Irish Regulatory Provisions for Using Derivatives in Long Short and 130-30 Strategies in UCITS Funds

DILLON EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

IRISH REGULATORY PROVISIONS FOR USING DERIVATIVES IN LONG SHORT 130-30 STRATEGIES IN UCITS FUNDS

Introduction

Under UCITS III, UCITS funds may invest in derivative instruments for investment purposes as well as for EPM purposes.

The Financial Regulator has, through its UCITS Notices and Guidance Notes prescribed, in detail, the risk management conditions that must be met by Irish UCITS funds investing in derivatives.

The paper aims to give a brief overview of the risk management framework and a summary of the regulatory risk management requirements that must be met by Irish UCITS funds investing in derivatives.

In addition, following a recent Policy Note issued by the Financial Regulator, Irish UCITS may now invest in covered physical short sales. This allows Irish UCITS to pursue direct long/short and 130/30 strategies without being required to replicate synthetically through derivatives. The paper will look briefly at how the 130/30 strategy has been working to date within the UCITS sphere and will give an overview of the conditions outlined in the Policy Note that will apply to UCITS funds seeking to engage in direct short sales.

UCITS III and Irish Regulatory Framework Documentation

Prior to the introduction of UCITS III, UCITS funds could only employ derivatives for efficient portfolio management purposes. Regulation 45 of the Irish UCITS Regulations[1] provides that Irish UCITS funds may invest in exchange traded or over-the-counter derivative instruments for investment or EPM purposes, subject to certain conditions.

[1] The European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 (Statutory Instrument No. 211 of 2003) as amended.

Regulation 45 reflects the provisions of EU Directive 2001/10/EC (the "UCITS Product Directive) which was introduced to widen the scope of instruments which a UCITS fund could invest in.

The Irish UCITS Regulations have been developed and expanded on by the Irish Financial Services Regulatory Authority (the "Financial Regulator") in the UCITS Notices and Guidance Notes. Specifically in relation to investing in derivatives, the following documents are of particular relevance:

- UCITS Notice 9 – outlines investment restrictions applicable to UCITS funds including limits on counterparties and counterparty criteria and provisions regarding index derivatives, uncovered short sales and warrants;

- UCITS Notice 10 – outlines derivatives provisions including summary of permitted derivatives, cover requirements and risk management requirements;

- UCITS Notice 12 - outlines provisions regarding permitted use of collateral received by a UCITS in the context of stock lending or repurchase contracts; and

- Guidance Note 3/03 – the outlines the provisions for the use of derivatives by UCITS funds.

Conditions for the Use of Derivatives by UCITS Funds

As outlined in UCITS Notice 10, Irish UCITS funds may invest in any type of exchange traded or OTC derivative for investment purposes or for EPM purposes, subject to the following conditions:

- the underlying asset relates to UCITS eligible assets, i.e. transferable securities, money market instruments, CIS, deposits, financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS fund may invest according to its investment objectives as stated in the trust deed, deed of constitution or memorandum and articles of association and prospectus of the UCITS fund;

- the counterparties to OTC derivative transactions are institutions subject to prudential supervision and belong to categories approved by the Financial Regulator (qualifying credit institutions; ISD authorised investment firms with a minimum credit rating of A2 or equivalent, or an implied rating of A2 or guaranteed by an entity with a rating of A2);

- the OTC derivatives are subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the initiative of the UCITS fund.

Positions may create long or short exposure to the underlying asset and may result in leverage to the portfolio (under UCITS I, both short positions and leverage were not permitted).

UCITS funds that use derivatives for investment or efficient portfolio management purposes must prepare a Risk Management Process and file it with the Financial Regulator. In addition, adequate disclosure of the derivatives investment must be made in the UCITS fund's prospectus – specific provisions in this regard are outlined in Guidance Note 3/03.

Guidance Note 3/03

The UCITS Directive[2] was very broad in terms of outlining how EU Member States were to implement risk management procedures and what needed to be contained in a UCITS fund's Risk Management Process.

The Guidance Note was produced by the Financial Regulator following the Commission Recommendation on the use of derivatives by UCITS funds[3] in order to ensure investor protection, by outlining the parameters for the use of derivatives by UCITS funds and providing guidance on the measurement and control of derivative associated risk by UCITS funds.

Guidance Note 3/03 contains detailed requirements regarding:

- the format and content of the Risk Management Process;

- the options for measuring and controlling risk exposure;

- requirements and limits on position exposure; counterparty exposure; and counterparty restrictions.

[2] Directive 85/611/EEC, as amended by EC Council Directive 2001/108/EC, on the Co-ordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS).
[3] Commission Recommendation 2004/383/EC of 27 April, 2004.

Risk Management Process

In order to monitor, measure and manage the risk profile of a UCITS fund, the investment manager must construct a formal Risk Management Process (RMP) that is adapted to the complexity and sophistication of the derivatives used within the UCITS fund.

Sophisticated vs. Non-sophisticated UCITS

The rules for measuring global exposure and leverage differ depending on whether a UCITS fund is characterised as ‘sophisticated’ or ‘non-sophisticated’.

The Commission Recommendation was unspecific on what constitutes a ‘sophisticated’ or ‘non-sophisticated’ UCITS, acknowledging that the distinction between the concepts and their precise definitions required further consideration. The Financial Regulator has not provided a formal definition of what constitutes a ‘sophisticated’ or ‘non-sophisticated’ UCITS fund, rather requiring the UCITS fund to classify itself as either ‘sophisticated’ or ‘non-sophisticated’ and provide a rationale for such classification.

Factors that may cause a UCITS fund to be considered ‘sophisticated’ include the following:

- where the use of derivatives forms a fundamental part of the UCITS fund’s investment objective and would be expected to be used in all market conditions;

- where the performance of the derivative is non-linear in relation to the underlying assets or the performance is based on a reasonably complex mathematical formula;

- where the use of cover for the derivative position is different from the underlying of the derivative.

The use of OTC derivatives might indicate the UCITS fund is more sophisticated but the complexity of the transaction should also be considered.

A ‘non-sophisticated’ UCITS generally will only use a limited number of simple derivative instruments for non-complex hedging or investment strategies.

Measurement of Global Exposure and Leverage – Non-Sophisticated UCITS

Guidance Note 3/03 provides that the global exposure and leverage of a non-sophisticated UCITS fund should be measured using the commitment approach. A UCITS fund’s global exposure may not exceed its net asset value. Thus a leverage limit of 100% applies (leverage being global exposure divided by net asset value).

The commitment approach takes into account the following in seeking to ensure that risk is monitored in terms of any future commitments to which the UCITS fund may be obligated:

i. the current value of the underlying assets the derivatives are based on (delta-adjusted in the case of options and warrants);
ii. counterparty risk;
iii. future market movements; and
iv. the time available to liquidate the position.

Measurement of Global Exposure and Leverage – Sophisticated UCITS

A sophisticated UCITS fund is required to use an advanced risk measurement methodology to measure global exposure. The Financial Regulator recommends the use of the Value-at-Risk (VaR) method and requires that the VaR model employed by the UCITS fund meets certain quantitative and qualitative criteria.

VaR

VaR may be calculated using an acceptable proprietary or commercially available model.

Absolute VaR or Relative VaR may be applied. Absolute VaR is the VaR of the fund capped as a percentage of net asset value. Generally, the Financial Regulator will impose a limit on Absolute VaR of 5% of net asset value.

Relative VaR is the VaR of the fund divided by the VaR of a benchmark or a comparable, derivatives-free portfolio. Under Relative VaR, VaR is limited to twice the VaR on the benchmark or comparable, derivatives-free portfolio.

The VaR model used must adhere to the following requirements:

- the confidence level should be 99%;

- maximum holding period of one month;

- minimum historical observation period of one year (less if justified, for example on the grounds of recent significant changes in price volatility);

- stress tests carried out at least quarterly (to assess the likely impact of potential movements in interest rates, currencies and credit quality);

- back testing of the VaR model (a formal statistical process to compare actual portfolio returns to the VaR predicted).

Details should also be disclosed of the following:

i. software used
ii. internal controls and internal audit of procedures;
iii. additional risk measurement methods employed; and
iv. profile and expertise of staff monitoring risk.

Netting/Hedging

Hedging positions may be offset and netting applied before calculating global exposure, counterparty exposure, position and cover requirements.

Netting

In the context of global exposure, position and cover requirements, purchased and sold derivatives positions may be netted subject to the following conditions:

- the positions must relate to the same underlying asset/reference item or, in the case of derivatives on fixed income securities, they must bear a high degree of negative correlation in terms of price movement and are cash settled in the same currency;

- the positions should be liquid and marked-to-market daily;

- in the event that one of the positions is exercised, arrangements are such that the fund will have the cover necessary to fulfil its actual or potential obligations under the outstanding position.

In the context of counterparty exposure, purchased and sold derivatives positions may be netted provided there is a contractual netting agreement in place with the counterparty.

Hedging

In addition, hedging positions that reduce the overall risk profile of the UCITS fund will be permitted where the transaction exhibits a high negative correlation with an asset, rate or index of an underlying position in the portfolio.

Position Exposure

Position exposure to the underlying assets of derivatives, when combined with positions from direct investments, may not exceed general investment limits. This exposure is measured using the commitment approach (after netting of any long and short positions to the same issuer, if appropriate).

A combination of the following issued by, or made or undertaken with the same body may not exceed 20% of a UCITS fund's net asset value:

- transferable securities or money market instruments;
- deposits;
- counterparty risk exposures from OTC derivative transactions; and/or
- position exposure to the underlying assets of derivatives.

There is no look through to underlying assets in respect of index derivatives, provided the index meets certain criteria.

Position Cover Requirements

Derivatives creating an obligation must be covered by a UCITS fund as follows:

Cash settled – the UCITS fund must hold liquid assets (i.e. cash or money market instruments) as cover.

Where physical delivery of the underlying asset is required for settlement, the UCITS fund must hold the following as cover:

- the underlying asset for the duration of the derivative; or

- sufficiently liquid assets where the underlying asset is a highly liquid fixed income security and/or the UCITS fund considers that the exposure can be adequately covered without holding the underlying asset, as disclosed in the RMP and the UCITS fund's prospectus.

Counterparty Exposure Limits

The counterparty exposure must include all exposures to the counterparty (i.e. exposure related to OTC derivatives and any other exposure to the counterparty).

Exposure is limited to 5% of net asset value or 10% in the case of certain credit institutions as follows:

- a credit institution authorised in the EEA;

- a credit institution authorised within a signatory state (other than an EEA Member State) to the Basle Capital Convergence Agreement of July 1998; or

- a credit institution authorised in Jersey, Guernsey, the Isle of Man, Australia or New Zealand.

As stated above, netting may be applied as appropriate before counterparty exposure is calculated. In addition, risk will be reduced where a counterparty provides collateral to the UCITS fund, in accordance with the provisions of UCITS Notice 12.

Counterparties must agree to close out positions on request at fair value.

Exchange-traded derivatives that are marked to market daily and subject to margin requirements are deemed to be free of counterparty risk.

Format and Content of Risk Management Process

The Risk Management Process must be prepared in accordance with the provisions of Guidance Note 3/03 and is subject to review and clearance by the Financial Regulator before being adopted.

It should give information on the trading process employed by the investment manager and, in detail, explain the responsibilities and expertise of the personnel involved in the derivative trading activity of the UCITS fund. It should explain clearly the types of derivative instruments used by the UCITS fund and their specific purpose. The RMP must cover all derivatives used.

The RMP should also explain the following:

- how the various exposures (global exposure and leverage, counterparty exposure etc.) are measured;
- what limits apply to each such exposure;
- how these limits are monitored and enforced;
- how breaches of limits are reported and escalated.

A worked example of exposure calculations should also be provided. This should incorporate examples of each type of derivative and also demonstrate how hedging is used.

Amendments to the RMP

Any material amendments to the RMP must be addressed in a revised RMP filed with the Financial Regulator. Any non-material amendments or update (for example change of personnel or systems) should be included in the annual derivatives report.

Annual Derivatives Report

UCITS Notice 10 requires that a UCITS fund must submit an annual report to the Financial Regulator on its derivative positions (an Annual FDI Report) so that the Financial Regulator may review the use of derivatives and any breaches of risk.

The Annual FDI Report should therefore include details of the following:

- Summary review on the use of derivatives by the UCITS fund during the year;
- Instances of any breaches of global exposure during the year, with an explanation of remedial action taken and duration of the breaches;
- Instances of any breaches of counterparty risk exposure during the year, with an explanation of remedial action taken and duration of the breaches;
- Where relevant, a summary of non-material updates to the RMP. In this instance a revised RMP should be attached.

In the case of UCITS funds using VaR:

- Year-end VaR number (expressed as a percentage of net asset value of the UCITS fund or as a percentage of the benchmark/comparable derivatives free portfolio, as appropriate);
- Instances of any breaches in VaR limits during the year, with an explanation of remedial action and duration of breach;
- Confirmation as to whether back-testing has been successful in accordance with the requirements and, if not, what actions the UCITS fund has taken to address the situation;
- Confirmation that the UCITS fund does have a stress testing regime, an overview of the broad assumptions behind such testing and a commentary on the results of the stress testing and its applicability to the day to day use of the model.

Annual and Semi-Annual Reports

The UCITS Notices require that annual and semi-annual reports of UCITS funds should include the following:

- a balance sheet separately identifying various types of securities and instruments held (including derivative instruments)

- a portfolio analysis identifying various types of securities and instruments held (including exchange traded and OTC derivative instruments)

- A portfolio statement providing details of open option positions including the strike price, final exercise date and an indication whether such positions are covered or not. Counterparties to OTC derivatives should also be identified.

- A general description of the use of financial derivative instruments, stocklending and repurchase/reverse repurchase agreements during the reporting period and the resulting amount of commitments. This description should identify the types of financial derivative instruments concerned, including OTC derivatives. It should indicate the purposes behind the use of the various instruments together with the attendant risks.

130/30 Funds

130/30 Strategy

130/30 is the term used to describe the strategy that falls between the traditional long only strategy and the long/short strategy whereby a fund sells short 30% of its equity portfolio and applies the proceeds to purchase an additional 30% of long positions. This results in a leveraged equity portfolio with an increased exposure to certain equity positions (enhanced alpha) but with a net market exposure of 100% (beta of 1).

While the portfolio could just as easily be weighted 120/20 or 140/40, the trend in the market has been towards a 130/30 weighting.

130/30 UCITS Funds

To date, promoters of UCITS funds have only been able to pursue a synthetic 130/30 strategy, within the UCITS III parameters, by taking short positions through the use of derivatives such as contracts for difference, swaps or options, provided they adhere to global exposure limits and meet the cover requirements. As discussed below, the Financial Regulator will now permit UCITS funds to physically short sell, subject to certain conditions.

A Sample Synthetic 130/30 UCITS Portfolio

- The UCITS fund holds 100% long positions in equities (Stock A) directly or through a derivative. A further 30% short position is achieved through a CFD referenced to the value of the shorted underlying (Stock B) whereby the UCITS fund will be liable for any increase in price of Stock B above initial price and the OTC counterparty will be liable for any decrease in price of Stock B below the initial price.

- A further 30% long position is then achieved through a CFD referenced to the value of the underlying (Stock C) whereby the UCITS fund will be liable for any decrease in price of Stock C below the initial price and the OTC counterparty will be liable for any increase in price of Stock C above initial price.

- A portion of the UCITS fund’s assets (long positions or cash) may be used as margin for the positions with the OTC counterparty in Stock B and Stock C, subject to UCITS restrictions.

As a result, the UCITS fund will hold 100% long in Stock A (direct or synthetic), 30% short (synthetic) in Stock B and 30% long (synthetic) in Stock C.

Physical Short Selling by UCITS Funds

Pursuant to the revised policy note issued by the Financial Regulator on 5th October, 2007, a UCITS fund is now permitted to engage in covered physical short sales where the cover is provided through stock borrowing. Additional rules apply as set out below. Going forward, this will mean that UCITS funds will be able to pursue long/short strategies without being limited to synthetic replication through derivatives.

Whilst of particular relevance for 130/30 type funds, this revised policy has broad application for any Irish UCITS fund wishing to short sell.

Background to Policy Change

Prior to the release of the revised policy note, UCITS funds were not permitted to engage in physical short selling but were able to pursue synthetic shorting strategies by taking short positions through the use of derivatives. The new policy reflects what is happening in the market place and the market's understanding of what constitutes "cover".

The position in relation to uncovered short sales remains – they are prohibited under Regulation 72 the Irish UCITS Regulations.

The Revised Policy

The revised policy provides that where stock is borrowed before entering into a physical short sale of that stock, the stock borrowing arrangement will be considered to constitute cover for the short sale.

The new policy is subject to the following parameters:

- Short sales are covered through a stock borrowing at the outset, in accordance with the UCITS Regulations;

- The stock borrowing arrangement must be in accordance with the Financial Regulator's requirements and the assets used by the UCITS fund to support the stock borrowing cannot be passed to the stock lender (although a charge over such assets may be given by the fund's trustee/custodian)*;

- General leverage limits are not exceeded;

- The strategy is adequately disclosed in the UCITS fund's Prospectus and Risk Management Process;

- The Prospectus should

  i. disclose a clear description of the covered short sale strategy including disclosure of how the cover is provided;

  ii. a risk factor must outline the unlimited risk of an increase in the market price of the security that is the subject of the short position;

  iii. give an indication of the expected level of leverage; and

  iv. confirm that leverage will be calculated taking into account the short exposure as well as any exposure created through the use of derivatives.

- The Risk Management Process should

  i. disclose details of the covered short sales strategy;

  ii. disclose details of expertise and prior work experience of the Investment Manager (or individuals within the Investment Manager) with short selling strategies;

  iii. disclose risk factors relevant to the short selling strategy;

  iv. confirm that any leverage created through covered short sales will be measured in accordance with the requirements of the Financial Regulator and will be added to any exposure created through the use of financial derivative instruments;

v. include a worked example to illustrate short selling strategy and effect on leverage and global exposure;

vi. disclose details of any systems data or controls relevant to the short selling strategy.

*The Financial Regulator has indicated that, in the context of the stock borrowing arrangement, it will not permit outright transfer of ownership of assets by the UCITS, so rehypothecation of assets by a counterparty will not be possible. This would be an integral aspect of a typical stock lending arrangement (for example, it would be typical under a GMSLA stock lending arrangement that there would be an outright transfer of ownership of collateral pledged by the stock borrower to the stock lender). As a result, it may be necessary to put in place a bespoke stock lending arrangement whereby the stock lender receives a charge over the fund's assets (and a premium) but does not acquire collateral on an outright transfer of ownership basis.

The policy note indicates that the Financial Regulator intends to revise UCITS Notice 12 and Guidance Note 3/03 shortly to reflect the change in policy.

We consider this be a significant and welcome development that opens up the UCITS framework to a new range of products that international asset managers may wish to promote.

Conclusion

Irish UCITS funds may invest in derivative instruments for investment purposes as well as for EPM purposes and, in addition, may now pursue direct long/short and 130/30 strategies without being required to replicate synthetically through derivatives.

Based on the UCITS Directive, the Commission Recommendation and the Irish UCITS Regulations, the Financial Regulator has, through its UCITS Notices, Guidance Notes and Policy Paper prescribed, in detail, the conditions that must be met by Irish UCITS funds engaging in such activity, thereby providing a risk management framework for UCITS funds that wish to invest in derivatives (or covered short sales).

Date: **December 2007**
Author: **Stephen Carty**

CONTACT US

Our Offices

Dublin
33 Sir John Rogerson's Quay,
Dublin 2,
Ireland.
Tel: +353 1 667 0022
Fax.: +353 1 667 0042

Cork
8 Webworks Cork,
Eglinton Street,
Cork, Ireland.
Tel: +353 21 425 0630
Fax: +353 21 425 0632

Boston
26th Floor,
225 Franklin Street,
Boston, MA 02110,
United States of America.
Tel: +1 617 217 2866
Fax: +1 617 217 2566

New York
245 Park Avenue
39th Floor
New York, NY 10167
United States
Tel: +1 212 792 4166
Fax: +1 212 792 4167

Tokyo
12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
Tel: +813 6860 4885
Fax: +813 6860 4501

e-mail: enquiries@dilloneustace.ie
website: www.dilloneustace.ie

Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.

Andrew Bates
e-mail: andrew.bates@dilloneustace.ie
Tel : +353 1 667 0022
Fax: + 353 1 667 0042

DILLON EUSTACE

DUBLIN CORK BOSTON NEW YORK TOKYO

33 Sir John Rogerson's Quay, Dublin 2, Ireland.
www.dilloneustace.ie

In alliance with Arendt & Medernach