Blogs
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Asset Management ADVocate

Market Volatility Regulatory Outline for Asset Managers

I. DERIVATIVES ISSUES

1. Inventory "relationship level" considerations in legal documentation that governs your derivatives trading relationships (ISDA Master Agreements, Futures Customer Agreements, Master Securities Forward Transaction Agreements, etc.)

a. Example: Decline in Net Asset Value Provisions (Common in ISDAs)

i. Identify the trigger decline levels and time frames at which transactions under the agreement can be terminated (25% over a 1-month period - is that measured on a rolling basis or by reference to the prior month's end?)

ii. Confirm whether all or only some transactions can be terminated (typically, it is all transactions)

iii. Identify the notice requirements that apply when a threshold is crossed

iv. Identify whether the agreement includes a "fish or cut bait clause" that restricts the ability of the other party to designate the termination of the transactions under the trading agreement

b. Example: Events of Default that relate to investment policies and strategies

i. Some representations or covenants make specific reference to prospectuses or investment strategies or have notice requirements that apply prior to making any changes to disclosure documents

ii. Operate in times of market volatility in a manner consistent with the requirements of these provisions - for example, give required notices

c. Margin and Collateral Provisions

i. Identify whether the counterparty/broker has latitude to change the margin or collateral requirements and, if so, whether advance notice of these changes is required

ii. Inventory what constitutes eligible collateral and what haircuts apply to different types of collateral with different counterparties/ brokers (and whether the counterparty/broker has latitude to unilaterally modify either the types of eligible collateral or the haircuts that apply

iii. Identify whether your trading documentation addresses the impact of negative rates on the obligations of the pledgor and secured party to pay interest on cash collateral posted by the other party

iv. Familiarize yourself with the operation of any dispute resolution provisions that apply with respect to margin calls and collateral valuation

v. Monitor collateralization levels, so as to avoid having excess margin at the counterparty/broker and putting unnecessary pressure on liquidity during a period of market volatility

vi. Monitor developments in counterparty risk

2. Inventory "Transaction-Specific Considerations":

a. Pandemic Bonds

i. Determine whether there is direct or indirect exposure to pandemic bonds and potential losses of principal for investors in the current market environment

b. Credit Derivatives

i. Monitor developments with respect to individual names, especially in industries that may be impacted by the causes of the market volatility

ii. Familiarize yourself with the mechanics of ISDA's auction protocol processes by looking at auctions related to credit events from 2008-2010 timeframe

c. Equity Derivatives

i. Inventory which Additional Disruption Events (e.g., Hedging Disruption, Increased Cost of Hedging, Loss of Stock Borrow, Increased Cost of Stock Borrow) apply to each Transaction by reviewing trade confirmations

ii. Analyze whether there have been modifications to the manner in which standard definitions (e.g., the 2002 ISDA Equity Derivatives Definitions) would operate with respect to the occurrence of these events

d. Interest Rates Derivatives

i. Review confirmations to determine whether there has been an election to use the Zero Interest Rate Method instead of the Negative Interest Rate Method (e.g. there is a variable rate loan with a "deemed zero" clause that is being hedged)

ii. Interest rate hedges embedded within structured products may have a "mismatch," so review both direct and indirect exposures

II. INVESTMENT MANAGEMENT DURING HIGHLY VOLATILE MARKETS

1. Follow Your Risk Management Plans

a. If you are an open-end investment company (other than a money market fund), you must have a liquidity risk management program. The program should address "reasonably foreseeable stressed conditions."

b. Many firms have more general risk management functions, including a Chief Risk Management Officer and a dedicated team. Their planning should cover management of risks beyond liquidity risk.

c. The virus outbreak may also trigger business continuity and disaster recovery plans. These may make it more difficult to coordinate other risk management measures.

2. Understand Your Role

a. A good plan doesn't require any one person to know or do everything to deal with market volatility

b. So let:

i. Traders and portfolio managers monitor market conditions and define what options are available and feasible

ii. Risk managers measure risk and coordinate mitigation efforts

iii. Compliance monitor compliance

iv. Investor Relations manage communications with shareholders and the press

v. Lawyers interpret regulatory and disclosure requirements, prepare required notices and filings, and manage communication with the Board

c. Communicate

Get the team together at specified times (e.g., before trading opens or after it closes) to share information and make decisions (e.g., reclassifying liquidity of classes of investments). **III. LIQUIDITY RISK MANAGEMENT**

1. The goal of liquidity risk management is to pay redemptions as promised. Implementing the program should help to accomplish this. Try to note any gaps to address in later revisions.

2. Rule 22e-4 Requirements

a. Must review classifications "more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications." As noted, this can be done on a regular basis at scheduled meetings of the risk management team.

b. If net redemptions are exceeding those anticipated by the program, you may also need to reassess the reasonably anticipated trading size (RATS) used for classification.

c. If net redemptions, portfolio sales and reclassifications have caused the fund to fall below its highly liquid investment minimum, assess the chances of alleviating the shortfall within the prescribed seven-day period. If the outcome is in doubt, consider notifying the Board before the period has expired. Remember, Board approval is required to lower the minimum after a shortfall has occurred.

d. If net redemptions and reclassifications cause the fund to exceed the 15% limit on illiquid investments, develop a plan to bring the fund back into compliance and notify the Board by the next business day.

e. File an N-Liquid if necessary.

f. We assume swing pricing isn't an option, either because the fund does not already have the required policies and procedures or because it wouldn't want to be the first to do it.

3. Other Considerations

a. If the funds have an intrafund lending order, review procedures and assess whether it could be useful. Also review lines of credit or confirm overdraft facilities with the funds' custodian.

b. If portfolio sales cause the fund to exceed other risk parameters (e.g., tracking error), develop plans to bring fund back within limits as expeditiously as possible.

IV. DISCLOSURE

1. Lawyers tend to view disclosure as "chicken soup," in that it rarely can make a situation worse. But a prospectus is not a newspaper and shouldn't be stickered for every new development. Materiality should be evaluated based on the "total mix" of available information, which includes information available from other sources.

2. Nevertheless, several funds (particularly international funds) have augmented their risk disclosure for pandemics. Therefore, updated disclosure may be needed on a case-by-case basis.

3. Rely on temporary defensive measures disclosure if appropriate.

4. Diversification and similar percentage limitations on investments generally apply at the time of acquisition, so net redemptions, changes in relative value and portfolio sales should not result in violations of these limitations. They may, however, result in a portfolio that is markedly different from its disclosed investment strategy. Be alert for opportunities to realign the portfolio with this strategy.

V. VALUATION

1. If the fund calculates its NAV at the close of the NYSE, and the exchange halts trading for the rest of the day before four, that is the time the NAV is determined. Orders received after that time should be priced the next day.

2. Problems with liquidity and valuation often go hand-in-hand. If you are reassessing a liquidity classification, you should also reassess the valuation methodology.

3. Providing pricing services with facts (CUSIP XYZ was offered at this level) can be helpful and appropriate. Challenges should also be based on facts.

4. Changing valuation methodology in response to adverse price changes is risky. This is a common factor in enforcement actions.

VI. OTHER CONSIDERATIONS

1. If the Fed continues to cut rates, money market funds may not have enough income to pay distribution fees. The sponsor may need to reactivate fee caps and waivers.

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