

**COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (USE OF FINANCIAL DERIVATIVE INSTRUMENTS FOR UCITS) INSTRUMENT 2005**

**Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions:
- (1) the following sections of the Financial Services and Markets Act 2000 (“the Act”):
    - (a) section 138 (General rule-making power);
    - (b) section 140 (Restriction on managers of authorised unit trust schemes);
    - (c) section 156 (General supplementary powers);
    - (d) section 157(1) (Guidance);
    - (e) section 242 (Applications for authorisation of unit trust schemes);
    - (f) section 247 (Trust schemes rules); and
    - (g) section 248 (Scheme particulars rules); and
  - (2) regulation 6 (FSA rules) of the Open-Ended Investment Companies Regulations (SI 2001/1228).
- B. The provisions of or under the Act relevant to the rules and listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

**Commencement**

- C. This instrument comes into force on 1 March 2005.

**Amendments to the Collective Investment Schemes sourcebook**

- D. The Collective Investment Schemes sourcebook is amended in accordance with Annex A to this instrument.

**Amendments to the New Collective Investment Schemes sourcebook**

- E. The New Collective Investment Schemes sourcebook is amended in accordance with Annex B to this instrument.

**Citation**

- F. This instrument may be cited as the Collective Investment Schemes Sourcebook (Use of Financial Derivative Instruments for UCITS) Instrument 2005.

By order of the Board  
20 January 2005

## Annex A

### Amendments to the Collective Investment Schemes sourcebook

In this Annex underlining indicates new text (except where a website address is to be inserted) and striking through indicates deleted text.

Spread: general

5.2.13 R ...

- (12) For the purpose of calculating the limits in (7) and (10), the exposure in respect of an *OTC derivative* may be reduced to the extent that collateral is held in respect of it if the collateral meets each of the conditions specified in (13).
- (13) The conditions referred to in (12) are that the collateral:
- (a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;
  - (b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
  - (c) is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party; and
  - (d) can be fully enforced by the *UCITS scheme* at any time.
- (14) For the purpose of calculating the limits in (7) and (10), *OTC derivative* positions with the same counterparty may be netted provided that the netting procedures:
- (a) comply with the conditions set out in Section 3 (Contractual netting (Contracts for novation and other netting agreements)) of Annex III to the *Banking Consolidation Directive*; and
  - (b) are based on legally binding agreements.
- (15) In applying this rule, all *derivatives* transactions are deemed to be free of counterparty risk if they are performed on an exchange where the clearing house meets each of the following conditions:
- (a) it is backed by an appropriate performance guarantee; and
  - (b) it is characterised by a daily mark-to-market valuation of the *derivative* positions and an at least daily margining.

Guidance on spread: general

- 5.2.13A G (1) CIS 5.2.13R(12) to (15) reflect the provisions of Article 5 of the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (in this Section referred to as “the Commission Recommendation on the use of financial derivative instruments”). This Recommendation may be accessed via [http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l\\_199/l\\_19920040607en00240029.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_199/l_19920040607en00240029.pdf).
- (2) The attention of *authorised fund managers* is specifically drawn to condition (d) in CIS 5.2.13R(13) under which the collateral has to be legally enforceable at any time. It is the FSA’s view that it is advisable for an *authorised fund manager* to undertake a legal due diligence exercise before entering into any financial collateral arrangement. This is particularly important where the collateral arrangements in question have a cross-border dimension. *Depositaries* will also need to exercise reasonable care to review the collateral arrangements in accordance with its duties under CIS 7.5.3R(2) (Duties of the ACD and depository: investment and borrowing powers) or CIS 7.10.3R(2) (Duties of the manager and trustee: investment and borrowing powers), as appropriate.

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Permitted transactions (derivatives and forwards)

- 5.2.22 R ...
- (5) A transaction in a *derivative* must not be entered into if the intended effect is to create the potential for an uncovered sale of one or more *transferable securities, money market instruments, units in collective investment schemes, or derivatives* provided that a sale is not to be considered as uncovered if the conditions in CIS 5.2.24R(3) (Requirement to cover sales) are satisfied.

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Requirement to cover sales

- 5.2.24 R ...
- (3) Paragraph (1) does not apply where:
- (a) the risks of the underlying financial instrument of a *derivative* can be appropriately represented by another financial instrument and the underlying financial instrument is highly liquid; or

(b) the authorised fund manager or the depositary has the right to settle the derivative in cash, and cover exists within the scheme property which falls within one of the following asset classes:

(i) cash;

(ii) liquid debt instruments (e.g. government bonds of first credit rating) with appropriate safeguards (in particular, haircuts); or

(iii) other highly liquid assets having regard to their correlation with the underlying of the financial derivative instruments, subject to appropriate safeguards (e.g. haircuts where relevant).

(4) In the asset classes referred to in (3), an asset may be considered as liquid where the instrument can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market.

Guidance on requirement to cover sales

5.2.24A G CIS 5.2.24R(3) to (4) reflect the provisions of Article 7 of the Commission Recommendation on the use of financial derivative instruments.

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Risk management process

5.2.27 G ...

(6) Firms carrying out the risk management process should note the methodologies set out in Article 3 (Appropriately calibrated standards to measure market risk) of the Commission Recommendation on the use of financial derivative instruments.

(7) In assessing the risk of OTC derivatives, firms should note the methodologies set out in Article 5.3 (Invitation to use the standards laid down in Directive 2000/12/EC as a first reference) of the Commission Recommendation on the use of financial derivative instruments.

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Cover for transactions in derivatives and forward transactions

5.3.3 R ...

(5) The total global exposure relating to derivatives held in a UCITS scheme may not exceed the net value of the scheme property (Article 2(1) of the Commission Recommendation 2004/383/EC).

## Annex B

### Amendments to the New Collective Investment Schemes sourcebook

In this Annex underlining indicates new text (except where a website address is to be inserted) and striking through indicates deleted text.

Spread: general

5.2.11 R ...

- (11) For the purpose of calculating the limits in (7) and (10), the exposure in respect of an *OTC derivative* may be reduced to the extent that collateral is held in respect of it if the collateral meets each of the conditions specified in (12).
- (12) The conditions referred to in (11) are that the collateral:
- (a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;
  - (b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
  - (c) is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party; and
  - (d) can be fully enforced by the *UCITS scheme* at any time.
- (13) For the purpose of calculating the limits in (7) and (10), *OTC derivative* positions with the same counterparty may be netted provided that the netting procedures:
- (a) comply with the conditions set out in Section 3 (Contractual netting (Contracts for novation and other netting agreements)) of Annex III to the *Banking Consolidation Directive*; and
  - (b) are based on legally binding agreements.
- (14) In applying this rule, all *derivatives* transactions are deemed to be free of counterparty risk if they are performed on an exchange where the clearing house meets each of the following conditions:
- (a) it is backed by an appropriate performance guarantee; and
  - (b) it is characterised by a daily mark-to-market valuation of the *derivative* positions and an at least daily margining.

Guidance on spread: general

- 5.2.11A G (1) COLL 5.2.11R(11) to (14) reflect the provisions of Article 5 of the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings for collective investment in transferable securities (in this Section referred to as “the Commission Recommendation on the use of financial derivative instruments”). This Recommendation may be accessed via [http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l\\_199/l\\_19920040607en00240029.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_199/l_19920040607en00240029.pdf).
- (2) The attention of *authorised fund managers* is specifically drawn to condition (d) in COLL 5.2.11R(12) under which the collateral has to be legally enforceable at any time. It is the FSA’s view that it is advisable for an *authorised fund manager* to undertake a legal due diligence exercise before entering into any financial collateral arrangement. This is particularly important where the collateral arrangements in question have a cross-border dimension. *Depositaries* will also need to exercise reasonable care to review the collateral arrangements in accordance with its duties under COLL 6.6.4R (General duties of the depositary).

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Permitted transactions (derivatives and forwards)

- 5.2.20 R ...
- (5) A transaction in a *derivative* must not be entered into if the intended effect is to create the potential for an uncovered sale of one or more *transferable securities*, money-market instruments, *units* in *collective investment schemes*, or *derivatives* provided that a sale is not to be considered as uncovered if the conditions in COLL 5.2.22R(3) (Requirement to cover sales) are satisfied.

...

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Requirement to cover sales

- 5.2.22 R ...
- (3) Paragraph (1) does not apply where:
- (a) the risks of the underlying financial instrument of a *derivative* can be appropriately represented by another financial instrument and the underlying financial instrument is highly liquid; or
- (b) the *authorised fund manager* or the *depositary* has the right to settle the *derivative* in cash, and cover exists within the *scheme property* which falls within one of the following asset classes:

- (i) cash;
  - (ii) liquid debt instruments (e.g. government bonds of first credit rating) with appropriate safeguards (in particular, haircuts); or
  - (iii) other highly liquid assets having regard to their correlation with the underlying of the financial derivative instruments, subject to appropriate safeguards (e.g. haircuts where relevant).
- (4) In the asset classes referred to in (3), an asset may be considered as liquid where the instrument can be converted into cash in no more than seven *business days* at a price closely corresponding to the current valuation of the financial instrument on its own market.

Guidance on requirement to cover sales

5.2.22A G COLL 5.2.22R(3) to (4) reflect the provisions of Article 7 of the Commission Recommendation on the use of financial derivative instruments.

...

Risk Management process

5.2.25 G ...

(6) Firms carrying out the risk management process should note the methodologies set out in Article 3 (Appropriately calibrated standards to measure market risk) of the Commission Recommendation on the use of financial derivative instruments.

(7) In assessing the risk of OTC derivatives, firms should note the methodologies set out in Article 5.3 (Invitation to use the standards laid down in Directive 2000/12/EC as a first reference) of the Commission Recommendation on the use of financial derivative instruments.

...

Cover for transactions in derivatives and forward transactions

5.3.3 R ...

(5) The ~~total~~ global exposure relating to derivatives held in a UCITS scheme may not exceed the net value of the scheme property (Article 2(1) of the Commission Recommendation 2004/383/EC).