



Integrity

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Asset Management and Investment Funds Briefing

The Financial Regulator publishes Rules relating to Share Classes

Irish collective investment schemes may establish separate share classes representing interests in a fund but, to date, the Financial Regulator has insisted that each fund must constitute a single common pool of assets, with each class participating in the gains and losses in proportion to the percentage of total assets represented by the class.

Typically, classes were established on the basis of different charging structures, distribution policies or currency share classes which could be partially or fully hedged, with the costs of hedging borne by the class which undertook the hedging.

The Financial Regulator has now confirmed that it will allow the following strategies to be pursued at the class level:

Interest Rate Hedging

It is permissible to establish a class with interest rate hedging carried out at the class level. The cost of hedging must be borne by the class. The prospectus must clearly disclose the intention to hedge and the constitutive documents must provide for the charging of the costs to the relevant class. If the intention is to ensure that the interest rate exposure is fully hedged, then it is likely that the Financial Regulator will allow a hedging margin of up to 105% of the net asset value of the class as it accepts that over-hedged or under-hedged positions can occur due to factors outside the control of the funds, such as redemption and subscription activity. The prospectus must disclose that hedging positions will be kept under review to ensure that over-hedged positions do not exceed the permitted level, and it is likely that positions materially in excess of 100% will not be permitted to be carried forward from month to month.

Financial Derivative Instruments at Share Class Level

The Financial Regulator will permit the use of financial derivative instruments at share class level in order to produce different returns or different levels of capital protection for a class of shareholders. This strategy must be clearly set out in the prospectus and provision must be made to ensure that the costs are borne by the relevant class.

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.

It is a requirement that the financial derivative instruments for each share class must relate to the same underlying portfolio or index and that the transaction cannot result in a leveraged return per share class.

Other than in the case of currency or interest rate hedging, the Financial Regulator must be satisfied that there is segregated liability at the class level. Since statutory segregated liability is only available in the case of a fund, it will be necessary to achieve segregated liability through the contracts relating to the derivative instruments. Assuming that over-the-counter derivatives are used, the counterparties to these contracts will be required to acknowledge that they are entered into on the basis that recourse is limited only to the rights of the relevant class to participate in the common pool of assets. The counterparty must not be permitted to have direct access to the assets of the fund. The Financial Regulator will require two confirmations: (a) a legal opinion on the effectiveness of the segregated liability; and (b) confirmation from the board of the fund that it has reviewed and is satisfied that the arrangements will not result in any prejudice to investors in one class over another class, and that there will be no cross liability between share classes.

It may be necessary also to amend the agreements with the administrator and the custodian, or at the very least to obtain an acknowledgement from them that segregated liability will be maintained at the class level.

Restricted Persons investing in New Issues

Under the US Financial Industry Regulatory Authority Rule 5130 relating to new issues, certain investors are not permitted to purchase shares in an initial public offering. The purpose of the rule is to protect the integrity of the initial public offering by ensuring that certain categories of investors, notably industry insiders such as investment managers, do not take advantage of their position to purchase new issues for their own benefit at the expense of public investors.

A fund which proposes to invest in initial public offerings in the US must therefore distinguish between investors which are deemed to be restricted persons for the purposes of Rule 5130 and those who are not prohibited from investing in initial public offerings in the US. The prohibition in relation to restricted persons is for a very limited period of time. Nevertheless, to date, it has been necessary to create a separate fund where a fund proposes to invest in initial public offerings and is likely to have restricted persons investing in the fund. This change will allow funds to benefit from economies of scale and reduced costs, thus obviating the necessity to create separate funds to accommodate investment by restricted persons.

However, the change relates only to professional investor funds and qualifying investor funds. The Financial Regulator does not propose to allow UCITS funds to create separate classes in this case as it believes that a UCITS fund should be comprised of a common pool. It has also indicated that it would not be prepared to allow a UCITS to create a "side pocket" to hold new issues.

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