of the currency hedging transactions at class level, contain

- ~~• clear provisions for the valuation of the transactions;~~
- clear provisions for the charging of the resultant costs and gains/losses to the relevant share class;

- ~~• a requirement that transactions be clearly attributable to a specific class (e.g. currency exposures of different currency classes may not be combined or offset and currency exposures of assets of the CIS may not be allocated to separate share classes);~~
- ~~• a requirement that a currency share class must not be leveraged as a result of these transactions, i.e. it must not be over-hedged.~~

~~The latter two requirements may alternatively be provided for in the prospectus.~~

Prospectus

The prospectus must clearly describe the general currency hedging strategies of the CIS and the features of individual currency share classes.

Where the CIS intends to invest in assets denominated in currencies other than the base currency, the prospectus should disclose whether it is the intention of the CIS to hedge the resulting currency exposure back into the base currency and, if so, to what extent. The general costs and/or exchange rate risks associated with the currency strategy must also be disclosed.

In the case of an unhedged currency share class, the prospectus should disclose that a currency conversion will take place on subscription, redemption and distributions at prevailing exchange rates. Where appropriate it should disclose that the value of the share expressed in the class currency will be subject to exchange rate risk in relation to the base currency. In the case of hedged share classes, the prospectus should provide that the performance of the class is likely to move in line with the performance of the underlying assets and that investors in the hedged share class will not benefit if the class currency falls against the base currency and/or the currency in which the assets of the CIS are denominated.

In the case of hedged currency share classes the prospectus must disclose the implications of the hedging policy. Typically this will include:

- a statement indicating the extent to which the CIS intends to hedge against currency fluctuations and noting that while not the intention, over-hedged or under-hedged positions may arise due to factors outside of the control of the CIS. ~~which in no case should exceed 100% of the net asset value of the class;~~
- In the case of CIS which market to retail investors (UCITS and non-UCITS) or to professional investors, the prospectus must provide that over-hedged positions will not be permitted to exceed 105% of the net asset value of the class².
- A statement that the hedged positions will be kept under review to ensure that over-hedged positions do not exceed the permitted level, or, in the case of QIFs, the provisions set out in the prospectus. This review will also incorporate a procedure to ensure that positions in excess of 100% will not be carried forward from month to month.
- A statement that transactions will be clearly attributable to a specific class. (Therefore currency exposures of different currency classes may not be combined or offset and currency exposures of assets of the CIS may not be allocated to separate share classes):
- ~~a warning that this strategy may substantially limit holders of the class from benefiting if the class currency falls against the base currency and/or the currency in which the assets of the CIS are denominated;~~
and
- a disclosure that the costs and gains/losses of the hedging transactions will accrue solely to the relevant class.

Periodic Reports

As with any transaction undertaken to provide protection against exchange rate risks the periodic reports should indicate how these transactions have been utilised.

Administration

In order to provide currency hedging at class level, the valuation systems operated by the management company, investment company or

² In the case of UCITS, over-hedged positions must be included in calculations of global exposure – ref Guidance Note 3/03 (UCITS - Financial Derivative Instruments)

administration company must be capable of processing and identifying the relevant hedge transactions at share class level. Systems must also be in place to enable a review of the hedge be undertaken in the light of ongoing flows into and out of the share class.

Financial Institutions and Funds Authorisation
Financial Regulator
February 2007

Guidance Note 1/00

Valuation of the Assets of Collective Investment Schemes

Paragraph 2 of non-UCITS Notice NU 8 provides:

" The assets of a collective investment scheme, including any techniques or instruments used for the purposes of efficient portfolio management (Ref. NU 16), will be valued by a method clearly defined in the trust deed, articles of association or partnership agreement and approved by the Financial Regulator. The method of valuation used will be disclosed in the prospectus."

Paragraph 2 of UCITS Notice UCITS 5, provides:

" Unless otherwise provided for in the trust deed, the deed of constitution or the articles of association, the value of the assets of a UCITS shall be based, in the case of securities traded on a stock exchange or on a regulated market, on the last known stock exchange or market quotation unless such quotation is not representative. For securities not so quoted and for securities which are so quoted but for which the latest quotation is not representative, the value shall be based on probable realisation value which must be estimated with care and in good faith. Financial derivative instruments will be valued by a method clearly defined in the trust deed, the deed of constitution or the articles of association."

The Irish Financial Services Regulatory Authority ["the Financial Regulator"] reviews valuation provisions contained in the trust deed, deed of constitution, articles of association or partnership agreement during its assessment of an application. This note provides guidance on the Financial Regulator's application and interpretation of the above conditions. As a fundamental principle, valuation methodologies and the pricing of units must strive to promote fair treatment of incoming, existing and outgoing investors in collective investment schemes ("CIS").

1. METHODS OF VALUATION

...

f) *Off-exchange derivative contracts:*

- ◆ The Financial Regulator's Notices (NU 16, NU 20, NU 21) require that the counterparty must be prepared to value off-exchange derivative contracts at least weekly. In the case of UCITS, a daily valuation is required (UCITS 10). On application the Financial Regulator may accept monthly valuations from the counterparty in the case of closed-ended CIS and/or PIF and QIF CIS that value on a monthly or less frequent basis and ~~certain professional and qualifying investor schemes with not less than monthly valuation policies~~
- ◆ ~~The valuation of the position is that supplied by the counterparty provided that such~~ The valuation provided by the counterparty must be is approved or verified, at least monthly, by a party who is approved for the purpose by the trustee and who is independent of the counterparty. In the case of UCITS the valuation must be approved or verified by the independent party at least weekly. The reference to an independent party can include the CIS. It can also include a party related to the OTC counterparty provided that the related party constitutes an independent unit within the counterparty's group which does not rely on the same pricing models employed by the counterparty. In this case the relationship between the parties, and the attendant risks, must be disclosed in the prospectus.
- ◆ In the case of UCITS and non-UCITS retail CIS, where the independent party is related to the OTC counterparty and the risk exposure to the counterparty may be reduced through the provision of collateral, the position must also be subject to verification by an unrelated party to the counterparty, on a six monthly basis.
- ◆ The valuation of the position may be that supplied by the counterparty or by an independent party provided that there are

no unreconciled differences or both valuations are reconciled under predetermined tolerance levels.³

- ◆ Where valuations provided by different OTC counterparties (or by the independent party(ies) referred to above) in respect of the same or similar derivatives positions differ significantly, outside market norms, these should be ~~promptly~~ immediately investigated and reconciled.

³ The Financial Regulator considers that, except in the case of reconciled timing differences, unreconciled or permanent differences are adjusted to reflect the OTC counterparty valuation.



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