Alternative Investment Management Association

Committee of European Securities Regulators,
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FRANCE

Submitted online to CESR (www.cesr.eu)

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Dear Sirs,

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

The Alternative Investment Management Association (AIMA)[1] is pleased to have the opportunity to respond to CESR's consultation on its proposals for level 3 guidance to accompany the level 2 implementing measures in the context of risk measurement and the calculation of global exposure and counterparty risk for UCITS.

Interest and issue for AIMA members

As you will be aware, there has been a great deal of interest from hedge fund managers recently in launching UCITS funds.

We note that CESR's paper seeks to harmonise and (to some extent) prescribe many aspects of risk management in UCITS. We limit our comments to an issue of very significant concern for our members - that covered in section 4.2 of the consultation and addressed in question 48. The consultation proposes that where the credit exposure of a UCITS' OTC derivatives counterparty is novated to a central clearing house, the risk exposure for the purposes of the UCITS concentration limits (in Article 52(1) of the UCITS Directive[2]) would be that of the central counterparty (CCP), thus limiting exposure only to that CCP. AIMA would argue that CESR's approach is inconsistent with the wider political and regulatory aim of encouraging the use of central clearing, and is inconsistent with similar provisions on exchange traded derivatives.

Specific comments

All UCITS funds are currently governed, in terms of counterparty risk, by Article 52(1) of the UCITS Directive, which limits the risk exposure of a UCITS fund to a counterparty to an OTC derivative trade to 5% of its assets (or 10% if the counterparty is a credit institution).

On this issue, Box 26 on page 45 of the consultation paper provides that:

"The following exposure must also be calculated within the OTC counterparty limits specified in Article 52(1):

- "Any exposure with a central clearing house whereby exposure with the OTC counterparty is novated to the clearing house. **In this case the risk exposure is with the clearing house and not the OTC counterparty**."

1 AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,100 corporate bodies in over 40 countries.

2 Directive 2009/65/EC.

The guidelines propose that the UCITS 5% (or 10%) concentration limit apply to the risk exposure to the CCP for OTC derivatives novated from a counterparty to a central clearing party. The consequence of which is that the UCITS is limited in the exposure it can take to the CCP, not the exposure it can take to the counterparty.

Such a requirement places the risk exposure with the CCP instead of the OTC derivatives counterparties for the purposes of the UCITS concentration limit, and thus actively discourages the use of such clearing houses by limiting possible trades that can be done with the CCP. This is contrary to the move by European regulators and policy makers to encourage OTC derivatives to be centrally cleared, to mitigate counterparty risk. Such mitigation of counterparty credit risk is one of the many initiatives undertaken by regulators globally to ensure greater financial stability.

The concentration rule is in place to avoid too big a build-up of credit risk with a single counterparty. CCP clearing is being introduced as a means of reducing counterparty credit risk, – i.e. the risk that the counterparty will default before completion of the contract - which is mitigated by the CCP (designed to be well capitalised and subject to funding arrangements that prevent failure) taking the place of the buyer for every seller and of the seller for every buyer. Accordingly, an OTC derivative counterparty that novates its exposure to the clearing house is *a priori* less risky for the UCITS than with the original counterparty and it follows that, if the European Commission wishes to encourage CCP use, limiting the exposure of a UCITS fund to a clearing house on the grounds of reducing counterparty credit risk does not make sense.

The proposal is also inconsistent with provisions, as seen in the UK implementation of the UCITS Directive at COLL 5.2.11 R (14) of the FSA handbook, that exempt from the UCITS risk concentration limits exchange traded derivatives which are cleared by a clearing house, margined daily and backed by a clearing member's default guarantee fund. In such situations, the UCITS' exposure is determined to be "free of counterparty risk", and thus it is not required to count such exposure towards its concentration limits.

Summary
In summary, we point out that the proposal that a UCITS counterparty would be a clearing house where an OTC derivatives counterparty novates their contract to the clearing house is inconsistent with:

- EU regulators and policy makers' wishes to have more OTC derivatives centrally cleared; and
- the fact that exchange traded derivatives are effectively exempt from the UCITS concentration limit where they are, amongst other things, cleared at a clearing house.

To proceed with such guidance would have the effect of stifling development of central clearing of OTC derivatives by UCITS funds, and undermine efforts to reduce counterparty risk in the market and improve financial stability.

We urge CESR to reconsider the guidance and we are, of course, very happy to provide any further comment or information to assist consideration of this issue.

Yours sincerely,

Mary Richardson
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