

MEMO# 29011

May 26, 2015

ESMA Issues Opinion on Calculation of Counterparty Risk by UCITS for OTC Financial Derivative Transactions Subject to Clearing Obligations

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TO: INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 13-15
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: ESMA ISSUES OPINION ON
CALCULATION OF COUNTERPARTY RISK BY UCITS FOR OTC FINANCIAL DERIVATIVE
TRANSACTIONS SUBJECT TO CLEARING OBLIGATIONS

On May 22, the European Securities and Markets Authority (“ESMA”) issued its opinion calling for a modification of the UCITS Directive to take into account the clearing obligation of certain types of over-the-counter (“OTC”) financial derivatives transactions as required by the European Markets Infrastructure Regulation (“EMIR”). [\[1\]](#) The ESMA Opinion follows publication by ESMA of a discussion paper on the calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations in July 2014. [\[2\]](#) We understand that the European Commission is expected to consider ESMA’s recommendation as part of the overall review of the UCITS Directive.

Under the UCITS Directive, only investments in OTC financial derivative transactions are subject to counterparty risk exposure limits. According to the ESMA Opinion, the UCITS Directive should no longer distinguish between OTC financial derivative transactions and exchange traded derivatives (“ETDs”) for purposes of counterparty risk limits. ESMA is of the view that the distinction should be between cleared financial derivative transactions and non-cleared financial derivative transactions. For OTC financial derivative transactions that are not centrally cleared, ESMA believes that the UCITS Directive does not need to be modified and the current counterparty risk limits should continue to apply. ESMA made certain specific recommendations as follows:

- Central Counterparties (“CCPs”): ESMA is of the view that UCITS may need to apply counterparty risk limits to some EU-CCPs and non-EU CCPs recognized by ESMA but that these limits should be high. For non-recognized third country CCPs, ESMA believes UCITS might need to apply counterparty risk limits to these CCPs.

- Clearing Members: Counterparty risk limits should be calibrated to the different types of segregation arrangements. For individual segregation arrangements, UCITS should not apply any counterparty risk limits to clearing members. For omnibus client segregation arrangements, UCITS should apply counterparty risk limits to clearing members in proportion to the assets that are not passed on to the EU CCP or the non-EU CCP recognized by ESMA by the clearing member. For other types of segregation arrangements, ESMA believes UCITS should apply some counterparty risk limits to clearing members and the limits should be proportionate to the degree of protection offered to UCITS. These limits would be in addition to the counterparty risk limits to the CCP (as discussed above).
- Clearing Arrangements with Non-EU CCPs Outside EMIR: ESMA is of the view that UCITS should treat transactions cleared through a non-EU clearing member by a non-recognized third country CCP as bilateral OTC derivative transactions and apply the counterparty risk limits of the UCITS Directive (both to the clearing member and the non-recognized third country CCP).

Jennifer S. Choi
Associate General Counsel

endnotes

[1] ESMA 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 (May 22, 2015), available at http://www.esma.europa.eu/system/files/2015-880_esma_opinion_on_impact_of_emir_on_ucits.pdf (“ESMA Opinion”).

[2] 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”). For a summary of the Discussion Paper, see ICI Memorandum No. 28312 (Aug. 14, 2014), available at <http://www.ici.org/iciglobal/pubs/memos/memo28312>. ICI Global’s comment letter in response to the Discussion Paper is available at <http://www.ici.org/pdf/28472.pdf>.