Blogs
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Asset Management ADVocate

VaR Funds vs. Limited Derivatives Users—Programs vs. Procedures

Our last post explained the two basic alternatives for managing derivatives risks under new Rule 18f-4 by qualifying either as a Limited Derivatives User or a VaR Fund. This post outlines 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.

Elements of a DRM Program

As indicated in our last post, VaR Testing is an essential requirement of a DRM Program. But this is only *one* of the elements required by Rule 18f-4(c). At its core, a DRM Program must identify and assess a VaR Fund's derivatives risks that arise from all of its derivatives transactions, taking into account its other investments. Rule 18f-4 also requires a DRM Program to include the following.

Derivatives Risk Manager

A VaR Fund's board of directors or trustees, including a majority of independent directors or trustees (its "Board"), must approve the designation of an officer (or committee of officers) of the Fund's investment adviser to act as the "derivatives risk manager." The derivatives risk manager administers the DRM Program, including making certain determinations and reports to the Board required by Rule 18f-4. The derivatives risk manager cannot be a portfolio manager or, if a committee is designated, a majority of its members cannot be portfolio managers. The derivatives risk manager must review the DRM Program at least annually.

Derivatives Risk Guidelines

A DRM Program must establish:

> guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks … that the fund does not normally expect to exceed, and measures to be taken if they are exceeded."

An example of a quantitative guideline might be that a VaR Fund could not use derivatives transactions to extend its duration by more than a fixed amount or percentage relative to its designated index. An example of an "other criteria" might be that a VaR Fund will borrow securities only under the SIFMA Master Securities Lending Agreement.

Stress Testing

A VaR Fund must conduct stress tests, at least weekly,

> to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio …."

The stress tests must account for correlations of risks and resulting payments (including margin) to counterparties.

Back Testing

A VaR Fund must compare its gain or loss on each business day with the losses estimated for such day by its VaR model. The Fund must treat any losses in excess of the model's estimated loss as an exception. The Fund may conduct back testing weekly, but it must test each business day during the period.

Internal and Board Reporting

Before implementing the DRM Program and at least annually thereafter, the derivatives risk manager must provide the Board with a written report representing

> that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the elements [required by Rule 18f-4]."

The DRM Program must specify in what circumstances the derivatives risk manager will provide VaR Fund portfolio managers with stress testing results and notify them of violations of the risk guidelines or other material risks arising from the Fund's derivatives transactions. The program must also specify the (presumably more significant) circumstances in which the derivatives risk manager will notify the Board of such matters. The manager must report to the Board any violations of the risk guidelines and the results of stress and back testing at intervals established by the Board.

Policies & Procedures

In contrast, a fund that qualifies as a Limited Derivatives User need only adopt

> written policies and procedures reasonably designed to manage the fund's derivatives risk."

Presumably, the fund's Chief Compliance Officer (rather than a derivatives risk manager) may implement these policies and procedures subject to the general Board oversight required by Rule 38a-1 (which will also apply to a DRM Program). Rule 18f-4 gives a Limited Derivatives Users flexibility

> to scale their policies and procedures to address the different strategies funds may pursue, the different level of derivatives exposure they may seek …, and the different risks associated with their derivatives transactions"

We trust that readers will appreciate how the lighter touch applied by Rule 18f-4 to Limited Derivatives Users may be attractive to Fund advisers even if they already have access to VaR models. But qualifying as a Limited Derivatives User has its own challenges, which we will now explore.

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