Blogs
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Asset Management ADVocate

Rule 18f-4: Trimming Hedges—Hedges Excluded from Derivatives Exposure

Our post on the derivatives exposure equation began with a separate equation concerning interest rate and currency hedges. This post explains the significance of this equation and what hedges should be excluded from a fund's derivatives exposure. Our next post will address hedges included in derivatives exposures before we raise some interpretive questions about how the exclusion should be applied.

Why Hedges Matter

A fund attempting to operate as a "limited derivatives user" must maintain a derivatives exposure that does not exceed 10% of its net assets. Rule 18f-4(c)(4)(B) excludes from a fund's derivatives exposure currency or interest rate derivatives transactions that :

- are entered into and maintained by the fund for hedging purposes;
- hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the fund, or a fund's borrowings; and
- have a notional amount that does not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10 percent.

We refer to derivatives transactions excluded from derivatives exposure as ("Hedging Derivatives"). Excluding these Hedging Derivatives reduces the derivatives exposure of a fund, thereby making it easier to qualify as a limited derivatives user. Because any hedge should reduce the "value-at-risk" of a VaR Fund, a VaR Fund should not need to identify whether a derivatives transaction is a hedge or match it to a specific investment.

What Is a "Hedging Purpose?"

Despite the significance of hedging, it may (or may not) come as a surprise that Rule 18f-4 does not explicitly define what constitutes a "hedging purpose". Nevertheless, two statements in the release adopting Rule 18f-4 (the "Adopting Release") point to a narrowly defined concept of a "hedging purpose" that restricts the exclusion of Hedging Derivatives from derivatives exposure. First, the Commission provided an exception for currency and interest rate hedges, and not for other types of hedges:

> because they will predictably and mechanically provide the anticipated hedging exposure without giving rise to basis risks or other potentially complex risks that should be managed as part of a derivatives risk management program."

This suggests to us that the "hedging purpose" should be simple (not "potentially complex") and directly linked ("mechanically") to the hedged risk. For example, a fund should include a cross-currency "hedge," in which the fund shorts another currency as a proxy for the currency in which an investment is denominated, in its derivatives exposure because it depends on the correlation of the two currencies and, thus, does not simply and directly hedge the investment's currency risk. For similar reasons, we believe that, for a fund with shares denominated in U.S. dollars, the fund must hedge to dollars and not another currency. Second, in discussing why derivatives exposure would still include other types of hedges, the Commission referred to these as hedges that "could mitigate funds' portfolio risks." This implies that the Commission believes that the purpose of Hedging Derivatives should be to mitigate currency or interest rate risk. It may seem obvious that a hedge should mitigate risk, but portfolio managers sometimes use derivatives to add risk to their portfolio in order to reduce the tracking error of a fund relative to its benchmark. This may mitigate "tracking error risk," but it would not mitigate portfolio risk and thus would not be an appropriate "hedging purpose" for a limited derivatives user.

Specific Investments

A Hedging Derivative must hedge risks "associated with one or more specific equity or fixed-income investments." In the case of a currency derivative, the investment must be "foreign-currency-denominated." As we just explained, we believe a currency Hedging Derivative must be for the foreign currency in which these specific investments are denominated. We believe this will require the compliance procedures of a limited derivatives user to track which specific investments are hedged by a Hedging Derivative. It is clear that the matching does not have to be one-to-one; a fund might use a single currency derivative to hedge its entire exposure to investments denominated in that currency. But it will be easier to demonstrate compliance if the fund maintains a record of those investments has having been hedged by the derivative.

The 10% Buffer

How to apply the "not more than 10%" of the value of the specified investments requirement raises important interpretive issues that we will discuss at length in separate posts. But first, our next post will examine hedges that the Adopting Release indicates should be included in a fund's derivatives exposure.

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