

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

Date 21 October 2014  
Your ref  
Our ref MASTERJ/  
Direct dial 0845 497 0504  
jonathanmaster@eversheds.com

**Submitted online**

To whom it may concern

**Discussion paper on calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations**

We welcome the opportunity to respond to the ESMA discussion paper ESMA/2014/876 on calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations published on 22 July 2014 (the "**Discussion Paper**"). We support the need for full consultation and appropriate engagement with market participants.

A detailed response to the questions contained in the Discussion Paper are enclosed with this letter.

Please feel free to contact Jonathan Master on the above contact details if you would like to discuss our responses or any other matter further.

Yours faithfully



**Eversheds LLP**

**Eversheds LLP**  
One Wood Street  
London  
EC2V 7WS

Tel 0845 497 9797  
Fax 0845 497 4919  
Int +44 20 7919 4500  
DX 154280 Cheapside 8  
www.eversheds.com



lon\_lib1\11472252\1\deanhe

**Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations**

**Q1: Do you agree with the working assumptions above?**

We broadly agree with the working assumptions.

However, we believe that the discussion paper should also address the way in which UCITS should take exposure to EU CCPs and non-EU CCPs which are recognised by ESMA and not focus solely on the impact of a default of a CM or of other clients of a CM. This may be particularly relevant where UCITS access CCPs by way of an agency model (where the UCITS directly faces the CCP, as opposed to a principal model where the CM is principal to both the client leg of the cleared trade as well as the CCP leg).

**Q2: 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 low? If so, please explain.**

We agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low. EMIR is designed to ensure that CCPs are safe and sound and comply with stringent organisational, business conduct and prudential requirements and sets out detailed requirements for CCPs to achieve this and to manage credit, liquidity, operational and other risks.

**Q3: Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?**

We do not consider that UCITS should be required to apply any counterparty risk limits to ESMA-recognised CCPs.

If UCITS are required to apply counterparty risk limits, this could act as a disincentive to clearing OTC derivative trades, which would not be in line with the G20 objective of encouraging central clearing. It could also mean that UCITS will need to establish multiple clearing arrangements covering different CCPs which will increase operational complexity and cost for investors.

If UCITS are to be required to apply counterparty risk limits, the basis on which, and manner in which, they must do this should be clearly set out.

**Q4: 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.**

We agree.

**Q5: 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?**

No.

**Q6: 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.**

We agree.

**Q7: Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?**

No. Even if the CM defaults before it posts assets to the CCP such assets should be protected by client assets rules and held separately from the CM's own assets.

**Q8: 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 significantly likely scenario that should be taken into account by the UCITS?**

In the event that a CM defaults in times of extreme economic circumstances, it would not surprise us if a CCP was unable to find another CM willing to accept the porting of open transactions and was therefore forced to liquidate such transactions. Whilst this scenario is unlikely in normal market circumstances, in our view it should still be taken into account by UCITS.

**Q9: 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.**

We agree.

**Q10: 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?**

Ignoring the segregation model issue, the level of counterparty credit risk should really be covered within the UCITS Directive, which already sets out restrictions on entities that may act as a derivatives counterparty in respect of UCITS funds. A case has not been made to state that these restrictions are insufficient and therefore case-by-case analysis of counterparties should not be necessary. If case-by-case assessment is to apply, the basis on which, and manner in which, counterparties must do this should be clearly set out.

**Q11: 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. We note that under omnibus client segregation excess margin that the CM might collect from clients might not be passed on to the CCP, as prescribed under individual

client segregation. If the CM does not pass excess margin on it creates an exposure of the UCITS to the CM.

On a related note, where the positions of the UCITS are held in an omnibus account, the UCITS will also have exposure to the other clients of the CM whose positions are held in the same account.

**Q12: Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus client 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?**

No for the reasons specified in our response to Q10.

**Q13: 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.**

If the decision is taken to apply counterparty risk limits to CMs, then we agree that these should be the same for both OTC derivatives and ETDs. However, we do not think that such limits should be applied to CMs.

**Q14: Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangement? What should be the limits and the criteria for setting them?**

Please see our response to Q10. Where the UCITS enters into derivatives transactions with a number of counterparties, but in fact only uses a limited number of CMs to clear its trades, applying the counterparty risk limits to the CMs is not practical unless the limits are very high. As a practical point, there are fewer CMs in the market than simple counterparties, therefore if such levels are introduced to CMs, they would need to be significantly higher than the existing counterparty levels in the UCITS Directive.

**Q15: 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.**

Please see our response to Q13.

**Q16: 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.**

We agree.

**Q17: 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.**

We agree.

**Q18: 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?**

Possibly. The circumstance described in our response to Q11 is also relevant to ICAs. If excess margin is not passed on to the CM, this could result in the UCITS having an exposure to the CMs clients for the excess margin.