

Guidance Note 3/03

Undertakings for Collective Investment in Transferable Securities (UCITS)

Financial derivative instruments

Regulation 45 of the European Communities (UCITS) Regulations 2003, as amended, (hereafter "the amended Regulations"), provides that a UCITS may invest in financial derivative instruments ("FDI"). Permitted investments include FDI traded on a regulated market and FDI dealt in over-the-counter, "OTC derivatives".

This note provides guidance on a number of issues which arise from the amended Regulations.

1. Calculation of position exposure

A UCITS must ensure that its global exposure relating to derivative instruments does not exceed total net assets. Global exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions.

To calculate global exposure a UCITS may:

- (i) apply a "commitment approach" under which positions in FDI are converted into the equivalent position in the underlying assets. In the case of forwards, futures and swaps the assessment is then based on the market value of the underlying asset. The equivalent cash position in the case of options and option swaps may be calculated by reference to the delta of the option. Where this procedure is not appropriate, the exposure must be based on an estimate of the maximum possible loss represented by the transaction.

and additionally, in the case of sophisticated UCITS¹,

¹ A "sophisticated" UCITS will generally be regarded as a UCITS which may use FDI for investment purposes, particularly, but not exclusively, those UCITS which can employ leverage in their use of FDI and/or UCITS which will use OTC derivatives.

- (ii) apply a Value-at-Risk ("VaR") approach, including stress testing.

The commitment approach should be applied by all UCITS to calculate exposure arising from an individual FDI position, in order to meet with individual cover requirements.

2. Risk management process

A UCITS must employ a risk management process, which enables it to monitor, measure and manage the risks attached to FDI positions. Details of this process must be provided to the Irish Financial Services Regulatory Authority ("the Authority").

Authorisation requirements: A UCITS must submit details of the proposed risk management process to the Authority, in the form of a formal statement, duly dated. It must be submitted in good time to allow it to be assessed prior to authorisation.

- Where risk management is to be carried out by an entity other than the UCITS, the submission from the UCITS must include details from the third party of the risk management process which it will carry out. This report, which must be set out on the headed paper of the third party, must include contact details if the person(s) responsible for its execution.
- The submission from the UCITS must outline how it will ensure that the procedures set out by the third party will be carried out on an ongoing basis.

The following minimum information must be included:

- (i) proposed FDI, including embedded derivatives in transferable securities and money market instruments, and purpose behind their use. The Authority will permit that, notwithstanding that a wide range of FDI may be referred to in the prospectus, the risk management process may provide only for those FDI which the UCITS will employ at the outset. In this case the prospectus must include a statement to the effect that FDI which have

not been included in the risk management process will not be utilised until such time as a revised submission has been made;

- (ii) the extent to which the UCITS may be leveraged through the use of FDI. In the case of embedded derivatives information provided should clarify the extent to which these instruments may give rise to a leveraged position;
- (iii) details of attached risks;
- (iv) any relevant quantitative limits;
- (v) the level of expertise required and what expertise is in place to engage in planned FDI activity;
- (vi) information in relation to all relevant controls and systems in place to effectively manage the use of FDI. This will include a detailed description of management controls which will provide for the monitoring of compliance with quantitative limits and details of how breaches of limits are dealt with and controlled. Details of internal control systems and strategic planning processes including the facility to carry out sensitivity analysis are required in the case of sophisticated UCITS;
- (vii) details, including worked examples, of how leverage will be measured in the context of each FDI, notwithstanding that the UCITS may not intend to employ leverage as a part of its investment policy;
- (viii) methods for estimating risks (see below);
- (ix) valuation rules for all FDI, including policy with regard to the valuation of illiquid FDI;
- (x) policy in relation to appointment of counterparties including policy as to how unrated counterparties may be deemed to have implied ratings; and
- (xi) policy in relation to the management of legal risk², particularly in the context of OTC derivatives.

A management company, which proposes to employ a risk management process details of which have been provided to the Authority in the context of an earlier application, is not required to re-submit details, where the management

² Legal risk is the risk of loss because of the unexpected application of a law or regulation or because a contract cannot be enforced.

company confirms in writing that the same process will be applied without amendment.³

Notification of amendments: Material amendments to the initial information must be submitted to the Authority in advance.

Ongoing reporting requirements: A UCITS must submit a report to the Authority on its FDI positions on an annual basis. The report, which must include information under the different categories identified under authorisation requirements above, must be submitted with the annual report of the UCITS. A UCITS may be required to provide this report to the Authority at any time.

Methods for estimating risk: A UCITS may measure risk through a commitment approach and additionally, where appropriate, a VaR approach, as outlined above in relation to exposure requirements. The Authority will require however, that a UCITS which will engage in complex OTC derivatives must adopt the VaR method. In this regard, procedures to calculate counterparty exposure, including any proposed netting arrangements, must be provided.

In its assessment of a VaR model, the Authority will take the following matters into account:

- The parameters of the model such as the minimum holding period, confidence level and historical observation period;
- The reliability of the model through appropriate back testing;
- Proposed stress testing;
- Internal auditing;
- The appropriateness of the model to the business of a UCITS.

3. Counterparty risk exposure

Paragraph 13 of Notice UCITS 9 limits exposure to OTC derivative counterparties. Counterparty risk exposure should be measured in accordance

³ The provisions of this paragraph also apply in the case of a self-managed UCITS umbrella investment company, where additional sub-funds are proposed.

with the counterparty risk calculation method set down in Annex II to the Authority's Notice "Implementation of EC Own Funds and Solvency Ratio Directives for Credit Institutions Incorporated in Ireland" - Ref: BSD S 1/00 of 30 June 2000. (This Notice is available from the Authority's website - www.ifsra.ie).

Exposure may be reduced where the counterparty will provide the UCITS with collateral and:

- the collateral falls within the categories of permitted collateral set out in paragraph 2 (i), (ii), (iii) and (iv) of Notice UCITS 12 and in the case of non-cash collateral is rated AAA;
- the UCITS has a perfected security interest in the collateral;
- the collateral is marked to market daily;
- the collateral is held at the credit risk of the counterparty;
- the collateral is transferred to the trustee or its agent - it cannot be sold or pledged; and
- the UCITS will have instant access to this collateral, without recourse to the counterparty, in the event of a default by that entity.

- Cash collateral may not be invested other than in:
 - Deposits, which are capable of being withdrawn within 5 working days, and subject to the provisions of paragraphs 7 and 12 of Notice UCITS 9;
 - Government or other public securities which are rated AAA;
 - Certificates of deposit, which are rated AAA;
 - Repurchase agreements, in accordance with the provisions of Notice UCITS 12, provided that the collateral received under the agreements meet with the requirements of this Guidance Note.

UCITS are permitted to net OTC derivatives positions with the same counterparty provided that the netting procedures applied comply with the provisions of Annex II to Notice BSD S 1/00 referred to above.

Counterparty risk exposure must be measured on an aggregate basis and will include, for example, exposures arising from investments in securities issued by the counterparty, amounts held on deposit and OTC derivative positions.

4. Index-based FDI

Paragraph 4 of Notice UCITS 10 provides that: *Position exposure to the underlying assets of FDI, including embedded FDI in transferable securities or money market instruments, may not exceed the investment limits set out in the Notices. This provision does not apply in the case of index based FDI provided the underlying index is one which meets with the criteria set out in Regulation 49A of the Regulations.*

Regulation 49A allows UCITS to track certain stock or debt indices which are recognised by the Authority. However, to avail of the derogation provided for in paragraph 4 of Notice UCITS 10, it is not necessary to ensure that the index in question has been accepted by the Authority for the purposes of Regulation 49A. Rather, the index must meet with the criteria set out in that Regulation as follows:

- (i) the index's composition must be sufficiently diversified; ("Sufficiently diversified" for the purposes of paragraph 4 can be taken to mean that the index meets with the concentration limits of Regulation 49 of the Regulations.)
- (ii) the index represents an adequate benchmark for the market to which it refers; and
- (iii) the index is published in an appropriate manner. (i.e. information in relation to the index must be publicly available).

5. Borrowings

A UCITS may not use borrowings to invest in derivatives transactions or as cover for individual FDI positions. Borrowing may only be used to finance temporary cash flow mismatches.

6. Netting of positions

The Authority will permit purchased and sold derivatives positions to be regarded as a single position provided that:

- Both relate to the same underlying asset, or, if not the same, in the case of underlying fixed income securities:
 - they bear a high degree of correlation in terms of price movement;
 - both are cash settled with the same currency exposure.
- Both are sufficiently liquid and are marked to market on a daily basis;
- In the event that one of the positions is exercised, arrangements are such that the UCITS will have the cover necessary to fulfil its actual or potential obligations under the outstanding position.

7. Credit Derivatives

A UCITS which proposes to engage in credit derivatives must have a rigorous risk management system in place to include the following:

The board of the management company/investment company and senior management where relevant should have a full understanding and appreciation of the implications of such transactions for the risk profile of the UCITS. The objectives and policies concerning the use of credit derivatives must be outlined in the prospectus and included in the risk management process.

The entity which will carry out risk management must ensure that the personnel responsible for these FDI fully understand the differences between these and traditional FDI.

The legal and documentation issues involved must be monitored and addressed, particularly issues relating to enforceability of contracts and limitations thereon.

The effect that credit derivatives will have on the risks passed on or assumed by the UCITS should be fully reflected in the risk management process, i.e. the total exposure to a single counterparty arising from all activities should be captured in the process.

The extent to which sensitivity analysis will include the testing of risk arising from credit derivatives should be included in the risk management process referred to above.

A UCITS which will act as a protection seller must consider the risk and impact of a credit event occurring and its ability to fulfil its obligations in this event. The UCITS, in addition to all other provisions, must have the risks attached to the derivative independently assessed on a half-yearly basis. (Independence, in relation to this assessment, will not prevent an assessment from being carried out by an entity related to the management of the UCITS provided that the entity is independent of the counterparty).

8. FX Transactions

A UCITS may utilise FX transactions which alter the currency exposure characteristics of transferable securities held by the UCITS.

The intention behind the use of FX transactions must be clearly outlined in the investment policy section of the prospectus. Disclosure should focus on possible currency strategies and attendant risks. The prospectus should include a statement to the effect that performance may be strongly influenced by movements in FX rates because currency positions held by the UCITS may not correspond with the securities positions held.

Details of transactions entered into during the reporting period and the resulting amount of commitments must be provided in periodic reports

9. Disclosure

The following requirements are taken from Notice UCITS 6 - Prospectus.

Additional information requirements for UCITS which use financial derivative instruments.

A UCITS which may engage in transactions in FDI must include a prominent statement to this effect, which will indicate if FDI may be used for investment purposes and/or solely for the purposes of hedging. This statement must also

indicate the expected effect of FDI transactions on the risk profile of the UCITS. A description of the permitted types of FDI must be provided.

Where a UCITS will invest principally in FDI, it must insert a warning of this intention at the beginning of the prospectus and any other promotional literature.

The following general requirements are also included in Notice UCITS 6:

- (xvi) Where the net asset value of a UCITS is likely to have a high volatility, due to its investment policies or portfolio management techniques, this possibility must be highlighted in the prospectus and in any promotional literature which it issues.*
- (xvii) A statement that the UCITS will, on request, provide supplementary information to unitholders relating to the risk management methods employed, including the quantitative limits that are applied and any recent developments in the risk and yield characteristics of the main categories of investments.*

Each UCITS must therefore provide for specific disclosure in relation to the use of FDI, to clarify at the outset the purpose behind the use of these instruments and to set out the extent to which the UCITS may or may not be leveraged as a result.