FINANCIAL REGULATOR
Rialtóir Airgeadais

Guidance Note 3/99

Share classes – hedging against exchange rate movements

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Assistance Paper

Contents

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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 scheme*[1] *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;*
- *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.*

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

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

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, <u>subject to a) clear disclosure in the prospectus and b) unambiguous valuation and allocation provisions in the constitutional document of the CIS</u>, 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.

2. 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 charging of the resultant costs and gains/losses to the relevant share class.

3. 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 indicate that, to the extent that hedging is successful, the performance of the class is likely to move in line with the performance of the underlying assets and that investors in the hedged 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. 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 class;[2]
- 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 Qualifying Investor Funds, the provisions set out in the prospectus. This review will also incorporate a procedure to ensure that positions materially 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 disclosure that the costs and gains/losses of the hedging transactions will accrue solely to the relevant class.

4. Periodic Reports

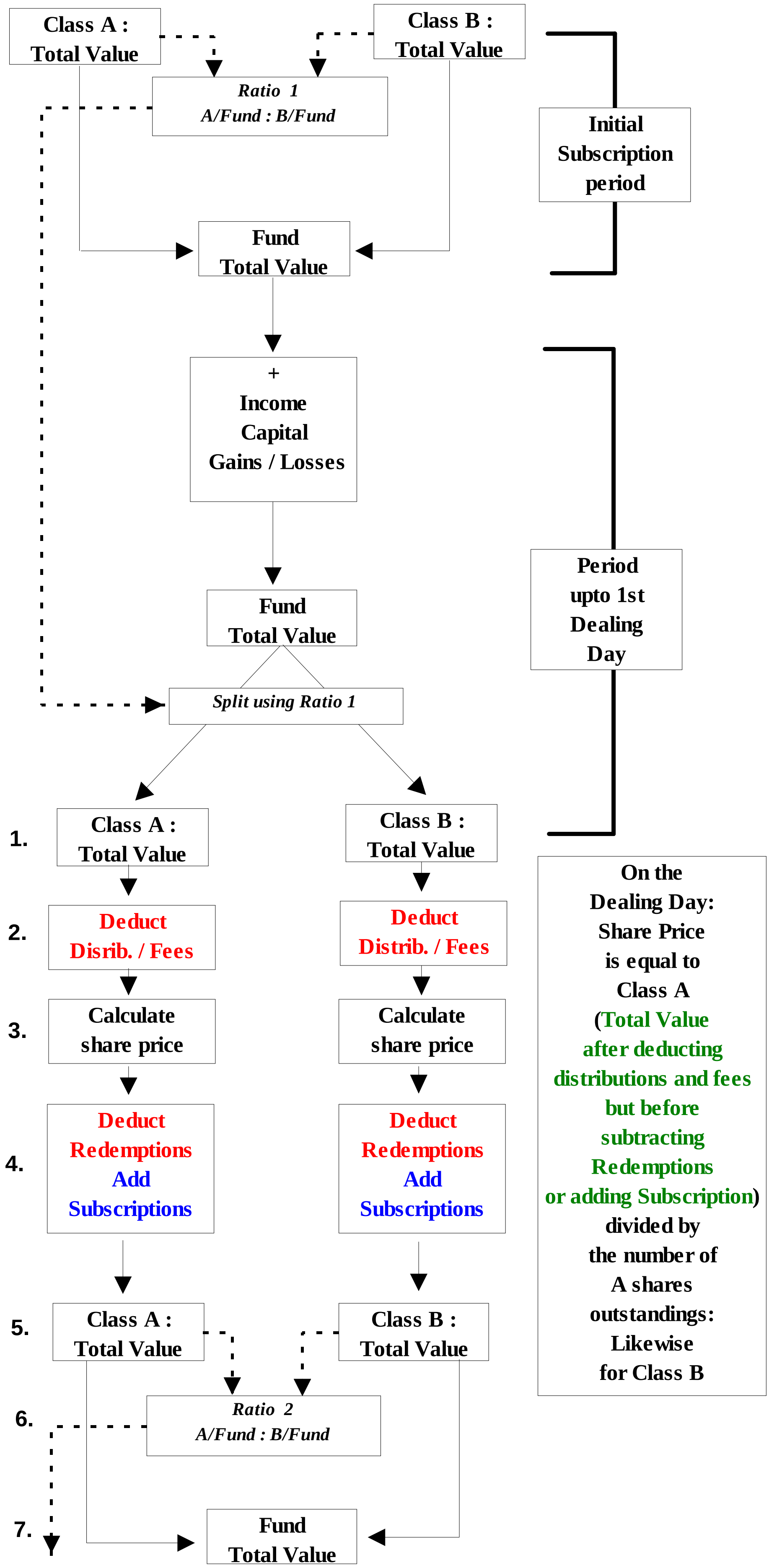
As with any transaction undertaken to provide protection against exchange rate risks the periodic reports should indicate how these transactions have been utilised.

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

5. Administration

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

Appendix 1 – Simplified Pricing Methodology



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