WEBINAR Q&A

The latest SEC proposed derivatives rules and how they can impact your business

Audience questions from January 14, 2016 Webinar

Responses provided by Nora M. Jordan, Partner, Davis Polk and Gregory S. Rowland, Partner, Davis Polk

Davis Polk

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WHAT IS THE SEC'S RATIONALE FOR APPLYING THESE RULES ONLY TO REGISTERED FUNDS?

The SEC may only exercise authority granted to it by Congress. The SEC's authority in this case stems from Section 18 of the Investment Company Act of 1940, which only applies to registered funds.

HOW DOES THIS RULE RELATE TO THE 300% ASSET COVERAGE RULE?

This is an important unresolved issue in the proposal. The SEC did not address this question and specifically asked for comment about how the proposal should interact with the asset coverage requirements under Section 18.

WHEN THE PROPOSAL DISCUSSES THE BOARD, IS IT THE BOARD OF THE FUND OR THE BOARD OF THE INVESTMENT ADVISOR?

The requirements in the proposal apply to the board of the fund.

DOES THIS AFFECT ETFS?

Yes, the proposal will apply to ETFs.

ARE EQUITY-LINKED SECURITIES SUCH AS PARTICIPATORY NOTES IN THE SCOPE OF THE DEFINITION?

So long as an equity-linked security, such as a participatory note, does not involve a future payment obligation on the part of the fund, it should not be in the scope of the definition.

IS THERE A DISTINCTION BETWEEN LISTED AND UNLISTED DERIVATIVES?

The proposal does not make any explicit distinction between listed and unlisted derivatives for the purposes of calculating exposure. It is possible however, that a fund

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board could consider whether or not a derivative is listed as a factor that affects the risk-based coverage amount that they believe is appropriate.

DO YOU THINK TBAS ARE INTENDED TO BE TREATED AS FINANCIAL COMMITMENT TRANSACTIONS?

If a transaction involves a commitment by a fund to make a future payment (such as a TBA transaction where a fund commits to buy a certain amount of securities at a stated price), then it will likely be considered a financial commitment transaction under the proposal.

WOULD MARGIN LOANS TO A '40 ACT FUND (I.E., A COMMITTED CREDIT FACILITY SECURED BY MARGIN STOCK) BE WITHIN THE SCOPE OF THE DEFINITION OF FINANCIAL COMMITMENT TRANSACTIONS? IF NOT, WOULD THEY STILL NEED TO BE COUNTED FOR PURPOSES OF DETERMINING EXPOSURE?

No, we would expect that margin loans would not be considered financial commitment transactions under the proposed rule. They would probably continue to be treated as loans under Section 18 of the Investment Company Act. However, they would be counted in a fund's exposure because a fund's total exposure under the proposed rule is the sum of three separate categories (i) the notional amount of its derivatives exposure, (ii) its aggregate financial commitment obligations and (iii) its other capital structure indebtedness, which includes margin loans.

WHAT TYPE OF VAR CALCULATION DOES A FUND NEED TO USE UNDER THE PROPOSAL (I.E. HISTORICAL, MONTE CARLO, OR PARAMETRIC)?

The proposal would allow a fund to use any method for calculating VaR so long as it takes into account and incorporates all significant, identifiable market risk factors associated with the fund's investments. If a fund elects to use the historical method, it must use at least three years of market data. Additionally, any VaR calculation must be at a 99% confidence interval using a time horizon of at least 10 but less than 20 trading days.

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WHAT IS CURRENT PRACTICE WITH RESPECT TO EXPOSURE LIMITS UNDER THE NO-ACTION REGIME?

Under most interpretations of current law, there is no explicit exposure limit, but there are asset segregation requirements that function as practical limitations on the amount of exposure a registered fund can achieve. Generally, under current law, a fund holding a cash-settled derivative is required to segregate its mark-to-market liability and a fund holding a physically-settled derivative is required to segregate assets equal in value to the underlying asset.

DOES THE LOOK THROUGH PROVISION OF THE RULE APPLY TO ALL INDEXES OR JUST TO INDEXES THAT REPLICATE A MANAGED ACCOUNT?

There are special look-through rules for calculating the notional amount of a fund's exposure when the underlying reference asset is a managed account or an entity formed primarily for the purpose of investing in derivatives, as well as indexes referencing either of these two categories. We believe that generally the look-through should not apply unless the derivative reflects the performance of such a managed account or entity.

DO YOU NET LONG AND SHORT EXPOSURE?

Generally, no. Total exposure is the sum of the absolute values of all exposure. There is a limited exception allowing netting of directly offsetting transactions when calculating exposure.

ARE THE EXPOSURE LIMITS CALCULATED ON A MARKET VALUE BASIS OR A NOTIONAL BASIS?

A fund's exposure is calculated based on the notional value of the derivatives it holds, which is generally calculated as the market value of an equivalent position in the underlying reference asset (or the principal amount upon which payment obligations are calculated). If this is the only transaction the fund has entered, its exposure will be $100mm, assuming the market value of the underlying asset is $100mm.

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HOW DOES THE RULE MEASURE EXPOSURE FOR FX FORWARDS LEGS?

Generally, exposure for an FX forward is the notional contract value of the currency leg(s).

DOES THE PROPOSED RULE DIFFERENTIATE BETWEEN ABSOLUTE AND BENCHMARK-RELATIVE RISK?

While it is true that derivatives can lower the risk of a portfolio compared to a benchmark, the proposed rule is only concerned with absolute risk; even a portfolio that is less risky than its benchmark could have too much exposure to comply with the proposed rule.

HOW SHOULD TENDER OPTION BONDS (TOBS) BE VIEWED UNDER THE PROPOSED RULE: DERIVATIVE TRANSACTIONS OR FINANCIAL COMMITMENT OBLIGATIONS?

The proposed rule is unclear on this issue. It is possible that a registered fund's holding of tender option bonds would be outside the scope of the proposed rule and thus treated as indebtedness subject to the 300% asset coverage requirement. It is also possible that the TOBs would be treated as financial commitments under the proposed rule as they are in some ways similar to repurchase agreements (or possibly even treated as derivatives transactions). It is likely that this topic will be covered in a number of comment letters.

DOES THE MARK-TO-MARKET COVERAGE APPLY TO BOTH CASH AND PHYSICALLY-SETTLED DERIVATIVE INSTRUMENTS?

Yes, a fund must segregate its mark-to-market obligations for both cash-settled and physically-settled derivatives. This is one of the few areas of the proposal that is more favorable for funds than current law; under most interpretations of current guidance, a fund holding a physically-settled derivative must segregate the entire amount it could owe under the transaction, not just its mark-to-market liability.

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WHAT IS THE DIFFERENCE BETWEEN A FUND'S RISK-BASED COVERAGE AMOUNT AND INITIAL MARGIN?

A fund is required to segregate a risk-based coverage amount meant to account for the possibility it will need to exit a transaction during periods of market stress, but may reduce this by the amount of initial margin it has already posted. If a fund reasonably determines that the initial margin already takes into account all the relevant risks of a transaction and it would not be required to pay more to exit during a period of market stress, then it may be able to determine that no additional segregation is necessary.

DO "ASSETS THAT TIMELY CONVERT TO OR GENERATE CASH" INCLUDE LIQUID EQUITY SECURITIES?

The proposed rule allows a fund some flexibility in determination of an asset's convertibility or ability to generate cash. If, in conjunction with policies and procedures approved by the fund's board of directors, a fund determines that certain equity securities it holds will generate enough cash to cover its obligations under a financial commitment transaction in a timely manner, then it may use those assets to fulfill the segregation requirement.

AN "UNLEVERAGED" EQUITY MUTUAL FUND CAN INVEST IN COMPANIES THAT HAVE FINANCIAL LEVERAGE. DOES THE PROPOSED RULE REQUIRE A LOOK THROUGH OF THE LEVERAGE OF THOSE COMPANIES?

We do not believe that a look through will be required of operating companies.

DOES THE PROPOSAL REQUIRE REGISTERED FUND-OF-FUNDS TO LOOK THROUGH TO UNDERLYING PORTFOLIO FUNDS' EXPOSURES?

The rules apply to a fund-of-funds if it is a registered fund and uses derivatives or financial commitment transactions. Generally, a fund-of-funds will not be required to look through to the exposure of its underlying funds.

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IS PHYSICAL SEGREGATION OF COVERAGE ASSETS REQUIRED?

Physical segregation is not required by the proposal; a fund may "segregate" assets by identifying the specific assets daily on its books and records.

BANK LOANS THAT ARE COVERED BY THE PROPOSED RULE REFERS TO DIRECT BORROWING BY THE FUND OR THE ASSET CLASS?

Section 18 and the proposed rule are referencing a fund's ability to *borrow from* a bank and issue other capital structure indebtedness (such as preferred stock and bonds).

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Nora M. Jordan, Partner, Davis Polk nora.jordan@davispolk.com
Gregory S. Rowland, Partner, Davis Polk gregory.rowland@davispolk.com

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Americas - 1 888 588 4567 (toll free)
clientservice@msci.com

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