

Derivatives Exposure: A Circuitous Path to “Gross Notional Amounts”

In this post, we tackle the question of how to calculate the "gross notional amount" of a derivatives transaction for purposes of the limited derivatives user provision of [Rule 18f-4](#). This is a surprisingly difficult question because, although the adopting release for Rule 18f-4 (the "[Adopting Release](#)") refers to "notional amount" 63 times, the release never directly addresses what the term means. We think we found an answer, but it required us to wind our way through a series of earlier SEC statements.

First Clue

According to the Adopting Release, the SEC:

[proposed a 10% derivatives exposure threshold based in part on staff analysis of funds' practices regarding derivatives use based on Form N-PART filings.](#)

[Item C.11](#) of Form N-PART (among other items), requires funds to report the "notional amount" of certain derivatives. Although the term "gross" does not appear in N-PART, the Adopting Release refers to these reported notional amounts when estimating the "gross notional amount" of derivatives held by funds. So, the Adopting Release equates the "notional amount" reported in N-PART with the "gross notional amount" of derivatives transactions.

Second Clue

Form N-PART was first promulgated in October 2016. To assist in implementing the new form, the SEC staff issued [FAQs](#) in July 2017. Question 15 is: "Is there a prescribed calculation of notional amount that funds should follow?" The staff responded:

The Commission staff understands that funds currently use different methods for calculating notional amount of a derivatives investment. For example, the staff understands that some common methods used by funds for determining a derivative transaction's notional amount may include the methods listed in Table 1 on page 69 of the Derivatives Proposing Release."

The staff's response was hardly unequivocal, but this Table 1 would seem to provide examples of how a fund may calculate the gross notional amount of some derivatives transactions.

Which Proposing Release?

Anyone who reaches for the proposing release for the final version of Rule 18f-4, which was issued over two years after the FAQ, and flips to page 69 will not find any tables. This is because the FAQ is referring to the [release](#) that originally proposed Rule 18f-4 in December 2015. This means that the best guidance we have found for calculating gross notional amounts comes from a rule proposal that the SEC abandoned when it re-proposed Rule 18f-4 in late 2019.

Forwards	
FX forward	Notional contract value of currency leg(s)
Forward rate agreement	Notional principal amount
Futures	
Treasury futures	Number of contracts * notional contract size * (futures price * conversion factor + accrued interest)
Interest rate futures	Number of contracts * contract unit (e.g., \$1,000,000)
FX futures	Number of contracts * notional contract size (e.g., 12,500,000 Japanese yen)
Equity index futures	Number of contracts * contract unit (e.g., \$50 per index point) * futures index level
Commodity futures	Number of contracts * contract size (e.g., 1,000 barrels of oil) * futures price
Options on futures	Number of contracts * contract size * futures price * underlying delta
Swaps	
Credit default swap	Notional principal amount or market value of underlying reference asset
Standard total return swap	Notional principal amount or market value of underlying reference asset
Currency swap	Notional principal amount
Cross currency interest rate swaps	Notional principal amount
Standardized Options	
Security options	Number of contracts * notional contract size (e.g., 100 shares per option contract) * market value of underlying equity share * underlying delta
Currency options	Notional contract value of currency leg(s) * underlying delta
Index options	Number of contracts * notional contract size * index level * underlying delta

v.

We have several

concerns regarding this table. For example, it is incomplete (e.g., no mention of interest rate swaps other than cross currency ones, although our assumption is that these would be measured consistently with cross currency swaps and forward rate agreements). In addition, many of the notional amounts are not expressed in dollars, so the table does not completely answer the question of [what price to use to calculate a notional dollar value](#). We have other reservations about using N-PORT notional amounts to calculate derivatives exposure that we will discuss in subsequent posts. But for now, this is the best guidance we could find.

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