J.P.Morgan
Asset Management

28th May 2010

CESR
11-13 avenue de Friedland
75008 PARIS
FRANCE

Dear Sir/Madam,

CESR/10-108: CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

Thank you for the opportunity to comment on your proposals published in CESR/10-108. I look forward to hearing from you if there is any clarification you would find useful on the points we have raised.

Yours sincerely

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1. Definition and scope of Global Exposure

1. Do you agree with the proposed Level 3 Guidelines for the definition and scope of global exposure?

a. We agree with the calculation frequency stated in Box 1, Point 1.
b. Regarding Box 1, Point 2. three methods are discussed, global exposure, VaR and 'any other methodology to calculate global exposure' (Box 1, 5.). The consultation document contains no guidance on this third category, other than the statement that the category exists. Therefore if UCITS are limited to 'those methodologies on which CESR has published level 3 Guidelines' an approval process matching the time to market of new fund products needs to be established to permit innovation within this third category.
c. VaR is superior to the commitment approach in that only VaR addresses the risk of leverage (volatility of unit prices in excess of that of the benchmark) and of underinvestment arising within the physical portfolio. A similar advantage is found in ex-ante tracking error. The complexity introduced to the commitment method by the proposed guidelines has potentially rendered the advanced VaR methodology, and ex-ante tracking error if permitted within the third category, both simpler and cheaper to execute than the commitment method. For this reason the obligation to apply an advanced risk measurement methodology when derivative usage exceeds a stated threshold should be supplemented with recognition that an advanced method might be adopted on grounds of simple superiority.

2. Do you have any alternative suggestions?

See above

2 Calculation of Global Exposure using the Commitment Approach

2.1 Conversion Methodologies

2.1.1 Standard Derivatives – Embedded Derivatives and Non-Standard Derivatives

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3. Do you agree with the proposed conversion methodologies for the different types of financial derivative instrument?

Overall comments:

The notional values calculated below are in the local currency of the instrument and should be converted into base currency equivalent using the spot or forward rate as appropriate.

In discussing futures and options on futures reference is often made to the tick value method. A tick is the smallest movement in the price of a future for which variation margin will be paid and the tick value is the amount of margin that is paid for a one tick movement on one contract. In the calculation methods set out below we use the factor 'cash value of one point'. The relationship between a tick value and the cash value of one point is tick value / tick size in points = cash value of one point. The tick value method is preferred to applying contract size, because the tick value method corrects the overstatement which arises in interest rate futures but produces identical results for other types of future and option on future.

Bond Future

3. No. Using the price of the cheapest to deliver is computationally complex, as it requires selection of one among a changeable list of cheapest to deliver bonds. The apparent gain in accuracy is eliminated by the inaccuracy of subsequent netting, hedging and sensitivity processes.

4. Use number of contracts * notional contract size * market price of the future in points * price factor.

e.g. A Bund future has a contract size of EUR 100,000. If 177 contracts are held and the current price is 115.96 the commitment is:

177 * EUR 100,000 * 115.96 / 100 = EUR 20,524,920.

The same result may be obtained by the following calculation, which is consistent with that applied to interest rate and index futures: number of contracts * cash value of one point * market price of the future in points.

The Bund future has a cash value of one point of EUR 1,000. Applying this preferred method the commitment is:

177 * EUR 1000 * 115.96 = EUR 20,524,920.

Where price is quoted on a yield basis, as in Australian bond futures, use number of contracts * notional * fair value of the underlying.

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For example, a fund is long 1094 contracts of Australian 3 year bond futures, which are quoted on a yield basis. The futures price is 98.31, corresponding to a yield of 100 – 98.31 = 1.69%. The notional per futures contract is AUD 100,000 and the coupon is 6%. Using the formula published by the Sydney Futures Exchange the underlying value per futures contract comes out at AUD 112,556.05. The commitment is thus 1094*AUD 112,556.05 = AUD 123,136,318.70.

Interest Rate Future

3. No. The calculation 'change in value divided by percentile price movement equals effective market exposure' is a useful tool for assessing the appropriateness of methods of calculating the exposure from linear instruments. This test indicates that using contract notional overstates the exposure four or twelve fold depending on whether the duration is a quarter or a month. Overstatement will give rise to use of one month interest rate futures to hedge away exposures in the zero to two year bucket at minimal expense in terms of duration impact.

4. Use number of contracts * cash value of one point * index level in points.

For example, a fund is long 80 contracts of a 90 day Sterling interest rate future. The value per point is GBP 1,250 and the current price is 95.16. The commitment is 80 * GBP 1,250 * 95.16 = GBP 9,516,000

Currency Future

3. No. There should be two legs, one of which may be disregarded if in base currency.

4. Use number of contracts * notional contract size(s)

Equity Future

3. No.

4. Use number of contracts * notional contract size in units of the underlying equity * local currency price of the underlying equity

Index Futures

3. No.

4. Use number of contracts * cash value of one point * price of the future in points.

For example, the S&P/MIB future has a value per point of EUR 5. The current price is 30,595. The commitment of a long position in 30 contracts is 30 * EUR 5 * 30,595 = EUR 4,589,250.

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Plain Vanilla Bond Option

3. No.

4. Use number of contracts * cash value of one point * local currency price of the underlying in points * delta.

Plain Vanilla Equity Option

3. No.

4. Use number of contracts * number of underlying shares per contract * price of the underlying share in local currency * delta.

Plain Vanilla Interest Rate Option

3. No.

4. Use number of contracts * cash value of one point * underlying index level in points * delta.

Plain Vanilla Currency Option

3. Yes.

4. N/A.

Plain Vanilla Index Options

3. No.

4. Use number of contracts * cash value of one point * price of the underlying index in points * delta.

Plain Vanilla Options on Futures

3. No.

4. Use number of contracts * cash value of one point * price of underlying in points * delta.

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Plain Vanilla Swaptions

3. Yes.

4. N/A.

Warrants and Rights

3. We suggest that rights should be excluded as they are not normally treated as derivatives. Similarly low exercise price options (LEPO) should be excluded, as their market value is similar to their exposure value.

4. For warrants use number of warrants * number of units of the underlying per warrant * price of one unit of the underlying * delta.

Plain Vanilla Fixed/Floating Rate Interest Rate and Inflation Swaps

3. No. Notional is the best basis for matching a swap and a hedged instrument.

4. Use notional value of the fixed leg. Choice of the fixed leg determines the sign to be used in netting and hedging - receive fixed is long, pay fixed is short.

Currency Swap

3. Yes.

4. N/A.

Cross currency Interest Rate Swaps

3. Yes.

4. N/A.

Basic Total Return Swap

3. Yes.

4. N/A.

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Non-basic Total Return Swap

3. Yes.

4. N/A

Single Name Credit Default Swap

3. No.

4. Use notional value. For the purposes of netting and hedging, buy protection = negative notional = short. Sell protection = positive notional = long.

Contract for Differences

3. Yes

4. N/A

FX forward

3. We agree with the calculation method. However, there are particular problems arising from cross FX transactions which require consideration. In a cross FX, say a USD/GBP forward in a fund with a base currency of EUR, the risk factor is the USD/GBP exchange rate and the exposure should be the notional value. The methodology of splitting the instrument into two legs creates initially exposures to two exchange rates, USD/EUR and EUR/GBP. The same double count may arise in currency swaps, cross currency interest rate swaps and plain vanilla currency options. We recognise that netting procedures, particularly in the currency of the short leg, may subsequently reduce this double count to a single count. However, in moving foreign exchange exposure from one foreign currency to another a cross hedge arguably does not meet the global exposure definition of incremental exposure and on this basis cross hedges could be totally excluded from global exposure calculations. 4. The basic formula for FX forwards should be notional value of the currency leg(s).

Forward rate agreement:

3. No.

4. We recommend using the notional of the fixed leg. The fixed leg determines the sign of the exposure, which is needed for netting and hedging purposes.

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Convertible bonds

3. No. Arbitrage will keep the market value of the bond and that of the underlying equity roughly in line. There is no conversion to the equity without elimination of the bond, hence this instrument does not create significant incremental exposure.

4. Exclude convertible bonds from global exposure calculations.

Credit linked notes

3. Yes. 4. N/A.

Partly paid securities

3. No. Treat this as a physical.

4. N/A

Warrants and Rights

3. We agree with the calculation method for warrants. We would suggest that rights should be excluded as they are not normally treated as derivatives. Similarly low exercise price options (LEPO) should be excluded, as their market value is similar to their exposure value.

4. N/A

Variance swaps

3. No comment.

4. N/A

Volatility swaps

3. No comment.

4. N/A

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Barrier (knock-in knock-out) Options

3. Our initial reaction is that applying maximum delta is more indicative of a stress scenario than of an attempt to estimate the current market value of underlying exposure. We can identify some cases in which use of the maximum delta is actually inappropriate. For instance in the case of down-out-puts (which are embedded derivatives in bonus certificates) it is possible to find maximum deltas of the order of 10,000% shortly before the maturity of the option, and higher values can arise.

4. In our opinion UCITS should be given the discretion to use the maximum economic exposure as the commitment value when this is considered appropriate.

4. Do you have any alternative suggestions?

a. See the response to question 3.

5. Do you find the numeric examples useful in providing further clarity?

The provision of numeric examples provides clarity to both the provider and the recipient. The default should therefore be to provide numeric examples. Measures for an entire portfolio, such as the application of exclusions per Box 4, netting and hedging to derive global exposure, should be illustrated with entire demonstration portfolios in Excel format.

6. In particular, do you consider that the use of the market (or notional) value of the underlying reference asset for a credit default swap is appropriate? Do you have any alternative suggestions?

Use of the notional value would be easier to apply, particularly in the case of basket CDS. A CDS provides default protection for a specified notional amount of the reference security. However, in matching for the purposes of netting or hedging both the CDS and the reference instrument, or similar instruments of the same issuer, should be quantified in terms of notional in base equivalent.

2.1.2 Types of financial derivative instruments which may be excluded from the global exposure calculation

7. Do you agree that derivatives which do not result in incremental exposure for the UCITS should be excluded from the global exposure calculation? If you do not agree please explain your answer

Yes. 2.1.2 offers the potential to exclude from global exposure derivatives used to equitise cash. This is sensible as equitisation does not bring market exposure above 100%. The remaining measure of global exposure is more closely related to

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investors' concept of leverage as exposure in excess of 100%. It is necessary to clarify whether the concession may be applied to synthetic cash created by short futures. This is advisable, as transfers of exposure under tactical asset allocation do not increase aggregate market exposure. In addition in simple equity funds the netting of actual and synthetic cash offers a quick method of ensuring that total investment exposure does not exceed 100% of NAV.

8. Do you consider that the examples provided in the explanatory text properly reflect circumstances which do not result in incremental exposure for the UCITS?

Yes, this is simply recognition of epm strategies providing a synthetic alternative to physical securities.

2.1.3 Netting and Hedging

9. Do you agree with the proposed definitions of netting and hedging?

In the document the criteria for netting and hedging are clearly expressed. However, no attempt is made to address the issue of hedging to benchmark, an alternative concept found in some prospectuses under which the investor is seen as contracting for benchmark exposure and derivatives which move exposures towards benchmark weights are classified as hedges, even if they raise exposure. This approach recognises the risks both of overinvestment and underinvestment. Similarly no guidance is given to the treatment of derivatives the financial impact of which is restricted to specific share classes, such as selling base currency forward and buying a foreign currency to create a non-base hedged share class. Within the overall portfolio the forward FX deal would appear to generate additional exposure, but the financial impact on the related share class is that of a hedge.

Box 5, 4. prohibits the use of hedging and netting arrangements to reduce commitment on derivatives if the UCITS uses a conservative calculation of their commitment value, rather than an exact calculation. The principle of allowing conservative imprecision when measuring against maximum limits is well established and paradoxically is actually applied by this prohibition of the principle. It is advisable to quantify the impact of the prohibition. It is likely that global exposure measures will be increased by the absolute notional, unreduced by a delta, of all rights, warrants, convertible bonds and options for which a default delta of 1 is applied in the absence of a precise delta from a data vendor or from an in-house analytical system. In addition where the UCITS' monitoring system cannot perform the dynamic selection of the price of the cheapest to deliver, the options netting, hedging and offset by the sensitivity approach will not be available and the absolute notional of all bond futures will be added to the measure of global exposure. The quest for precision at the individual instrument level will therefore potentially severely overstate the final global exposure measure. It would be advisable to allow UCITS to avail themselves of the convention to which CESR itself has needed recourse.

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10. Do you agree with the proposed criteria for netting and hedging in order to reduce global exposure?

The conceptual difference between netting and hedging is clear.

Box 5, Point 6, bullet 1 excludes from hedging strategies that aim to generate a return. Hedging is a strategy which works precisely by generating in the hedging instrument a return which offsets a loss foreseen in the hedged instrument. Application of this test is therefore unsafe. For instance a Brazilian investor selects a Brazilian Real hedged share class as an alternative to a standard USD denominated unit precisely because he thinks he will make more money.

Explanatory text 20, bullet 3 introduces a significant, but appropriate innovation, namely the multiple allocation of derivatives as hedges for a single physical instrument. A bond is hedged with a credit default swap and an interest rate swap. No reason is given not to permit the application of a third instrument, namely a forward to hedge currency risk in the bond. Permitting the offsetting of multiple derivatives against a single physical instrument in hedging, while not permitting the combination of multiple derivatives to generate an equivalent underlying instrument, is asymmetrical. Under the commitment method a 10% position in a foreign currency government bond counts as 10% of NAV, but a synthetic equivalent created with a future and currency forward is counted as 20%.

The criteria applied in Box 5 are the aims of derivative strategies, the impact on the portfolio, the risks linked to derivative instruments, and their effectiveness in stressed market conditions. These factors are not directly recorded as parameters in trade, position or instrument records and they cannot be readily derived by automated analytical procedures applied to portfolios. In addition the proposal requires multiple iterations of a series of judgements to simulate exclusion of equitisation, netting, and hedging. During this process it is necessary to control the frequency with which positions in specific instrument types are offset, the frequency being adjusted depending on which phase the calculation is performing: exclusion of equitisation, netting, hedging, or conversion to absolute. Application of 2.1.5 option one or two adds to this process bucketing of fixed income instruments by duration or maturity and the application of factors determined by the distance between offset buckets. For many simple portfolios, in particular unsophisticated fixed income and balanced funds, the document renders the VaR method organisationally less complex than the commitment method, in addition to which only the VaR method deals with physical leverage. Industry packages already in use by portfolio managers, such as Factset and Barra, produce data on the risk of the aggregate portfolio which is not dissimilar to VaR. The third category, any other methodology to calculate global exposure, requires development.

11. Do you have any alternative suggestions?

See the response to question 10.

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12. Do you agree with the examples provided of strategies where netting is possible?

Yes

13. Do you agree with the examples provided where hedging is possible?

Yes

14. Do you agree with the examples provided where hedging is not possible?

Yes. However, in a production environment it is unclear how a gradual conversion from the scenario in explanatory text 20 bullet point 2 to that in 21 bullet point 2 would be identified.

In particular do you agree that so-called beta-hedging strategies may not be taken into account for hedging purposes when calculating global exposure?

In explanatory text 20 bullet three a bond has its default risk removed with a credit default swap and its interest rate exposure removed with a swap. This is classified as meeting the criteria for hedging. In explanatory text 21 bullet two, the beta is removed from a basket of shares but the alpha exposure is retained. This is disallowed because the objective is to retain the alpha exposure. On this basis it would appear that buying foreign equities and hedging the FX exposure to base would have to be disallowed because there is an intention to retain the equity market exposure. In the same vein hedging only the default risk in the abovementioned bond might fall to be disallowed as a hedge. More rigorous criteria are required, or clarification. Similarly the status of the hedge applied to create a hedged share class needs to be clarified

2.1.4 Efficient Portfolio Management Techniques

15. Do you agree with the proposed approach to the treatment of leverage generated through efficient portfolio management techniques?

Yes.

16. Do you have any alternative suggestions?

The concept of risk free requires clarification. An approach based on the yield of short dated domestic sovereign debt in base currency may fail in a Greek UCITS. Diversification, credit rating and duration factors may need to be included.

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2.1.5 Sensitivity Approach

17. What are the advantages and disadvantages of each methodology?

Advantage: both options attempt to address the issue of variable sensitivity to market movements in fixed income portfolios. Disadvantages: excessive complexity, inability of commercial compliance monitoring systems to perform calculations in accordance with these methods, cost of a bespoke internal systems development, at best a very approximate method of handling correlation.

18. Which methodology do you consider more appropriate? Please give explanations and indicate whether additional safeguards should be included.

Option 2. The critical point is that portfolio managers will have to perform pretrade calculations to ensure that they remain within the limits. Option 1 is too complex. The value of 150% for step 6 (c) appears excessive when compared with the understandable 100% for 6 (d) and the equivalent 75% of 7(c). Option 1 is based on too many assumed values (1%, 0.85%, 0.7% interest changes, non-correlations of 2%,40% and 150%, and the 12.5 grossing up factor) Option 2 is nearer to the method employed by portfolio managers. The difference between duration in option 1 and maturity in option 2 is offset by imprecision introduced by employing zones, amounting to an incremental 40% of a matched position arising from a minimal shift in duration/maturity taking it from one zone to the next. Overall we would recommend adapting the mental arithmetic technique employed by portfolio managers: for each position calculate years of duration contribution by modified duration in years * weight of tick value notional within the portfolio, assign duration contributions to zones based on the duration of the instrument, match to derive the total amount in years of duration contribution, and finally convert to commitment limit usage by total amount in years of duration contribution/benchmark duration in years %.

In our opinion dictating the range and size of buckets to be used is unwise. Some funds may warrant a more granular approach in their bucket structure than others. In addition at times of market stress assumed correlations within a bucket may be lost and adjustment to the structure may be necessary. Better would be to define a reliable methodology for calculating the percentile factors to be applied when matching adjoining and more remote buckets – see Box 8 7.

19. In the last step of Option 1, the total amount is multiplied by 12.5. Do you consider that (i) this takes due account of the sensitivity of the UCITS and (ii) that this is in line with the commitment conversion methodology (e.g. conversion of the derivative into the market value of the equivalent position in the underlying assets)?

No. 12.5 is not adapted to the particular fund. A more appropriate figure is obtained by calculating total amount in terms of years of duration contribution , and

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then converting it (a) into commitment limit usage by applying the calculation total amount in years of duration contribution/benchmark duration in years %, or (b) into a base currency value by applying the calculation total amount in years of duration contribution/benchmark duration in years * NAV in base currency.

20. Under option 2 the target sensitivity of the UCITS can be longer than the sensitivity of the derivative while the equivalent underlying position is relatively small. This can result in high levels of leverage within the UCITS. Please provide views on the additional safeguards that could be introduced to mitigate this risk.

An apparent problem of high levels of leverage in a UCTS associated with target sensitivity of the UCITS exceeding that of the derivative is simply the product of viewing size and sensitivity separately. A tick value approach or duration contribution approach handles exposures without having to split one exposure into two factors.

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

3.1 General Principles and general requirement

21. Do you agree with the general principles outlined for the use of VaR?

Yes

3.2 VaR Approaches – Relative VaR and Absolute VaR – The Choice

22. Do you agree with the proposals regarding the choice of the VaR approach?

Yes

3.3 Relative VaR approach

23. Do you agree with the proposed approach regarding the use of the relative VaR?

Yes

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24. Do you agree with the proposed criteria for the reference portfolio?

Partial agreement. Re explanatory text 50,"a long-only benchmark should not be used as a reference portfolio for a long/short strategy", we would see a 130:30 fund as being primarily a long 100 fund with an additional 30/30 overlay. In that context we would suggest that using the long only portfolio as the reference is a reasonable approach, and if anything somewhat conservative.

25. Do you have any alternative suggestions?

No

3.4 Absolute VaR approach

26. Do you agree with this description of absolute VaR?

Yes

3.5 Minimum requirements for VaR approach

3.6 VaR approach: Quantitative requirements

3.6.1 Calculation Standards

27. Do you agree with the calculation standards proposed for the VaR approach?

Yes

28. Do you agree with the proposals regarding setting different default parameters and rescaling?

Yes

29. Do you consider the examples for the rescaling of parameters are useful in providing further clarity?

Yes

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30. Do you have any alternative suggestions?

No

3.6.2 Risk Coverage

31. Do you agree with the requirement regarding the risks which should be taken into account in the VaR model?

Yes.

3.6.3 Completeness and accuracy of the risk assessment

32. Do you agree with the proposals regarding the completeness and accuracy of the risk management process?

Yes

3.6.4 Back Testing

33. Do you agree with the proposals regarding back testing of the VaR model?

Yes

34. Do you have any alternative suggestions?

No

3.6.5 Stress testing

35. Do you agree with the proposals regarding the VaR stress testing programme?

Yes.

36. In particular do you agree with the proposed quantitative and qualitative requirements?

Yes

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37. Do you have any alternative suggestions?

No

3.7 VaR approach: Qualitative requirements

38. Do you agree with the proposed tasks under the responsibility of the risk management function?

Yes

39. Do you agree with the requirements regarding model testing and validation?

Yes

3.8 VaR: Additional safeguards and disclosure

3.8.1 Additional safeguards

40. Do you agree with the proposals regarding the monitoring of leverage and the use of other risk measurement methods?

1. UCITS using VaR to regularly monitor their leverage - No. VaR itself is a measure of leverage superior to that defined in Box 23 3, hence Box 22 1. adds minimal value. 2. Partial agreement - shortfalls perceived in current exposure measurement would be addressed initially by innovation within the stress testing process.

3.8.2 Disclosure

a) Prospectus

41. Do you agree with the proposals regarding prospectus disclosure?

1. Disclosure in prospectus of method used for the calculation of global exposure - Yes. 2. UCITS using VaR - disclosure in prospectus of expected level of leverage and possibility of higher leverage - No. 3. Leverage calculated as the sum of the notionals of derivatives used - No.

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42. In particular do you agree that UCITS using VaR to calculate global exposure should disclose the expected level of leverage in the prospectus?

No. Investors' concept of leverage is one of incremental market exposure – "Leverage is an investment technique in which you use a small amount of your own money to make an investment of much larger value". Box 23 3. adopts a regulator's definition, namely the sum of the notionals of the derivatives used, which disregards whether the derivatives increase or decrease market exposure. As illustrations of the potential impact of this approach (a) a US equity fund consisting solely of common stocks would be correctly portrayed as unleveraged, but a clone in which all foreign exchange risk had been eliminated by hedging to base would be reported as 100% leveraged, (b) among accounts using VaR, a 200% long/short market neutral fund structured with total return swaps would be reported as having the VaR of a bond fund and 400% leverage, and (c) hedged share classes would be reported as leveraged. These conceptual differences would confuse investors.

43. Do you agree with the proposed method of calculating leverage for the purposes of prospectus disclosure?

No. See the response to question 42. An enhanced, educational approach based on VaR would be better.

b) Annual reports

44. Do you agree with the proposals for disclosure in the UCITS annual reports regarding the VaR methodology?

No (a) It is necessary to clearly state that the VaR limit of which utilization data would be published is the regulatory limit (20% absolute or two times benchmark). A published internal limit would no longer be internal. In an absolute VaR fund publication might also render it ineffective as a cap on market exposure, as there would be a tendency to increase limits to reduce the risk of breaches. (b) VaR is only one of a range of available risk measures and often is secondary to other risk measures employed by the portfolio manager. (c) The high and low levels of VaR for some funds may vary considerably over time reflecting different market conditions.

4 OTC Counterparty Risk Exposure

4.1 Collateral

45. Do you agree with the proposals in Box 25? In particular, do you consider that the proposed criteria for the acceptability of collateral to reduce counterparty exposure are appropriate?

Yes, except box 25 1. bullets 7 (collateral must be held by a third party custodian) and 9 (collateral cannot be sold, re-invested or pledged): (a) In securities lending with the receipt of cash collateral compensation is earned by reinvesting the cash

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collateral and sharing the yield with the collateral giver. Similarly receiving cash collateral in respect of OTC derivatives would entail an obligation to generate a yield by means of risk free investment. (b) Bullet 7 is unclear as to whether tri-party collateral arrangements are required or not.

46. Do you have any alternative suggestions?

No

47. Do you consider that it would be useful to include some examples of minimum haircuts for different asset classes? Do you have a preference on what these haircuts might be?

No. Haircuts are set by market standards and imposing a higher standard would simply render UCITS uncompetitive in markets such as that for securities lending. It would be better to impose on the UCIT an obligation to assess the adequacy of the haircut for the particular combination of exposure type, collateral type, revaluation frequency, speed of collateral top up, and currency of denomination.

4.2 Counterparty/issuer Concentration

48. Do you agree that exposure to a clearing house should be considered as part of the counterparty exposure limit? Do you have any alternative suggestions?

No. If the clearing house mitigated exposure to the counterparty the exposure to the clearing house would be contingent. In addition if the liabilities of the clearing house were met by the members this would also be a diversified exposure.

49. Do you agree that margin passed to a broker which is not protected by client money rules should be included in the counterparty exposure limit? Do you have any alternative suggestions?

Yes. If legally offsettable against the loss covered by the margin the exposure would be reduced to any haircut.

Comment:

50. Do you agree that exposures to a counterparty generated through stock-lending or repurchase agreements should be included in the OTC counterparty exposure limit? Do you have any alternative suggestions?

No, these are collateralised exposures. The UCITS should have procedures to check periodically that the collateral process is ensuring adequate cover.

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51. Do you agree that a UCITS position exposure should be calculated using the commitment approach?

Yes. The consultation has failed to address regulatory arbitrage relating to grouping. The CSSF do not require group level testing for the 5/10/40% tests and only require testing at the ultimate parent level in the complex 20% test. Under COLL, by contrast, testing of the 5/10/40% rule is applied at the ultimate parent level.

5 Cover rules for transactions in Financial Derivative Instruments

52. Do you agree with the proposed cover rules for financial derivative instruments?

Yes

53. Do you think there should be further restrictions on the assets held by the UCITS as cover?

No. Haircuts are set by market standards and imposing a higher standard would simply render UCITS uncompetitive in markets such as that for securities lending. It would be better to impose on the management company an obligation to assess the adequacy of haircuts to cover volatility.

6 Glossary of Terms

54. Do you agree with the proposed definitions?
55. Do you consider that CESR should provide other definitions in these guidelines? Do you have any suggestions for other definitions?

54. Yes
55. No

CESR's initial views on specific guidelines for structured UCITS

56. Do you consider that these types of structured UCITS should calculate global exposure using an approach which differs from the standard VaR and commitment methodologies?

Yes. The UCITS 3 part 1 restrictions are designed to protect investors who (i) invest in a dynamic structure, (ii) may subscribe at any time, (iii) have invested with an uncertain payout, and (iv) may take that payout at any time in the future. In the structured funds in question investors (i) have selected a static structure, (ii) generally invest at the beginning of the life of the fund, (iii) expect a defined payout, and (iv) expect that payout at a defined future date. Modification of the structure in

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reaction to intervening passive breaches will put attainment of the investment objective at risk. Such funds often benefit from external guarantors. The guarantors themselves rely on the static nature of the structure in giving that guarantee. Modification in reaction to passive breaches therefore also potentially deprives investors of the protection of the external guarantee.

57. If you agree that a different commitment calculation should be permitted, please provide a rationale for this approach.

We would leave the proposal of a different commitment calculation to asset managers who develop such products.

58. Please indicate which of the above criteria would provide sufficient safeguards for investors in UCITS which apply this approach

Not applicable.

59. Can you suggest any additional criteria?

Not applicable.

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