SEC Considering Key Changes to Derivative Exposure Calculations

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On November 1, 2016, the Securities and Exchange Commission's (SEC) Division of Economic and Risk Analysis (DERA) published additional economic analysis setting forth the methodology used to analyze certain comments received on the SEC's proposed rule regarding the use of derivatives by registered funds and business development companies.[1] According to DERA, many commenters proposed that the final rule should measure a fund's derivatives exposure using notional amounts adjusted to reflect the risks of the underlying reference assets. DERA evaluated elements of the proposal that included (i) the consistency of using risk-adjustment and haircut schedules across asset classes, and (ii) categories created for the purposes of risk adjustment and risk weighting with respect to the rule.

I. Adjusting Notional Amounts of Derivatives for Risk

As proposed, both the exposure-based and risk-based portfolio limits prescribed in rule 18f-4 would cap a fund's notional amounts attributable to derivatives.[2] The proposed rule defines "notional amounts" generally to mean either (i) the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions); or (ii) the principal amount on which payment obligations under the derivatives transactions are calculated.[3] These gross notional calculations with different underlying assets, however, translate to substantially different risks and potential obligations. Focusing on notional exposures could disadvantage certain types of funds that use categories of derivatives with high notional amounts but lower risk profiles, such as taxable bond funds that use interest rate derivatives to manage duration and currency hedged funds.

DERA's release suggests that the SEC may allow funds to adjust the notional amounts attributable to derivatives based on underlying asset classes. This is consistent with DERA's previous white paper on investment company use of derivatives, noting that "because of differences in expected volatilities of the underlying assets, notional amounts of derivatives across different underlying asset[s] generally do not represent the same risk."[4] In the past, the SEC and other regulators have allowed for adjustments to notional exposure by an appropriate factor in order to address concerns related to the inconsistent risk profiles of notional values. In setting the standardized "look-up table" of initial margin requirements for uncleared swaps, the Commodity Futures Trading Commission (CFTC) set the initial margin requirements as different percentages of notional amounts for each underlying asset class to better reflect the varying risk profiles for derivatives with different underlying asset classes.[5]

Notably, proposed rule 18f-4 would not differentiate between the use of derivatives for speculation and for hedging.[6] DERA's failure to take into account hedges that reduce or eliminate economic exposure in its November 1 release suggests that the final rule may treat all derivative transactions consistently for purposes of coverage requirements and other obligations. As a result, funds should prepare to include derivatives transactions entered into for discrete hedging purposes in their notional amount calculations for the Exposure-Based Limit and the Risk-Based Limits contemplated in proposed rule 18f-4.

II. Expanding Types of Assets Eligible as Qualifying Coverage Assets

DERA's release suggests that the SEC is reconsidering the proposal's significant departure from previous SEC guidance, the margin requirements of other US regulators and the international margin standards. Under the SEC's proposal, qualifying coverage assets for derivatives transactions would be limited to cash and cash equivalents.[7] These strict limitations on qualifying coverage assets would substantially narrow the categories of liquid assets that funds may segregate to cover obligations under derivatives transactions under previous Commission staff guidance.[8] The increased demand for cash under the proposed rule and other regulatory requirements would result in adverse consequences for fund investors, including increased “cash drag” on fund performance and an increased cost of cash equivalents in the capital markets due to a regulation-induced pressure on demand. Many comment letters discussed this objection.[9]

Both the Prudential Regulators Margin Rules and the CFTC Margin Rules permit risk adjustments, which range from 0.6 percent for eligible government securities with a residual maturity of less than one year to 25 percent for equity securities included in the S&P 1500 Composite or a related index.[10] Allowing a broader group of qualifying coverage assets, combined with appropriate risk adjustments, would allow funds both to continue to hold assets consistent with their investment strategy and minimize cash drag while also addressing the Commission's concern that funds have sufficient assets available to meet their obligations even if their assets decline in value.

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[1] See Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015).

[2] See proposed Rule 18f-4(c)(3)(i) (defining “exposure” to include “the aggregate notional amounts of the fund's derivatives transactions”).

[3] See proposed Rule 18f-4(c)(7)(i) and (ii).

[4] See Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (2015).

[5] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,

81 Fed. Reg. 636 (Jan. 2, 2016).

[6] Legitimate hedges may include (i) a currency derivative that provides short exposure to a currency in which a security held by the fund is denominated, and the short exposure does not exceed the value of the security; (ii) a written call option on securities in the fund's portfolio; and (iii) a purchased single-name CDS that provides credit protection on the issuer of a security held by the fund with a notional exposure that does not exceed the principal amount of the security.

[7] Proposed Rule 18f-4(c)(8). In limited situations, the proposal also would permit funds to use a particular asset for any transaction in which a fund may satisfy its obligation under the transaction by delivering the asset.

[8] See Release No. 10666 (permitting segregation of cash, US government securities and other high-grade debt obligations); Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) (permitting segregation of any "liquid assets," including equity securities and non-investment grade debt securities).

[9] See Letter from BlackRock to Brent J. Fields, Secretary, Securities and Exchange Commission (Mar. 28, 2016) ("the requirement for [currency-hedged products] to hold cash or cash equivalents against FX exposures will result in cash drag and introduce significant tracking error, making these products less palatable and less available to investors."). See also Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission (Mar. 28, 2016) ("Restricting qualifying coverage assets to cash and cash equivalents can penalize investors by creating a 'cash drag' on the performance of a fund that otherwise would be fully invested."); Letter from SIFMA AMG to Brent J. Fields, Secretary, Securities and Exchange Commission (Mar. 28, 2016) ("[…] the attendant "cash drag" imposed on regulated funds if they were required to hold cash in order to utilize the derivatives necessary to risk manage the portfolio could reduce fund performance.").

[10] Additionally, under the BCBS/ IOSCO Final Margin Policy Framework, assets can serve as margin if they are "highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress." See *Margin requirements for non-centrally cleared derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013).

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