Blogs

In our extensive examination of the requirements for Limited Derivatives Users under Rule 18f?4(c)(4) we have tried to be conscientious in pointing out matters open to interpretation. While we have not been shy about arguing for interpretations that would reduce a fund's derivatives exposure and thus ease compliance with these requirements, we acknowledge that these are just our informed opinions. Absent guidance from the SEC staff, chief compliance officers and counsel to fund directors and trustees will need to consider these matters and reach their own conclusions. This post wraps up our examination of the Limited Derivatives User requirements with a list of these interpretive questions. While we are sure it is incomplete, at least it provides a starting point for consideration.

Are the following derivatives transactions?

- An inverse floater from which the fund did not receive any of the proceeds of companion securities or use such proceeds to purchase the underlying assets.
- A swap that does not require the fund to make any payments or deliveries in the future (e.g., the purchase of credit protection under a credit default swap for a single premium).
- An exchange traded note that may reduce interest or principal payments made to a fund based on the performance of a referenced asset, rate, or index.
- Short sales against the box.

Can a fund use different methods to calculate the gross notional amount of derivatives transactions?

- If not, what method must be used? If so, what criteria (if any) should guide which method to use?
- How should the gross notional amount of interest-rate derivatives be converted to a 10-year bond equivalent?
- What price should be used to determine in dollar terms the gross notional amount of a derivative not denominated in dollars (e.g., foreign exchange or commodity derivatives)?

In determining what derivatives transactions to exclude from a fund's derivatives exposure:

- What close-out transactions will result in no credit or market exposure from the closed-out derivatives transaction?
- What currency and interest-rate derivatives can serve a "hedging purpose" for specific equity or fixed-income investments? Can the notional amount of such derivatives be divided into hedging and non-hedging purposes?
- Can a deliverable currency forward hedging a "when-issued" purchase of securities denominated in that currency be excluded?
- Can an interest-rate derivative be excluded if the maturity of the underlying security or rate differs from the maturity of the specific investment being hedged?

When applying the "10% buffer" for excluding currency and interest-rate derivatives, should a fund:

- Calculate the 10% buffer in the aggregate or on a hedge-by-hedge basis?
- Continue to exclude the notional amount of a derivative that exceeds the market value, par amount or principal amount of the specific hedged investment or borrowing but does not exceed the 10% buffer?
- Adjust interest-rate hedges, or both the interest-rate hedges and specific hedged investments, to 10-year bond equivalents?

That's all for Limited Derivatives Users. Next, we consider fund-of-funds under Rule 18f-4.

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