ANNEXURE 2B: DRAFT NOTICE – INVESTMENT AND DISCLOSURE OF DERIVATIVE INSTRUMENTS FOR PENSION FUNDS

FINANCIAL SERVICES BOARD

No. _____ _____ 2010

I, Dube Phineas Tshidi, Registrar of Pension Funds, hereby prescribe the conditions for investment and disclosure of derivative instruments for pension funds as per Regulation 28(4) of the Regulations made under the Pension Funds Act, 1956 (No. 24 of 1956) as set out in the Schedule below.

This Notice takes effect on the date of publication thereof.

DP TSHIDI
Registrar of Pension Funds

Schedule

Investment in and disclosure of derivative instruments for pension funds

1. Definitions

The following definitions are to be used in the interpretations of this document –

(i) **"asset class"** refers to a collection of like assets e.g. listed equities, listed bonds.

(ii) **"delta"** refers to the sensitivity of an option or strategy utilising combinations of options, to a change in the level of the underlying instrument.

(iii) **"derivative instruments"** has the meaning assigned to it in Regulation 28, and includes *inter alia* forwards and futures, options, and swaps. Exposure may be long (positive) or short (negative) or both (e.g. exchange rate derivatives provide exposure to two currencies simultaneously).

(iv) **"efficient portfolio management"** refers to using **derivative instruments** to either increase or decrease exposure to certain assets or **asset classes**, so as to limit the costs of trading in the underlying physical instruments i.e. so as to not have to buy or sell actual shares.

(v) **"gross exposure"** is the total exposure measured by counting both physical and **derivative instrument** exposure, whether long or short, and only offsetting exact positions i.e. a portfolio of shares may not be arbitrarily offset by an ALSI (FTSE/JSE All Share) future.

(vi) **"hedging"** refers to the reduction of exposure to a certain risk. Typically, the risk that is hedged is the market risk relating to a specific asset i.e. the risk of the asset's price falling, but it may also refer to the risk inherent in the price of **liabilities** (or how **liability** values are calculated) i.e. interest rate or inflation rate risk.

(vii) **"leverage"** is the term given to the process of obtaining more exposure than the value of the investment would allow when investing directly in the physical asset i.e. the exposure to the underlying asset is more sensitive to a change in the price of the asset than if the investment had been made directly in the asset. Most **derivative instruments** allow leverage, as the margin required to enter into the contract is a fraction of what would be required to buy the same exposure physically.

(viii) **"liabilities"** refer to the promise by a fund to make certain benefit payments at any time in the future. Liabilities include member credits in defined contribution funds, and pension payments (or annuity purchases) in defined benefit funds;

(ix) **"net exposure"** allows for the offsetting of long and short positions, even when the matching is not done exactly;

(x) **"uncovered position"** is a position in which the asset (e.g. cash or security) needed to settle a derivative contract is not held for the duration of the contract.

2. Use of Derivative Instruments

A fund may invest in **derivative instruments** subject to the following conditions–

(i) the investment is made solely for purposes of reducing (**hedging**) investment risk or various **liability** risks, or for **efficient portfolio management**, and may not be used for purely speculative purposes;
(ii) no leverage may be used;
(iii) at no time must there be **uncovered positions**, taking the fund's liability position into consideration i.e. long positions must be fully covered by cash and short positions must be fully covered by the actual underlying, or either must be covered by the liabilities;
(iv) the **gross exposure** to each asset and asset class, does not, at any time, exceed the maximum percentages ascribed to the asset and **asset class** as set out in regulation 28; and
(v) exposures may only be offset to the extent that they are exact i.e. the reasonable correlation of assets is not enough to offset exposures;
(vi) where over-the-counter (OTC i.e. those not traded on a recognised exchange) **derivative instruments** are used, counterparty limits must also not be breached in accordance with Regulation 28;
(vii) over-the-counter instruments should also be appropriately collateralised i.e. require high quality assets as collateral, which is measured regularly and adjusted as required;
(viii) the look-through principle should apply to any structures or strategies utilising derivative instruments i.e. derivative instruments must either

relate to the asset classes in Regulation 28 or to a fund's liabilities (which would not appear as an asset class under Regulation 28);

(ix) the board of management of the fund has the relevant reporting structures in place to monitor such investments, and must understand the use of derivatives.

3. Disclosure of Derivative Instruments

Where a fund uses **derivative instruments**, the following disclosure requirements must be adhered to –

(i) The **gross exposure** resulting from an investment in **derivative instruments** –

   (a) must be used in the calculation of the exposure to the particular assets and / or asset classes concerned;

   (b) the exposure must be appropriately calculated using **delta** for options; and

   (c) together with the fair value of any other direct or indirect investment in assets or asset classes, may not exceed the maximum investment limits as per regulation 28.

(ii) For purposes of calculating the **gross exposure**, the netting of long and short positions is only allowed per specific asset, and the exposure to different assets or asset classes may not be offset by the exposure of a different asset or asset class, irrespective of the fact that the derivative transaction has been entered into to hedge against an asset or asset class i.e. reasonable correlation of assets is not enough for off-setting when **hedging**. For clarity, this does not prohibit the use of derivatives on broad market indices for **hedging** the exposure to the asset class, but requires netting off to be done precisely and **gross exposure** to be precisely calculated.

(iii) Full details and exposures of the investment in **derivative instruments** must be disclosed in note G of the financial statements, including detail regarding the netting of positions and other exposures to **derivative instruments**.

(iv) For purposes of Annexure IA, the underlying assets of linked policies, including where a certificate of compliance with the provisions of regulation 28 has been obtained, must be disclosed as in the case for direct investments. Any exposure to **derivative investments** must be included in the relevant investment categories.

(v) When categorising **derivative instruments** for purposes of regulation 28, the underlying asset, on which the derivative instrument is based, is to be regarded as the relevant asset class i.e. a derivative instrument on a security listed on the JSE will be regarded as a listed security.

4. Trustees' Responsibilities

In determining the investment policy of a fund where such policy allows for the investment in derivative investments, trustees should ensure that –

(i) Properly authorised investment mandates have been entered into and are reviewed regularly and that such mandates are in compliance with the conditions as set out in this document and the investment strategy of the fund;

(ii) that actual investments are monitored for adherence to the investment mandate and mandate drift is managed; and

(iii) risks including counterparty risk relating to investment in derivatives are understood and managed adequately.