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Asset Management and Investment Funds Bulletin

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Equities added to list of eligible collateral for UCITS in OTC derivative transactions

On 30 December 2009 the Financial Regulator published a document outlining a change to its policy in relation to the types of collateral which may be accepted by a UCITS fund in order to reduce its risk exposure to an OTC derivative counterparty by designating equity instruments which are listed on certain stock exchanges (detailed below) as an eligible form of collateral. In making this decision the Financial Regulator has taken into account the ongoing work of the Committee of European Securities Regulators ("CESR") in the area.

In June 2009 CESR issued a paper as part of the UCITS IV consultation process focussing on the risk measurement techniques employed by UCITS funds for the purposes of calculating global risk exposure. The consultation paper notes that under the UCITS Directive there are general principles to be observed when reducing counterparty risk exposure through the use of collateral such as the requirement for the collateral to be (i) marked-to-market on a daily basis, (ii) exposed to negligible risks and (iii) held by a third party custodian. In addition, further high level principles are set out in the consultation paper regarding issues such as liquidity, pricing and issuer credit quality. CESR observed that there is no reference in the UCITS Directive to the specific types of instruments which may be used as collateral and noted that Member States have typically identified these individually in the light of the general UCITS requirements and CESR guidance. It is in this context that the Financial Regulator has added equity instruments to the list of permitted collateral.

UCITS restrictions on OTC derivative counterparty exposure

Under the UCITS Directive, a UCITS fund's exposure to a counterparty to an OTC derivative transaction is limited to 5% of its net assets or 10% of its net assets where the counterparty is a designated credit institution. In addition, a UCITS fund may not invest more than 20% of its net assets in aggregate in the transferable securities, money market instruments or deposits of any one particular counterparty. The use of collateral is particularly important in enabling a UCITS to reduce its risk exposure to an OTC derivative counterparty.

This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

Equity Instruments as Eligible Collateral

The Financial Regulator has now expanded the list of eligible collateral to include equity instruments which are listed on a stock exchange in the EEA, Switzerland, Canada, Japan, the United States, Jersey, Guernsey, the Isle of Man, Australia or New Zealand. In addition to the requirement that the equity instrument be listed on a particular stock exchange, the UCITS must also ensure on an ongoing basis that the particular instrument complies with the general principles set out in the UCITS Directive and relevant CESR guidance. For example, the instruments must be sufficiently liquid to ensure that they can be sold quickly at a robust price which is close to a pre-sale valuation. The Financial Regulator also requires that the collateral must trade in a deep and liquid market place with transparent two-way pricing. The UCITS must also be satisfied as to the confidence and ability of those charged with the management of collateral to assess issues of importance, such as the correlation of the collateral to the OTC counterparty, adequate diversification and the quality of the issuer, and be satisfied that procedures and controls are in place in relation to the management of collateral generally. Finally, the Financial Regulator has stipulated that a 20% discount or “haircut” shall be applied to equity instruments that are used as collateral to reduce OTC derivative counterparty risk exposure.

UCITS are now permitted to receive the following types of collateral from OTC counterparties: cash; government or other public securities; certificates of deposit issued by designated institutions; and bonds/commercial paper issued by designated institutions or by non-bank issuers where the issue and issuer are rated A1 or equivalent; and certain listed equity instruments.

Future Developments

The Financial Regulator has indicated that this change of policy is to be regarded as an interim measure pending the finalisation of CESR’s work which may result in a different level of “haircut” being applied later this year. This policy change will undoubtedly be welcomed by investment managers of Irish domiciled UCITS that use financial derivative instruments as part of their investment strategy and investment managers who are looking for a suitable jurisdiction in which to establish a UCITS fund that will invest in OTC derivatives.

Straight-A Funding Certificates approved as Government Securities for Money Market Funds

The Financial Regulator has confirmed that instruments issued by Straight-A Funding LLC as part of a student loan short-term note programme can be categorised as government securities for money market funds. This follows the decision of the US Securities and Exchange Commission in July 2009 confirming that Straight-A notes could be considered government securities for the purposes of Rule 2a-7 under the Investment Company Act of 1940, as amended.

The key features of Straight-A instruments are as follows:

1. Straight-A is a Delaware limited liability company.
2. Straight-A issues student loan short-term notes to investors. The monies received from investors are used to purchase variable funding notes from various sellers, such as: (i) state agencies; (ii) not-for-profit organisations that cannot file for bankruptcy; or (iii) special purpose vehicles (“Intermediate Vehicles”). These Intermediate Vehicles use the proceeds received from the issue to purchase or originate student loans which meet certain eligibility criteria. The notes issued by the Intermediate Vehicles will be secured by the student loans and the rates will be rated AAA.
3. To provide the degree of security which one would expect from a government security, the following protections are in place:
 - (a) there is a liquidity loan agreement in place between Straight-A and the Federal Financing Bank. The Federal Financing Bank is a body corporate of the US Government under the supervision of the Secretary of the Treasury. It will be required to make liquidity advances without any right of set-off or recourse to Straight-A except: (i) in the event of the insolvency of Straight-A; or (ii) certain force majeure events. Otherwise, Federal Financing Bank is required to provide loans to Straight-A in order to enable it to fund redemptions in the event that it does not have sufficient cash to do so;
 - (b) Straight-A has a put-agreement with the Department of Education enabling it to call on the Department of Education to purchase student loans in certain events, such as a default on the loans;

- (c) Straight-A's activities are limited solely to those relating to the programme. Its borrowing is limited to: (i) the monies raised on the issue of notes; and (ii) funds from the Federal Financing Bank; and
- (d) all participants in the programme agree not to seek to make Straight-A bankrupt.

The cumulative effect of these features is to provide Straight-A notes with the protections usually associated with government securities.

Contacts

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