Class Level Assets within Irish Funds

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CLASS LEVEL ASSETS WITHIN IRISH FUNDS

The Irish Financial Regulator has issued a Policy Update (February 9, 2010) in relation to class level assets within Irish funds clarifying the circumstances in which:

- financial derivative instruments may be used at share class level to provide for standard class level distinctions (currency and interest rate hedging, different distribution policies and fee structures) but, <u>more importantly</u>, to provide different levels of participation in the performance of the underlying portfolio;

- investment in New Issues can be carried out at share class level; and

- interest rate hedging can be carried out at share class level.

Background

For many years Irish funds have been permitted to issue multiple share classes in respect of a single portfolio of assets, with the differentiating features between the different classes usually being currency hedging at class level and different class level distribution policies, management fees and front end/exit fees.

The core principles underpinning the Financial Regulator's approach to multiple classes in respect of a single portfolio of assets (a "Fund") are that:

- each Fund must consist of a single common pool of assets;
- assets may not be allocated to individual share classes; and
- 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 Fund.

These principles are themselves founded on a general "equality of treatment" principle and legitimate concerns that to allow allocation of assets to individual classes could result in "cherry picking" of assets and other potential abuses.

Over the years some exceptions or variations have been permitted, most notably hedged currency share classes where the costs of and gains/losses on the hedging contract are allocated solely to the hedged class. Similar exceptions have allowed interest rate hedging at class level where derivatives have been used to provide different interest rate exposures on different classes in respect of, for example, a diversified bond portfolio.

More recently, allocation of assets to side pockets has been allowed for non-UCITS as a measure to deal with portfolio illiquidity, subject to quite specific rules set down by the Financial Regulator.

Following a number of industry submissions, the Financial Regulator has now formalised a series of welcome changes to its approach which will facilitate the engineering of different returns on different classes and a more suitable approach to investing in New Issues.

The opportunities offered by this Policy Update are explained below.

Financial Derivative Instruments used at Share Class Level

The Financial Regulator notes in its Policy Update that it will permit the use of financial derivative instruments at share class level where their purpose is to effect currency and interest rate hedging (subject to the principles set out in Guidance Note 3/99) or different distribution policies or fee structures at share class level. This is really a statement of current practice.

<u>However</u>, the Policy Update also provides that the Financial Regulator will consider proposals where financial derivative instruments may be used at share class level <u>to enable a different level of participation in the performance of the underlying portfolio or different levels of capital protection</u>, subject to the following conditions:

(a) the financial derivative instrument for each share class must be based on the same underlying portfolio or index;

(b) the transactions cannot result in a leveraged return per share class (i.e. the participation rate can be up to but not exceeding 100% of the relevant share class' performance of the underlying portfolio);

(c) the issue of segregated liability between share classes must be addressed.

With regard to point (c) above, the Financial Regulator will require:

(i) a legal opinion that the OTC counterparty's recourse to the Fund is limited to the relevant share class' participation in the assets of the Fund; and

(ii) confirmation from the board of the Fund/management company that it has reviewed and is satisfied that the proposal will, as a result of the agreement between the Fund and the OTC counterparty, not result in any prejudice for investors in one class over another. The board must also confirm that there will be no cross liability between share classes.

In practice, amendment of the Fund's constitutional document may be required as may contractual agreement between the parties that the recourse of the OTC counterparty be limited to the assets [attributed to] the relevant share class.

Professional and Qualifying Investor Funds

In the case of professional and qualifying investor funds, the Financial Regulator will also consider proposals for use of financial derivative instruments at share class level with different features, <u>for example to provide an additional add-on exposure to that generated from the underlying portfolio, or to generate a leveraged return at share class level or where the underlying of the derivatives are different versions of the same underlying</u>, e.g. two classes with different swap instruments based on sub-indices derived from the same initial index.

This may be of significant interest to many investors and asset managers, the key being the capacity to ring-fence the class level liabilities.

Other arrangements similar to these examples will be considered by the Financial Regulator on a case-by-case basis, subject to demonstrating segregated liability between share classes in the manner described above.

General Conditions

Key requirements for utilising this opportunity include that:

- the Fund's constitutional document makes specific provision for the creation of share classes and contains <u>clear</u> provisions for the charging of any resultant gains/losses on the transaction to the relevant share class;

- the prospectus contains a clear description of the strategies being pursued at share class level and the effect this will have on investors in each share class;

- the use of financial derivative instruments at share class level creates positive benefits for investors and does not prejudice the interests of holders in other share classes.

New Issues

Another regulatory hurdle which certain Funds have faced is how to deal with Rule 5130 of the U.S. Financial Industry Regulatory Authority, Inc. ("FINRA"), which imposes restrictions on the participation by certain persons involved in the securities industry ("Restricted Persons") in equity securities issued in initial public offerings. In summary, the Rule prohibits the sale of equity securities issued in initial public offerings through FINRA member firms (so called, "New Issues") to accounts in which Restricted Persons have a significant beneficial interest (a 10% *de minimis* exemption applies).

FINRA Rule 5130 defines "Restricted Persons" as including FINRA members or other broker dealer personnel (officers, directors, general partners etc.), immediate family members thereof, finders or persons acting in a fiduciary capacity to the managing underwriter of a New Issue, portfolio managers, or persons owning a broker dealer.

The Policy Update provides that the Financial Regulator will now permit professional and qualifying investor funds to establish a separate class within a Fund where any gains/losses on investment in "New Issues" can be allocated for the benefit of investors not deemed to be Restricted Persons in accordance with Rule 5130 of FINRA. The constitutional documents and prospectus must clearly provide for these arrangements.

This is a welcome development as in the past an Irish Fund either had to have two sub-funds (one for Restricted and one for Unrestricted), not accept Restricted Persons or avoid New Issues entirely.

Interest Rate Hedging

The Policy Update clarifies that Financial Regulator will permit interest rate hedging at share class level where the benefits and costs of such hedging may be accrued and attributed solely to investors in a hedged share class.

This is not an entirely new development as the Financial Regulator previously allowed interest rate hedging within UCITS where one class of shares offered an unhedged exposure to a long bond asset class and a second class provided investors with the same opportunity but sought to hedge (80% - 100%) against interest rate risk thereby allowing investors to limit downside asset risk through the use of derivatives. In that example, the allocation of gains or costs involved with the derivatives (including relevant unwinding costs) were charged to the second class only.

Such arrangements must be effected in accordance with the principles set out in Guidance Note 3/99, namely:

- clear disclosure of the exchange rate hedging strategy, the risks associated therewith and the implications of the strategy to be set out in the prospectus;

- unambiguous valuation and allocation provisions to be set out in the constitutional document of the Fund;

- an indication of how the hedging transactions have been utilised to be included in the periodic reports of the Fund; and

- the valuation systems operated by the Fund or its delegate must be capable of processing and identifying the relevant hedge transaction at share class level.

Conclusion

Although taking advantage of these new opportunities may require changes to existing Fund's constitutional documents (and therefore shareholder approval), these are welcome developments and are further evidence of the ongoing steps being made by the Irish funds industry to provide a dynamic environment for regulated funds.

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