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Derivatives at fund level

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Overview

Managers may consider entering into derivatives transactions at fund level for broadly one of two reasons: to protect investors from downside risks otherwise beyond the manager's control; and/or to seek to generate additional returns for investors.

This chapter considers, at a high level, certain key structuring and legal issues that should be considered. These issues are not tailored to any particular strategy, although certain considerations will be more relevant where derivatives transactions are used for hedging purposes, and other considerations will be more relevant where derivatives transactions are used for investment purposes.

Introduction

Derivatives use can generally be split between those entered into for speculative or investment purposes and those entered into to hedge risk. In the case of the former, funds can use derivatives in the active pursuit of return; for example, using total return swaps as a form of leverage to gain exposure to assets with amplified returns. At the other end of the spectrum, derivatives can be used to mitigate the economic impact of a particular risk. The most common examples of risks managed at the fund level are: foreign exchange (FX) exposure (for example, mitigating the currency risk for a EUR fund that will be drawing investor commitments in EUR to fund an investment denominated in USD); and interest rate exposure (for example, mitigating the risk of an adverse movement in interest rates increasing the amount required to be paid on borrowings made by the fund).

Advantages and considerations when entering into derivatives at fund level

The primary economic motivation for entering into derivatives at fund level is that the benefit of the derivative (whether as an investment or a hedge) will sit at the most effective level within the capital structure. For example, where a particular risk affects the fund directly, it is often desirable to hedge that risk at the same level.

Putting in place a fund-level derivatives platform, utilising market-standard International Swaps and Derivatives Association (ISDA) Master Agreements and Schedules with one or more counterparties, also means that the manager can enter into multiple derivatives transactions using the same documentation, avoiding the additional cost, complexity and delay associated with negotiating documentation on multiple occasions (as would be required if each new derivative were entered into, on a case-by-case basis, by the different vehicles within the fund bearing the risk or seeking the benefit from the relevant investment). Netting can also be effected across these multiple transactions under the same ISDA Master Agreement, helping to reduce credit exposure, and therefore the likelihood of the fund having to exchange collateral with its counterparties.

Fund structuring considerations of entering into derivatives at fund level

When entering into derivatives at the fund level, managers should consider which fund vehicle (or vehicles) should enter into those transactions.

From an operational perspective, it is often most straightforward for the fund entity bearing the risk or seeking to benefit from the investment (e.g. the investor partnership) to enter into the derivatives transaction itself. However, in practice, fund structures are frequently more complex than this. Even where a fund has a single investment policy, it will often comprise multiple investment vehicles, with those vehicles collectively investing in a portfolio of assets in certain proportions. Each fund investment vehicle will either face a proportion of underlying risk (typically commensurate with the investment vehicle's investment proportion), or will want to obtain a proportion of the economic benefits of the derivatives transaction. It would be operationally and legally complex for each investment vehicle to enter into a derivatives transaction *pro rata* to the underlying proportion of risk faced or benefits sought by that vehicle.

A common solution to this problem is for managers to establish one or more special purpose vehicles within the fund "group" (or use existing entities within the fund group, such as an aggregator or a treasury vehicle) for the purposes of entering into derivatives transactions on behalf of several participating vehicles. This allows multiple investment vehicles to benefit from the fund's derivatives strategy whilst also streamlining counterparty trading lines and associated documentation through a single entity within the fund group.

The use of a special purpose vehicle comes with its own considerations. Firstly, the question of whether a special purpose vehicle falls within the fund group for the purposes of derivatives regulation can be legally complex. Secondly, counterparties are unlikely to be satisfied that a special purpose vehicle alone is sufficiently creditworthy (because it will have little or no assets of its own) and counterparties will therefore require some form of recourse against the fund itself (for example, by way of a guarantee from the fund of the special purpose vehicle's obligations, or by way of the fund providing an equity commitment letter to the special purpose vehicle). The impact of any such recourse on the wider fund needs to be considered carefully. Additional complexity will arise if the fund is set up, wholly or in part, as a liquid or semi-liquid fund (as counterparties will need to understand how this could affect their recourse).

These structuring considerations are more complex where the fund comprises multiple sleeves, where different fund investment vehicles face different risks (or have different investment strategies). For example, in a fund structure that has multiple currency sleeves (as a result of investors advancing commitments to the fund in different currencies), it may be commercially desirable for different hedging strategies to be used in the different sleeves. Managers will need to give thought as to how to structure the fund in order to implement multiple hedging strategies within the same fund. One possible solution to this issue is to establish a different special purpose vehicle within each sleeve for the purpose of hedging that sleeve's specific risks.

Regulatory considerations of entering into derivatives at fund level

Although fund-level derivatives transactions are now entered into by funds routinely, there are regulatory considerations that the manager must be aware of.

Regulatory regimes including the European Market Infrastructure Regulation (EMIR) (and its "onshored" UK equivalent, UK EMIR) and the Dodd-Frank Wall Street Reform and Consumer Protection Act may impose obligations on parties entering into derivatives transactions. These include obligations to report on, and actively mitigate the risk of, their derivatives transactions. Specified classes of derivatives face more onerous regulatory obligations, including, in some circumstances, requirements to clear those derivatives through approved central clearing houses (CCPs) (mainly affecting certain interest rate and credit default derivatives), and to exchange credit support (margin/collateral).

If a derivatives transaction involves an obligation to exchange margin, the manager must monitor and respond to ongoing margin maintenance requirements, which may require daily exchange of margin. Some managers will not have the in-house resources to manage such processes, nor the ready access to liquidity (particularly those managers who would need to rely on calling unfunded commitments from their investors). Even for those managers that do have access to such liquidity, the deployment of cash or securities as margin constitutes an investment drag, which may have an adverse impact on fund returns.

Consequently, careful analysis of these regulatory obligations is required by any manager who is considering entering into derivatives at fund level. For example, the definition of "Financial Counterparty" under EMIR/UK EMIR and thresholds based on trading volume determine the entities that are in-scope for material obligations such as mandatory clearing. A range of vehicles (including, in particular, regulated alternative investment funds) potentially fall within the "Financial Counterparty" definition, so managers will need to consider whether the fund entities through which they intend to transact may fall within scope of those obligations.

There are, however, some useful carve-outs and exemptions that may apply to funds. For example, EMIR/UK EMIR includes a "Small Financial Counterparty" classification, exempting Financial Counterparties that fall below certain trading volumes (measured by reference to the aggregate notional amount of in-scope derivatives, known as "Clearing Thresholds") from the requirement to clear their derivatives transactions. Accordingly, many smaller funds that use interest rate derivatives (of a type that would otherwise need to be cleared) may be able to sidestep the clearing obligation. Further, under EMIR/UK EMIR, physically settled FX forwards and swaps are exempt from the obligation to exchange variation margin, provided that the fund is not a credit institution or an investment firm treated as an institution for prudential purposes that is established in the EEA (in the case of EMIR) or the UK (in the case of UK EMIR) (or equivalent entities located in a third country). The result is that most funds can trade physically settled FX forwards and swaps without being subject to the requirement to exchange variation margin.

When assessing how these rules might affect a fund's derivatives strategy, the regulatory burden can often be reduced by careful structuring of the derivatives or by using an appropriate vehicle (such as a special purpose vehicle, as described earlier in this chapter) to enter into the transactions. For example, a special purpose vehicle that is used by the fund to enter into derivatives transactions can usually be structured as a "Non-financial Counterparty" for the purposes of EMIR/UK EMIR. This is a beneficial regulatory classification, as certain Non-financial Counterparties are not in scope of some of the more onerous regulatory obligations applying to derivatives transactions under EMIR/UK EMIR (such as mandatory clearing and mandatory collateralisation). However, this is dependent on the quantum of derivatives transactions (measured by reference to the Clearing Thresholds) entered into by the special purpose vehicle and, potentially, other entities within the fund's "group" that have entered into derivatives, and the nature of those transactions (i.e. whether they are for speculative or hedging purposes). This requires careful consideration on a case-by-case basis.

Brexit has complicated matters further. Obligations for funds under EMIR and UK EMIR have diverged, exacerbated by the latest set of amendments to EMIR introduced in December 2024 (known as EMIR 3.0). EMIR 3.0 will change the Clearing Thresholds, and the associated calculation methodology, for both Financial Counterparties and Non-financial Counterparties. Equivalent changes have not currently been adopted into UK EMIR, and so EU funds managed by a UK manager (or UK funds managed by an EU manager), or funds trading with both EU and UK bank counterparties, may need to conduct different Clearing Threshold calculations under the different regimes. Depending on their trading volumes, EU funds may also be required to comply with stricter obligations to use EU-based CCPs. In view of these changes, managers are advised to work with their legal counsel to stay abreast of further divergence, in particular for UK managers managing EU funds (or EU managers managing UK funds) where there is the increased regulatory burden of navigating dual compliance.

Another consideration for funds subject to the Alternative Investment Fund Managers Directive (AIFMD) is whether the use of derivatives at fund level would create leverage within the fund, and the extent to which this may be undesirable. Detailed consideration of these issues sits outside the focus of this chapter, but funds that are "leveraged" for AIFMD purposes will be subject to more onerous disclosure requirements, both during the fundraising process and during the lifecycle of the fund.

Constitutional considerations when entering into derivatives at fund level

A manager that is considering entering into derivatives at fund level will need to ensure that it has the power and authority under the fund's constitutional documentation to do so (taking into account any limits on quantum/type of its derivatives exposure, which, in certain circumstances, may be contained in side letters with its investors). Ideally, the question of whether, and in what circumstances, the fund is entitled to enter into derivatives transactions should be considered at the formation stage with any permission, together with any parameters around that permission, clearly addressed in the constitutional documentation when the fund is established.

An express prohibition on entering into derivatives in the fund's constitutional documents is rare; however, for older funds, it is possible for constitutional documentation to be silent on derivatives use, which may require the fund's legal counsel to opine on the fund's ability to enter into derivatives transactions.

Examples of other restrictions that may appear in fund constitutional documents are:

(a) *Limitation on the level of financial indebtedness that the fund may incur.* If the constitutional documents contain limits on the financial indebtedness that the fund is permitted to incur, then the fund will need to consider whether actual (or contingent) exposures under derivatives will constitute financial indebtedness and, if so, how the exposure under the derivatives will be valued for the purpose of complying with the relevant provisions.

(b) *Prohibition from entering into speculative derivatives.* Here, the manager will need to consider carefully the nature of the derivatives to be entered into by the fund and whether, on a correct construction of the limitation language, they could be caught. For example, a derivatives transaction entered into to hedge FX rate exposure is unlikely to be speculative, because it is hedging a genuine risk faced by the fund. However, managers looking to use, for example, total return swaps as part of the investment strategy of the fund will need to carefully consider whether these are speculative derivatives transactions for the purposes of the limitation language.

Constitutional limitations in relation to granting credit support for derivatives transactions

If, commercially or as a matter of regulation, the fund's derivatives transactions will need to be collateralised or supported by a fund guarantee or an equity commitment letter (for example, if the derivatives are being entered into by a special purpose vehicle), then the manager will need to ensure that giving that credit support is permitted under the fund's constitutional documentation:

(a) *Security.* Fund documentation will frequently circumscribe the ability to grant security. This may be prohibited or limited by reference to either the value of collateral that may be exchanged or the assets over which security may be granted, and the manager will need to ensure that the limitations are not breached.

Security or quasi-security arrangements for derivatives can be effected in a number of ways, including by the creation of security interests over collateral or by title transfer collateral arrangements. When derivatives arrangements are required, either as a result of regulation or by virtue of the commercial agreement between the parties, to include security or title transfer collateral arrangements, the market-standard approach is to employ the appropriate form of ISDA's Credit Support Annex (CSA) or Credit Support Deed.

However, due to investment drag caused by both security and title transfer collateral arrangements, many managers will, where possible, look to either agree CSAs with embedded thresholds that ensure that collateral is only required to be exchanged once the fund's exposures exceed an agreed (ideally high) figure, or establish non-CSA trading lines and provide different forms of credit support to their counterparties.

(b) *Guarantees*. The fund may be required by its counterparty to guarantee the obligations of a fund-owned or special purpose vehicle that has entered into derivatives transactions for the benefit of the fund. In these circumstances, it will be necessary to consider whether the fund's constitutional documents limit its ability to do so. A limitation could take the form of a direct limit on the giving of guarantees, or it could be effected indirectly by including exposure under the relevant guarantee within another limitation (for example, a limitation on financial indebtedness).

If guarantees are so limited, then the manager will need to understand how the guaranteed obligations are to be valued for the purpose of ensuring compliance with the limitation. For example, is the maximum contingent exposure used, or is the correct figure for these purposes the accounting value placed upon the guarantee?

(c) *Indemnities*. Similar to guarantees, the manager will need to consider whether the fund's constitutional documents limit its ability to give indemnities in respect of derivatives and, if so, how the contingent liability under any such indemnity is to be valued for the purpose of the limitation. For example, the standard form 2002 ISDA Master Agreement contains an indemnity for certain costs and expenses.

Constitutional limitations on the ability to draw investor commitments to make payments in respect of derivatives transactions

The manager will also need to consider any ongoing requirements under the proposed derivatives transaction to make payments or to exchange collateral. The proposed source of any required liquidity will need to be identified. It would usually be undesirable for investors' uncalled commitments to be used for making payments, or exchanging collateral because of the investment drag associated with this, as well as the relative illiquidity of uncalled commitments. However, if it is intended that investors' uncalled commitments will be used in this way, the manager will need to consider whether commitments can be drawn down for this purpose under the fund's constitutional documents and whether those commitments can be posted to counterparties within the timeframes specified in the relevant credit support documents, given the time it will take to draw down such commitments from investors.

If the fund has a subscription facility or other credit agreement where the available facility is calculated by reference to uncalled commitments, the manager will also need to factor into its use of such a facility the effect of payments funded from undrawn commitments.

The derivatives documentation

The manager will need to negotiate its derivatives documentation with reference to the fund's circumstances and needs. Among the matters that the manager should consider are:

(a) *Recourse*. The manager will need to ensure that its derivatives documents reflect the correct separation of liability and recourse across its fund structure (for example, if hedging is only for liabilities relating to certain investors (say a USD sleeve of a fund that mainly raises capital in EUR and invests in EUR assets) or certain fund-owned vehicles but not others (such as friends-and-family or carry vehicles)). Further, and as noted earlier in this chapter, derivatives counterparties will likely require recourse against the fund where they are transacting with a special purpose vehicle and managers will usually want to ensure that a counterparty's recourse to the fund's investment vehicles is limited in line with each investment vehicle's proportionate participation in the hedging undertaken by the special purpose vehicle.

(b) *Cross-default*. The manager should consider carefully the extent to which a default under any credit agreement could give rise to a termination right under its derivatives documents (for example, under paragraph 5(a)(vi) (Cross-Default) of the 2002 ISDA Master Agreement). The manager should seek to agree appropriate thresholds in its ISDA documentation to ensure that only material breaches of the fund's other debt obligations will give rise to a potential close-out of derivatives under the ISDA.

(c) *Additional termination events*. Derivatives counterparties will usually seek to include additional termination events (ATEs) in their derivatives documents, unless the manager has a very strong negotiating position or established relationship with the derivatives counterparty. Examples of ATEs commonly seen in the London market include:

(1) *Uncalled commitments cover*. This termination event is triggered if the financial indebtedness of the fund exceeds an agreed ratio of the fund's uncalled capital commitments.

The concern with this ATE is that a reduction in the fund's uncalled capital commitments is not necessarily a sign that it is in financial difficulty. Indeed, managers will be actively seeking to draw down investor commitments in order to invest them. Without careful consideration, this ATE could give rise to a "hair trigger" later in the lifecycle of the fund where the manager has substantially drawn down commitments from its investors. A common approach is for this kind of ATE to include a "sunset" provision whereby the ATE "switches off" once an agreed percentage of the fund's commitments has been drawn down and the ATE pivots to test a different financial metric (such as the fund's net asset value (NAV)).

(2) *NAV floor*. This termination event is triggered if the fund's NAV drops below a particular level. The problem with this ATE is that a successful fund expects to reduce its NAV as it realises assets and returns value to investors. Conversely, "zombie" funds that continue well beyond their scheduled termination date, or that are not being actively managed, may not trigger this ATE. If a NAV floor is set too high, the fund should not plan to have derivatives transactions outstanding with the relevant counterparty significantly beyond the point where the fund's NAV is expected to approach the floor (with a suitable degree of headroom). Depending on where the NAV floor has been set, this could be as early as the beginning of the fund's realisation and distribution phase. Even the most generous NAV floors will, at some point, become problematic for the fund as its NAV will necessarily fall below the NAV floor as it reaches the end of its lifecycle.

Whilst the need for derivatives may reduce as the fund's lifecycle moves to the realisation and distribution phase, it does not disappear entirely. If a particular counterparty refuses to agree to there being appropriate flexibility in the NAV floor trigger (for example, a step down following the realisation of assets in line with the fund's strategy), the manager would want to be able to trade with one or more alternative counterparties who do not insist on a NAV floor trigger that would prevent or seriously limit derivatives use towards the end of the fund's lifecycle, making diversity of covenants across counterparties especially important.

(3) *NAV decline*. This termination event is triggered if the fund's NAV decreases by more than prescribed amounts (or percentages) over particular periods. This trigger is difficult for a manager if the termination event has not been calibrated to deal with expected NAV movements – particularly where the manager is seeking to return cash to investors during the realisation and

distribution phase, or where it wishes to realise an asset early in its investment period (which could trigger a dramatic decrease in NAV if it is the only, or one of only a handful of, investment(s) made by the fund at that date). The manager should seek to mitigate any such trigger appropriately. This could be achieved by, for example, adjusting the trigger movement thresholds to reflect different stages of the fund's life; adding back distributions to investors that remain eligible for recall; or applying the trigger only to decreases that have a material adverse effect upon the fund's ability to perform its payment obligations under the relevant derivative.

There are other ways for the manager to mitigate this point, such as agreeing that instead of a termination trigger, a decrease in NAV will increase the level of collateral required to be exchanged by the fund in respect of its hedging exposure (which a manager may consider to be the lesser of the two evils), or agreeing that disposals made in the ordinary course of the fund's business will be excluded from consideration of NAV decline.

(d) *Use of collateral*. In addition to the issues relating to collateral highlighted above, managers should note that, to the extent the fund is required by regulation to exchange collateral in respect of its derivatives, it may not be possible for the manager to control the amount and frequency of collateral by setting large transfer threshold amounts and minimum transfer amounts. However, as noted earlier in this chapter, these risks can be mitigated by the careful structuring of the derivatives transactions or by the use of an appropriate vehicle to enter into derivatives on behalf of the fund group.

(e) *Compliance with applicable regulation*. Relatedly, and where transacting through a vehicle that is directly subject to EMIR or UK EMIR, managers will need to ensure that appropriate provisions enabling the fund to comply with its other risk mitigation and reporting obligations under EMIR or UK EMIR are included in the derivatives documentation.

Additional considerations in respect of semi-liquid funds

The increasing prevalence of semi-liquid strategies has been accompanied by increased demand for hedging strategies adapted to the unique characteristics of these funds.

One notable difference is the demand from investors for share-class hedging in these strategies in addition to asset-level hedging where the base currency of the fund differs from the currency of the share class in which an investor may subscribe. This can introduce further structuring concerns and may necessitate the establishment of a special purpose vehicle where the currency of the share class to be hedged is not one that is capable of physical settlement in the fund's trading location of choice but the fund wishes to remain exempt from the obligation to exchange variation margin.

Furthermore, attention will need to be given at the inception of the fund to the disclosures contained within the fund's offering documentation on the fund's intended use of derivatives in order to ensure that these are drafted with sufficient breadth and detail to accommodate the fund's future hedging strategy. Consideration will also need to be given to whether the fund may need to exchange collateral, provide guarantees or utilise other credit support in relation to the hedging activity.

The semi-liquid nature of these strategies also dictates the package of ATEs that will be sought by bank counterparties and that will be palatable to the fund. Bank counterparties will be concerned with ensuring that, in the absence of the possibility of drawing down further commitments from investors, there is sufficient liquidity available within the fund to meet hedging costs, and funds need to ensure that NAV-based termination events are calibrated to allow for the fluctuations brought about by periodic redemptions.

Interaction with credit agreements

The manager will also need to be aware of any contractual restrictions contained in any credit agreements to which the fund is party. Depending on the fund, and its use of leverage, this might be a subscription (or capital call) facility, a NAV facility, a hybrid facility or something else as the options in a manager's liquidity toolkit continue to grow.

Contractual limitations under credit agreements in relation to entering into derivatives transactions

Limitations commonly appear in credit agreements that directly address the ability of the fund to enter into derivatives transactions:

(a) *Restriction on entering into derivatives transactions*. The underlying credit agreement should be reviewed for any restrictions on entry into derivatives transactions. Although a blanket prohibition is unlikely, other restrictions are more common and may include, for example, restrictions on entering into derivatives for speculative purposes.

(b) *Restriction on incurring financial indebtedness*. Credit agreements will often restrict the fund's ability to incur financial indebtedness. The exposure of the fund under derivatives transactions will usually, but not always, be treated as financial indebtedness. If derivatives exposure is treated as financial indebtedness, then the next question is how the exposure should be measured. The common measure is the mark-to-market value of the derivatives transactions from time to time, but again this is a question of interpretation of the contractual provision. A manager may be able to mitigate this risk by negotiating a sufficiently large permitted "basket" of financial indebtedness to allow for anticipated fluctuations in derivatives exposure.

Contractual limitations under credit agreements in relation to granting credit support for fund-level derivatives transactions

Credit agreements will also commonly contain provisions that would otherwise limit the fund's ability to give credit support in relation to derivatives so, if the fund needs to exchange collateral or give any guarantee in respect of the proposed derivatives, appropriate permissions will need to be included:

(a) *Security*. Credit agreements will usually include a negative pledge that limits the fund's ability to grant security. This restriction will always (in the context of a subscription facility) apply to security over the investors' uncalled commitments and any collateral or deposit account into which any investor commitments are paid when called, but it may apply to the creation of other security as well.

    A fund that may be required to enter into security arrangements in relation to derivatives should seek to include appropriate permissions to allow for this.

(b) *Guarantees*. If a fund guarantee may be required, the manager will need to ascertain whether any finance documents limit its ability to give such a guarantee. This could be by way of a direct limitation on the giving of guarantees, or an indirect limitation where another restriction is broad enough to apply to guarantees (such as guarantees being designated as financial indebtedness for the purposes of the limitation on financial indebtedness). Alternatively, such guarantees may be permitted but constitute financial indebtedness for the purposes of calculating the borrowing base (on a subscription line) or otherwise for financial covenant purposes. In this scenario, the manager will need to understand how the guarantee will be valued for these purposes.

(c) *Indemnities*. As with guarantees, careful thought must be given as to whether indemnities are limited, directly or indirectly, through any other limitation (for example, on financial indebtedness) and, if so, how the indemnity liability is to be valued for this purpose.

Further issues to consider under credit agreements in relation to the fund entering into derivatives

There are a number of other potential points of interaction between a fund's credit agreement and its derivatives documents. These need to be considered on a case-by-case basis by reference to the terms of the relevant documents, but common issues are:

(a) *Availability of subscription facility*. Derivatives transactions may impact upon the availability of a subscription facility (or other credit agreements, where the facility limit is dictated by the level of uncalled commitments). This is because the terms of the credit agreement may require that, when calculating the borrowing base, the uncalled commitments are reduced by the amount of any derivatives liabilities (and any guarantee given in relation to derivatives liabilities).

More generally, if the manager proposes to use a subscription facility to fund payments under, or to fund collateral in respect of, its derivatives transactions, then the manager will need to ensure that the subscription facility permits such use and that it can be drawn down quickly enough (taking into account the currency in which the relevant collateral needs to be exchanged) to meet the requisite timing of the payment.

(b) *Financial covenants*. The manager will also need to consider the impact of any derivatives on the financial covenants (if any) contained in its credit agreements. Whilst a pure subscription facility is unlikely to look much beyond uncalled commitments cover, NAV facilities (for example) are likely to contain a more comprehensive suite of financial covenants. When negotiating its credit agreements, the manager should seek to tailor the terms of any financial covenant definitions and ratios so that anticipated derivatives use does not erode headroom and, as the fund moves through its lifecycle, the financial covenants do not dictate or materially compromise the fund's derivatives strategy.

Derivatives use may impact upon a number of financial covenants:

(1) *Uncalled commitments cover*. This financial covenant typically measures the level of financial indebtedness incurred by the fund against the quantum of its uncalled commitments. As noted above, the manager will need to understand to what extent derivatives exposure (including any guarantee, where relevant) is included within financial indebtedness for the purpose of this covenant and how that exposure is measured.

(2) *Interest cover*. This financial covenant, often seen in NAV or hybrid facilities, measures the level of finance charges that the fund must pay under its financial indebtedness against net cashflow generated by its portfolio of investments. The manager will need to determine to what extent payments and other charges on its derivatives will constitute finance charges for the purpose of calculating the covenant.

(3) *Loan to value*. This financial covenant, usually found in NAV or other "aftercare" facilities, compares the level of financial indebtedness to fund NAV. The manager will need to identify the extent to which derivatives transactions will either need to be included in the financial indebtedness calculation or will impact upon the NAV figure. Impact on NAV is more likely in circumstances where the derivatives have been entered into below fund level.

Conclusion

Fund-level derivatives transactions are now entered into by funds routinely, and managers continue to use these instruments both for the purpose of hedging risks faced by the fund and as part of the investment strategy of the fund. A manager who intends to enter into derivatives transactions at fund level should obtain appropriate legal and regulatory advice in order to ensure that the fund's investment and/or hedging programme is legally robust.

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