

Executive Order on the Use of Derivative Financial Instruments by Investment Associations, Special-Purpose Associations, Restricted Associations and Innovation Associations¹⁾

Executive Order no. 672 of 24 June 2004 **EXCLUDING MINOR AMENDMENTS**

The following shall be laid down pursuant to section 89(3); section 99; section 106(1), cf. section 89(3) and section 99; section 109(4), cf. section 89(3) and section 99; section 113, cf. section 89(3) and section 99; and section 132(3) of Act no. 1169 of 19 December 2003 on investment associations and special-purpose associations as well as other collective investment schemes etc. as well as pursuant to section 44(3) and section 61(5) of Innovation Associations Act, cf. Consolidated Act no. 981 of 5 December 2003:

Part 1

Scope

1.-(1) An investment association, special-purpose association and restricted association may use derivative financial instruments and effect securities lending to hedge risks and as part of portfolio management, provided that the utilisation of such derivative financial instruments complies with the provisions of sections 14-22 and 24-25. These provisions shall be complied with at all times during the term of the derivative financial instruments.

(2) An innovation association may use derivative financial instruments and effect securities lending to hedge risks and as part of portfolio management, provided that the utilisation of such derivative financial instruments complies with the provisions of sections 14-18 and 23-25. These provisions shall be complied with at all times during the term of the derivative financial instruments.

(3) An investment association, special-purpose association, restricted association and innovation association will hereafter be referred to an "association".

(4) The derivative financial instruments shall be based on securities, securities indexes, foreign currencies, interest, or money-market instruments which may be included in the assets of an association or a division of an association.

Part 2

Definitions

2. In this Executive Order, "derivative financial instruments" shall mean financial instruments, the value of which is dependent on the underlying securities, indexes, foreign currencies, interest or money-market instruments.

3. "Securities lending" shall mean lending of securities against later return of the security or an identical security, which does not involve the transfer of liquidity from borrower to lender, other than a fee. The performance of securities lending shall be with due respect for the provisions of section 25 of this Executive Order.

4.-(1) A "net position" in a security, money market instrument or index shall mean the difference between the sum of the market value of long positions and the sum of the market value of short positions in the security, money market instrument or index, including the underlying long and short positions in the security, money market instrument or index that are linked to use of the derivative financial instruments based on securities, money-market instruments and indexes.

(2) A "position" in an index shall mean the nominal transaction amount in the relevant index multiplied by the price of the index.

(3) A "long position" shall mean a position that yields a premium in the event of a rise in prices or fall in interest rates for the relevant security, money market instrument or index. A "short position" shall mean a position that yields a loss in the event of a rise in prices or fall in interest rates for the relevant security, money market instrument or index.

5. The "total exposure in shares and share indexes" of an association or division shall mean

the sum of the long net positions in the shares and share indexes owned by the association or division, plus
the sum of the short net positions in the shares and share indexes owned by the association or division.

6. The "exposure to a given issuer of bonds and money-market instruments or to a given bond index" of the association or division shall mean the difference between

the market value of the association's or division's long net positions in bonds and money-market instruments with the relevant issuer or based on the relevant bond index, including long and short net positions that are linked to use of derivative financial instruments based on the bonds, money-market instruments and bond indexes, and
the market value of the association's or division's short net positions with the same issuer or based on the same bond index.

7. The "total exposure in securities, money-market instruments and indexes" of an association or division shall mean

the total exposure in shares and share indexes plus
the sum of the numerical value of the exposures with issuers of bonds and money-market instruments as well as bond indexes.

8.-(1) A "net position in a foreign currency" shall mean the difference between the sum of the long positions and the sum of the short positions in the relevant currency, including the underlying exposures in currencies linked to currency-based derivative financial instruments.

(2) A "long position in a currency" shall mean a position that yields a premium in the event of a rise in the rate of the relevant currency against DKK. A "short position in a currency" shall mean a position that yields a loss in the event of a rise in the rate of the relevant currency against DKK.

(3) The "total currency exposure" of an association or a division shall mean the sum of the long net positions and short net positions in foreign currencies.

9. In the calculation of the net position in accordance with sections 4 and 8 in the underlying assets linked to derivative financial instruments in which there is an option element, the market price of the underlying assets shall be multiplied by the option's delta.

10.-(1) The counterparty risk linked to the use of a derivative financial instrument traded OTC shall mean the positive market value of the derivative financial instruments with an addition for the potential future amounts receivable. This addition shall be calculated in accordance with annex 1.

(2) If an association has entered into a netting agreement, and if said agreement meets the conditions for agreements on netting laid down in sections 58h and 58i of the Securities Trading, etc. Act, the value of the derivative financial instruments with a negative market value may be set against the value of the derivative financial instruments with a positive market value with the same counterparty in the calculation of the counterparty risk in accordance with subsection (1).

(3) In the calculation of the exposure under subsections (1) and (2), deductions may be made for collateralisation received as securities and money-market instruments that may be included in the total assets of the association or division.

11. "Position risk" shall mean the risk that an association or division suffers a loss as a result of changes in the market value of a position in securities, money-market instruments, or indexes. The position risk shall be divided into

the general risk, ie. the risk that the association or division suffers a loss because the market value of a position changes as a result of conditions related to the market as a whole, and

the specific risk, ie. the risk that the association or division suffers a loss because the market value of a position changes as a result of conditions related to the individual issuer of the security or individual security itself.

12. A "synthetic money market deposit" shall mean a holding of securities that is combined with derivative financial instruments based on the relevant securities, so that the holding is set off by a corresponding short position in the underlying assets of the derivative financial instruments.

13. "Cash and cash equivalents" shall mean demand deposits or deposits with a term of less than one month in banks; paid-in margins deposited in banks, investment companies, stock exchanges, and clearing centres; as well as securities and money-market instruments stated in section 93(1), nos. 2 and 3 and section 94(1) of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act with variable interest rates or with a remaining term of no more than six months, and which are not part of a synthetic money market deposit, cf. section 12. Furthermore synthetic money market deposits and amounts falling due within three months in the form of called bonds, interest, and declared dividends shall be included.

Part 3

Calculation of interest-rate risk

14.-(1) An association shall calculate the total interest-rate risk linked to positions in the association's portfolio or the portfolio of the divisions of the association, including the interest-rate risk on payments linked to the use of derivative financial instruments. The interest-rate risk shall be calculated for each currency separately. In the calculation of the total interest-rate risk, the

numerical value of the interest-rate risk for the individual currencies shall be summed.

(2) The calculation of the total interest-rate risk in accordance with subsection (1) shall be prepared on the basis of the sum of the changes in the market value of the association's or division's positions in bonds, money-market instruments and bond indexes, including changes in the current value of the payments linked to the use of derivative financial instruments in the event of an increase in the interest rate of one percentage point. The calculation may be based on measurements for duration and modified duration calculated on the basis of the regulations laid down in point 3 in annex 2 of the Danish FSA Executive Order on Capital Adequacy.

Part 4

Use on a covered basis

15. An association or division may use derivative financial instruments on a covered basis.

16.-(1) Use of derivative financial instruments based on a given share shall be regarded as being on a covered basis, if

they do not increase the association's or division's net position in the share, and
they do not mean that overall the association or the division obtains a short net position in the share.

(2) Use of derivative financial instruments based on a share index shall be regarded as being on a covered basis, if

part of the shares held by the association or division comprises shares that are listed on the same stock exchange or which are traded on the same market as the shares in the index,
the association or division has not used other derivative financial instruments that are covered by shares in this part of the shareholding,
it is extremely unlikely that the derivative financial instruments will increase the loss of the association or division in the event of a reduction in the value of the relevant shareholding, and
it is extremely unlikely that the derivative financial instruments will lead to a net loss in holdings and instruments for the association or division in the event of an increase in the value of the relevant shareholding.

(3) Use of derivative financial instruments based on shares or share indexes shall also be regarded as being also on a covered basis, if

the association or division has cash and cash equivalents corresponding to the sum of the numerical value of the short and long net positions in the underlying shares or share indexes, and use of derivative financial instruments does not mean that the association or division in total obtains a short net position in any share or share index that is not covered by subsection (2).

(4) Acquisition of warrants shall be regarded as being on a covered basis, if this takes place in connection with the acquisition of the bonds to which they were linked on issue.

17.-(1) Use of derivative financial instruments based on bonds, bond indexes, money-market instruments, or interest shall be regarded as being on a covered basis, if they

do not increase the total interest-rate risk of the association or division in any currency,
do not mean that the association or division obtains a negative interest-rate risk in a foreign currency,
do not increase the exposure of the association or division with a given issuer of bonds and money-market instruments or a given bond index, and
do not mean that the association or division obtains a negative exposure with a given issuer of bonds and money-market instruments or a given bond index.

(2) Subsection (1), nos. 3 and 4 shall not cover indexes exclusively based on the securities and money-market instruments stated in section 93(1), no. 3a-c of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act.

18. Use of derivative financial instruments based on currencies shall be regarded as being on a covered basis, if they do not increase the total currency exposure of the association or division.

Part 5

Use on a non-covered basis

19.-(1) An investment association, special-purpose association and restricted association or divisions of such associations may, in addition to on a covered basis, cf. part 4, use derivative financial instruments, provided

the total exposure in securities, money-market instruments and indexes linked to derivative financial instruments that are not on a covered basis at no time exceeds 100 per cent of the total assets of the association or division, the sum of the short net positions in securities and money-market instruments linked to derivative financial instruments that are not on a covered basis, does not exceed the sum of cash and cash equivalents, 90 per cent of the market value of the holding of securities and money-market instruments covered by section 93(1), nos. 2 and 3, and section 94(1) of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act, except for securities covered by the definition of cash and cash equivalents, and 75 per cent of the market value of the holding of shares and bonds that are part of an index approved by the Danish FSA pursuant to section 95 of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act, the total numerical value of the interest-rate risk does not exceed the numerical value of an interest-rate risk that the association or division could achieve without using derivative financial instruments, and the total foreign-currency exposure of the association or division is not different from a total foreign-currency exposure that the association or division would otherwise have had without using currency-based derivative financial instruments.

(2) Subsection (1), no. 2a, shall not cover elements of cash and cash equivalents that hedge share-based derivative financial instruments used on a covered basis in accordance with section 16(3).

Part 6

Use of VaR models

20.-(1) An investment association, special-purpose association and restricted association may apply to the Danish FSA for authorisation to use VaR models (Value at Risk models) to calculate the position risk connected to the use of derivative financial instruments by the association or in one or several of the association's divisions. Authorisation shall require that the conditions in annex 2 are met.

(2) Authorisation pursuant to subsection (1) may be restricted to only cover use of VaR models to calculate position risks for a sub-portfolio in an association or division, including separately for shares, debt instruments or foreign currency respectively. Authorisation pursuant to the first clause may

also be restricted to only cover the use of VaR models to calculate the general risk.

(3) Authorisation pursuant to subsection (1) shall mean that at the association or division is not covered by the provisions of section 19, cf. however section 21(2)-(4).

21.-(1) An association or division with authorisation to use VaR models pursuant to section 20 may, in addition to using derivative financial instruments on a covered basis, use derivative financial instruments, provided the position risk of the association or division does not then exceed 200 per cent of the position risk of the association or division without the use of derivative financial instruments.

(2) When using VaR models to calculate the position risk of a sub-portfolio in an association or division, cf. section 20(2), 1st clause, subsection (1) shall be complied with for the sub-portfolio(s) covered by VaR models, and the provisions of section 19 shall be complied with for the sub-portfolios not covered by VaR models.

(3) If the authorisation only includes use of VaR models to calculate general risk, cf. section 20(2), 1st clause, then subsection (1) of this section and section 19(1), no. 2, and section 19(2) shall be complied with.

(4) Notwithstanding the provisions of subsections (1)-(3), an association or division with authorisation to use VaR models to calculate position risk may use derivative financial instruments, when section 19(1), no. 1 has been complied with.

Part 7

Calculation of investments covered by placement limits etc.

22. Investment associations, special-purpose associations and restricted associations or divisions of such associations shall, when using derivative financial instruments make a calculation of the investments covered by the placement limits in sections 93, 102-104 and 106 of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act in accordance with the provisions of sections 97 and 98 of said Act, cf. however section 24 below.

23.-(1) Innovation associations' or divisions of innovation associations' direct investments in securities and money-market instruments shall be added to the exposure in the underlying assets of the derivative financial instruments as

well as the counter party risk on contracts traded OTC in the calculation of investments covered by the provisions on the placement of funds and liquidity etc. by innovation associations in sections 43-45 of the Innovation Associations Act, cf. however section 24 below.

(2) The provisions on the placement of funds and liquidity by innovation associations in subsection (1) shall not apply for exposures in underlying assets linked to derivative financial instruments based on an index approved under section 95(2) of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act.

24. Securities and money-market instruments received as collateral for counterparty risk on contracts traded OTC, and which the association deducts in the calculation of counterparty risk in accordance with section 10(3), shall be included in the calculation of the associations' or division's investments covered by placement limits in sections 93, 102-104 and 106 of the Investment Associations and Special-Purpose Associations as well as other Collective Investment Schemes etc. Act and the provisions on the placement of funds and liquidity etc. by innovation associations in sections 43-45 of the Innovation Associations Act.

Part 8

Securities lending

25. Associations, which carry out securities lending, shall ensure that there is adequate guarantee or collateral for the securities lent and the other amounts receivable following from the terms of the loan.

Part 9

Provisions regarding penalties and entry into force

26.-(1) Any person violating section 1(1), (2) and (4) shall be liable to a fine.

(2) Companies, etc. (legal persons) may incur criminal liability according to the regulations in chapter 5 of the Criminal Code.

27.-(1) This Executive Order shall enter into force on 3 July 2004.

(2) At the same time, Executive Order No. 959 of 1 November 2001 on the Use of Derivative Financial Instruments by Investment Associations, Special-Purpose Associations and Innovation Associations shall be repealed.

While this translation was carried out by a professional translation agency, the text is to be regarded as an unofficial translation based on the latest official Executive Order no. 672 of 24 June 2004. Only the Danish document has legal validity.

September 2005, GlobalDenmark a/s

The Danish Financial Supervisory Authority, 24 June 2004

Henrik Bjerre-Nielsen

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Annex 1

Additions for potential future exposure in items with counterparty risk

In the calculation of the counterparty risk, the individual contract is included at the positive market value of the contract plus an addition as stated in the table as a percentage of the principal amount of the contract. The potential future exposure is to be included even in the event that the market value is negative.

Items	Addition (per cent of principal amount)
Items related to interest rates, remaining term up to and including one year	0.5
Items related to interest rates, remaining term more than one year but less than five years	1.0
Items related to interest rates, remaining term more than five years	1.5
Items related to shares, remaining term up to and including one year	6.0
Items related to shares, remaining term more than one year but less than five years	8.0
Items related to shares, remaining term more than five years	10.0
Items related to foreign-exchange rates, remaining term up to and including one year	1.0
Items related to foreign-exchange rates, remaining term more than one year but less than five years	5.0
Items related to foreign-exchange rates, remaining term more than five years	7.5
Repo and reverse repo transactions related based on bonds, remaining term up to and including one year	0.5
Repo and reverse repo transactions based on bonds, remaining term more than one year	1.0
Repo and reverse repo transactions based on shares, remaining term up to and including one year	6.0
Repo and reverse repo transactions based on shares, remaining term more than one year	8.0

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September 2005, GlobalDenmark a/s

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Annex 2

Use of VaR models

The requirements regarding use by associations of VaR models are based on similar regulations for, for example, use by banks of internal models to calculate items with position risks for capital adequacy purposes. In guidelines for banks etc., the Danish FSA has laid down general requirements for internal models that are to be used to calculate items with position risks.

Authorisation to use VaR models may only be granted if the association complies with the following qualitative and quantitative requirements.

1. Qualitative requirements

The model(s) of the association may only be used to calculate position risks, if the risk management and controls of the association are adequate and are carried out appropriately. This means that, amongst other things, the following qualitative requirements must be met:

The model(s) must be closely integrated in the daily risk management of the association and must form the basis of risk reporting to the board of directors and board of management of the association.

The association must have a risk control function, which reports directly to the board of management of the association. The risk control function is responsible for designing, updating and implementing the risk-management systems of the association, including the VaR models. The function must prepare and analyse reports regarding the results of the model(s), including reporting on compliance with the limits laid down in instructions etc.

The board of directors and board of management of the association must be active in the risk control process, and the daily reports from the risk control function must be processed at a management level with sufficient powers to be able to reduce the positions and risks of the association or the division.

The association must have an adequate number of qualified employees.

The association must lay down control procedures to ensure that the written instructions and procedures of the association regarding use of model(s) are complied with and monitored.

The association must have adequate historical documentation that the model(s) has/have previously calculated the association's or the division's risks with reasonable accuracy.

The association must carry out stress tests, and the results of these must be reviewed by, amongst others, the board of management. The results of the stress tests completed must be reflected in the instructions and limits laid down by the board of directors and the board of management.

The auditors must carry out an independent review of the model(s) and their use.

No less than once a year, the association must carry out an examination of the model(s) and risk management as a whole, which as a minimum, should involve examination of the adequacy of the documentation of model(s), risk management, and the organisation and tasks of the risk control function, how market risks in the model(s) is/are integrated in daily risk management, and the adequacy of management reporting, the procedures of the association for approval of the methods of risk calculation and measurement, the market risks covered by the methods of risk calculation, and assessment of any material changes in the methods of risk calculation, the correctness and adequacy of the calculation of the positions of the association or division, the accuracy of the volatilities and correlations calculated, as well as the accuracy of the calculation as well as the calculations of risk sensitivities, the control process used by the association in assessment of whether the sources of information used in the model(s) are consistent, up-to-date and reliable, as well as whether such sources of information are independent, and the procedures of the association for preparation of back tests, which are carried out in order to assess the accuracy of the model(s).

2. Quantitative requirements

As a minimum, the model(s) of the association must apply the following quantitative criteria in the calculation of position risks:

Calculation of the potential risks of the association or division on at least a daily basis.

Uniform 99 per cent confidence interval.

Bearer period corresponding to 10 days.

Effective observation period of no less than one year, unless a shorter observation period is permitted as a result of a significant change in the price volatility.

No less than quarterly updating of correlations, volatilities etc.

3. Calculation of general risk

If the association uses VaR models, the general risk comprises the largest amount of the following values:

The general risk calculated for the previous day's positions.

The average of the general risk calculated for the previous 60 working days.

4. Risk factors

The model(s) must take account of a sufficiently large number of risk factors depending on the level of activity of the association or the division in the respective markets, including significant risks regarding options and options-like positions. The following provisions must be met as a minimum:

For interest-rate risks the model must apply a number of risk factors corresponding to the interest rates in the individual foreign-exchange rates in which the association or division has interest-rate-sensitive positions. The association must estimate the yield curves from applying generally accepted methodologies. For significant interest-rate risks in the most important foreign-exchange rates and on the most important markets, the yield curve must be divided into no less than six term segments in order to highlight differences in volatilities along the yield curve. The model must also highlight the risk that the correlation between different yield curves is not perfect.

For exchange-rate risks, the model must apply risk factors corresponding to the individual foreign currencies in which the association or division has positions.

For share-price risks, the model must apply no less than one separate risk factor for each of the stock markets in which the association or division has positions.

The Danish FSA may grant the association authorisation to apply empirical correlations within the risk categories and across risk categories, if the model(s) of the association to assess correlations function well and is/are appropriately implemented.

5. Calculation of specific risk

The Danish FSA may grant the association authorisation to use VaR models to calculate specific risk for shares and debt instruments. In addition to the requirements in point 4, the models must comply with the following:

Describe the historical price fluctuations of the portfolio.

Take account of the concentration expressed as the size of the changes in the composition of the portfolio.

Be insensitive to changes in assumptions.

Be validated through back tests aiming at assessing how accurately the specific risk is accounted for. If the Danish FSA permits the use of back tests on the basis of relevant sub-portfolios, these must be selected consistently.

If the Danish FSA grants an association authorisation to use VaR models in accordance with points a)-d) in order to calculate the specific risk, then the specific risk must be calculated for each risk category, ie. shares and debt instruments or for sub-portfolios of these which have a specific risk.

If the specific risk for sub-portfolios in the association or division is calculated, the association must report in advance the composition of the sub-portfolios and it may not change these without the consent of the Danish FSA.

The Danish FSA may omit to impose the requirements on separate calculation of the specific risk described above. Such omission requires that the association documents that, in line with the agreed international standards, its model(s) for calculation of general risk accurately take(s) account of unforeseen events and defaults (event and default risk) for its shares and debt instruments.

6. Back tests

The association must check the accuracy and results of the model by performing back tests. Back tests are carried out by comparing the daily potential risk for losses, calculated using the association's model for daily closing positions of the portfolio, with the daily change in the value of the portfolio at the close of the following trading day. The association must be able to perform back tests on the basis of both actual and hypothetical changes in the value of the portfolio.

Back tests on the basis of hypothetical changes in the value of the portfolio must be performed by comparing the daily closing value of the portfolio assuming unchanged positions, with its value at the close of the following day, ie. trading carried out in the following day is ignored.

Back tests on the basis of actual changes in the value of the portfolio must be performed by comparing the daily closing value of the portfolio with the association's or the division's portfolio on the following day, ie. trading on the following day is taken into account.

An excess is when a daily change in the value of the portfolio exceeds the related potential risk calculated using the model(s) of the association.

If there are many excesses in association's model(s), which would indicate that it/they are not sufficiently accurate, the Danish FSA will withdraw authorisation or order the association to take the measures necessary to ensure that the model(s) is/are improved.

The association must take appropriate measures to improve its back tests, if these are deemed to be inadequate.

Official notes

¹⁾ This Act contains provisions implementing Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), (Official Journal L 375, p. 3), as partially amended by Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 with a view to regulating management companies and simplified prospectuses, (Official Journal L 41, p. 20), and Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 with regard to investments of UCITS (Official Journal L 41, p. 35).

Links to EU directives, cf. note 1

[Directive 1985/611/EEC](#) Celex no. 31985L0611

[Directive 2001/107/EC](#) Celex no. 32001L0107

[Directive 2001/108/EC](#) Celex no. 32001L0108

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