Chapter 5

Investment and borrowing powers

5

5.3 Derivative exposure

Application

5.3.1 R This section applies to an *authorised fund manager* of a *UCITS scheme* and to an *ICVC* which is a *UCITS scheme*.

Introduction

5.3.2 G

(1) A *scheme* may invest in *derivatives* and forward transactions as long as the exposure to which the *scheme* is committed by that transaction itself is suitably covered from within its *scheme property*. Exposure will include any *initial outlay* in respect of that transaction.

(2) Cover ensures that a *scheme* is not exposed to the risk of loss of property, including *money*, to an extent greater than the net value of the *scheme property*. Therefore, a *scheme* is required to hold *scheme property* sufficient in value or amount to match the exposure arising from a *derivative* obligation to which the *scheme* is committed. This section sets out detailed requirements for cover of a *scheme*.

(3) In accordance with COLL 5.1.3 R (2)(b) (Treatment of obligations), cover used in respect of one transaction in *derivatives* or forward transaction should not be used for cover in respect of another transaction in *derivatives* or a forward transaction.

5.3.3 R

(1) [deleted]

(2) [deleted]

(3) [deleted]

(4) [deleted]

(5) [deleted]

Cover for investment in derivatives and forward transactions

5.3.3A R The *authorised fund manager* of a *UCITS scheme* must ensure that its global exposure relating to *derivatives* and forward transactions held in the *UCITS scheme* does not exceed the net value of the *scheme property*.

[**Note:** article 51(3) first paragraph of the *UCITS Directive*]

Daily calculation of global exposure

5.3.3B R An *authorised fund manager* of a *UCITS scheme* must calculate its global exposure on at least a daily basis.

[**Note:** article 41(2) of the *UCITS implementing Directive*]

5.3.3C R For the purposes of this section, exposure must be 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.

[**Note:** article 51(3) second paragraph of the *UCITS Directive*]

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Guidance on cover

5.3.4 G

(1) An *authorised fund manager* should note that the scope of COLL 5.3.3C R is extended in relation to underwriting commitments by COLL 5.5.8 R (4) (General power to accept or underwrite placings).

(2) Property the subject of a transaction under COLL 5.4 (Stock lending) should not be considered as available for cover unless the *authorised fund manager* has taken reasonable care to determine that it is obtainable (by return or re-acquisition) in time to meet the obligation for which cover is required.

Borrowing

5.3.5 R

(1) Cash obtained from borrowing, and borrowing which the *authorised fund manager* reasonably regards an *eligible institution* or an *approved bank* to be committed to provide, is not available for cover under COLL 5.3.3A R (Cover for investment in derivatives and forward transactions), except if (2) applies.

(2) Where, for the purposes of this section, the *ICVC* or the *depositary* for the account of the *AUT* or *ACS* on the instructions of the *authorised fund manager*:

(a) borrows an amount of currency from an *eligible institution* or an *approved bank*; and

(b) keeps an amount in another currency, at least equal to the borrowing for the time being in (a), on *deposit* with the lender (or his agent or nominee);

then this section applies as if the borrowed currency, and not the deposited currency, were part of the *scheme property*.

5.3.6 R

(1) [deleted]

(2) [deleted]

Calculation of global exposure

5.3.7 R An *authorised fund manager* must calculate the global exposure of any *UCITS scheme* it manages either as:

(1) the incremental exposure and leverage generated through the use of *derivatives* and forward transactions (including embedded derivatives as referred to in COLL 5.2.19R (3A) (Derivatives: general)), which may not exceed 100% of the net value of the *scheme property*; or

(2) the *market risk* of the *scheme property*.

[**Note:** article 41(1) of the *UCITS implementing Directive*]

5.3.8 R

(1) An *authorised fund manager* must calculate the global exposure of a *UCITS scheme* by using:

(a) the commitment approach; or

(b) the value at risk approach.

(2) An *authorised fund manager* must ensure that the method selected in (1) is appropriate, taking into account:

(a) the investment strategy pursued by the *UCITS scheme*;

(b) the types and complexities of the *derivatives* and forward transactions used; and

(c) the proportion of the *scheme property* comprising *derivatives* and forward transactions.

(3) Where a *UCITS scheme* employs techniques and instruments including *repo* contracts or *stock lending* transactions in accordance with COLL 5.4 (Stock lending) in order to generate additional leverage or exposure to *market risk*, the *authorised fund manager* must take those transactions into consideration when calculating global exposure.

(4) For the purposes of (1), value at risk means a measure of the maximum expected loss at a given confidence level over the specific time period.

[**Note:** articles 41(3) and 41(4) of the *UCITS implementing Directive*]

Commitment approach

5.3.9 R

Where an *authorised fund manager* of a *UCITS scheme* uses the commitment approach for the calculation of global exposure, it must:

(1) ensure that it applies this approach to all *derivative* and forward transactions (including embedded *derivatives* as referred to in COLL 5.2.19R (3A) (Derivatives: general)), whether used as part of the *scheme's* general investment policy, for the purposes of risk reduction or for the purposes of *efficient portfolio management* in accordance with the *rules* of this chapter; and

(2) convert each *derivative* or forward transaction into the market value of an equivalent position in the underlying asset of that *derivative* or forward (standard commitment approach).

[**Note:** articles 42(1) and 42(2) first paragraph of the *UCITS implementing Directive*]

5.3.10 R

(1) An *authorised fund manager* of a *UCITS scheme* may apply other calculation methods which are equivalent to the standard commitment approach.

(2) An *authorised fund manager* may take account of netting and hedging arrangements when calculating global exposure of a *UCITS scheme*, where those arrangements do not disregard obvious and material risks and result in a clear reduction in risk exposure.

(3) Where the use of *derivatives* or forward transactions does not generate incremental exposure for the *UCITS scheme*, the underlying exposure need not be included in the commitment calculation.

(4) Where the commitment approach is used, temporary borrowing arrangements entered into on behalf of the *UCITS scheme* in accordance with COLL 5.5.4 R (General power to borrow) need not form part of the global exposure calculation.

[**Note:** articles 42(2) final paragraph, 42(3), 42(4) and 42(5) of the *UCITS implementing Directive*]

ESMA guidelines

5.3.11 G

Authorised fund managers of *UCITS schemes* are advised that *ESMA* has issued guidelines which, in accordance with the *UCITS implementing Directive*, *authorised fund managers* should comply with in applying the *rules* in this section in relation to *UCITS schemes*:

Guidelines: Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788)

https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf

Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS (ESMA 2012/197)

https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-197.pdf

Guidelines to competent authorities and UCITS management companies on ETFs and other UCITS issues (ESMA 2012/832)

https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf