Blogs
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Asset Management ADVocate

Rule 18f-4: Trimming Hedges—Hedges Included in Derivatives Exposure

This post continues our examination of how a fund must treat hedges when calculating its derivatives exposure to qualify as a limited derivatives user. Commenters on proposed Rule 18f-4 suggested several types of derivatives hedges, in addition to currency derivatives, that the Commission might exclude from derivatives exposure. In the release adopting Rule 18f-4 (the "Adopting Release"), the Commission agreed to exclude interest rate derivatives from the calculation of derivatives exposure, but rejected the other suggestions. These other hedging strategies should therefore be included in a fund's derivatives exposure. We previously discussed covered call options and purchased option spreads, which are derivatives transactions and should be included in derivatives exposure. Other potential hedges that should be included in derivatives exposure include the following.

Duration Management

Funds may use derivatives to adjust the average weighted duration of their portfolio. This may provide a more efficient means of managing the fund's exposure to changes in general interest rates or the shape of the yield curve than constantly adjusting the fund's other portfolio holdings. When a fund uses this to reduce its duration, the derivatives should mitigate the interest rate risk of the portfolio. Regardless, a fund should include derivatives used for duration management in its derivatives exposure because:

> duration hedging is not directly matched to a particular instrument in a fund's portfolio, but rather seeks to modify a portfolio's general interest rate exposure."

Moreover, "[d]uration hedging … can require a degree of sophistication to implement and manage," which the Commission believes is better suited to a derivatives risk management program (assuming that the fund is required to have such a program).

"Synthetic" Securities

A fund can create the equivalent of a security position by, for example, entering into a swap to receive (if positive) or pay (if negative) the total return of a designated security during the term of the swap. If the fund sets aside cash equal to the notional amount of the swap, this would be equivalent to paying the purchase price for the underlying security and would assure that the fund has ready cash for any swap payment even if the security's value falls to zero. This would not be a hedge, but the segregation of the full notional amount in cash should remove the leverage and asset sufficiency risks that Rule 18f-4 is intended to regulate. Regardless, such a swap must be included in derivatives exposure because:

> There could be events that cause these synthetic positions to behave differently than the equivalent cash-market position."

The Adopting Release provides various examples of such events, such as an early termination event upon a merger or tender option. The Commission's analysis would also seem to require inclusion of currency and interest rate derivatives used to create synthetic positions. For example, a global bond fund might try to create a synthetic euro investment by matching a specific dollar denominated bond to a euro currency swap with an equivalent notional amount. The fund would need to include this swap in its derivatives exposure, first, because a currency derivative may only be excluded if it hedges a foreign-currency denominated investment and, second, because the Commission did not intend to exclude synthetic positions.

Credit Default Swaps

The Commission declined to exclude credit default swaps because they:

> will not always predictably and mechanically provide the anticipated hedging exposure without giving rise to basis risks or other risks that, if incurred in sufficient size, should be managed as part of a derivatives risk management program."

The Commission based its position primarily on the administration of credit default swaps by the International Swaps and Derivatives Association, which includes the determination of when there has been a credit event and the amount payable. Gains on a credit default swap may not always correspond to the losses incurred by the fund on the hedged security.

Commodity Hedges

A fund must match an excluded derivative to specific "equity or fixed-income investments," which does not include commodities. While a fund may exclude a commodity derivative that fully closes out another commodity derivative from its derivatives exposure, the Commission declined to exclude more complex strategies for "hedging the exposure created from investments in commodity derivatives with other commodity derivatives." One commenter suggested that funds might want to hedge direct holdings of foreign currencies, but the Commission declined to make an exception because:

> based on our staff's analysis of Form N–PORT filings, … funds rarely hold foreign currency in such significant amounts, and for an extended period, that they would hedge this currency risk."

Conclusion

Having reviewed what the Adopting Release tells us about which hedges to include and exclude when calculating derivatives exposure, we now move on to some of the interpretive challenges we have encountered.

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