

## Opinion

Impact of Regulation 648/2012 on Articles 50(1)(g) (iii) and 52 and of Directive 2009/65/EC for over-the-counter financial derivative transactions that are centrally cleared

### 1. Legal basis

1. ESMA's competence to deliver an opinion is based on Article 34 of Regulation (EC) No 1095/2010 (the 'Regulation'). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.
2. In this opinion to the EU institutions, ESMA calls for a modification of Articles 50(1) (g) (iii) and 52 of Directive 2009/65/EC (the UCITS Directive) to take into account the clearing obligation of certain types of over-the-counter (OTC) financial derivative transactions required by Regulation 648/2012 (EMIR).

### 2. Background

3. The UCITS Directive allows UCITS to invest in both exchange-traded derivatives (ETDs) and in OTC financial derivatives. Only investments in OTC financial derivative transactions are subject to counterparty risk exposure limits in the UCITS Directive. More specifically, according to Article 52 of the UCITS Directive, the risk exposure to a counterparty in an OTC financial derivative transaction shall not exceed 5% of the assets of a UCITS, or 10% when the counterparty is a credit institution.
4. However, paragraph 1 of Box 27 of the guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) recommends that initial margin posted to and variation margin receivable from a broker relating to ETDs which are not protected by client money rules or other similar arrangements should also be taken into account for the calculation of counterparty risk of Article 52 of the UCITS Directive.
5. Under EMIR, certain OTC financial derivative transactions are subject to the clearing obligation. Therefore, the question arises as to how the limits on counterparty risk in OTC financial derivative transactions that are centrally cleared should be calculated by UCITS and whether UCITS should apply the same rules to both OTC financial derivative transactions that are centrally cleared and ETDs.
6. In December 2013 ESMA published a revised version of the Q&A on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (ESMA/2013/950)<sup>1</sup>.

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<sup>1</sup> [http://www.esma.europa.eu/system/files/2013-1950\\_qa\\_risk\\_for\\_ucits.pdf](http://www.esma.europa.eu/system/files/2013-1950_qa_risk_for_ucits.pdf)



The Q&A clarified the main elements that UCITS management companies should take into account when they calculate their counterparty risk for OTC financial derivative transactions subject to clearing obligations, without being prescriptive on how counterparty risk should be calculated. The Q&A also indicated that further work would take place with a view to providing more detailed guidance.

7. In July 2014 ESMA published a discussion paper<sup>2</sup> (ESMA/2014/876) on the calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations. This discussion paper distinguished between different clearing arrangements. For each of those clearing arrangements, ESMA analysed the impact of a default of the clearing member (CM) and the client for the calculation of the counterparty risk by UCITS. ESMA published a feedback statement on the discussion paper (ESMA/2015/881)<sup>3</sup>.

### 3. Opinion

#### 3.1. Calculation of counterparty risk for OTC financial derivative transactions that are centrally cleared under EMIR

8. ESMA is of the view that the provisions on the counterparty risk limits for OTC financial derivative transactions in the UCITS Directive should be amended to take into account the clearing obligation for certain types of OTC financial derivative transaction under EMIR.
9. In particular, ESMA believes that the UCITS Directive should no longer distinguish between OTC financial derivative transactions and ETDs. Instead, the distinction should be between cleared financial derivative transactions and non-cleared financial derivative transactions. This would have the merit of treating ETDs and cleared OTC financial derivative transactions which display similar characteristics in terms of counterparty risk in the same manner.
10. As for OTC financial derivative transactions that are not centrally cleared, ESMA is of the view that there is no need to modify the UCITS Directive and the current counterparty risk limits of Article 52 of the UCITS Directive should continue to apply.
11. When developing this opinion, ESMA considered the two following approaches for the calculation of counterparty risk of cleared OTC financial derivative transactions by UCITS:

- *Approach #1:*

The first approach, which was not pursued, was to apply the same rules as for ETDs under the UCITS Directive. This means that UCITS would not have to apply any counterparty risk limits to cleared financial derivative transactions (OTC and ETDs). This approach had the merit of being simple and consistent with the current treatment of the counterparty risk for

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<sup>2</sup> <http://www.esma.europa.eu/system/files/2014-esma-876.pdf>

<sup>3</sup> [http://www.esma.europa.eu/system/files/2015-881\\_feedback\\_statement\\_on\\_emir-ucits.pdf](http://www.esma.europa.eu/system/files/2015-881_feedback_statement_on_emir-ucits.pdf)



ETDs under the UCITS Directive. However, this option was considered as not appropriate because it did not take into account the possible counterparty risk along the clearing chain.

- *Approach #2:*

The second approach consisted of adopting a more conservative approach whereby UCITS had to look at the details of the clearing arrangements to assess the counterparty risk. This approach had the merit of not overlooking potential counterparty risk that may exist along the clearing chain. However, this approach would have an impact on UCITS because UCITS would have to calculate a counterparty risk for ETDs which is currently not required by the UCITS Directive. ESMA believes that the assessment of the exact impact of this approach would warrant further consultation with stakeholders.

12. Even though UCITS are not required to apply any counterparty risk limits to ETDs under the UCITS Directive, ESMA is of the view that cleared financial derivative transactions (both OTC and ETDs) should not be considered automatically as free of counterparty risk. However, ESMA appreciates that cleared OTC financial derivative transactions do not all have the same characteristics and do not display the same level of counterparty risk.
13. According to Article 39 of EMIR, CCPs must offer CMs at least two types of segregation arrangement, namely individual client segregation and omnibus client segregation. Also, CCPs may offer CMs alternative segregation arrangements. ESMA believes that the counterparty risk limits should be calibrated to the different types of segregation arrangement taking into account elements such as the portability of the positions in the case of a default of the CM, the type of segregation arrangements or the legal regime applicable.

#### 3.1.1. Counterparty risk to EU Central Counterparties (CCPs) and non-EU CCPs recognised by ESMA

14. EU CCPs and non-EU CCPs recognised by ESMA<sup>4</sup> are entities subject to stringent requirements which are assessed on an on-going basis by the relevant authorities. Therefore, they should generally be considered as market infrastructures with relatively low counterparty risk. This is consistent with other pieces of legislation such as the Capital Requirements Regulation (Regulation 575/2013), where trade exposures with CCPs benefit from a lower capital treatment without being considered as risk-free. Furthermore, the EU regulatory framework and the clearing obligations under EMIR recognise that CCPs should contribute to lowering systemic risk by reducing the number of bilateral derivative exposures<sup>5</sup>.
15. Therefore, ESMA believes that UCITS may need to apply counterparty risk limits to some EU-CCPs and some non-EU CCPs recognised by ESMA. However, these limits should be high because of the relatively low counterparty risk of CCPs.

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<sup>4</sup> The requirements for recognition of non-EU CCPs, and the process to be followed, are set out in Article 25 of EMIR.

<sup>5</sup> See in particular Articles 305 and 306 CRR



- *Non-recognised third country CCPs*

16. ESMA is of the view that UCITS should not treat non-recognised third country CCPs in the same way as EU CCPs or non-EU CCPs recognised by ESMA in terms of counterparty risk. Indeed, these CCPs are subject to standards which might not be equivalent to those applicable to EU CCPs or non-EU CCPs recognised by ESMA. Therefore, ESMA believes that UCITS might need to apply counterparty risk limits to non-recognised third country CCPs.

### 3.1.2. Counterparty risk to Clearing Members (CMs)

- *Individual client segregation with EU CCPs and non-EU CCPs recognised by ESMA*

17. Under an individual client segregation with EU CCPs or non-EU CCPs, in the case of a default of a CM, the CCP has an obligation to attempt the transfer of the assets and positions of the UCITS to another CM or to close the positions of the UCITS. If the CCP liquidates the positions, the UCITS will get directly from the CCP (if the UCITS is known to the CCP) the liquidated value of its positions and any residual collateral to cover such positions. In other words, the UCITS' assets will be returned directly to the UCITS (again, if known to the CCP) without the risk of being impacted by the default of the CM. Furthermore, under individual client segregation, the assets and positions of the UCITS are legally and operationally separated from the assets and positions of other clients of the CM.

18. Therefore, ESMA believes that under individual client segregation, UCITS should not apply any counterparty risk limits to CMs. However, UCITS should apply counterparty risk limits to the EU CCP or the non-EU CCP recognised by ESMA as recommended in paragraph 14 of the opinion.

- *Omnibus client segregation with EU CCPs and non-EU CCPs recognised by ESMA*

19. In an omnibus client segregation, the obligation for the CM and the CCP is only to distinguish the assets and positions of the CM from the assets and positions held for the account of the clients of the CM. This means that the CM is allowed to post to the CCP only the net amount of collateral necessary to clear the OTC transactions of its clients. There is no individual segregation of the collateral at the CCP level and no requirement to collect the margins from clients on a gross basis.

20. In the case of a default of a CM under an omnibus client segregation model, in the majority of cases the CCP will deliver back to the CM/the liquidator of the CM the residual collateral (if any) following the liquidation of the CM's clients positions. This means that (a) UCITS may not get their assets back (initial and variation margins + excess margin if applicable) or (b) there may be a substantial delay in the return of the assets because this depends on the outcome of the liquidation procedure of the CM. It also means that the UCITS will be unhedged and will therefore be exposed to market risk until such time as it re-establishes a new position since the original derivatives position was liquidated.



21. Hence, ESMA believes that omnibus client segregation provides UCITS with less protection than individual client segregation when the CM defaults<sup>6</sup>. In particular, under omnibus client segregation, UCITS will be exposed to both the default of the CM and of other clients of the CM.
22. Therefore, ESMA is of the view that UCITS should apply counterparty risk limits to CMs in the case of omnibus client segregation and that these limits should be applied to the proportion of the assets that are not passed onto the EU CCP or the non-EU CCP recognised by ESMA by the CM. In case the UCITS is not in a position to quantify the amount of assets that stay at the level of the CM, the UCITS should apply the counterparty risk limits to all of the assets passed to the CM. These limits should be applied in addition to the counterparty risk limits to the EU CCP or the non-EU CCP recognised by ESMA as recommended in paragraph 14 of the opinion.
23. The counterparty risk limits to CMs should not be too low otherwise UCITS might not be able to diversify their exposure to CMs because of the limited number of CMs available<sup>7</sup>, which would have as direct impact to limit the ability of UCITS to invest in centrally-cleared OTC financial derivative transactions.
  - *Other types of segregation arrangements with EU CCPs and non-EU CCPs recognised by ESMA*
24. In addition to individual client segregation and omnibus client segregation that CCPs are required to offer to CMs pursuant to Article 39 of EMIR, CCPs may offer different types of client segregation arrangements and those arrangements may differ from one CCP to another. For example, some CCPs offer different types of gross omnibus segregation arrangements. These clearing arrangements are omnibus accounts where the margins from clients are collected by the CM on a gross basis and posted to the CCP on a gross basis (while the margins are held in an omnibus account, assuming the CM is subject to MiFID or equivalent client asset requirements, it will be the case that client margins are individually identified in the books and records of the CM). Under this type of segregation arrangement, the CCP could ensure the portability of the clients' positions (either individually or collectively) to another CM, although it may be more complex than under individual segregation.
25. Even if there is no portability, the CCP may have a similar level of resources to deal with the liquidation of clients' positions as under an individual client segregation model. However, participation in a gross omnibus account is combined with a risk of loss mutualisation with other clients of that account.
26. In this type of segregation arrangement the value of the liquidated positions and the residual collateral are returned to the CM (or the liquidator of the CM) for the account of its clients.

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<sup>6</sup> ESMA recognises that certain types of omnibus client segregation arrangements may nevertheless offer a higher level of protection – please see paragraphs 24-27

<sup>7</sup> ESMA analysed the number of CMs available in Europe in the consultation papers on clearing obligation under EMIR.



However, the excess margin that the CM might collect from clients might not be passed on to the CCP, as prescribed under individual client segregation. Also, in the case of a default of the CM, and although this will be documented in the books and records of the CM where the CM is subject to MiFID or equivalent client asset requirements, the CCP might not be in a position to allocate the excess collateral between the clients of the CM. Finally, the UCITS might be unhedged (and therefore exposed to market risk) until such time as it re-establishes a new position since the original derivatives position was liquidated.

27. Therefore, ESMA believes that UCITS should apply some counterparty risk limits to CMs under these other types of segregation arrangement. The counterparty risk limits should be proportionate to the degree of protection offered to the UCITS. For example, if the degree of protection is equivalent to individual client segregation, UCITS should not apply any counterparty risk limits to CMs. However, if the protection is lower than an individual client segregation, the UCITS should apply a counterparty risk limit to the CM and the level should not be lower than the one for omnibus client segregation because omnibus client segregation should be considered as the clearing arrangement that provide the lowest level of protection. These limits should be applied in addition to the counterparty risk limits to the EU CCP or the non-EU CCP recognised by ESMA as recommended in paragraph 14 of the opinion.

- *Clearing arrangements with non-EU CCPs outside the scope of EMIR*

28. UCITS may enter into OTC derivative transactions (not subject to the clearing obligation) cleared through a non-EU CM<sup>89</sup> by non-recognised third country CCPs. Since those third country CCPs are subject to standards which may not be equivalent to those applicable to EU CCPs, it seems logical to consider that those transactions do not provide a level of protection equivalent to OTC derivative transactions centrally cleared under EMIR.

29. Therefore, ESMA is of the view that UCITS should treat those transactions as bilateral OTC derivative transactions and apply the 5%/10% counterparty risk limits of Article 52 of the UCITS Directive to CMs. These limits should be applied in addition to the counterparty risk limits to non-recognised third country CCPs as recommended in paragraph 16 of the opinion.

### 3.2. Liquidation of OTC financial derivative transactions that are centrally cleared

30. According to Article 50(1)(g)(iii) of the UCITS Directive, UCITS can invest in OTC financial derivative instruments provided that those instruments 'can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS' initiative'.<sup>10</sup> To ensure compliance with the UCITS Directive, a clause of unilateral termination right was added to

<sup>8</sup> For the purpose of complying with the clearing obligation only authorised or recognised CCPs under EMIR can be used.

<sup>9</sup> Under EMIR, third country CCPs which are not recognised by ESMA under EMIR are prohibited from offering services to EU clearing members (unless transitional provisions apply).

<sup>10</sup> The words 'by an offsetting transaction' only refer to the verb 'closed' and not to the verbs 'sold' and 'liquidated'. This means that in the absence of an offsetting transaction, the OTC derivative will need to be liquidated through the unilateral action of the UCITS.



the ISDA standard documentation for bilateral OTC financial derivative transactions. Pursuant to Article 5(4) of EMIR, the clearing obligation is subject, among other things, to the level of standardisation of the OTC contract.

31. ESMA is aware that for OTC transactions subject to the clearing obligation under EMIR, some CCPs do not accept the unilateral termination clause of Article 50(1)(g)(iii) of the UCITS Directive. At the same time, ESMA neither intends to exclude UCITS from the clearing obligation nor has the possibility to require CCPs to accept this clause in the light of EMIR Article 5(4).
32. Therefore, ESMA believes that there is a conflict between the operation of the UCITS Directive and the operation of EMIR for the OTC financial derivative positions of UCITS funds which are subject to the clearing obligation.