PRICEWATERHOUSECOOPERS

Flash News

CSSF Circular 07/308
dated August 2, 2007

New Circular on Risk Management for UCITS using financial derivative instruments

After publication of the implementing Directive 2007/16/EC on eligible assets for UCITS, the Luxembourg regulatory environment applicable to UCITS funds is still evolving.

In the middle of the summer, while most of us were starting holidays, the CSSF issued a Circular 07/308 dated August 2, 2007, on "Guidelines for undertakings for collective investment in transferable securities relating to the use of a financial risk management method and the use of financial derivative instruments".

The objective of this awaited Circular, which replaces CSSF Circular 05/176 providing guidance for UCITS using financial derivative instruments, is to further clarify how a UCITS should implement its Risk Management Process within the meaning of article 42 of the Law of December 20, 2002 relating to Undertakings for Collective Investment.

The new Circular defines various concepts that, although appearing in the earlier regulation, were not adequately defined, thus permitting many interpretations, for example:

Sophisticated/non sophisticated UCITS
A sophisticated UCITS is defined as a fund that widely invests its assets in financial derivative instruments or uses complex strategies/instruments while a non sophisticated UCITS is a fund using fewer derivatives, fewer complex strategies/products or entering into financial derivative instruments for hedging purposes only.

Commitment approach
The Circular further clarifies how global exposure should be determined for the following financial derivative instruments: options, warrants, futures, forward exchange transactions, interest rate swaps, credit default swaps, currency swaps and total return swaps.

Value-at-Risk ("VaR") thresholds
As it was already the case in other EU Member States such as France, Germany or Ireland, the new Circular now makes the distinction between the Relative VaR and the Absolute VaR. A UCITS measuring its global exposure may not exceed twice the VaR of its benchmark or reference portfolio which does not contain any derivatives positions (Relative VaR). In the case where it is not possible to refer to a benchmark or to create a reference portfolio, the UCITS should define a limit in terms of Absolute VaR taking into account its investment policy and risk profile. This limit may never exceed 20%.

Moreover, the new Circular confirms CSSF's current understanding on matters which were not always so obvious based on the Law and other regulations, such as:

Organisational principles in terms of risk management
The Circular insists on the requirements imposed to risk management teams, mainly in terms of qualifications, experience, independence of the staff and tools used by such teams.

Borrowings
The Circular confirms that a UCITS may borrow up to 10% of its assets on a temporary basis provided that it is not for investment purposes.

Counterparty exposure
The counterparty exposure to a single entity should be assessed on the basis of the "Marked to Market" method laid down in Directive 2000/12/EC. This three steps method takes into account the remaining maturity of the instruments, the type of underlying assets and the quality of the counterparty.

Global exposure
The Circular clarifies that global exposure is defined as market risk only.

Risk management teams and Boards of Directors of funds and their management companies will probably be awfully busy over the next months, reviewing and updating their risk management process. CSSF wants this to happen fast: the Circular is applicable immediately.

Contacts

For further information, please contact the PricewaterhouseCoopers Luxembourg experts:

Anne Mergeai-Laurent
Partner
+352 49 48 48-2549
anne.mergeai-laurent@lu.pwc.com

John Parkhouse
Partner
+352 49 48 48-2505
john.m.parkhouse@lu.pwc.com

Odile Renner
Partner
+352 49 48 48-2615
odile.renner@lu.pwc.com

PricewaterhouseCoopers

400, route d'Esch, B.P. 1443
L-1014 Luxembourg
Telephone +352 49 48 48-1
Facsimile +352 49 48 48-2900