THE LATEST SEC PROPOSED DERIVATIVES RULES AND HOW THEY CAN IMPACT YOUR BUSINESS

January 14, 2016

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TODAY’S SPEAKERS

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Overview

Proposed Rule 18f-4 would impose new restrictions on the use of derivatives and financial commitment transactions by registered funds

- Important shift in SEC's approach and change from industry practice
- New requirements include:
  - Overall portfolio exposure limit
  - Asset segregation requirement
  - Formal derivatives risk management program
  - Recordkeeping requirements
  - Reporting obligations
- Comments due March 28, 2016

Covered Transactions

The proposed rule covers two types of transactions, which are treated differently based on the SEC's views of the risks they involve

- Derivatives Transactions
  - Swaps, security-based swaps, futures contracts, forward contracts, options, or any similar instruments under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise
  - Fully-paid instruments are outside the scope of the definition
- Financial Commitment Transactions
  - Repos, reverse repos, short sale borrowings, any firm or standby commitment agreements, or similar agreements
  - This definition is designed to include unfunded commitments

Portfolio Exposure Limits

OVERVIEW OF PORTFOLIO EXPOSURE LIMITS

A registered fund engaging in derivatives transactions must comply with one of two portfolio exposure limits

- Limits are based on ratio of fund's NAV to the notional amount of its derivatives transactions
  - Exposure-based limit – 150% of NAV, even if exposure increases fund's risk
  - Risk and exposure-based limit – 300% of NAV
    - Derivatives transactions reduce fund's risk
    - "Portfolio VaR" (with derivatives) must be lower than "Securities VaR" (without derivatives)
- Board must approve applicable portfolio limitation and monitor compliance
- Compliance with the applicable limit is calculated immediately after fund enters into a transaction
  - A fund would not be required to unwind a transaction solely because its exposure subsequently increased beyond the applicable exposure limit due to changes in market values.

Portfolio Exposure Limits (cont.)

CALCULATING EXPOSURE

A fund's "exposure" is the sum of three amounts:

- Aggregate notional amount of the fund's derivatives transactions
- Aggregate financial commitment obligations
- Aggregate indebtedness under any other transactions covered by Section 18

Derivatives Transactions	• Generally, the principal amount or market value of an equivalent position in the underlying reference asset
Financial Commitment Obligations	• Amount of cash or other assets the fund is obligated to pay
Other Capital Structure Indebtedness	• Primarily bank loans, preferred securities, and bonds

Asset Segregation Requirement
DERIVATIVES TRANSACTIONS

In addition to meeting one of the portfolio limits, fund must segregate "qualifying coverage assets" sufficient to cover its potential obligations

- Determined at least once per day
- Mark-to-market coverage
  - The amount payable if the fund were to exit the transaction at that time
  - May be reduced by a netting agreement as well as by any variation margin or collateral already posted

- PLUS -

- Risk-based coverage
  - An amount representing a reasonable estimate of the amount payable if transaction exited under stressed conditions
  - Determined in accordance with board-approved policies and procedures
  - Reduced by any applicable netting agreement and by initial margin or collateral already posted

Asset Segregation Requirement (cont.)

FINANCIAL COMMITMENT TRANSACTIONS

Fund must maintain assets sufficient to meet its aggregate "financial commitment obligations"

- Determined at least once per day
- The amount of the fund's aggregate "financial commitment obligations"
  - The amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver
  - Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation is the value of the asset

Asset Segregation Requirement (cont.)

QUALIFYING COVERAGE ASSETS

The types of assets a fund must segregate vary depending on the type of transaction

Type of Transaction		Qualifying Coverage Assets		
		Cash and Cash Equivalents	Underlying Assets to be Delivered by Fund	Assets That Timely Convert to or Generate Cash
Derivatives transaction	Cash settled	X		
	Physically settled	X	X	
Financial commitment transaction		X	X	X

- **<u>Cash and Cash Equivalents</u> are commonly considered to include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.**
- **<u>Assets convertible to or expected to generate cash</u> include "highly liquid" assets that could be easily converted to cash and fixed-income securities that mature prior to the date of the financial commitment transaction. A registered fund's board must adopt policies and procedures regarding the determination of which assets meet this definition.**

Derivatives Risk Management Program

- Required in two situations:
  - Fund's aggregate derivatives exposure exceeds 50% of NAV
  - Fund enters into "complex derivatives transactions"
- If fund does not trigger either prong, no formal risk management required so long as fund monitors its portfolio to ensure it does not trigger either test.
- Otherwise, must enact derivatives risk management program consisting of:
  - Written policies and procedures
  - Board oversight of risk management program
  - Designation of an employee of the fund or the adviser to be responsible for risk management, including administration of risk management policies and procedures

Derivatives Risk Management Program (cont.)

SPECIFIC REQUIREMENTS

Written Policies and Procedures

- **Assessment of risks** associated with the fund's derivatives transactions
- **Management of risks**, including any special risks identified in the risk assessment phase
- **Segregation of functions** associated with risk management from those associated with portfolio management
- **Periodic review and update** of the risk management program (at least annually)

Board Approval and Oversight

- Initial approval of derivatives risk management program and any material changes
- Approval of the employee or officer who is responsible for administering the program
- Review a written report about the derivatives risk management program and prepared by the person responsible for it at least quarterly

Reporting and Recordkeeping Requirements

Recordkeeping Requirements

- Written copy of derivatives policies and procedures
- Daily records reflecting the coverage amount for each derivatives transaction
- Daily records identifying the specific qualifying coverage assets for each derivatives transaction and financial commitment transaction
- All records must be maintained for at least five years (past two years in an easily accessible place)

Reporting Requirements

- Form N-PORT
  - Required of any fund that has a derivatives risk management program
  - Filed quarterly
  - Report detailed, technical information about fund's derivatives transactions
- Form N-CEN
  - Required of all funds
  - Filed annually
  - Identify the portfolio limitation (exposure-based or risk-based) with which fund complies

Final Thoughts

- All registered funds will be affected
  - Even funds that do not engage in derivatives transactions or engage in minimal derivatives transactions will need to monitor their compliance with the portfolio limitation to avoid enacting a formalized derivatives risk management program
- Additional oversight responsibilities for board
- Certain methods of achieving leverage likely less favorable under new rule

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