In case of discrepancies between the French and English text, the French text shall prevail

Luxembourg, 5 April 2005

To all Luxembourg undertakings for collective investment and all parties involved in the operation and supervision of such undertakings

CSSF CIRCULAR 05/176

<u>Re:</u> **Rules of conduct to be adopted by undertakings for collective investment in transferable securities in relation to the use of financial derivative instruments**

Ladies and Gentlemen,

The purpose of this Circular is to set out rules of conduct to be followed by Undertakings for Collective Investment in Transferable Securities subject to Part I of the Law of 20 December 2002 (hereinafter "UCITS") in the context of the use of financial derivative instruments with the meaning of Article 41 (1) g) of the amended law of 20 December 2002.

Pursuant to Article 41 (1) g), of the amended law of 20 December 2002, UCITS are authorised to invest, under certain circumstances, in financial derivative instruments.

In this case, the guidelines presented hereafter are applicable.

1. Risk-measurement systems adapted to the risk-profile of the UCITS

Pursuant to Article 42 (1), the UCITS must employ risk measurement systems that are adapted to its risk profile in order to make sure that it accurately measures all material risks it incurs.

2. Limitations to the UCITS' risk exposure

2.1. Limitation to the global exposure related to financial derivate instruments

Under the provisions of Article 42 (3) of the amended law of 20 December 2002, UCITS have to ensure that the overall risk exposure related to financial derivative instruments does not exceed the total net asset value of their portfolio.

This means that the global exposure relating to the use of financial derivative instruments may not exceed 100% of the UCITS' net asset value (NAV or net assets), and hence that the UCITS' overall risk exposure may not exceed 200% of the NAV on a permanent basis.

2.2. Limitation to possible temporary borrowing

The overall risk exposure of the UCITS may not be increased by more than 10% by means of temporary borrowing, so that the UCITS' overall risk exposure may not exceed 210% of the NAV under any circumstances.

2.3. Joint application of point 3 and 4

For applying the 100% NAV global exposure limit relating to financial derivative instruments, both points 3 and 4 hereabove have to be complied with.

3. Appropriately calibrated standards to measure market risk

3.1. Adaption of risk-measurement methodologies to the risk- profile of a UCITS

A distinction must be made whether the UCITS may be considered as "non-sophisticated" or "sophisticated".

3.2. Non-sophisticated UCITS

3.2.1. Use of the commitment approach

The market risk must be assessed by using the commitment approach, whereby the financial derivative instruments positions of a UCITS are converted into the equivalent positions in the underlying assets, provided that the buying and selling positions on the same underlying asset may be compensated.

To that end, certain other criterias have to be taken into account, such as: the UCITS' global exposure deriving from the use of financial derivative instruments, the nature, aim, number and frequency of the contracts entered into by the UCITS and the management techniques adopted.

3.2.2. Technical details

In the case of options, it is allowed to apply the delta approach, which is derived from the sensitivity of the change in the option's price to marginal changes in the price of the underlying financial instruments. The conversion of forwards, futures and swaps positions should depend on the precise nature of the underlying contracts. In case of simple contracts, the marked-to-market value of the underlying or the notional, as the case may be, of the contract will usually be relevant.

3.3. Sophisticated UCITS

3.3.1. Standard use of Value-at-Risk (VaR) approach with stress tests

In principle, in the case of "sophisticated" UCITS, a VaR approach must be applied regularly. With this type of approach, the maximum potential loss that a UCITS portfolio could suffer within a certain time horizon and a certain degree of confidence is estimated. The UCITS must apply stress tests in order to help manage risks related to possible abnormal market movements. Stress tests measure how extreme financial or economic events affect the value of the portfolio at a specific point of time.

For the application of VaR approaches, the following parameters are to be used: a 99% confidence interval, a holding period of one month and "recent" volatilities, i.e. no more than one year from the calculation date.

By derogation to the foregoing, and provided there is an adequate justification, other parameters than those described above may be used in particular cases with the prior approval of the CSSF.

3.3.2. Internal risk-measurement models

The internal risk-measurement models proposed by a management company or an investment company are only acceptable if they are subject to appropriate safeguards, including those set out in this circular. The CSSF must give its prior approval to the use of these internal risk-measurement models.

3.4. Description of risks

UCITS which use financial derivative instruments for other purposes than hedging, should include in their prospectus an adequate description of risks arising from the use of such instruments. This description may include an indication of the level of leverage or of the VaR.

4. Appropriately calibrated standards to assess leverage

4.1. Use of the commitment approach (Non-sophisticated UCITS)

To asses a non-sophisticated UCITS' leverage, the commitment approach shall be applied.

4.2. Use of advanced methodologies (sophisticated UCITS)

For sophisticated UCITS, referred to under item 3.3, the CSSF may recognise a method of assessing leverage by the means of VaR-approaches and stress tests, provided that the CSSF is convinced that the management company or investment company concerned has already developed and tested such a method assessing leverage in an appropriate manner and to the extent the method of assessing is duly documented by the company concerned.

5. Applying appropriate standards and recognised risk-mitigation techniques to limit counterparty risk

5.1. Criteria for the limitation of counterparty risk exposure to OTC-financial derivative instruments

All financial derivative instruments transactions which are deemed to be free of counterparty risk have to be performed on an exchange where the clearinghouse meets the three following conditions:
- it is backed by an appropriate performance guarantee;
- it performs a daily mark-to-market valuation of the financial derivative instruments positions; and
- it proceeds to at least daily margin calls.

5.2. Recommendation to use maximum potential loss

The exposure per counterparty on an OTC-financial derivative instruments transaction must be measured on the basis of the maximum potential loss incurred by the UCITS if the counterparty defaults and not on the basis of the notional value of the OTC contract.

5.3. Invitation to use the standards laid down in Directive 2000/12/EC as a first reference

In compliance with the quantitative prudential limits already imposed by Directive 2001/108/EC, the counterparty risk with regard to OTC-financial derivative instruments shall be assessed in accordance with the marked-to-market method laid down in Directive 2000/12/EC of the European Parliament and of the Council, notwithstanding the need of appropriate pricing models when the market price is not available.

Besides, the use of the full credit equivalent approach laid down in Directive 2000/12/EC, including an add-on methodology to reflect the potential future exposure, is to be applied.

5.4. Recognition of collateral for the purpose of assessing a UCITS' counterparty risk exposure

5.4.1. General criteria

It is allowed to recognise collateral in order to reduce a UCITS' counterparty risk provided that, in accordance with the prudential rules laid down in Directive 2000/12/EC and taking into account further developments, the collateral:

a) is marked-to-market at a frequency at least equal to the frequency of the NAV calculation of the UCITS concerned;
b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;
c) is held by a third party safekeeper not related to the provider or is legally secured from the consequences of a failure of a related party;
d) can be fully enforced by the UCITS at any time.

It is noted that the UCITS may disregard the counterparty risk provided that the value of the collateral, valued marked-to-market and taking into account of appropriate haircuts, exceeds the amount at risk.

5.4.2. Risk concentration limits

In accordance with the general principle of risk-spreading, the exposure to counterparty risk on a given entity, respectively group, after taking into account any collateral received from that entity, or group, may not be higher than the 20% limit laid down in the amended law of 20 December 2002, both at individual level in accordance with Article 43 (2), second sub-paragraph, of said law and at group level, in accordance with Article 43 (5).

In this context, it is reminded that the group limit is distinct from the counterparty limit. Thus, a UCITS may invest its assets in two counterparties of the same group, but the risk spreading limit on the group may not exceed 20% of the net assets of the UCITS.

5.5. Recognition of netting

UCITS may net their OTC-financial derivative instruments exposure vis-à-vis the same counterparty, provided that the netting procedures comply with the conditions laid down in Directive 2000/12/EC and that they are based on legally binding agreements.

6. Using adequate methodologies when applying limitations to issuer risk

6.1. Adaption of the risk-measurement methodologies to the financial derivative instruments typology

The first sentence of the third paragraph of Article 42 (3) of the amended law of 20 December 2002 provides that: "A UCITS may invest, as a part of its investment policy and within the limits laid down in Article 43, paragraph (5) in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits laid down in Article 43.".

For the purpose of applying this provision, the financial derivative instruments shall be converted into equivalent underlying positions.
The method used for converting the financial derivative instruments into equivalent underlying positions must be adequate for the type of instruments considered.

Generally, the use of the delta approach is the most relevant for options. In cases where this approach is not relevant or technically impossible, due to the complexity of the financial derivative instrument concerned, it is allowed to make use of an approach based on the maximum potential loss linked to that financial derivative instruments as a maximum threshold assessment of the solvency risk. This maximum potential loss is therefore considered as a maximum threshold assessment of the solvency risk.

6.2. Case of index-based derivatives

The third paragraph of Article 42 (3) of the amended law of 20 December 2002 provides:
"When a UCITS invests in index-based financial derivative instruments, these investments do not have to be combined to the limits laid down in Article 43.".

This provision covers the financial derivative instruments which relate to an index which meets the following requirements:

- the composition of the index is sufficiently diversified;
- the index represents an adequate benchmark for the market to which it refers;
- it is published in an appropriate manner.

As a general matter it is to be noted that, for the application of this provision, a management company or investment company shall not make use of financial derivative instruments based on a self-composed index with the intent to circumvent the issuer concentration limits of Article 43 of the amended law of 20 December 2002.
Management companies or investment companies shall not make use of financial derivative instruments based on indices which do not comply with the conditions mentioned above.

6.3. Risk-concentration limits

The counterparty risk must be cumulated with the issuer risk on the same entity or group for the purpose of the 20% NAV-limit under Article 43 (2), second sub-paragraph and Article 43 (5) of the amended law of 20 December 2002.

7. Applying relevant cover rules to transactions with both listed, and OTC, financial derivative instruments

7.1. Appropriate cover in the absence of cash-settlement

When the financial derivative instrument provides, either automatically or at the counterpart's choice, for physical delivery of the underlying financial instrument on maturity or exercise, and provided that physical delivery is common practice on the considered instrument, the UCITS must hold this underlying financial instrument as cover in its investment portfolio.

7.2. Exceptional substitution with an alternative underlying cover in the absence of cash settlement

In cases where the underlying financial instrument of a financial derivative instrument is highly liquid, the UCITS is allowed to hold exceptionally other liquid assets as cover provided that they can be used at any time to purchase the underlying financial instrument to be delivered and that the additional market risk which is associated with that type of transaction is adequately measured.

7.3. Substitution with an alternative underlying cover in the case of cash-settlement

Where the financial derivative instrument is cash-settled either automatically or at the UCITS discretion, the UCITS is allowed not to hold the specific underlying instrument as cover. In this case, the following categories of instruments constitute an acceptable cover:

a) cash;
b) liquid debt instruments (e.g. government bonds of first credit rating) with appropriate safeguards (in particular, haircuts);
c) other highly liquid assets, recognised by the CSSF in consideration of their correlation with the underlying of the financial derivative instrument, subject to appropriate safeguards (e.g. haircuts where relevant).

For the application of Article 52 of the amended law of 20 December 2002, are considered as "liquid" those instruments which can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market. This cash amount must be at the UCITS' disposal at the maturity/expiry or exercise date of the financial derivative instrument.

7.4. Calculation of the level of cover

The level of cover must be calculated in line with the commitment approach.

7.5. Nature of the underlying financial instrument

The underlying financial instruments of financial derivative instruments, whether they provide for cash-settlement or physical delivery, as well as the financial instruments held for cover purposes have to be compliant with Part I of the amended law of 20 December 2002, and the investment policy of the UCITS.

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Yours sincerely,

COMMISSION OF THE SUPERVISION OF THE FINANCIAL SECTOR

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