



22 October 2014

Steven Maijor
European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

Online to: www.esma.europa.eu

Dear Mr Maijor,

ESMA/2014/876

Discussion Paper on the Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to central clearing obligations

The Depositary and Trustee Association ("DATA") represents all depositaries and trustees of UK based authorised funds. At the end of October 2013, the members of DATA were responsible for safeguarding £765 billion of fund assets, a substantial proportion of which are held in UCITS.

DATA's members provide depositary services to UK authorised collective investment schemes including UCITS. Our members have responsibility for the safeguarding of the scheme property of the UCITS and therefore welcome the discussions on the appropriate measures to manage counterparty risk for both cleared OTC derivative transactions and Exchange Traded Derivatives (ETDs). We agree the level of segregation should determine the counterparty risk limits of the UCITS in respect of exposure to clearing members (CMs), and recognise that this may require some amendments to Article 52 of Directive 2009/65/EC (as amended by Directive 2014/91/EC).

65 KINGSWAY LONDON WC2B 6TD TEL: +44 (0)20 7831 5873

WEBSITE: www.datasoc.co.uk

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Please find attached DATA's response to the questions raised in the discussion paper.

Please do not hesitate to contact me if you would like to discuss any of the points we have raised.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Darren Banks', with a stylized, flowing script.

Darren Banks
DATA Deputy Chairman

DATA Response to ESMA/2014/876

Discussion Paper on the Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to central clearing obligations Summary

Responses to Questions

Question 1: Do you agree with the assumptions above? (Section III)

In the context of this discussion paper we agree that UCITS exposure to the default risk of an EU CCP or an ESMA recognised non-EU CCP is outside the scope of the paper. However, whilst the risk of default of an EU CCP or an ESMA recognised non-EU CCP may be considered low, it is accepted that these entities are not risk-free so the risk of default should not be ignored. EU CCPs and ESMA recognised non-EU CCPs may, in present market conditions, be considered as market infrastructures with relatively low counterparty risk but, as we have seen, events can occur that were not foreseen and could result in the default of one or more CCPs.

Question 2: In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA-recognised CCPs for which counterparty risk may not be so low? If so, please explain.

Yes, DATA agrees that in theory the counterparty risk of all ESMA-recognised CCPs may be regarded as relatively low. DATA understands that to date no non-EU CCPs have been recognised by ESMA but takes the view that if, in future, concerns relating to the counterparty risk applicable to one or more ESMA-recognised CCPs were identified, then these matters should be investigated and, if the concerns prove to be justified, recognition withdrawn.

Question 3: Do you think UCITS should apply any counterparty limits to ESMA-recognised CCPs? What should be the limits?

If it is deemed necessary to apply counterparty risk limits to CCPs they should be applied consistently to both EU and ESMA recognised non-EU CCPs, once the latter receive recognition.

Question 4: Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.

DATA agrees that when assessing counterparty risk vis-à-vis the CM the type of segregation arrangement should be taken into account.

Question 5: When assessing the counterparty risk for centrally-cleared OTC derivative transactions, do you think that UCITS should look at other factors than the segregation arrangements? If yes, what are those factors?

Yes, UCITS are potentially exposed to the default of the CM (and the client of the CM where indirect clearing arrangements are entered into) after a position has been established but

before assets can be posted to the CCP. Consequently, due diligence should be undertaken by the UCITS to assess, inter alia, the default risk of the CM (and in the case of indirect clearing the client of the CM).

Question 6: Do you agree that under an individual client segregation UCITS have a low counterparty risk vis-à-vis the CM for all the assets posted (initial margins, variation margin and excess margin if applicable)? If not, please justify your position.

Yes, because there is no co-mingling of the margin posted by the UCITS to the CM with the margin posted by the CM's other clients.

Question 7: Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?

Although counterparty risk may be considered low, such arrangements are not risk-free so the risk of default should not be ignored. However, no counterparty risk limits need be applied under individual client segregation provided that the UCITS Management company is satisfied on an ongoing basis that the laws and jurisprudence applicable to the CM recognise the segregation for the UCITS assets from those belonging to the CM itself or its other clients, otherwise the UCITS 5%/10%/20% counterparty risk limit in Article 52(2) second paragraph should be applied.

Question 8: To what extent do you think that the liquidation of derivative positions by a CCP in respect of a defaulting CM (and the associated market risk) is a significant likely scenario that should be taken into account by the UCITS?

Where Individual Client Segregation arrangements apply this should facilitate the porting of margin and return of margin should be certain. The risks arising from the liquidation of derivative positions could be dealt with by appropriate investor disclosure by the UCITS in the Prospectus.

Question 9: Do you agree that UCITS should apply the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs? If not, please justify your position.

Yes.

Question 10: Notwithstanding the choice of segregation model, do you believe that the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk should be assessed on a case-by-case basis?

Yes.

Question 11: Do you agree that, under an omnibus client segregation, UCITS have a higher counterparty risk vis-à-vis the CM than under an individual client segregation? If not, please justify your position.

Yes. Due to co-mingling of margin, UCITS are exposed to the risks of the positions and default of other clients in the same pooled account. Porting of margin in the event of the

CM's default would be difficult as ALL clients in the pool would need to agree to a new CM and to port. Due to co-mingling there is also the risk that not all of the UCITS original margin will be returned following porting. Excess margin that is not returned and held by the CM exposes the UCITS to the default risk of the CM.

Question 12: Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus segregation? If yes, do you agree that UCITS should apply those limits to the amount of collateral posted to the CM (i.e. initial margin, variation margins and excess collateral if applicable)? What should be the limits?

Yes. The 5%/10% and 20% single body limits in Article 52 (1) and (2) of Directive 2009/65/EU should continue to apply to the exposure to the CM where omnibus segregation is used.

Question 13: Do you agree that UCITS should be subject to the same counterparty risk limits to CMs under omnibus client segregation for both OTC derivatives and ETDs? If not, please justify your position.

ESMA has commented in Paragraph 16 on the default risk of ETDs and OTC derivatives, however the relative risks attributed to these product types may indicate a case for a variation in the treatment of the risk limits.

Question 14: Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangements? What should be the limits and criteria for setting them?

Yes, the 5%/10% and 20% single body limits in Article 52 (1) and (2) of Directive 2009/65/EU should continue to apply in respect of exposure to the CM for these types of segregation.

Question 15: Do you agree that UCITS should be subject to the same counterparty risk limits applying to the CM under these other types of segregation arrangement for both OTC financial derivatives and ETDs? If not, please justify your position.

Yes.

Question 16: Do you agree that UCITS should treat OTC derivative transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.

Yes

We note that in the US, an "agency" model applies in respect of the relationship between the CM and the CCP. In such a context, it may therefore be more appropriate to consider counterparty exposure of the UCITS as being with the CCP rather than at the level of the CM once the collateral has been posted onto the CCP. However, there may be a "daylight" exposure to the CM whilst they are holding the monies (i.e. before they can pass monies on

to the CCP or return it to the UCITS), and this being the case appropriate counterparty risk limits should be applied at the level of the CM whilst this exposure exists.

Question 17: Do you agree that ICAs should be considered equivalent to direct clearing arrangements and that the same limits envisaged for the different segregation models in a direct clearing arrangement should apply to an ICA? If not, please justify your position.

Yes.

Question 18: Do you believe there might be circumstances under ICAs where UCITS have an exposure to the client of the CMs? If yes, what are those circumstances and do you think that UCITS should be subject to counterparty risk limits applying to the clients of the CMs? What should be the limits?

Yes, unless UCITS positions and margins are held in accounts that are subject to individual client segregation the UCITS is exposed to the positions and default of other clients in the omnibus account.