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NEGOTIATING DERIVATIVES WITH IRISH UCITS

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1. INTRODUCTION

Ireland is internationally recognised as one of the world's most advantageous jurisdictions in which to establish international investment funds. Investment funds often use derivatives for efficient portfolio management and investment purposes. However, as regulated entities, there are myriad legal, regulatory, technical and commercial considerations that should be reflected in the trading documents to ensure that they remain legally enforceable and to protect the commercial interest of the parties.

The specific regulations applied by the Central Bank of Ireland (the "Central Bank") to an investment fund will depend on the type of investors to whom the fund is to be sold and its specific investment policies. The regulatory framework in Ireland is divided between Undertakings for Collective Investment in Transferable Securities ("UCITS") and Alternative Investment Funds ("AIFs"), both of which are governed by European and Irish legislation as well as the rules and guidance issued by the Central Bank. The primary difference in the regulation of each relates to the nature of investments which they are permitted to make, and to the particular investment rules and borrowing restrictions imposed by the Central Bank. UCITS are a form or retail or mutual fund while AIFs are restricted to sophisticated investors.

2. WHAT IS A UCITS?

UCITS are diversified, limited leverage, open ended investment funds whose object must be to invest capital raised from the public in transferable securities and other liquid asset classes. UCITS are open ended insofar as investors must generally be entitled to redeem their shares or units on request at least twice per month at regular intervals. There are restrictions on UCITS' investment and borrowing policies and on their use of leverage and financial derivative instruments.

The advantage of establishing a fund as a UCITS is that it can generally be sold without any material restriction to any category or number of investors in any EU Member State, subject to the filing of appropriate documentation with the relevant

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regulatory authority in those EU Member States. The UCITS brand has gained global recognition, with UCITS regarded as well-regulated funds with robust risk management procedures and a strong focus on investor protection. UCITS are widely accepted for sale in Asia, the Middle East, and Latin America.

The criteria used to determine eligible investments for UCITS are set out in detail in the Eligible Assets Directive.[1] In summary, a UCITS must invest at least 90% of its assets in transferable securities or liquid financial assets listed or traded on recognised exchanges or markets. These include exchange traded or OTC financial derivative instruments. When first introduced, UCITS were only permitted to use derivatives for efficient portfolio management (i.e. hedging) purposes, but since 2003 they have been permitted to use derivatives for investment purposes as well.

3. LEGAL ENTITY TYPES

A broad variety of public tax-exempt investment fund vehicles can be established in Ireland. They are regulated by, and require the authorisation of, the Central Bank. The regulatory framework is divided between UCITS and AIFs, but for the purposes of this article we are focusing on investment funds regulated as UCITS. A UCITS may be established through any one of the following vehicles:

- an investment company (public limited company or plc);
- an Irish Collective Asset-management Vehicle ("ICAV");
- a unit trust; and
- a common contractual fund ("CCF").

INVESTMENT COMPANY

An investment company is an entity with distinct legal personality that is managed and controlled by its board of directors and can enter into contracts in its own name. The assets are the property of the company, and each fund investor holds shares. A depositary is appointed to safekeep the assets on the company's behalf. An investment fund established as a company may be self-managed or appoint a management company. It must operate on the principle of risk spreading.

The paid-up share capital of the company must at all times equal the company's net asset value, the shares of which have no par value. An investment company may be structured as a stand-alone fund or an umbrella fund (see the section headed "*Umbrella funds*" below). Shareholders in an investment company have limited liability.

ICAV

The ICAV is a form of corporate fund structure introduced in March 2015. The ICAV has overtaken the investment company structure as the most popular of the Irish fund structures.

The ICAV represents a modernising and streamlining of the investment company fund structure and is designed specifically with the needs of investment funds in mind. The ICAV may be regarded as similar to a Luxembourg *"SICAV"* or a UK "OEIC." The ICAV is registered (incorporated) with the Central Bank and provides a tailor-made fund vehicle that is available as a corporate structure to both UCITS and AIFs as umbrella or standalone funds.

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One of the main advantages of the ICAV is that it is a corporate entity that can elect its classification under the U.S. check-the-box taxation rules. The ICAV has its own legislative regime (the ICAV Act 2015), which assists in ensuring that the ICAV is distinguished from ordinary companies and therefore avoids those aspects of company law legislation that would not be relevant to a collective investment scheme.

Like the investment company an ICAV can be established as a standalone or an umbrella structure. Investors own shares in the ICAV and the ICAV can issue and redeem shares continually. An ICAV must have a board of directors to govern its affairs. Similar to an investment company, the ICAV may either be managed by an external management company or be a self-managed entity.

The ICAV offers a range of potential benefits which reduce costs for ICAV investors and means that the ICAV has become the Irish investment fund vehicle of choice, regardless of the domicile of the investor base.

UNIT TRUST

A unit trust is created by a trust deed entered into by the trustee and the manager of the fund and this structure requires a management company. A unit trust is a contractual arrangement and the trust is not a separate legal entity, with the result that a unit trust does not have power to enter into contracts in its own name. In general, the manager or trustee enters into contracts for the account of a unit trust.

The trustee is registered as the legal owner of the assets on behalf of the investors, who receive units, each of which represents a beneficial interest in the assets of the unit trust. A unit trust may be structured as a stand-alone fund or an umbrella fund.

CCF

A CCF is an unincorporated body established by a manager pursuant to which the investors, through contractual arrangements, participate and share in the assets of the fund as co-owners; each investor holds an undivided co-ownership interest as a tenant in common[2] with the other investors. The CCF has a similar structure to FCPs (Fonds Commun de Placement) established in Luxembourg.

The CCF is constituted under contract law (and not company law or trust law) by way of deed of constitution executed under seal between the manager and the depositary and does not have a distinct legal personality. Accordingly, the CCF cannot assume liabilities and, in the same manner as a unit trust, the manager and the depositary enter the various agreements for and on behalf of the CCF. The assets of the CCF are entrusted to a depositary for safe-keeping. A CCF may be structured as a stand-alone fund or an umbrella fund.

The main feature differentiating CCFs from other investment funds is that a CCF is totally tax-transparent. This means that investors in a CCF are treated as if they directly own a proportionate share of the underlying investments of the CCF rather than shares or units in an entity which itself owns the underlying investments. This is of particular interest to investors such as pension schemes, charities and life insurance schemes which have preferential tax rates on their investments and can retain these rates while obtaining

the benefit of pooled investment management of their assets.

UMBRELLA FUNDS

It is possible to constitute any UCITS legal entity type as an umbrella fund comprising a number of separate sub-funds with different investment policies. Each sub-fund of an umbrella fund must be approved by the Central Bank.

Each sub-fund within an umbrella fund is represented by a different series of shares or units. The fund may be structured so that one sub-fund of the umbrella can invest in another sub-fund of the same umbrella, which facilitates fund promoters seeking to avail of economies of scale within their own investment fund complexes and to rationalise fund offerings.

Irish law provides for a statutory recognition of segregated liability for umbrella investment companies and umbrella ICAVs.[3] Broadly, these provisions state that:

(a) notwithstanding any statutory provision or rule of law to the contrary, (i) any liability incurred on behalf of or attributable to any sub-fund of an umbrella fund shall be discharged solely out of the assets of that sub-fund; and (ii) no umbrella fund, nor any director, received, examiner, liquidator, provisional liquidator or any other person shall apply, nor be obliged to apply the assets of any sub-fund in satisfaction of any liability incurred on behalf of or attributable to another sub-fund of the same umbrella;[4]

(b) the umbrella fund must ensure that the words "*an umbrella fund with segregated liability between sub-funds*" are included in all agreements entered into in writing with a third party;

(c) the umbrella fund must disclose to a third party that it is a segregated liability umbrella fund before it enters into an oral contract with a third party;

(d) every contract, agreement, arrangement or transaction entered into by an umbrella fund shall contain an implied term, that:

(i) the party or parties contracting with the umbrella fund shall not seek, whether in any proceedings or by any other means whatsoever or wheresoever, to have recourse to any assets of any sub-fund of the umbrella fund in the discharge of all or any part of a liability which was not incurred on behalf of that sub-fund;

(ii) if any party contracting with the umbrella fund shall succeed by any means whatsoever or wheresoever in having recourse to any assets of any sub-fund of the umbrella fund in the discharge of all or any part of a liability which was not incurred on behalf of that sub-fund, that party shall be liable to the umbrella fund to pay a sum equal to the value of the benefit thereby obtained by it; and

(iii) if any party contracting with the umbrella fund shall succeed in seizing or attaching by any means, or

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otherwise levying execution against, any assets of a sub-fund of an umbrella fund in respect of a liability which was not incurred on behalf of that sub-fund, that party shall hold those assets or the direct or indirect proceeds of the sale of such assets on trust for the umbrella fund and shall keep those assets or proceeds separate and identifiable as such trust property;

(e) while a sub-fund of an umbrella fund is not a legal person separate from the umbrella fund, the umbrella fund may sue and be sued in respect of a particular sub-fund and may exercise the same rights of set-off, if any, as between its sub-funds as apply at law in respect of companies and the property of a sub-fund is subject to orders of the courts as it would have been if the sub-fund were a separate legal person; and

(f) nothing in the relevant legislative provisions shall prevent the application of any enactment or rule of law which would require the application of the assets of any sub-fund in discharge of some or all of the liabilities of any other sub-fund on the grounds of fraud or misrepresentation and, in particular, by reason of the application of certain Irish claw-back rules relating to fraudulent transfer of assets or unfair preference of creditors.

While not subject to any similar legislative protections, unit trusts and CCFs are normally structured to provide for segregated liability between sub-funds.

4. NEGOTIATING DERIVATIVES CONTRACTS WITH IRISH UCITS

CONSIDERATIONS FOR UMBRELLA FUNDS

As the counterparty to the derivatives trading will often be an umbrella fund, it is important to be able to identify which sub-fund is a party to the agreement. This can be done in one of two ways:

(a) negotiate the trading document and then replicate the agreement out with each sub-fund signing a separate agreement. In this instance the UCITS would typically be described in the agreement as "*[Umbrella fund name] acting solely in respect of its sub-fund, [Sub-fund name]*"; or

(b) negotiate a single trading document with a "separate agreement" clause which deems a separate agreement to be entered into between the relevant counterparty and the umbrella fund acting severally in respect of each of the sub-funds named in the agreement. In this instance the UCITS would typically be described in the agreement as "*[Umbrella fund name] acting severally and not jointly in respect of each of its sub-funds specified in [relevant Annex to the agreement]*."

Where the second option above is used the agreement will typically provide that the annex containing the list of sub-funds may be updated from time to time by notice/accession agreement so that new sub-funds may be added and old sub-funds removed. In these circumstances it is best practice to include language in the annex to

clarify the effective date of each sub-fund's addition to the agreement. It is an offence under Irish law for a fund to commence business prior to being authorised by the Central Bank; it is crucial to avoid any suggestion that the relevant sub-fund may be party to an agreement with an effective date prior to the sub-fund's date of authorisation by the Central Bank.

When an umbrella fund enters into an ISDA Master Agreement it is typical to amend the definition of "Affiliates" to provide that the sub-fund shall be deemed to have no Affiliates, to avoid any unintentional interconnectedness between sub-funds. In addition it is typical for the agreement to contain language to the effect that an event of default or termination event in respect of a single sub-fund would not constitute an event of default or termination event with respect to any other sub-fund (notwithstanding that each sub-fund would have signed a single physical agreement). The negotiator should also consider whether it is appropriate to amend change of control events (such as the credit event upon merger provisions of the ISDA Master Agreement) where it is expected that interests in the fund will be publicly traded and it is difficult to monitor change of control.

While Irish law implies segregated liability language into all contracts entered into by umbrella funds which are established as investment companies or ICAVs, it is nevertheless considered best practice to include an express segregated liability clause in the relevant trading documents.

UCITS REGULATIONS

The main sources of rules applicable to UCITS trading derivatives in Ireland are (i) the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (the "UCITS Regulations"); and (ii) Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (the "Central Bank UCITS Regulations").

OPTIONAL TERMINATION RIGHT

As UCITS are open-ended retail investment funds, regulators expect that UCITS will only invest in highly liquid investments. To reflect this, Regulation 68(1)(g)(iii) (Permitted Investments) of the UCITS Regulations provides that a UCITS may invest in OTC derivatives if "*the OTC derivatives. . . can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS' initiative*."

A UCITS will typically require an optional termination right, when negotiating bilateral trading documents, allowing it to terminate any transaction at any time. A counterparty may seek to protect itself from an arbitrary triggering of this right by specifying that (i) when calculating the termination amount the UCITS will be the sole Affected Party, and (ii) if the UCITS seeks to terminate some but not all transactions, the counterparty will have the right to terminate the remaining transactions (thereby avoiding the risk of the UCITS only terminating transactions where it is in-the-money).

Regulation 68(1)(g)(iii) does not apply to exchange traded derivatives. However the UCITS Regulations do not draw any distinction between cleared OTC derivatives (which are similar to exchange trade derivatives) and uncleared OTC derivatives. A particular challenge arises when

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considering the UCITS termination requirements in the context of cleared OTC derivatives, as the ruleset of the relevant clearing house will often replace any unilateral termination rights in the OTC derivatives with the standard rules of the clearing house. This conflict between standard clearing house practices and the UCITS rules was noted by the European Securities and Markets Authority (ESMA) in a 2015 opinion[5], though no solution was suggested.

In the absence of a legislative solution, market practice is to seek to address the UCITS liquidation rights in the contract between the UCITS and its clearing member/futures clearing merchant. While the clearing member will generally not accept the UCITS having a unilateral termination right, they will often accept an obligation to submit for clearing any order placed by the UCITS which is solely risk reducing/has the effect of offsetting any existing cleared transaction. In this way the UCITS can ensure that its cleared OTC transactions may be "*closed out by an offsetting transaction*" at any time.

COUNTERPARTY ELIGIBILITY REPRESENTATION

Regulation 68(1)(g)(ii) of the UCITS Regulations provides that a UCITS may only invest in OTC derivatives where the counterparties "*are institutions subject to prudential supervision, and belonging to the categories approved by the [Central] Bank*." This requirement is expanded upon by Regulation 8 (*Financial derivative instruments*) of the Central Bank UCITS Regulations which provide that a UCITS may only invest in an OTC derivative if the derivative counterparty is within at least one of the following categories:

(a) a credit institution that is:

   (i) authorised in the European Economic Area (EEA) (being European Union Member States, Norway, Iceland, Liechtenstein);

   (ii) authorised within a signatory state, other than a Member State of the EEA, to the Basle Capital Convergence Agreement of July 1988 (being the UK, Switzerland, Canada, Japan, and the United States);

   (iii) in a third country deemed equivalent pursuant to Article 107(4) of Regulation (EU) No 575/2013 (the Capital Requirements Regulation).

(b) an investment firm authorised in accordance with the Markets in Financial Instruments Directive (the EU legislation dealing with the regulation of broker-dealers);

(c) a group company of an entity approved as a bank holding company by the Federal Reserve of the United States of America where that group company is subject to bank holding company consolidated supervision by the Federal Reserve.

In respect of (b) above, on March 7, 2019 the Central Bank issued a notice of intention[6] stating that it will consider whether UK entities authorised under MiFID before Brexit should remain eligible counterparties and, while this is under consideration, the Central Bank does not propose to treat these counterparties as ineligible for UCITS purposes.

To address this requirement when entering into uncleared OTC derivatives, a UCITS will fre-

quently seek a representation from its counterparty to the effect that it satisfies the eligibility requirements set out under the UCITS Regulations and the Central Bank UCITS Regulations.

To deal with cleared OTC derivatives the Central Bank UCITS Regulations provide at Regulation 8(5) that where an OTC derivative entered into by a UCITS is subject to a novation, the counterparty after the novation must be -

(a) an entity that is within any of the categories set out in paragraph (a), (b) and (c) above, or

(b) a central counterparty that is -

(i) authorised or recognised under EMIR, or (see the section ''*European Markets Infrastructure Regulation*'') below;

(ii) pending recognition by ESMA under Article 25 of EMIR, an entity classified -

(1) by the SEC as a clearing agency, or

(2) by the Commodity Futures Trading Commission of the United States of America as a derivatives clearing organisation.

As at the date of writing, the U.S. central counterparties recognised under EMIR are Chicago Mercantile Exchange, Inc, ICE Clear Credit LLC, Minneapolis Grain Exchange, Inc., ICE Clear US, Inc and Nodal Clear, LLC.

MAINTAINING ASSETS IN CUSTODY

In March 2016, Directive 2014/91/EU (known as UCITS V) entered into force and introduced additional safe-keeping obligation for depositaries of UCITS. These rules were implemented in Ireland in Regulation 34(4) of the UCITS Regulations, which provides that:

> "*for financial instruments that may be held in custody, the depositary shall*
>
> (i) *hold in custody all financial instruments that may be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary, and*
>
> (ii) *ensure that all financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts. . . opened in the name of the UCITS or the management company acting on behalf of the UCITS. . .*"

These new requirements have a particular impact on UCITS posting collateral by granting a security interest over financial instruments (e.g. bonds, equities etc), as is the case when trading under a New York law governed Credit Support Annex. In these circumstances notwithstanding that the UCITS has granted a security interest over the financial instruments, title to the financial instruments remains with the UCITS and therefore the depositary's safekeeping obligations apply, requiring the depositary to hold the securities in custody (either with itself or with a sub-custodian). This obligation conflicts with the operation of the standard New York law Credit Support Annex where the securities are posted to the counterparty as collateral.

When faced with this issue there are four potential solutions that can be explored:

- use a title transfer collateral arrangement (such as an English or Irish law governed Credit Support Annex) whereby title to the securities is transferred to the counterparty.

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As the UCITS no longer has title to the securities the depositary's safe-keeping obligation in relation to the securities ceases to apply;

- transfer the securities to the counterparty in the usual way, but have the counterparty agree to hold the securities as sub-custodian on behalf of the UCITS. Counterparties are reticent to adopt this approach as they do not want to undertake any fiduciary obligations to the UCITS;
- transfer the securities to a segregated account with the depositary, with the UCITS' counterparty granted a security interest over the segregated account and a tri-partite account control arrangement entered into between the UCITS, the depositary and the counterparty allowing the counterparty to enforce against the collateral if an event of default occurs; or
- restrict the eligible collateral under the security collateral arrangement to only cash, as the depositary's obligation is to hold financial instruments in custody. In respect of cash the depositary's obligation is only to maintain a record of the cash, as opposed to holding it in custody in an account with the depositary.

COUNTERPARTY EXPOSURE LIMITS

When investing in OTC derivatives (but not exchange traded derivatives) UCITS are subject to certain counterparty credit risk exposure limits. In particular, the risk exposure to the counterparty may not exceed 5% of the assets of the UCITS, or 10% when the counterparty is a credit institution.

Where the counterparties exchange variation margin to collateralise their exposure this counterparty exposure limit is usually not an issue, as in the ordinary course, the UCITS will have limited credit risk on the counterparty. However, should the counterparty require the UCITS to provide initial margin prior to trading, the amount of initial margin held by the counterparty must be counted towards the UCITS' credit risk on the counterparty.

A UCITS will often seek to implement a tripartite secured account structure (as discussed in the section "*Maintaining assets in custody*" above) to avoid inadvertent breaches of the counterparty exposure limits when providing initial margin, where the initial margin is posted to a segregated account held with the UCITS' depositary. The segregated account is secured in favour of the counterparty and subject to a tripartite account control agreement allowing the counterparty to enforce against the collateral if an event of default occurs. This provides the counterparty with the collateral it requires without contributing to the UCITS counterparty exposure limits.

EUROPEAN MARKETS INFRASTRUCTURE REGULATION

Regulation 648/2012/EU of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories (as amended) (commonly referred to as the European Markets Infrastructure Regulation or EMIR) entered into force on August 16, 2012 and radically altered the treatment of derivatives contracts in the EU.

EMIR imposes extensive regulatory requirements on "*financial counterparties*" who enter

into derivatives contracts. The category of "financial counterparties" includes *"a UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC, unless that UCITS is set up exclusively for the purpose of serving one or more employee share purchase plans*."

Derivatives contracts are defined in EMIR as "*financial instrument[s] as set out in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006*." This covers almost all types of derivatives, though it excludes spot FX transactions and certain FX transactions that are used as a means of payment.

The key obligations set out under EMIR may be summarised as follows:

- Trade reporting—The UCITS must ensure that details of each derivatives contract entered into by it are reported to an ESMA authorised or recognised trade repository in accordance with EMIR.
- Risk-mitigation techniques—The UCITS must implement certain risk mitigation techniques in respect of OTC derivatives contracts entered into by it which are not cleared by a central counterparty ("CCP").
- Mandatory clearing—If the UCITS exceeds the clearing thresholds set out under EMIR it must put in place arrangements to clear certain types of OTC derivatives contracts which have been declared subject to the clearing obligation under EMIR.

The Central Bank is the relevant enforcement authority for the purposes of enforcing EMIR in Ireland. The Central Bank has published a number of guidance statements and recommendations in relation to EMIR compliance.

TRADE REPORTING

The UCITS' management company (or if there is no management company, the UCITS itself) must report the details of any derivatives contracts (both exchange traded and OTC) to a trade repository registered with, or recognised by, ESMA as well as each modification or early termination of these contracts, no later than the working day following the conclusion, modification or termination of the contract. Compliance with the reporting obligation may be delegated to a third party (including the counterparty to the relevant derivative contract) but this does not absolve the management company/UCITS (as the case may be) of the legal liability for failures in reporting.

In practice the UCITS will typically ask its counterparty to report on its behalf and ISDA has prepared a standard delegated reporting agreement[7] that may be used to document this delegated reporting service (which is usually provided free of charge).

RISK MITIGATION TECHNIQUES

UCITS that enter into an OTC derivative contract not cleared by a CCP must ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least:

- the timely confirmation, where available, by electronic means, of the terms of the relevant OTC derivative contract; and
- formalised processes which are robust,

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resilient and auditable in order to reconcile portfolios, to manage the associated risk and to identify and resolve disputes in a timely manner, and to monitor the value of outstanding contracts.

Compliance with these risk mitigation techniques requires the UCITS to maintain certain policies but also requires certain contractual terms to be agreed between the UCITS and its counterparty prior to commencing trading. Rather than bilaterally negotiating these terms, parties usually seek to incorporate the terms of the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol[8] into their trading agreement(s).

Included in the UCITS risk-mitigation obligations is a requirement to implement risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts not cleared by a CCP. Such risk-management procedures must comply with Commission Delegated Regulation (EU) 2016/2251 with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (the Uncleared Margin Rules, or "UMR").

The UMR impose certain specified eligibility requirements on the type of collateral that may be accepted by a UCITS and the procedures which must apply to the exchange of collateral between the UCITS and its counterparty. Some of these imposed changes to the prevailing market practice before the UMR, most significantly, now variation margin must be transferred on the same day as the margin requirement calculation is performed (as opposed to the next business day standard that had applied prior to the UMR). This requirement can be particularly challenging for UCITS trading with, or managed by, U.S. entities, as there may be only a short window of time to receive the calculation of required margin and make the transfer instruction before close of business in Ireland due to time differences.

The simplest way to ensure compliance with the UMR in respect of variation margin is for the parties to post collateral using the relevant form of the 2016 ISDA Credit Support Annex for Variation Margin (VM) published by ISDA, which was specifically drafted to comply with the UMR requirements. Any alternative approach needs to be carefully considered for compliance with the UMR.

The UMR also contains rules applicable to initial margin. These initial margin rules have been introduced over the last number of years based on the aggregate average notional amount of non-centrally cleared derivatives outstanding of the relevant entity. Phase 5 entities (those with more the €50 billion in aggregate average notional amount of non-centrally cleared derivatives outstanding) will come into scope from September 1, 2021. Phase 6 entities (those with more the €8 billion in aggregate average notional amount of non-centrally cleared derivatives outstanding, and the final initial margin phase) will come into scope from September 1, 2022. Given the large notional amounts involved, and that fact that the amount outstanding is calculated on a per-sub-fund basis, it is expected that few Irish UCITS will be in scope for the UMR initial margin rules.

MANDATORY CLEARING

With effect from June 17, 2019 and at least every 12 months thereafter, a UCITS must either

(i) elect not to calculate their aggregate month-end average position in OTC derivatives for the previous 12 months in accordance with EMIR, or (ii) elect to perform such calculation in respect of each of its sub-funds to determine whether, in respect of any particular asset class, any sub-fund exceeds the following thresholds:

EUR 1 billion*	Credit derivative contracts
EUR 1 billion*	Equity derivative contracts
EUR 3 billion*	Interest rate derivative contracts
EUR 3 billion*	Foreign exchange derivative contracts
EUR 3 billion*	Commodity derivative contracts and others

* In gross notional amount

The UCITS must retain records capable of demonstrating to the Central Bank that the calculation of positions at the level of the sub-fund (rather than the umbrella level) does not lead to:

- a systematic underestimation of the positions of any of the sub-funds; and
- a circumvention of the clearing obligation.

If the calculation shows that a sub-fund exceeds one of the clearing thresholds, or the calculation is not performed in respect of a sub-fund, then the UCITS shall:

- immediately notify ESMA and the Central Bank, and, where relevant, indicate the period used for the calculation;
- establish clearing arrangements within four months after the notification referred to above; and
- become subject to the clearing obligation referred to in Article 4 of EMIR for all OTC derivative contracts pertaining to any class of OTC derivatives, which is subject to the clearing obligation entered into or novated more than four months following the notification referred to in above.

Given the importance for counterparties in knowing whether or not the EMIR clearing obligations applies to their trading relationship, it is common for counterparties to request confirmation from the UCITS that it is not subject to the clearing obligation (commonly referred to as being a "small financial counterparty" or "SFC").

SECURITIES FINANCING TRANSACTIONS REGULATION

Under Article 15 of Regulation (EU) 2015/2365 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (commonly known as the Securities Financing Transactions Regulation or "SFTR") any right of a counterparty to re-use financial instruments received as collateral (whether under derivatives trading agreements or otherwise) shall be subject to both of the following conditions:

(a) the providing counterparty has been duly informed in writing by the receiving counterparty of the risks and consequences that may be involved in one of the following:

(i) granting consent to a right of use of collateral provided under a security collateral arrangement in accordance with Article 5 of Directive 2002/47/EC;

(ii) concluding a title transfer collateral arrangement (for example, under an English-law-governed ISDA Credit Support Annex);

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(b) the providing counterparty has granted its prior express consent, as evidenced by a signature, in writing or in a legally equivalent manner, of the providing counterparty to a security collateral arrangement, the terms of which provide a right of use in accordance with Article 5 of Directive 2002/47/EC, or has expressly agreed to provide collateral by way of a title transfer collateral arrangement.

To ensure compliance with Article 15 of SFTR, whenever a UCITS enters into a trading relationship with a new counterparty it is best practice for each of the UCITS and the counterparty to exchange an SFTR information statement substantially in the form published by the Association for Financial Markets in Europe (AFME), the Futures Industry Association, Inc. (FIA), the International Capital Market Association (ICMA), ISDA and the International Securities Lending Association (ISLA).[9]

SHARE CLASS HEDGING

UCITS may be established with multiple classes of shares or units. In the case of an umbrella fund, these multiple classes of shares and units can be established within each sub-fund of the umbrella fund. These share or unit classes may be differentiated on the basis of currency, distribution policies or charging structures. They may also be used for the purpose of hedging currency risk through the use of derivatives.

Historically there were diverging national practices across EU Member States as to the types of share classes that were permitted, ranging from very simple share classes (e.g., with differing levels of fees) to much more sophisticated share classes (which may have different investment strategies). In 2017, ESMA published an opinion on UCITS share classes[10] setting out four high-level principles which UCITS must follow when setting up different share classes:

- Common Investment Objective: share classes of the same fund should have a common investment objective reflected by a common pool of assets (the common investment objective principle). Significantly, ESMA considered that hedging arrangements at share class level—with the exception of currency risk hedging—are not compatible with the requirement for a fund to have a common investment objective;
- Non-contagion: UCITS management companies should implement appropriate procedures to minimise the risk that features specific to one share class could have a potentially adverse impact on other share classes of the same fund (the "non-contagion principle");
- Pre-determination: all features of a share class should be pre-determined before it is set up; and
- Transparency: differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes.

Since the publication of ESMA's opinion, the only hedging that may be entered into by a UCITS at share class level is currency hedging. However, any such hedging must comply with the non-contagion principle. In order to ensure that the use of derivatives does not lead to contagion risk, ESMA stated that currency hedging at

share class level must be scaled and managed appropriately; and set out the following operational principles that UCITS and UCITS management companies ought to observe as a minimum standard:

- the notional of the derivative should not lead to a commitment to deliver or receive securities with a value which cannot be serviced by that portion of the common pool of assets on which the share class investors have a claim;
- there should be a level of operational segregation which ensures, at a minimum, that there is a clear identification of the assets, liabilities and profit or loss to the respective share classes on an ongoing basis, and, at the very least, at the same valuation frequency of the fund;
- stress tests should be implemented to quantify the impact of losses on all investor classes of a fund that are due to losses relating to share class-specific assets that exceed the value of the respective share class; and
- the share class currency hedge should be implemented according to a detailed, predefined and transparent hedging strategy.

Some UCITS sought to insert limited recourse provisions into their derivatives trading documents, to ensure compliance with the non-contagion principle, whereby the counterparty to the trade would agree to limit its recourse to the assets attributed to the share class. This was often heavily resisted by the counterparty on the basis that the counterparty should not have to take on additional credit risk by agreeing to limit its recourse to only a portion of the assets of the fund.

In 2019, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) and Division of Clearing and Risk (DCR) issued CFTC Letter 19-17 regarding CFTC Regulation 1.56(b),[11] Regulation 1.56(b) provides that an FCM may not in any way represent that it will: (i) guarantee any person against loss; (ii) limit the loss of such person; or (iii) not call for or attempt to collect required margin. The letter clarifies that the FCM must retain the ability to ultimately look to funds in other accounts of the beneficial owner, including accounts that may be under different control, as well as the right to call the beneficial owner for additional funds.

This guidance has provided further grounds for FCMs to resist any attempts by UCITS to include language limiting the FCM's recourse to only the assets of a particular share class of the UCITS. The assets of each share class are ultimately assets of the UCITS and there is no scope to treat the share classes separately under the CFTC guidance.

5. CONCLUSION

Particular attention should be paid whenever negotiating derivatives trading arrangements with Irish UCITS because of the various legal, regulatory and commercial requirements governing them. In particular, consideration needs to be given to the regulatory environment at the outset when negotiating outline commercial terms. For example, a counterparty may typically seek a relatively modest amount of initial margin when trading with mutual funds, but if this will require additional security documentation and account control agreements to be drafted, the operational complexity should be taken into account. As the market and its regulation continue to evolve, the

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requirements for trading derivatives with Irish UCITS will likely become increasingly complicated and a detailed knowledge of the regulatory landscape will become crucial.

ENDNOTES:

[1]Commission Directive 2007/16/EC implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions

[2]Tenancy in common is an arrangement where two or more people are co-owners of an asset, each having a distinct beneficial interest to a given share of the asset, notwithstanding that the shares have not been divided between them. When a tenant in common dies their interest in the relevant share of the asset passes to their estate, unlike a joint tenancy where the interest would pass to the other co-owners. In addition, as each tenant in common owns a distinct beneficial share of the asset, each can transfer their share without the consent of the other.

[3]In the case of investment companies, Sections 1405-1407 of the Companies Act; in the case of ICAVs, Sections 35-37 of the ICAV Act.

[4]There are certain additional rules which apply when considering the segregated liability of umbrella funds established prior to June 30, 2005.

[5] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-880_esma_opinion_on_impact_of_emir_on_ucits.pdf

[6] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/190305_notice-of-intention_investment-in-uk-inv-funds-and-uk-cps-to-otc.pdf?sfvrsn=2

[7] https://www.isda.org/2019/12/19/mrra/

[8] https://www.isda.org/protocol/isda-2013-emir-port-rec-dispute-res-and-disclosure-protocol/

[9] https://www.isda.org/book/isda-sftr-information-statement#:~:text=The%20SFTR%20Information%20Statement%20is,a%20title%20transfer%20collateral%20arrangement.

[10] https://www.esma.europa.eu/sites/default/files/library/opinion_on_ucits_share_classes.pdf.

[11]17 C.F.R. § 1.56(b).