

Derivatives—Session 2

Fund Operations and Regulatory Considerations

Deeper Dive Webinar Series

July 16, 2015

2:00 – 3:15 pm ET

Panelists

- » Susan B. Kerley, Moderator
Independent Director
MainStay Funds
Legg Mason Partners Fixed Income Funds
- » Joseph Alessie
Chief Compliance Officer
UBS Global Asset Management (Americas) Inc.
- » Alison Fuller
Partner
Stradley Ronon Stevens & Young, LLP

Agenda

- »» Brief overview of funds' use of derivatives
- »» Legal and regulatory considerations
- »» Fund operations
- »» Board oversight and reporting

Overview of Use of Derivatives in Portfolios

Primary Uses of Derivatives

- » Manage risk
- » Gain exposure

Using Derivatives to Manage Risk

- » Hedge duration risk
- » Hedge currency risk
- » Hedge credit risk
- » Manage liquidity risk
- » Achieve overall risk target
- » Enhance income and reduce risk in equity strategies

Using Derivatives to Gain Exposure

- »» Alternative way to gain exposure to desired risk
- »» More efficient way to gain exposure
- »» Only way to gain exposure
- »» Arbitrage opportunity between cash security and derivative
- »» Provide asymmetric payoffs; using options and credit default swaps
- »» Gain economic leverage
- »» Sell volatility

Derivatives Overview

- » Common derivatives
 - » Futures and forwards
 - » Options
 - » Swaps
- » Exchange-traded vs. over-the-counter

Legal and Regulatory Considerations

Derivatives Regulation Generally

- » Different roles for different agencies
- » The Securities and Exchange Commission
 - Registered funds
- » The Commodity Futures Trading Commission
 - Funds using “commodity interests” as commodity pools
- » Internal Revenue Service
 - Preserve pass through taxation
 - Controlled foreign subsidiary (Cayman) for 25% exposure

The SEC's Regulatory Agenda

- » Focus on the Financial Stability Oversight Council and Systemic Risk Regulation
 - » SIFI designations for asset managers
 - » The Regulatory Road map: Chair White speech December 11, 2014
<http://www.sec.gov/News/Speech/Detail/Speech/1370543677722>

Regulatory Road Map

1. Enhanced Data Reporting

- » Investment Company Reporting Modernization, proposed May 20, 2015
- » Amendments to Form ADV and Advisers Act Rules, proposed May 20, 2015

2. Leverage and Liquidity – coming soon?

3. Risk Management – coming soon?

The Regulatory Focus on Derivatives

- » The alternative funds sweep
 - » Board communications
 - » Compliance with asset segregation regime
- » Derivatives and leverage
 - » Introduction to “Section 18” and asset segregation
 - » Contrast margin/collateral regime
- » Step back and consider the greater context: the role of the board with respect to fund use of derivatives

Knowledgeable and Meaningful Oversight

“Directors who authorize the use of derivatives need not micromanage the minutiae of individual derivatives transactions, but they must exercise knowledgeable and meaningful oversight.”

– Arthur Levitt, SEC Chairman, 1994 letter to the ICI

Elements of Knowledgeable and Meaningful Oversight

- » Investment Risks: How does a fund use derivative instruments?
- » Operational Risks: Ask about internal controls – adviser’s and others.
- » Compliance, Regulatory Risks: Ask about whether derivatives use is consistent with authorizations and applicable regulations.
- » Disclosure Risks: Ask questions, review and approve; discuss with fund counsel.

Fund Operations

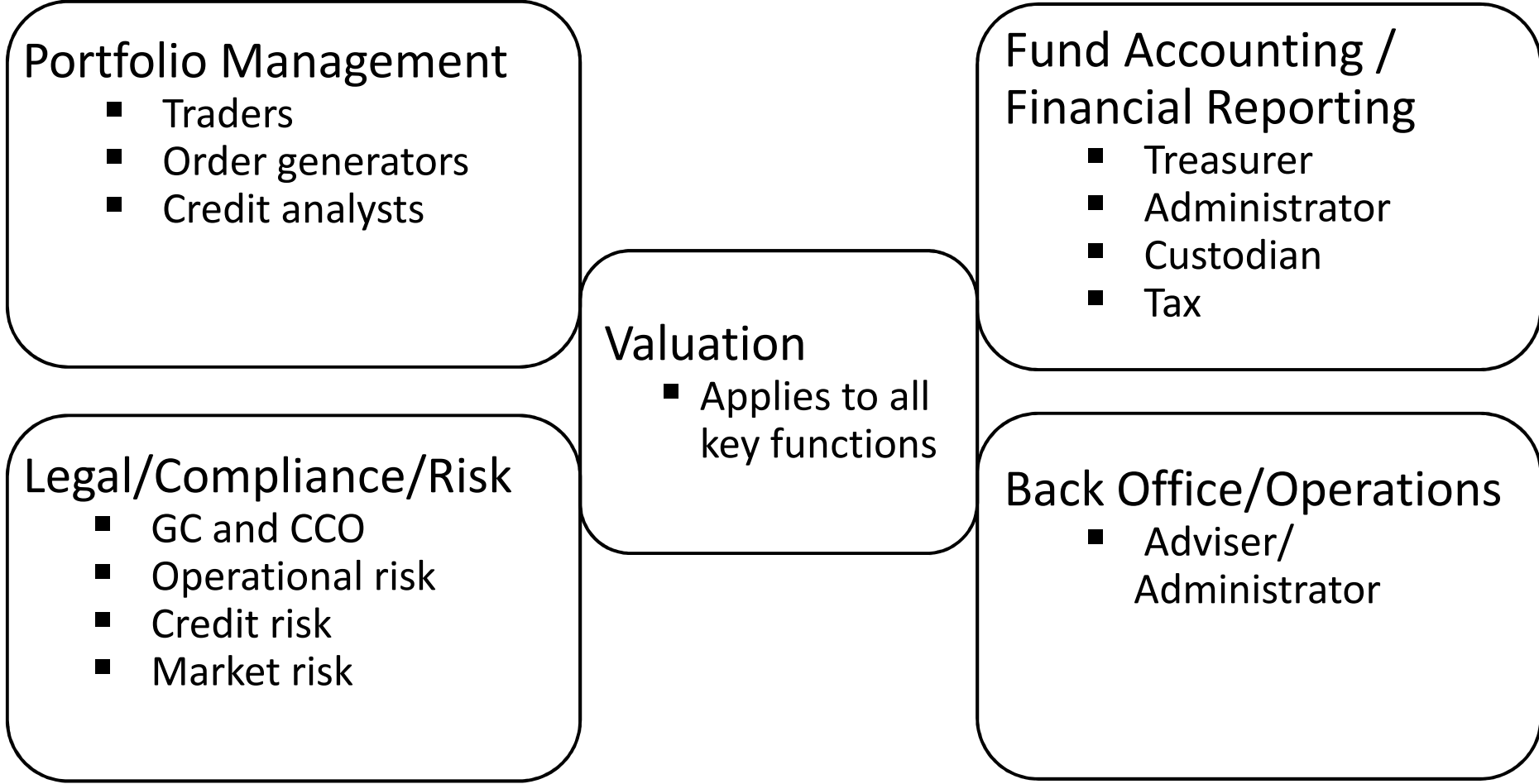
Fund Operations – Compliance Oversight

- » Internal roles and the responsible parties
- » How roles interact
- » Key risk exposures and controls
- » What might boards ask the CCO and adviser

Fund Operations – Compliance Oversight

- » Board oversight
- » Another portfolio holding
 - » Counterparty risk – no different than repo
- » CCO remit
- » Resource intensive
 - » Cross-functional coordination

Key Functions Related to Derivatives Investing



Key Functions Related to Derivatives Investing: Portfolio Management

- » 1st line of defense
- » Consistent with fund's investment objectives
- » Understand their risk budget
- » Experienced
- » Approvals before trading new instruments
- » Attribution

Key Functions Related to Derivatives Investing: Legal/Compliance/Risk

- » 2nd line of defense
- » Oversee compliance with fund disclosures, policies and procedures
- » Ensure PM stays within the guidelines
- » Negotiate OTC derivatives contracts
 - » Legal coordinates with PMs
 - » Time intensive
 - » Counterparty risk
- » Risk Management
 - » Risk metrics reporting
 - » Circle back to PMs and Compliance
- » Controls
 - » Segregation procedures
 - » Overarching derivatives policy
 - » Testing
 - » Chart of derivatives types and usage per fund
 - » Dedicated board attention

Key Functions Related to Derivatives Investing: Back Office/Operations

- » Process and document derivatives transactions
- » Back office personnel (of administrator or adviser)
- » Strong controls required
 - » Work-arounds
 - » Trade confirms and reconciliations
 - » OTC – people / paper
 - » Ongoing communications
 - » Sufficient staff / systems
 - » Heatmaps

Key Functions Related to Derivatives Investing: Fund Accounting/Financial Reporting

- » Back office personnel (of administrator or adviser)
- » Calculate daily NAV
- » Liaise with Custodian of portfolio assets, including collateral
 - » Tri – party arrangements
 - » De minimis collateral
 - » Understand how assets are encumbered
- » Determine accounting policies for derivatives' initial recording, income recognition, and valuation; and prepare financial statements
 - » Treasurer, fund accountant, fund auditor (to audit financial statements at year end)
- » Determine appropriate tax treatment
 - » Treasurer, tax personnel

Key Functions Related to Derivatives Investing: Valuation

- » Applies to all key functions
- » Board of directors' oversight
- » Provide prices for portfolio holdings
- » Pricing service, broker-dealers, counterparties, portfolio management (may provide input)
- » Determine accounting policies for derivatives' initial recording, income recognition
- » Due diligence
- » Meet with board of directors
- » Understand inputs
- » Liquidity
 - » Exchange-traded
 - » Swaps

Board Reporting

Board Reporting

- » How Often? Quarterly, Semi-annually, Annually?
- » Content
 - » Illustrate uses consistent with offering materials
 - » Amount of use
 - » Counterparties
 - » Amount of intentional leverage
- » Challenges of attribution reporting

Practices vary – one size does NOT fit all

Questions?

Panelist Biographies

- » **Susan B. Kerley** is an independent director of the MainStay Funds board (Independent Chair, 2005-2012) and the Legg Mason Partners Fixed Income Funds board. Until September 2014, she served as the Chair of the Independent Directors Council and as a member of the Investment Company Institute's Board of Governors and Executive Committee. Ms. Kerley holds a BA from Brown University and a Master's of Public and Private Management from the Yale School of Management.
- » **Joseph J. Alessie** is Managing Director and Head of Global AM Americas Compliance & Operational Risk Control, UBS Global Asset Management (Americas) Inc. Mr. Alessie joined the firm in 2005 and managed a team of lawyers and paralegals responsible for mutual funds (open and closed end), wrap programs and privately offered (onshore and offshore) funds. In January 2015, Joe was appointed the interim CCO for the Americas region of the Global Asset Management Division of UBS and appointed to the permanent role in June 2015. Prior to joining the team, Mr. Alessie worked at Kenmar Advisory Corp, a hedge fund of funds, Global Asset Management (GAM), an indirect, wholly owned subsidiary of UBS AG, and as counsel to the Bureau Chief for the New Jersey Bureau of Securities. Prior to that, he was an associate in the McDonald Group Law Firm and a former clerk to the Bureau of Securities of the State of Michigan. Mr. Alessie earned his BA from Pennsylvania State University (US) and his JD from Thomas M. Cooley Law School (US).

Panelist Biographies

- » **Alison M. Fuller** is the partner-in-charge of Stradley Ronon's Washington, D.C. office. She serves as counsel to the independent trustees of a number of different fund groups. Ms. Fuller spent ten years on the staff of the Securities and Exchange Commission, including eight years as Assistant Chief Counsel in the Division of Investment Management.

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