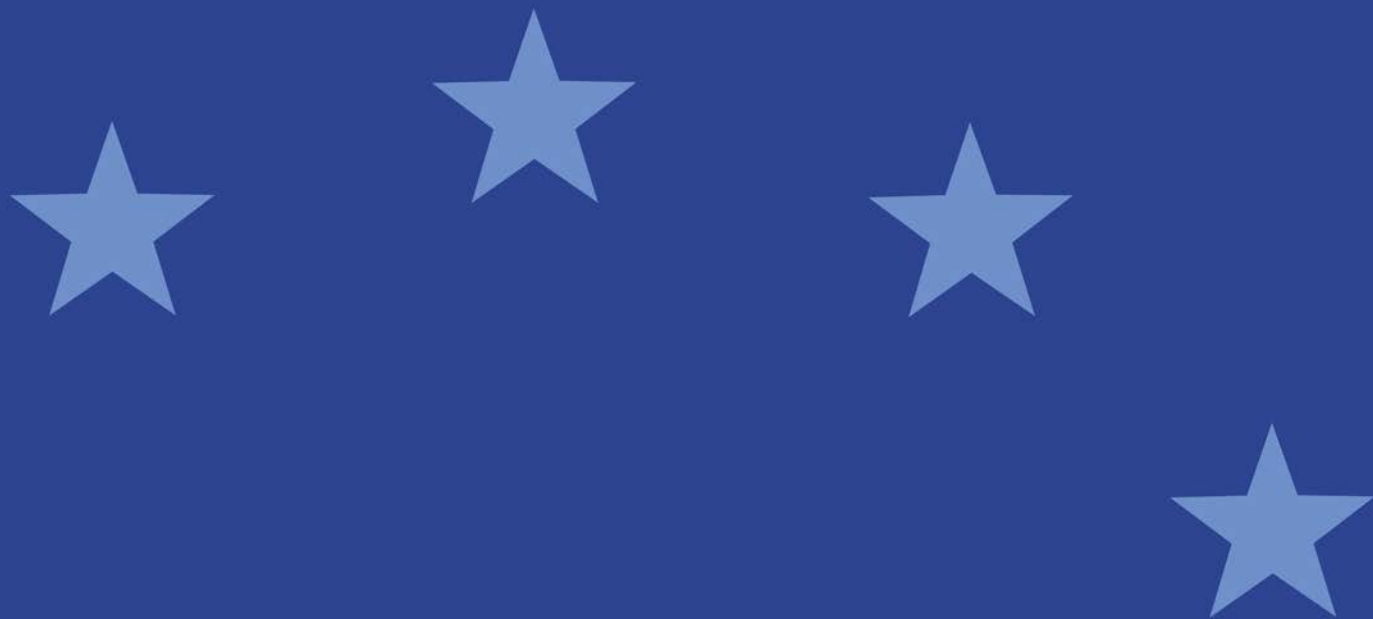


Questions and Answers

Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS



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I. Background

1. The revised Undertakings for Collective Investment in Transferable Securities (UCITS) Directive puts in place a comprehensive framework for the regulation of harmonised investment funds within Europe. The extensive requirements with which UCITS must comply are designed to ensure that these products can be sold on a cross-border basis. The most recent version of the Directive also introduces a management company passport.
2. The UCITS framework is made up of the following EU legislation:
 - a. Directive 2009/65/EC, which was adopted in 2009. It is a 'framework' Level 1 Directive which has been supplemented by technical implementing measures (see the Level 2 legislation in b. below).
 - b. Directive 2007/16/EC¹; Directive 2010/43/EU²; Regulation No 583/2010³; Directive 2010/42/EU⁴; and Regulation No 584/2010⁵.
3. ESMA's predecessor (CESR) produced a series of questions and answers (Q&A) based on questions received through CESR's MiFID Q&A mechanism. The Q&As reflected common positions agreed by CESR Members. They were one of the tools used by CESR to elaborate on the provisions of certain EU legislation, thereby fostering supervisory convergence, and were considered useful by external stakeholders. ESMA has therefore decided to introduce a similar mechanism in the UCITS area.
4. Similarly, ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices. In this regard, ESMA will continue to develop Q&As as and when appropriate.

II. Purpose

5. The purpose of this document is to promote common supervisory approaches and practices in the application of the UCITS Directive and its implementing measures. It does this by providing responses to questions posed by the general public and competent authorities in relation to the practical application of the UCITS framework.
6. The content of this document is aimed at competent authorities under UCITS to ensure that in their supervisory activities their actions are converging along the lines of the responses adopted by ESMA.

¹ COMMISSION DIRECTIVE 2007/16/EC of 19 March 2007 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 COMMISSION DIRECTIVE 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company

³ COMMISSION REGULATION (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website

⁴ COMMISSION DIRECTIVE 2010/42/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure

⁵ COMMISSION REGULATION (EU) No 584/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities



However, the answers are also intended to help UCITS management companies by providing clarity as to the content of the UCITS rules, rather than creating an extra layer of requirements.

III. Status

7. The Q&A mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation.⁶
8. Therefore, due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if they are not formally consulted on, ESMA may check them with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group or, where specific expertise is needed, with other external parties.
9. ESMA will review these questions and answers to identify if, in a certain area, there is a need to convert some of the material into ESMA guidelines and recommendations. In such cases, the procedures foreseen under Article 16 of the ESMA Regulation will be followed.

IV. Questions and answers

10. This document is intended to be continually edited and updated as and when new questions are received. The date each question was last amended is included after each question for ease of reference.
11. Questions on the practical application of any of the requirements of the guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788) may be sent to the following email address at ESMA: riskmeasurement@esma.europa.eu

⁶ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.

Question 1: Hedging strategies

Date last updated: July 2012

Question 1a: Can the following strategy be qualified as a hedging strategy as defined in CESR's guidelines?

A portfolio management practice which only aims to reduce the interest rate risk of a corporate bond portfolio by entering into a short position on bond future contracts (or an interest rate swap) in the same currency and with a similar interest rate duration. Note that in this case the portfolio credit risk would remain un-hedged.

Answer 1a: Yes. This strategy could be considered as a hedging arrangement as defined in CESR's guidelines as it is in line with the example set out in paragraph 33(a) of the guidelines.

Question 1b: Can the following strategy be qualified as a hedging strategy as defined in CESR's guidelines?

A portfolio management practice which aims to reduce the credit risk of a corporate or government bond portfolio through purchased Credit Default Swaps (CDS). Note that in this case the portfolio interest rate risk would remain un-hedged.

Answer 1b: Yes, but only if the corporate or government bond and the purchased CDS relate to the same issuer.

Question 1c: When calculating the global exposure according to the Commitment Approach, can UCITS that invest in other funds make use of hedging arrangements?

Answer 1c: According to Box 8 of CESR's guidelines, for the purpose of calculating global exposure under the Commitment Approach, hedging arrangements may only be taken into account if they relate to the same asset class. Therefore, hedging arrangements for UCITS funds of funds are possible provided that the management company of the investing UCITS has full knowledge of the underlying investments of the target funds.

Question 2: Disclosure of leverage by UCITS

Date last updated: July 2012

Question 2a: For UCITS using VaR to calculate global exposure, can the required disclosure of leverage be made on a net basis i.e. leverage calculated after netting/hedging arrangements are taken into account?

Answer 2a: No. In accordance with Boxes 24 and 25 of CESR's guidelines, leverage should be calculated as the sum of the notionals of the derivatives used.



Question 2b: Could UCITS using the VaR approach to calculate global exposure disclose leverage based on the Commitment Approach?

Answer 2b: Yes. However, the leverage should be disclosed based on both the 'sum of the notionals' as provided by CESR's guidelines and the Commitment Approach.

Question 3: Concentration rules

Date last updated: July 2012

Question: Article 54 of Directive 2009/65/EC permits competent authorities to authorise UCITS to invest up to 100% of their assets in transferable securities issued by certain issuers e.g. sovereigns. In such cases the UCITS must hold securities from at least six different issues and securities from any single issue shall not exceed 30% of its total assets.

Should this diversification rule apply on the basis of the net assets of the UCITS or on a gross basis?

Answer: The 100% diversification limit of Article 54 should be applied on the net assets (i.e. exposure to assets referred to in this article is limited to 100% of the net asset value) as all investment restrictions applicable to UCITS, including the diversification limits of Article 54, have to be applied with reference to their net assets and because any exposure beyond 100% to a sovereign issuer cannot be considered as 'equivalent protection' with regard to Article 52.

Furthermore, it is explicitly clarified that any exposure taken to assets referred to in Article 54, including through derivatives (e.g. bond future contracts such as Euro. Bund Future, 10 Year US T-Note future) and any efficient portfolio management techniques (e.g. reinvestment of cash collateral) must be included when calculating the limit of 100% according to Article 54.

Question 4: Calculation of global exposure for fund of funds

Date last updated: July 2012

Question: Is the look-through approach compulsory for the calculation of global exposure when UCITS invest in other funds?

Answer: No. For the purpose of calculating global exposure, a look-through approach is not compulsory when UCITS invest in other funds. As an alternative, UCITS may treat the NAV of the target fund as an equity and use it as a substitute in the calculation of global exposure, in particular when the VaR Approach is used.

This method may only be used if the risk management function can prove and document that this approach does not lead to an inaccurate picture of the fund of funds. In addition, UCITS fund of funds structures have to comply with all due diligence and risk management requirements laid down in the UCITS framework (Directive 2009/65/EC, Directive 2010/43/EU and the CESR guidelines on Risk Management principles for UCITS⁷). Finally, the method chosen by the UCITS should be disclosed in the prospectus.

⁷ CESR guidelines on Risk Management principles for UCITS – Ref. CESR/09-178, <http://www.esma.europa.eu/content/Guidelines-Risk-management-principles-UCITS>

Question 5: Calculation of counterparty risk for exchange-traded derivatives and centrally-cleared OTC transactions

Date last updated: December 2013

*****New*** Question:** How should UCITS calculate their counterparty risk for exchange-traded derivatives and OTC transactions that are centrally cleared under the European Market Infrastructure Regulation (EMIR)?

*****New*** Answer:** When calculating the counterparty risk for exchange-traded derivatives and OTC transactions that are centrally cleared, UCITS should look at the clearing model used to determine the existence of counterparty risk and, if any, where the counterparty risk is located. When analysing the clearing model used, UCITS should have regard to the existence of segregation arrangements of the assets and the treatment of claims on these assets in the event of bankruptcy of the clearing member or central counterparty.⁸

⁸ ESMA is continuing its work on the issue of calculation of counterparty risk by UCITS for exchange-traded derivatives and centrally-cleared OTC transactions in light of the provisions of EMIR. ESMA plans to issue more detailed guidance on this issue, dealing with such aspects as the status of the central counterparty and the level of segregation to be put in place by the UCITS, early in 2014.