April 15, 2021
Derivatives Exposure: Why It Matters And How To Calculate It

Our last post outlined the essential differences between VaR Funds and Limited Derivatives Users: primarily that the former must adopt a derivatives risk management program (a "DRM Program") while the latter need only have policies and procedures. Our post observed that the less prescriptive regulatory requirements may make operating as a Limited Derivative User an attractive alternative for many management investment companies (including business development companies but excluding money market funds, a "Fund"). As promised at the end of that post, this post initiates our exploration of the challenges of qualifying as a Limited Derivatives User. We begin by providing a high-level step-by-step guide to calculating a Fund's "derivatives exposure."

Why Derivatives Exposure Matters

A Fund that seeks to qualify as a Limited Derivatives User must satisfy three principal requirements:

- Adopt and implement written policies and procedures reasonably designed to manage the Fund's derivatives risk;
- Its derivatives exposure should not exceed 10 % of its net assets; and
- Should its derivatives exposure exceed 10% for more than five business days, the Fund must either promptly reduce the derivatives exposure to 10% (within no more than thirty calendar days of first exceeding 10%), in a manner that is in the best interests of the Fund and its shareholders, or else adopt and comply with a DRM Program as soon as reasonably practicable.

So, calculating a Fund's derivatives exposure is essential to complying with the second and third requirements.

Calculating Derivatives Exposure: The Big Picture

The following is a six-step guide to the information required to calculate a Fund's derivatives exposure.

Step 1: Identify Derivatives Transactions

You will find a summary of "derivatives transactions," all of which may be included in a Fund's derivatives exposure, at our Derivatives Transactions Recap post. We assume that a Limited Derivatives User will not elect to treat reverse repurchase agreements as derivatives transactions because that would increase the Fund's derivatives exposure.

Step 2: Quantify the Derivatives Transactions

The following table shows how derivatives transactions should be quantified (their "Exposure Amount") for purposes of calculating a Fund's derivatives exposure.

Type of Derivatives Transaction	Exposure Amount
Options	Delta adjusted gross notional amount
Interest rate derivatives (IRDs)	10-Year bond equivalent of the gross notional amount
Short sale borrowings	Market value of assets sold short
All derivatives transactions other than options, IRDs and short sale borrowings	Gross notional amount

Step 3: Identify Excluded Currency and Interest Rate Hedges

Qualifying IRDs and currency derivatives transactions do not count toward derivatives exposure. These include derivatives transactions that were entered into and maintained in order to hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the Fund or the Fund's borrowings. For these purposes, a derivatives transaction for foreign currency can only be used to hedge risks associated with an equity or fixed-income investment that is denominated in a currency other than U.S. dollars. To be excluded from the derivatives exposure calculation, the aggregate Exposure Amounts of these hedging IRDs and currency derivatives may not exceed the value of the hedged equity investments, the par value of the hedged fixed-income investments, or the principal amount of any hedged borrowings by more than 10%.

Step 4: Identify Closed-Out Positions

A Fund should identify derivatives that directly offset and close-out a derivatives transaction with the same counterparty. Note that a derivative that is not a "derivatives transaction" can be used for this purpose. For example, an option purchased by a Fund (which is not a derivatives transaction) can offset an option written by the Fund (which would be). These offset derivatives transactions do not count toward a Fund's derivatives exposure if they do not result in credit or market exposure to the Fund.

Step 5: Calculate the Fund's Derivatives Exposure

Sum the Exposure Amounts of the Fund's derivatives transactions after excluding the derivatives transactions identified in Steps 3 and 4. The result is the Fund's derivatives exposure.

Step 6: Determine Whether the Fund is a Limited Derivatives User

A Fund will be a Limited Derivatives User if its derivatives exposure does not exceed 10% of its net assets. We will now proceed to unpack steps 2 through 5 based on explanations provided in the adopting release for Rule 18f-4, identifying many questions we cannot answer along the way. But first, for those mathematically inclined, our next post will provide a "derivatives exposure formula."

Explore more in

Investment Management