



Our [last post](#) explained why the [Limited Derivatives User](#) provisions of [Rule 18f-4\(c\)\(4\)](#) may not "provide [the] objective standard to identify funds that use derivatives in a limited manner" anticipated by the SEC. Inconsistencies in methods of determining the notional amounts of derivatives transactions may cause funds that use such transactions in the same manner and to the same extent to be treated differently under the rule. The [previous post](#) also questioned whether requiring Limited Derivatives Users to perform the complex calculations required to determine their derivatives exposure each day might "incur costs and bear compliance burdens that may be disproportionate to the resulting benefits." This post points out some alternatives that would address our concerns, although it may be too late to implement one of them.

Base Notional Amounts on the Dollar Value of the Underlying Assets

As reiterated in our last post, there should be three possible prices that a fund might use to [translate a non-dollar denominated notional amount into a dollar equivalent](#) when calculating its derivatives exposure as a percentage of its net assets.

1. The current market price of the underlying asset. This would be consistent with the treatment of short sale borrowings but would leave a fund's status as a Limited Derivatives User at the mercy of changes in the market for the underlying assets.
2. The market price of the underlying asset at the time a fund enters into the derivatives transaction. This would be consistent with the usage of "notional amount" in swap transactions, but may permit a fund's derivatives exposure to impact its performance to a greater extent than the SEC intended.
3. The contract price of the derivatives transaction. As illustrated by the oil futures discussed in our [last post](#), this would produce inconsistent results unrelated to the extent funds use such futures.

Given that every alternative has drawbacks, we would recommend that the SEC choose either the first or second alternative and apply it consistently to all derivatives transactions. This would at least prevent the rule from skewing derivatives strategies by treating some types of derivatives as creating more derivatives exposure than others.

Test Compliance at the Time of a Derivatives Transaction

The Limited Derivatives User requirements would better "identify funds that use derivatives in a limited manner" if the requirements were applied when a fund **used** derivatives. This could have been accomplished by requiring a fund to comply with the 10% limit on derivatives exposure only when a fund enters into a derivatives transaction rather than requiring daily compliance. While this would have permitted some Limited Derivatives Users to temporarily have derivatives exposures exceeding 10% of their net assets, it would still prevent them from adding to their exposure during such periods. Testing compliance at the time of transactions would have given funds control over their status as Limited Derivatives Users without adding significantly to their derivatives risk. It would have also eliminated the need for the cumbersome remediation procedures outline in Part III of our [Compliance Checklist for Limited Derivatives Users](#).

What Alternatives Are Open?

Requiring Limited Derivatives Users to test compliance at the time of a derivatives transaction rather than each day would effectively amend Rule 18f?4(c)(4). We doubt that anyone is interested in a third round of notice and comment on this rule. We note, however, that the SEC staff used an [FAQ \(Question 50\)](#) to permit a government money market fund to determine compliance with the 99.5% government security requirement "each time it acquires a portfolio security." While we are troubled by the potential circumvention of the Administrative Procedures Act, we doubt anyone would object to a similar interpretation for Limited Derivatives Users. If Limited Derivatives Users were to determine compliance at the time of a derivatives transaction, then it would make sense to use the contemporaneous market price of the assets underlying all of its derivatives transactions to calculate its derivatives exposure. This would prevent the derivatives exposure of a Limited Derivatives User from further increasing after changes in market values and net assets caused it to exceed 10%. If Limited Derivatives Users must calculate their derivatives exposure daily, calculating the notional amount of a derivatives transaction based on market values at the time of the transaction would reduce cost and increase the fund's control over its status. Except for the notional amount of options sold (which must still be delta adjusted daily), notional amounts would be calculated at acquisition and would not need to be updated, reducing compliance costs. As changes in the market values of the underlying assets would not affect a fund's derivatives exposure, its continued status as a Limited Derivatives User would depend primarily on changes in its net assets,

making it less likely that the derivatives exposure might exceed 10% of net assets. Our final post on Limited Derivatives Users will collect the open issues we've identified in this series.

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