

**MEMO# 28312**

August 14, 2014

## **ESMA's Discussion Paper on Calculation of Counterparty Risk by UCITS for OTC Financial Derivatives Transactions**

[28312]

August 14, 2014

TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 52-14

ICI GLOBAL MEMBERS No. 30-14

INTERNATIONAL COMMITTEE No. 25-14 RE: ESMA'S DISCUSSION PAPER ON CALCULATION OF COUNTERPARTY RISK BY UCITS FOR OTC FINANCIAL DERIVATIVES TRANSACTIONS

Recently, the European Securities and Markets Authority ("ESMA") issued a discussion paper on the calculation of counterparty risk by UCITS for OTC financial derivatives transactions. [1] After the consultation, ESMA will determine its final views on how to proceed, including whether to make a recommendation to the European Commission on a modification of the UCITS Directive. Comments on the Discussion Paper are due by October 22. If you have any concerns with the Consultation Paper, please contact Jennifer Choi at [jennifer.choi@ici.org](mailto:jennifer.choi@ici.org) or at (202) 326-5876.

Under the UCITS Directive, investments in OTC derivatives transactions are subject to counterparty risk exposure limits. Specifically, under Article 52 of the UCITS Directive, the risk exposure to a counterparty in an OTC derivatives transaction must not exceed 5% of the assets of a UCITS or 10% when the counterparty is a credit institution. For centrally-cleared OTC derivatives, ESMA takes the view that application of the counterparty risk limits should depend on the type of segregation arrangement that is provided to assets posted as margin. [2]

With respect to individual client segregation, ESMA states that UCITS would have no counterparty risk vis-à-vis the clearing member or other clients of the clearing member but may have some exposure to market risk if the positions are liquidated by the clearinghouse and new positions need to be re-established. For omnibus client segregation, ESMA believes that UCITS will be exposed to both the default of the clearing member and of other clients of the clearing member. Therefore, ESMA notes that it would be logical for UCITS to apply counterparty risk limits to clearing members in the case of omnibus client segregation. For other types of structures provided by some clearinghouses (including where margin from clients are collected on a gross basis and posted to the clearinghouse on a gross basis but margin is individually identified in the books and records of the clearing member), ESMA

believes it would be justified to apply some counterparty risk limits to these types of segregation arrangements.

For transactions cleared through a non-EU clearing member by non-recognized third country clearinghouses, ESMA would treat those transactions as bilateral OTC transactions and apply the 5%/10% counterparty risk limits of the UCITS Directive to clearing members. ESMA believes that the third-country clearinghouses would not be subject to standards that are equivalent to those applicable to EU clearinghouses so those transactions would not receive a level of protection equivalent to OTC derivatives transactions centrally cleared under EMIR.

For indirect clearing arrangements, [3] ESMA is of the view that the same limits applicable to different segregation models for direct clearing arrangements should apply.

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#### **endnotes**

[1] European Securities Markets Authority, Discussion Paper, Calculation of Counterparty Risk by UCITS for OTC Financial Derivative Transactions Subject to Clearing Obligations (July 22, 2014), available at <http://www.esma.europa.eu/system/files/2014-esma-876.pdf> (“Discussion Paper”).

[2] The Discussion Paper also discusses how exchange-traded derivatives should be treated for purposes of counterparty risk limit calculation.

[3] An “indirect clearing arrangement” is where a client of a clearing member of a CCP (e.g., a dealer that is not itself a clearing member) is providing clearing services to its own clients (e.g., UCITS).