

Chapter 5

Investment and borrowing powers

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]

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:

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- (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*]

- (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

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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*]

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- (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

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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