Securities and Exchange Commission
PHILIPPINES

SEC Memorandum Circular No. 15
Series of 2020

TO : **ALL INVESTMENT COMPANIES**
FUND MANAGERS
OTHER ENTITIES DEALING WITH INVESTMENT COMPANIES

SUBJECT : **RULES ON INVESTMENT IN FINANCIAL DERIVATIVES**

WHEREAS, Section 35(a) of Republic Act No. 2629, or the Investment Company Act (ICA), and Section 72 of Republic Act No. 8799, or The Securities Regulation Code (SRC), vest upon the Securities and Exchange Commission the authority to make, issue, amend, and rescind rules and regulations and orders which are necessary or appropriate to the exercise of the powers conferred upon it in the ICA and the SRC;

WHEREAS, Rules 6.5, 6.8 (b), 6.8 (d) (iii) and 6.8 (h) of the Implementing Rules and Regulations of the Investment Company Act (ICA-IRR) provide for the basic rules on financial derivatives**;**

WHEREAS, the Commission seeks to enhance the Rules and provide specific guidelines for financial derivatives to be followed by investment companies, fund managers and other persons or entities involved therein;

WHEREAS, the Commission seeks to align the Rules with global standards and practices in order to develop the Philippine capital market and help prepare investment companies to qualify and compete in international cross-border transactions;

WHEREAS, the Rules are designed to improve the regulatory compliance of investment companies and their fund managers and to ensure adequate protection for shareholders and unitholders;

IN VIEW OF THE FOREGOING, without prejudice to the provisions of the ICA-IRR on financial derivatives not inconsistent with these Rules, the following are hereby promulgated:

SECTION 1. Requirements of Financial Derivatives

1. Financial derivatives must meet the following requirements:

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a) The investment must be dealt in:

1. On an exchange; or

2. Over the counter ("OTC financial derivative") provided that:

    A. The counterparty is a financial institution subject to prudential supervision, and approved by the relevant authority in its Home Jurisdiction;

    B. It is subject to reliable and daily valuations that are based on:

        1. Up-to-date market values, which do not rely only on market quotations by the counterparty; or

        2. Pricing models based on an adequate and generally accepted practice methodology and where the values are subject to verifications at an appropriate frequency by either:

            A. An independent third party; or

            B. A unit within the asset management company that is independent from the one in charge of managing the assets;

    C. It can be sold, liquidated or closed by an offsetting transaction at any time at its fair value.

b) The underlying must consist of:

1. Eligible assets;
2. Financial indices;
3. Foreign exchange rates/ currencies;
4. Interest rates;
5. Credit spread**;** or
6. A rate of inflation calculated, endorsed or determined by a government or government agency.

c) Where the underlying is a financial index, the index must satisfy the following requirements:

1. Comprises eligible assets and commodities;

2. Be diversified such that the maximum weight per constituent does not exceed thirty percent (30%) of the index or the underlying securities should have the same weight as the index;

3. Be developed by an independent and reputable agency, or unit within a financial institution or conglomerate that is independent

from the asset management unit, provided the fund manager shall have a system or effective arrangement in place to manage potential conflicts of interest and based on a recognized and accepted methodology;

4. Represents an adequate benchmark for the market and is widely accepted in international financial markets;

5. The index value is published daily through media, which disseminates information in a timely manner and is accessible either publicly or on a subscription basis; and

6. Information on the index is published and readily accessible.

Guidance

Information on the index includes the index composition and methodologies used to: (i) construct the index; (ii) select the constituents; (iii) collect the price data of constituents; and (iv) rebalance the index.

SEC. 2. Investment Limits

Single business group limit

1. An investment company must not invest, in aggregate, more than twenty (20%) of its net assets in:

a) Transferable securities;
b) Money market instruments;
c) Deposits; and
d) OTC financial derivatives

issued by any single business group, provided the investments in OTC financial derivatives with non-investment grade or unrated counterparty shall not exceed five percent (5%) of the net assets of the investment company.

Aggregate limit

2. Investments in:

a) Deposits placed with unrated or non-investment grade deposit-taking institution;
b) Debt securities or money market instruments not dealt in on organized market or issued by an unrated or non-investment grade issuing body;
c) Unlisted shares; and
d) OTC financial derivatives with non-investment grade or unrated counterparty

must not, in aggregate, exceed fifteen (15%) of the net assets of the investment company provided the investments enumerated herein shall not exceed five percent (5%) of the net assets of the investment company.

For the avoidance of doubt, the exposure to a counterparty of an OTC financial derivative should be measured based on the maximum potential loss that may be incurred by the investment company if the counterparty defaults, subject to the calculation method set out under clause 1 of the Appendix.

The aggregate fifteen percent (15%) limit does not apply to deposits, debt securities or money market instruments or OTC financial derivatives where the:

a) Deposit-taking institution, issuing body or counterparty is rated investment grade only with a national rating scale, which refers to a rating falling within the top four (4) long-term credit ratings or the top three (3) short-term credit ratings provided on an international scale; and

b) The jurisdiction in which the issuing body or counterparty is domiciled has a sovereign credit rating that is at least investment grade.

Use of Financial Derivatives

3. An investment company may invest in financial derivative instruments provided that the fund manager employs a risk-management process, which captures the risks associated with the use of financial derivatives and satisfies all of the following requirements on an ongoing basis:

a) The global exposure, calculated based on the commitment approach set out in the Appendix, to financial derivatives or embedded financial derivatives must not exceed twenty percent (20%) of the net assets of the investment company;

b) The investment company must, at all times, be capable of meeting all its payment and delivery obligations incurred by transactions involving financial derivative instruments;

   1. In the case of financial derivatives which will, or may at the option of the investment company, be cash-settled, the scheme should hold, at all times, liquid assets sufficient to cover the investment company's obligations.

      Guidance

      For example, when the investment company takes a long position on futures on listed stock, the scheme should hold liquid assets equal to the amount by which the exercise price of the underlying stock exceeds the spot price multiplied by the number of the contracts and the notional contract size at all times. Similarly, in case of a short position on futures or short call options, the amount of liquid assets *to be held should be equal to the amount by which the spot price exceeds the exercise price of the underlying stock multiplied by the number of the contracts and the notional contract size at all times. However, if the investment company takes a long position on call or put options on listed stock, the scheme will not be required to hold such liquid assets*.

2. In the case of financial derivatives which will, or may at the option of the counterparty, require physical delivery of the underlying assets, the investment company should hold the underlying assets in sufficient quantities to meet the delivery obligation at all times. If the fund manager deems the underlying assets to be sufficiently liquid, the investment company may hold as coverage other liquid assets in sufficient quantities, provided that such alternative assets may be readily converted into the underlying asset at any time to meet the delivery obligations.

Guidance

For example, when the investment company takes a short position on futures or short call options on ABC bond with the condition of physical delivery, and if ABC bond is not sufficiently liquid, the scheme should hold that ABC bond in sufficient quantities to meet the delivery obligation at all times. However, if ABC bond is sufficiently liquid, the scheme may hold as coverage other liquid assets in sufficient quantities.

c) The exposure to the underlying assets do not exceed, in aggregate, the investment limits laid down in clauses 1 to 2 of Section 2 and Rule 6.8 of the ICA-IRR except Rules 6.8 (b), 6.8 (d) (iii), and 6.8 (h); and

d) The fund manager of the investment company may not act as the counterparty to an OTC derivative invested into by the investment company.

4. Notwithstanding clause 3(a) of Section 2, the global exposure, calculated based on the commitment approach set out in the Appendix, of an index-tracking investment company that invests in exchange-traded financial derivatives for the purpose of index replication must not exceed one hundred percent (100%) of the net assets of the investment company.

Counterparty of Financial Derivatives

5. The maximum exposure of an investment company to the counterparty of an OTC financial derivative must not exceed:

a) In the case of a counterparty with a minimum long-term rating of investment grade, ten percent (10%) of the net assets of the investment company; or

b) In any other case, five percent (5%) of the net assets of the investment company.

Notwithstanding paragraph 5(a) of Section 2, the minimum credit rating requirement may be met if the scheme has the benefit of a guarantee by an entity which has a long-term rating of investment grade.

6. The total exposure to a single counterparty, or group of counterparties, is calculated by summing the exposure arising from all OTC financial derivative transactions entered into with the same counterparty or group, as the case may be.

7. Collateral arrangements may be taken into account to reduce a scheme's exposure to financial derivatives. To reduce the exposure, the collateral should be:

a) Marked to market daily;
b) Transferred to the investment company or its agent; and
c) Immediately available to the investment company, without recourse to the counterparty, in the event of a default of that entity,

subject to such guidelines or standards as may be prescribed by the Commission.

Embedded Financial Derivatives

8. Where a transferable security or money market instrument embeds a financial derivative, the requirements in clauses 3 and 4 of Section 2 apply to the embedded financial derivative.

9. Where the counterparty risk of the embedded derivative is or may be transferred to the scheme, the requirements in clauses 5 to 7 of Section 2 also apply to the embedded financial derivative.

10. A transferable security or money market instrument is considered to be embedding a financial derivative if it contains a component which fulfills the following criteria:

a) The component results in some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which functions as host contract to be modified according to a variable set out under clause 1 (b) of Section 2, and therefore vary in a way similar to a stand-alone financial derivative;

b) The component's economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and

c) The component has a significant impact on the risk profile and pricing of the transferable security or money market instrument.

11. A transferable security or a money market instrument should not be regarded as embedding a financial derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such a component should be deemed to be a separate financial instrument.

12. Where an instrument is structured as an alternative to an OTC financial derivative or tailor-made to meet the specific needs of a scheme, the instrument should be deemed as embedding a financial derivative.

SEC. 3. Glossary

Financial Derivative – refers to a financial instrument which derives its value from, or whose value depends on, the characteristics of one or more underlying assets, reference rates or indices.

Single Business Group – refers to a company, its subsidiaries, fellow subsidiaries, parent company and ultimate parent company.

SEC. 4. Effectivity

This Circular shall take effect fifteen (15) days after its publication in two (2) newspapers of general circulation.

Pasay City, Philippines, 21 April 2020.

For the Commission:

EMILIO B. AQUINO
Chairperson

Appendix

A. Calculation of Exposures in Financial Derivatives on Maximum Potential Loss

1. The calculation method for the exposure to a counterparty of an OTC financial derivative will be the sum of the:

    a) Current positive replacement cost of each OTC financial derivative by carrying out a valuation at market price; and
    b) "add-on factor" by multiplying the notional principal amount or the market value of the underlying asset of the OTC financial derivative, whichever is more conservative, by the percentages in the table below to reflect the potential credit risk:

Residual Term	**Interest rate contracts**	**Exchange rate contracts**	**Equity derivative contracts**	**Total Return Swaps and Credit Default Swaps**	**Other contracts**
1 year or less	0%	1%	6%	**10%**	10%
>1 year and <= 5 years	0.5%	5%	8%	**10%**	12%
<5 years	1.5%	7.5%	10%	**10%**	15%

For total return swaps, the relevant percentage is 10% regardless of the residual term.

B. Commitment Approach

1. The global exposure of a scheme is calculated as the sum of the:

    a) Absolute value of the exposure of each individual financial derivative not involved in netting or hedging arrangements; and

    b) Absolute value of the net exposure of each individual financial derivative after netting or hedging arrangements.

Netting arrangement

2. Netting arrangements may be taken into account to reduce a scheme's exposure to financial derivatives.

3. A scheme may net positions between:

   a) Financial derivatives on the same underlying assets, even if the maturity dates are different; or

   b) Financial derivatives and the same corresponding underlying asset, if those underlying assets are transferable securities, money market instruments or units in other schemes.

Hedging arrangements

4. Hedging arrangements may be taken into account to reduce a schemes' exposure to financial derivatives.

5. The marked-to-market value of transferable securities, money market instruments or units in schemes involved in hedging arrangements may be taken into account to reduce the exposure of an investment company to financial derivatives.

6. The hedging arrangement should:

   a) Not be aimed at generating a return;
   b) Result in an overall verifiable reduction of the risk of the investment company;
   c) Offset the general and specific risks linked to the underlying being hedged;
   d) Relate to the same asset class being hedged; and
   e) Be able to meet its hedging objective in all market conditions.

Conversion Methodology

7. The exposure to financial derivatives is determined by converting the position in the derivative into an equivalent home currency position (i.e., commitment value) in the underlying assets using the spot rate and as specified in the table below where appropriate:

Type of Derivatives	**Commitment Value**
Plain vanilla options (including bought/sold puts and calls)	
Bond Option	Notional Contract Value **X** Market Value of Underlying Reference Bond **X** Delta
Currency Option	Notional contract value of currency leg(s) **X** Delta
Equity Option	Number of contracts **X** Notional contract size **X** Market value of underlying equity share **X** Delta
Index Option	Notional Contract Value **X** Index Level **X** Delta or Point Value **X** Index level **X** Delta if appropriate
Interest Rate Option	Notional Contract Value **X** Delta
Warrants and Rights	Number of shares/bonds **X** Market Price of underlying Reference Instrument **X** Delta

Futures	
Bond Future	Notional Contract Size **X** Market Price of the Cheapest-to-Deliver Reference Bond
Currency Futures	Number of Contract **X** Notional Contract Size
Equity Futures	Notional Contract size **X** Market Price of Underlying Equity Security
Index Futures	Notional Contract Size **X** Index Level
Interest Rate Futures	Number of Contracts **X** Notional Contract Size
Commodity Futures	Notional Contract Size **X** Market Price of Underlying Commodity
Swaps	
Contract for Differences	Number of Shares/Bonds **X** Market Value of Underlying Reference Instrument
Credit Default Swap	Protection Buyer: Market Value of the Underlying Reference Asset Protection Seller: the Higher of the Market Value of the Underlying Reference Asset or the Notional Value of the Credit Default Swap
Currency Swap	Notional Value of Foreign Currency Leg(s)
Interest Rate Swap	Market Value of Underlying (the Notional Value of the Fixed Leg may also be applied)
Total Return Swap	Market Value of Underlying Reference Asset(s)
Forwards	
Forward Rate Agreement	Notional Value
FX forward	Notional Value of Foreign Currency Leg(s)