MATHESON ORMSBY PRENTICE

SUBMISSION IN RESPECT OF CONSULTATION PAPER (CESR/09-489) ON THE CALCULATION OF UCITS' GLOBAL EXPOSURE

Matheson Ormsby Prentice is one of the largest law firms in Ireland. It has a large banking and financial services practice serving both domestic and international financial institutions and it has a prominent asset management practice that serves the international mutual funds industry based in Ireland.

We welcome the proposals in Consultation Paper CESR/09-489 (the "**Consultation Paper**") to bring further clarity to concepts such as the commitment approach, Value at Risk and counterparty risk exposure and to ensure harmonisation of the approach adopted across the Member States and have set out below our comments in respect of some of the principal areas covered by the Consultation Paper. The comments below incorporate comments received from a number of clients with Irish authorised UCITS following a consultation process since publication of Consultation Paper by CESR on 15 June 2009.

Any capitalised terms used in this submission and not defined herein shall have the meaning given them in the Consultation Paper. We have not responded in respect of each of the 52 specific questions raised by CESR but have instead commented on the key proposals set out in the Consultation Paper.

Calculation of Global Exposure using the Commitment Approach

Clarification of scope of Global Exposure

We note the clarifications in section 1.1 of the Consultation Paper in respect of the calculation of global exposure and the approach that global exposure be reduced to its market risk dimension. We agree with the proposal that counterparty risk exposure remain the subject of the independent counterparty risk calculations and not be included in the global exposure calculation pursuant to Article 51(3) of the new UCITS Directive.

As a general comment, we note that while the definitions of the global exposure and total exposure of a UCITS are relatively settled, the definition of total exposure is derived from the global exposure limit and the proximity of terminology can create confusion amongst practitioners. As total exposure does not appear in the UCITS Directive, it may be worthwhile to abandon the total exposure definition and to refer instead to the concepts of (a) global market exposure; and (b) counterparty risk.

Proposals in respect of incremental exposure generated through repurchase and securities lending transactions

Our preference is that a UCITS should not be required to have regard to collateral received for securities lending and repurchase transactions for the purposes of its global exposure calculations.

This is on the basis that the primary purpose of securities lending transactions for UCITS is to gain additional income for the UCITS (through the relevant securities lending fees), rather than to leverage the UCITS through the reinvestment of collateral. We note that a UCITS may also receive collateral from counterparties to derivative transactions in order to reduce counterparty risk exposure and that there is no equivalent proposal in the Consultation Paper to include such collateral in global exposure calculations. In this regard, we note that Guidance Note 3/03 issued by the Irish Financial Services Regulatory Authority sets out restrictions in respect of the manner in which collateral may be reinvested. These are broadly consistent with the provisions regarding the reinvestment of collateral to mitigate counterparty exposure in respect of financial derivative transactions and the principles set out in section 3.3 of the Consultation Paper and we believe these provide protection to the UCITS in respect of the management of collateral which it may hold from time to time. Finally, it is unclear at this stage as to how the incremental global exposure generated through the re-investment of collateral might be calculated in practice and how the haircuts might be imposed in such calculations.

Commitment Approach – Calculation Methodology

We note the options set out in section 1.3 of the Consultation Paper in respect of derivatives with a "limited-loss" payoff function. Our preference is for Option 2, whereby UCITS would convert the position into the equivalent position in the underlying and then adjusts by the relevant Delta in order to take into account the likelihood of settlement. We believe this approach to be consistent with the approach taken for other financial derivative instruments (which generally looks to the underlying of the derivative) and to be a more accurate measure of the increased exposure gained by the UCITS through the use of the relevant derivative. By introducing a Delta based adjustment, the UCITS can allow for the likelihood of its actually exercising the option.

Some clients have observed that Option 1 (calculation by reference to maximum theoretical loss) might lead to unintended results where a UCITS has purchased large quantities of call options which are significantly out of the money and consequentially have a low premium. This UCITS may have a leveraged global exposure in circumstances where there was an increase in value of the underlying assets (call option becoming in the money) followed by decrease in the value of such underlying assets. For an investor subscribing into the UCITS when the calls are in the money, the global exposure would not be properly measured by the "maximum loss of the UCITS" (being the initial premium purchased).

We believe it may be useful, however, to offer further guidance in the on the use of Delta by a UCITS. There is a definition section in the Consultation Paper which refers to the Delta measuring the sensitivity of the option prices to changes in the price of the underlying asset. However, it may be useful to expand on this and to provide a discussion of circumstances in which Delta may change significantly and rapidly (for example, where a barrier option nears the relevant barrier) and those derivatives where Delta may not be meaningful.

Illustrative list of conversion methods for derivatives under the Commitment Approach

We welcome the illustrative list of conversion methods set out in section 1.4 of the Consultation Paper and note that this list is broadly reflective of the list included in the Irish Financial Services Regulatory Authority's Guidance Note 3/03.

We note the proposals in respect of "maximum-loss" payoff derivatives, where it is believed that such derivatives (including but not limited to binary/digital options, variance swaps and barrier options) should be subject to more conservative restrictions and it is suggested that these products should be calculated on a "maximum-loss " basis, where this amount represents a larger amount than the standard approach. Some clients have expressed concern as to how these proposals might operate in practice and have, in particular, raised the query as to whether a maximum loss calculation is appropriate given that the maximum loss on certain short positions is theoretically limitless. We believe it would be useful to offer greater clarity on these proposals in the consultation paper to be published by CESR in July.

Types of Financial Instrument which are not included in Global Exposure calculations

We welcome the proposals in section 1.5 in respect of types of financial derivative instruments which need not be included in the global exposure calculations.

Proposal Sensitivity Approach in respect of Interest Rate Derivatives

We welcome the proposals permitting a UCITS to use a sensitivity approach in respect of Interest Rate Derivatives. We understand that this will not be a compulsory change and that a UCITS will be able to elect to continue with the current approach or, alternatively, to use the Sensitivity Approach but it may be worthwhile to confirm that this is the case in the July consultation paper.

We would have a preference not to seek to set out detailed disclosures in the full prospectus regarding the use of the sensitivity approach and the relevant sensitivity interval. This is on the basis that to highlight the calculation methodology of one type of financial derivative instrument in this manner may detract from the proposed treatment of other types of financial derivative instruments. We believe that a UCITS which proposes to use a sensitivity approach should document this approach and the relevant parameters in full in its risk management process ("**RMP**"). It may then disclose in the relevant prospectus that a sensitivity approach is used and that fuller details are available in the RMP and such details will be provided to shareholders upon request. It is already a requirement for all Irish UCITS that it make available to investors upon request supplementary information to relating to the risk management methods employed including the quantitative limits that are applied and any recent developments in the risk and yield characteristics of the main categories of investments.

Consideration of Netting and Hedging effects

We favour the proposals in respect of netting and hedging and believe these to be broadly consistent with current requirements for Irish UCITS under Guidance Note 3/03.

However, we note that the proposals in relation to hedging in section 1.7.2 of the Consultation Paper require that the prices of both the positions to be hedged and the financial derivative instrument to (i) always move in opposite directions, <u>and</u> (ii) demonstrate a strong and negative correlation in all market conditions. We would prefer the existing formulation in the Irish Guidance Note 3/03 which permits hedging where the financial derivative instrument relates to the same underlying as the reference asset, rate or index and exhibits a high negative correlation; and/or it can be proved that the overall risk profile of the UCITS is reduced by the hedging transaction. We believe that the ability to demonstrate a reduction in the overall risk profile of the UCITS through hedging should be sufficient to allow the UCITS engage in such hedging transaction.

It should be noted that one of our clients had responded with a strong preference that hedging through different underlying assets should only occur on an exceptional basis for UCITS using the Commitment Approach. This was on the basis that the correlation between underlying and other hedging underlying may change (with the example given of equities and commodities) and that the monitoring of such change must be ensured by a suitable risk management process. We note that this concern may be addressed by the provision in section 1.7.2 of the Consultation Paper that the UCITS must be able to demonstrate that the prices of the positions to be hedged and the financial derivative instrument always meet the requirements outlined above. If a UCITS was not able to objectively demonstrate this, then the hedging would not be permitted.

Calculation of Global Exposure using the Value at Risk (VaR approach)

General Principles, Definition and Organisation

We believe the description of VaR in section 2.1 is in accordance with the common understanding of VaR and agree with the approach set out in section 2.2 to reconcile VaR methodology with the requirements of Article 51 of the new UCITS Directive. Having consulted with clients who use both the commitment approach and VaR as risk management tools, we support the view that, while the commitment approach may be more precise in measuring leverage (or global exposure) on a conservative basis, VaR is a better measure of market risk and, thus, might be more adequate to fulfil the requirements of assessing market risk and the concentration and interaction of risks.

We note the requirement in section 2.5 that the risk management model used must be internally validated by a function which is independent from that responsible for building the model and would welcome further clarification as to what is intended. In most cases, the risk management function for a UCITS is a dedicated unit within the investment manager which monitors risk on an ongoing basis and which is independent of the units in charge of managing and marketing the UCITS. The risk management model is designed by the risk management function in light of best practice, the relevant CESR guidance and the software designed or used by the risk management function. This model is then fully described by the risk management team in the RMP which is then reviewed and approved by the board of the relevant UCITS, or its manager. We believe that the approval by the relevant board should satisfy the internal validation requirement and would welcome confirmation on this point.

We note also the question as to whether it is considered that VaR models should be approved by competent authorities. As noted, the risk management model is described in detail in the RMP which, in Ireland, is submitted to the Financial Regulator for prior review and comment. We believe that to add to this process by requiring more formal approval of the VaR model might have a negative impact on the time to launch for any UCITS using a sophisticated risk management process.

Relative VaR

We agree that the three step approach set out in section 2.6 describes the appropriate methodology to be used by a UCITS in calculating Relative VaR.

In relation to the additional safeguards set out in section 2.7, we believe it sensible to take steps to ensure that there is a clear similarity between the UCITS and the reference portfolio in terms of exposure and risk. However, on consulting with clients as to the proposed qualitative limitations, we did receive some feedback that the limitations were too restrictive and/or did not provide efficient guidelines in light of the original objective of having an appropriate choice of reference portfolio for the UCITS. An alternative might be the use of statistical measurement such as “tracking error” (or comparison of risk-profiles over different periods of time) in order to capture the consistency between a UCITS and its reference portfolio than arbitrary and qualitative restrictions (such as similarity of asset class or of directional exposure). As an example, a low-volatility long/short strategy overlay applied to a long-only portfolio may not impact the very nature of the portfolio and would still be close to its reference asset (the long-only reference asset).

Absolute VaR

We believe Absolute VaR to be an appropriate method of measuring global exposure and that the thresholds set out in section 2.8 of the Consultation Paper are suitable. We also believe that it is appropriate to seek additional safeguards to be adopted by UCITS using leveraged arbitrage strategies, calculation methodology. It would be useful, however, to clarify the level of leverage which would apply before specific marketing restrictions are required and the type of additional disclosure required. In this regard, we believe it should be sufficient to provide for a specific disclosure in the Prospectus or Simplified Prospectus/ Key Information Document of the potential for higher leverage in the UCITS.

We would also appreciate further confirmation of those financial derivative instruments which CESR believes would prohibit the use of Absolute VaR as a calculation methodology (structured securities, credit linked financial instruments and financial derivatives designed to limit maximum loss at a given confidence level are given as examples in the Consultation Paper) and of the additional safeguards which CESR believes appropriate. We note that the effect of the reference in section 2.9 to ensuring that maximum loss and sensitivity to market movements in adverse conditions are consistent with the result of an amplification of market movements by a factor lower than 2 seems to be a de-facto imposition of a Relative VaR methodology.

Proposals in respect of Counterparty Risk Exposure

We welcome the clarification of the proposed method for calculating Counterparty Risk Exposure and the confirmation that the “add-on” for future credit exposure is not necessary. We note that the criteria outlined for determining suitability of collateral, including liquidity, valuation, credit quality, correlation with the OTC counterparty and diversification and have received some feedback from clients on the manner in which these criteria may be applied. These are generally supportive of the criteria subject to the following comments:

1. the Consultation Paper sets out a preference for collateral with short settlement cycles over collateral with longer settlement cycles, whereas some long-dated government bonds may be more liquid than shorter-dated securities; and

2. while it is agreed that correlation between collateral and the derivative counterparty must be avoided in general, there is already a restriction on the counterparty pledging its own debt as collateral and further guidance is sought on the criteria to be used in assessing correlation.

As collateral does not form part of a UCITS portfolio and is used only to mitigate counterparty risk and, given that the performance of the UCITS will not referable to the performance of the collateral received, we agree that collateral should not be subject to UCITS diversification requirements.

We also welcome the clarification in section 3.4 that the provision of collateral may form part of a derivative contract permitted by Article 50(1)(g) of the New UCITS Directive and is not in conflict with Article 32 and agree that it is appropriate to consider capturing any over-collateralisation in the issuer concentration limit of 20%.

Sophisticated v Non-Sophisticated UCITS

We would agree with the proposal to abandon the formal distinction between sophisticated and non-sophisticated UCITS as this terminology may in certain circumstances mislead an investor by suggesting that a sophisticated UCITS had a higher level of risk or more complex investment policy than a non-sophisticated UCITS (where the terminology is instead intended to describe the sophistication of the relevant UCITS' risk management procedures).

The prospectus and other fund documentation could still disclose the proposed method to measure global exposure (commitment approach or VaR approach).

For further information in relation to this client update, please contact Dualta Counihan at the details below. Full details of the Asset Management and Investment Funds Group, together with further updates and briefing notes can be accessed at www.mop.ie

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