

# SFAS 161 (ASC 815-10-50) Disclosures About Derivative Instruments and Hedging Activities: Implementation Guidance for the Alternative Investment Community

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Dear Clients and Friends:

As investors, analysts and regulators continue to reflect on the underlying causes of the global market crashes of 2008, some have focused on the role derivatives trading might have played in a crisis that so few saw coming. For many, the notion that a financial services insurance company like AIG could be humbled by its exposure to unregulated credit default swaps has emphasized the need to better understand the credit risks associated with the overall over-the-counter (OTC) derivatives markets. With the goal of reducing what has been characterized as rampant speculation in these markets, regulatory efforts have been aimed at providing greater transparency, with the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) expected to share jurisdiction.

Ultimately, the demand for enhanced transparency has been driven by investors and dealers. Market-driven solutions, however, can be effectively supported by a comprehensive regulatory framework that clarifies oversight authority and guidance regarding trading requirements. Current proposals under consideration may include more substantial capital requirements, the use of central clearinghouses and regulated exchanges, as well as dealer registration. While these measures continue to spark debate, the Financial Accounting Standards Board (FASB) sought to address the concerns about transparency in the disclosures of derivative activities through its March 2008 release of **Statement No. 161 ("SFAS 161"), Disclosures About Derivative Instruments and Hedging Activities (codified in ASC 815-10-50)**.

SFAS 161 follows SFAS 157, which revised financial reporting requirements for the alternative investment community in 2008, and included increased disclosures relating to the fair value measurements of securities and derivatives. By enhancing guidelines for the financial statement disclosures of OTC derivatives, SFAS 161 will afford investors an even greater insight regarding:

- How and why alternative investment funds are using derivatives
- The extent of an alternative investment fund's derivative trading activities
- The alternative investment fund's gross exposure to derivatives

As a leader in providing auditing, tax and consulting services to the alternative investment community, Rothstein Kass is pleased to present this guide to understanding SFAS 161. The material – including sample footnote disclosures and a frequently-asked-questions section – offers a practical approach to implementing the new disclosure requirements of SFAS 161.

We are excited to share this report with you and believe that you will find its content informative, practical and compelling. Please reach out to me or any of the Principals in our Financial Services Group if you have questions or if we can be of assistance.



Howard Altman  
Co-Managing Principal  
Rothstein Kass

# SFAS 161 (ASC 815-10-50) Disclosures About Derivative Instruments and Hedging Activities: Implementation Guidance for the Alternative Investment Community

## Overview

Legendary investor Warren Buffett famously referred to derivative instruments as “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.” This seemingly prophetic statement embodied some of the ongoing concerns about the opacity of “latent” risk factors related to derivative activities and the adequacy of financial statement disclosures in communicating such risks to investors and other users of such financial information.

As the use and complexity of derivative instruments has continued to expand in recent years, there have also been increasing concerns as to whether the guidance in Financial Accounting Standards Board (“FASB”) Statement No. 133 (“SFAS 133”), *Accounting for Derivative Instruments and Hedging Activities* (codified under FASB Accounting Standards Codification section (“ASC”) 815, effective for periods ending after September 15, 2009) provided for adequate disclosures about how derivative activities affect an entity’s financial statements. Some of the risk factors and concerns relating to derivative activities include, but are not limited to:

- Objectives and strategies for the use of derivative instruments
- Exposures to market, interest rate, credit, foreign currency exchange rate, and other risks
- The impact of derivative instruments on the financial condition, results of operations and cash flows of an entity
- Volume of an entity’s derivative activities
- Off-balance-sheet risk from the use of leverage
- Concentrations of credit risk with over-the-counter dealer counterparties
- Contingencies from credit events which can result in the termination of open contracts or the posting of additional collateral

In March of 2008, the FASB issued Statement No. 161 (“SFAS 161” or the “Statement”), *Disclosures about Derivative Instruments and Hedging Activities* (ASC 815-10-50), which amends and expands the disclosure requirements of SFAS 133 to provide enhanced information about an entity’s derivative activities. The primary objectives of SFAS 161 are to provide users of financial statements with an improved degree of transparency and understanding of how and why an entity uses derivative instruments, how derivative instruments are accounted for, and how derivative instruments affect an entity’s financial position, results of operations and its cash flows.

In order to provide such information to financial statement users, SFAS 161 requires qualitative disclosures about an entity's associated risk exposures, quantitative disclosures about fair value amounts of derivative instruments and the gains and losses from derivative instruments, and disclosures of credit-risk-related contingent features in derivative agreements.

The new disclosures required under SFAS 161 are applicable to all entities with derivative instruments subject to the accounting guidance under the scope of SFAS 133 and its related interpretations. Although common industry practice has been to classify options and warrants within investments in securities for financial statement purposes, these contracts are generally considered to be derivatives under SFAS 133. Since options and warrants will be subject to SFAS 161 disclosures, financial statement reclassification from investments in securities to derivative contracts is recommended. Investment funds may also need to review the provisions of SFAS 133 to evaluate whether certain contracts, such as royalty rights, milestone payments, and loan commitments are included within the scope of SFAS 133, to determine whether SFAS 161 disclosure requirements apply. Furthermore, certain investment funds such as loan origination and private equity funds may need to be aware of embedded derivative features which are measured at fair value separately from their host contracts. Such embedded derivative features which meet the bifurcation criteria of SFAS 133 are subject to the disclosure requirements of SFAS 161.

Certain disclosure requirements of SFAS 161 distinguish between derivative activities that are designated and qualifying as hedging transactions under SFAS 133 from other non-hedging derivative transactions. Since investment funds account for their investments at fair value under specialized industry accounting guidance, there seldom is a need for investment funds to apply the complex hedge accounting provisions of SFAS 133. Therefore, even if an investment fund's derivative activities may possess the substance of an economic hedge, **the general rule is that investment funds should treat its derivative activities as non-hedging transactions with respect to SFAS 161 disclosures.** Investment funds which qualify for and elect to apply the hedge accounting rules of SFAS 133 should be aware of the need to provide additional detail of the qualitative and quantitative disclosures based on the SFAS 133 accounting designation of their derivative activities.

## Qualitative Disclosures

### Objectives and Strategies for Using Derivative Instruments

The Statement requires an entity to describe its objectives for using derivative instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The Statement requires reporting entities to provide disclosures based upon each derivative instrument's primary underlying risk exposures. The different types of primary underlying risks listed in the Statement include interest rate risk, credit risk, foreign currency exchange rate risk, commodity price risk, and equity price risk. Investment funds should also consider the existence of other primary risk exposures, such as event-driven features, as part of disclosure of the risk factors underlying their derivative activities.

The qualitative descriptions should also distinguish between derivative instruments used for risk management purposes and those used for other purposes (e.g., price speculation). Derivative instruments used for risk management purposes include instruments used for economic hedges and other purposes related to the reporting entity's risk exposures. For derivative instruments not used for risk management purposes, their descriptions should include the purpose of the derivative activity.

Investment funds may include additional qualitative disclosures, such as the different types of derivative instruments used to manage each type of primary underlying risk, or specific exposures within each underlying risk category (e.g., concentrations in specific foreign currencies).

The recommended best practice for investment funds is to reorganize their derivative disclosures by type of risk and to provide qualitative disclosures as to how their derivative instruments are used to manage those risks (**Exhibit 1**). Investment funds which have significant concentrations in a specific underlying should consider including additional disclosure of specific exposures if the concentration can subject the investment fund to the potential of a near-term severe impact.

### Volume of Derivative Activities

The Statement also requires an entity to describe the volume of its derivative activities. In many cases, the total notional amounts, grouped by the directional risk exposures of each type of derivative instrument will provide meaningful information of the volume of derivative activity.

However, the Statement recognizes that this will not always be the case. In certain cases, the gross presentation of notional amounts can result in misleading amounts. One example is the entering of offsetting contracts for the purpose of effecting a synthetic termination of open derivative positions. Another example is the use of multiple contracts with recurring coupon dates used in the risk management of a single instrument.

Instead of prescribing a specific method to describe the volume of an entity's derivative activities, SFAS 161 allows the entity to exercise discretion in determining the most appropriate disclosure format based on the facts and circumstances that would best enable financial statement users to understand the volume of the entity's derivative activities. Our recommended best practice is to use the disclosure of notional amounts and number of contracts, where appropriate, as general methods for presenting the volume of an investment fund's derivative activities (**Exhibit 2**). As a best practice, we also recommend that investment funds disclose the methodology used to determine the volume of their derivative activities respective for each type of derivative instrument held during the reporting period. The methodologies should consider the applicability to each type of derivative instrument used, as well as the effects of offsetting contracts on the substance of the volume of derivative activities. For example, an investment fund may determine the volume of its activities in credit default swaps to be based on the notional value of the underlying reference obligations. However, an investment fund which trades primarily in oil and gas futures contracts may deem it appropriate to disclose the number of standardized units for each type of contract underlying, net of identical offsetting positions, as a measurement of the volume of its derivative activities.

### Quantitative Disclosures

The Statement requires two sets of disclosure tables to be presented for each reporting period for which a statement of financial condition and a statement of operations are presented. SFAS 161 does not require a specific location within the financial statements where these disclosures should be made. We recommend including the tabular disclosures within the same financial statement footnote which discusses the qualitative nature of the derivative instruments to facilitate locating relevant information regarding the investment fund's derivative activities.

## Statement of Financial Condition Disclosures

The first table requires disclosure of the location and the fair value amounts of derivative assets and liabilities reported in the statement of financial condition. The fair values of the derivative instruments are required to be presented on a gross basis in the tabular disclosure, even if the derivative instruments are subject to master netting arrangements with its counterparties and qualify for net presentation in the statement of financial position. Collateral balances associated with the derivative instruments should also be excluded from the fair value amounts reported in the tabular presentation.

In addition to presenting the fair value information on a gross basis, the Statement requires such information relating to the asset and liability amounts to be presented separately by primary underlying risk exposure (**Exhibit 3**). In addition to categorizing the asset and liability amounts by primary underlying risk exposure, we also recommend presenting additional detail by derivative instrument type within each primary underlying risk.

Funds transacting in multiple derivative positions may need to incorporate portfolio-level adjustments to consider the effects of certain risks on the valuation of derivatives, such as the nonperformance risk of a derivative counterparty. Since the tabular disclosures are constructed from an instrument-by-instrument level of detail, an allocation methodology may be needed to push down any top-side valuation adjustments for counterparty risks to individual derivative positions in conjunction with a complete presentation of the Statement's tabular disclosures.

Since the tabular disclosures will require the presentation of asset and liability derivatives on a gross basis, and the exclusion of the effects of master netting arrangements and collateral balances, it is possible that the amounts reported will not easily reconcile to the account balances reported in the statement of financial condition. **We recommend including reconciling details to provide financial statement readers with a roadmap between the statement of financial condition amounts (including the condensed schedule of investments) and the Statement's tabular disclosures.**

## Statement of Operations Disclosures

The second table requires the disclosure of the location and the amounts of gains and losses from derivative activities reported in the statement of operations. Similar to the statement of financial condition tabular requirements, the location and the amounts of gains and losses are required to be disclosed by primary underlying risk exposure (**Exhibit 4**). We also recommend presenting these disclosures by type of derivative instrument within each primary underlying risk category.

The gains and losses should be presented on a net basis by primary underlying risk category. The gains and losses presented in the tabular disclosure are not required to be bifurcated into realized and unrealized components.

## Other SFAS 161 Disclosures

### Credit-risk-related Contingent Features

SFAS 161 requires additional disclosures about credit-risk-related contingent features included in derivative instruments that are in a net liability position at the end of the reporting period. Credit-risk-related contingent features are contractual features that are enforceable by an entity's derivative counterparties, which can result in the termination of the entity's open derivative instruments or requiring the entity to post additional collateral upon the occurrence of a credit event (e.g., an insufficient asset coverage for its contracts, or a decline in an investment fund's net assets in excess of a stated percentage). These disclosures include the following:

- a. The existence and nature of credit-risk-related contingent features and the circumstances in which those features could be triggered.
- b. The aggregate fair value amounts of derivative instruments in a net liability position containing credit-risk-related contingent features.
- c. The aggregate fair value of assets that are already posted as collateral at the end of the reporting period, as well as the aggregate fair value of assets that would be required to be posted as additional collateral and/or to settle the instrument immediately, if the credit-risk-related contingent features were triggered at the end of the reporting period.

The purpose of these disclosures is to help assess the timing and likelihood of the occurrence of credit-risk-related contingent features, as well as to assess the potential impact on an entity's liquidity if such contingent features were triggered. These disclosures can provide valuable information about the magnitude of the impact of those contingencies resulting from an immediate termination of its derivative arrangements, or the requirement to post additional collateral with the counterparty.

**If an investment fund does not have any credit-risk-related contingent features for its derivative positions as of the financial statement date, we recommend including a description of that fact to clarify the status of the presence or absence of such contingent features.**

Since market volatilities can create fluctuations in the designation of net liability derivative positions which an investment fund may hold from period-to-period, a recommended best practice is for investment funds involved in a large volume of derivative activities to track the credit-risk-related contingency features of all of its derivative positions on an instrument-by-instrument basis for each counterparty where a separate agreement exists. This practice can facilitate the generation of the information on a timely basis after determining the extent of net liability positions subject to such disclosures at each financial statement date.

## Concentrations of Credit Risk

SFAS 161 amends Statement No. 107 (“SFAS 107”) *Disclosures about Fair Value of Financial Instruments* (ASC 825) to clarify that the disclosure of concentrations of credit risk is applicable to all financial instruments, including derivative instruments. Disclosures required by SFAS 107 (as amended) include the following for each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration.
- b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other securities, if any, for the amount due proved to be of no value to the entity.
- c. The entity’s policy of requiring collateral or other securities to support financial instruments subject to credit risk, information about the entity’s access to that collateral or other securities, and the nature and a brief description of the collateral or other securities supporting those financial instruments.
- d. The entity’s policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity’s maximum amount of loss due to credit risk.

While certain derivative instruments may be nonfinancial instruments in form, given the elevated degree of counterparty risks present in the financial industry, investment funds should consider providing the amended SFAS 107 disclosures for both financial and nonfinancial derivative instruments.

## Cross-referencing to Related Disclosures

To aid users in locating all important information relating to derivative instruments, the Statement requires entities to include adequate cross-references between footnotes when related required disclosures are included within multiple locations in the financial statements. To the extent possible, we recommend including all footnote disclosures relating to derivative activities within a single footnote in the financial statements. This will obviate the need to include cross-references between multiple related footnotes on a recurring basis.

## Additional Disclosure Requirements for Credit Derivatives

### Overview

The ongoing turmoil within the credit markets has raised concerns from regulators and market participants regarding the proliferation in credit derivative transactions, as well as the increasing risk of default among the referenced debt obligations underlying such credit derivatives. These adverse conditions may expose sellers of credit protection to increasing occurrences of payment obligations, which in turn can have a significant impact towards the liquidity and credit ratings of such entities. Likewise, these conditions can also subject purchasers of credit protection to an increase in risk of loss from counterparty failure as well as to an adverse impact on the fair values of the purchased credit derivatives.

In response to the increasing demand for more transparent disclosures of the impact of adverse changes in credit risks that sellers of credit derivatives are exposed to, the FASB fast-tracked the development and issuance of FASB Staff Position FAS 133-1 and FIN 45-4 (“the FSP”), *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (ASC 815-10-50), which amends SFAS 133 to require additional financial statement disclosures about credit derivatives. The FSP also amends FASB Interpretation No. 45 (“FIN 45”), *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (“ASC 460”), to require additional disclosures about the current status of the payment/performance risk of a guarantee.

The additional disclosures borrow from the provisions of FIN 45, which applies towards many types of guarantee contracts, including financial guarantees which have risk and reward attributes similar to credit derivatives. However, the economic similarities between credit derivatives and financial guarantee contracts did not often result in consistent disclosure presentations. As a result, the FASB decided to amend SFAS 133 to require additional disclosures for all credit derivatives<sup>1</sup> (including derivatives with multiple underlyings, and hybrid instruments with embedded credit derivatives) within the scope of SFAS 133 as well as those within the scope of FIN 45.

The intended goal of the FSP is to enhance the transparency of disclosures of the existence, nature, and use of credit derivatives used in the role of selling credit protection, the potential off-balance sheet exposure from the obligation to perform under a credit derivative, as well as the existence of any recourse provisions available to recover amounts paid during the performance of these obligations.

<sup>1</sup> For purposes of the FSP, the FASB defines a credit derivative as a derivative instrument (a) in which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities and (b) that exposes the seller to potential loss from credit-risk-related events specified in the contract.

## Disclosure Requirements

For each statement of financial condition presented, a seller<sup>2</sup> of credit derivatives should disclose the following information for each credit derivative, or each group of similar credit derivatives, regardless of the likelihood of a seller having to make any payments under the credit derivatives:

- a. The nature of the credit derivatives, including;
  - The approximate terms of the credit derivatives.
  - The reason(s) for entering into the credit derivatives.
  - The events and circumstances that would require the seller to perform under the credit derivatives.
  - The current status of the payment/performance risk of the credit derivatives (indicated by either recent external credit ratings or current internal groupings based on the manner in which the seller manages its risk).
- b. The maximum potential amount of future payments the seller could be required to make under the credit derivatives. Furthermore;
  - The amounts shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions.
  - If the terms of the credit derivatives do not provide for a limit to the potential future payments under the contract, that fact shall be disclosed.
  - If the seller is unable to estimate the maximum potential amount of future payments under the contract, the reasons why the amount cannot be estimated shall be disclosed.
- c. The fair value of the credit derivatives.
- d. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivatives and (2) any assets held by either the seller as collateral, or assets held by third parties, which can be obtained and liquidated by the seller upon the occurrence of specified conditions. If estimable, the extent of which the proceeds from liquidation can be applied towards the maximum potential amount of future payments under the credit derivatives. In its estimate of potential recoveries, the seller shall consider the effect of any purchased credit protection with identical underlyings.

<sup>2</sup> With respect to the disclosure requirements, the FASB uses the term “seller” to refer to the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, and any party that provides credit protection through an option-type contract, a credit default swap, or any other type of credit derivative contract.

The FSP includes recommended guidance for presenting information for groups of similar credit derivatives, first by segregating the disclosures by major types of contracts (for example, single-name credit default swaps, traded indexes, other portfolio products, and swaptions) and then, for each major type, to provide additional subgroups for major types of referenced/underlying asset classes (for example, corporate debt, sovereign debt, and structured finance) **(Exhibit 5)**.

The requirement to disclose the current status of the payment/performance risk is intended to yield information about the likelihood of the credit protection seller having to perform under the credit derivatives, and the potential impact on the financial statements. The FSP does not express a preference between the use of external credit ratings and current internal groupings to convey the current status of payment/performance risk. The FASB acknowledges that external ratings may not be current as of the reporting date or as relevant as other internal groupings used to manage risk. Due to the latitude allowed in the use of internal groupings, the FSP requires disclosure of how such groupings are determined and used for managing risk.

We have observed that the use of external credit ratings and the credit spreads of the underlying reference obligations have been the primary industry practices used to disclose the current status of payment/performance risk. Generally, we recommend the use of external credit ratings as a practical method to communicate the current status of the payment/performance risk of credit default swaps to the users of the financial statements. To the extent that more timely and/or more relevant information is available, other methods are acceptable and should be considered to provide meaningful information to financial statement users.

The maximum amount of future payments that the seller could be required to make to perform under the credit derivatives should not be reduced by any recourse provisions, amounts held as collateral, or identical offsetting contracts used to purchase credit protection. The nature and existence of recourse provisions or collateralization that would enable the seller to recover amounts paid under the credit derivative is disclosed separately to provide information of the extent that the maximum potential payments are mitigated. In addition, of the extent a seller of credit protection has purchased credit protection through identical offsetting contracts, the amount should be disclosed.

## Effective Dates

The Statement is effective for quarterly interim periods beginning after November 15, 2008, and fiscal years which include those interim periods. In the initial fiscal year of adoption, a reporting entity may omit disclosure of information attributed to quarterly interim periods beginning on or before November 15, 2008. The reporting entity should clearly disclose the periods covered by the disclosures.

For comparative financial statements, the Statement encourages, but does not require reporting entities to include disclosures for periods prior to the date of initial adoption. Comparative disclosures are required only for periods presented which are subsequent to initial adoption.

The FSP is effective for the first reporting period (annual or interim) ending after November 15, 2008.

## Conclusion

Similar to our recommendations towards the SFAS 157 implementation process, clients as a best practice need to designate a “champion” to coordinate the efforts between the information systems and investment management functions as part of managing the implementation challenges within a cohesive financial reporting process. Due to the complexity and high volume of information involved in many derivative trading activities, it is recommended that a similar role should be designated by fund managers to facilitate the transition in adopting the requirements of SFAS 161 and the FSP. When alternate methods of presentation are available, investment funds should consult with their administrators, auditors, and other service providers to determine the most meaningful basis of communicating risks associated with disclosure activities based on their individualized use of derivative instruments and the underlying information available.

The financial reporting process should be evaluated to ensure that transactional-based information from derivative activities by primary underlying risk exposures are effectively interfaced with the processes needed to construct the required disclosures at the financial statement level. We recommend establishing ongoing procedures to tag open derivative contracts with their assigned primary underlying risk exposure categories, and to assign such corresponding designations to the related gains and losses from the respective contracts. Investment funds will need to evaluate the different types of derivative contracts they transact in and designate the risk exposure categories to be assigned to those contracts. It will also be critical to be able to identify and aggregate the fair value amounts on a gross basis, based on the instrument-by-instrument-level asset or liability classification of the derivative instruments.

Other implementation challenges of SFAS 161 include identifying and keeping track of credit-risk-related contingent features attributed to open net liability derivative instruments, and to determine and document rational policies for allocating top-side valuation adjustments (e.g., nonperformance risk adjustments) to individual derivative positions transacted with a given counterparty.

We expect that the main challenge in implementing the disclosure requirements of the FSP is obtaining information relating to the payment/performance risk of the credit derivatives, as well as information relating to recourse provisions or claims on pledged assets, as such information may be dependent on external information which funds may not be able to immediately access without significant cost or effort. It is critical for funds involved in the selling or writing of credit derivatives to develop the necessary procedures and controls to extract the required information in order to effectively implement the disclosure requirements of the FSP.

The provisions of SFAS 161 and the FSP will provide valuable information to investment funds which closely monitor the financial performance of the financial institutions and other counterparties with whom they transact. Investment funds should take advantage of the additional degree of transparency available from their counterparties about their risk concentrations, liquidity commitments, and contingent features as part of an effective monitoring process over their concentrations of credit risks.

The adoption of SFAS 161 and the FSP holds significant challenges in providing newly acquired transparency in financial statement disclosures for funds involved in significant derivative activities. Investment funds will need to be prepared to evaluate their financial reporting processes and to enact the necessary steps to allow for the timely and accurate reporting of the new disclosure requirements. Please contact any of our Rothstein Kass Financial Services Group principals if you would like to discuss these requirements.

## Exhibit 1

### Sample Qualitative Disclosures

#### Derivative Contracts

In the normal course of business, the Fund utilizes derivative financial instruments in connection with its proprietary trading activities. Investments in derivative contracts are subject to additional risks that can result in a loss of all or part of an investment. The Fund's derivative activities and exposure to derivative contracts are classified by the following primary underlying risks: interest rate, credit, foreign currency exchange rate, commodity price, and equity price risks. In addition to its primary underlying risks, the Fund is also subject to additional counterparty risk should its counterparties fail to meet the terms of their contracts.

The Fund records its derivative activities at fair value. Gains and losses from derivative financial instruments are included in net gain (loss) from derivative contracts in the statement of operations.

#### Futures Contracts

The Fund is subject to equity and commodity price risk, interest rate risk, and foreign currency exchange rate risk in the normal course of pursuing its investment objectives. The Fund may use futures contracts to gain exposure to, or hedge against, changes in the value of equities and commodities, interest rates or foreign currencies. A futures contract represents a commitment for the future purchase or sale of an asset at a specified price on a specified date.

The purchase and sale of futures contracts requires margin deposits with a Futures Commission Merchant ("FCM"). Subsequent payments (variation margin) are made or received by the Fund each day, depending on the daily fluctuations in the value of the contract, and are recorded for financial statement purposes as unrealized gains or losses by the Fund. Futures contracts provide reduced counterparty risk to the Fund since futures are exchange-traded; and the exchange's clearinghouse, as the counterparty to all exchange-traded futures, guarantees the futures against default.

The Commodity Exchange Act requires an FCM to segregate all customer transactions and assets from the FCM's proprietary activities. A customer's cash and other equity deposited with an FCM are considered commingled with all other customer funds subject to the FCM's segregation requirements. In the event of an FCM's insolvency, recovery may be limited to the Fund's pro rata share of segregated customer funds available. It is possible that the recovery amount could be less than the total cash and other equity deposited.

#### Forward Contracts

The Fund enters into forward contracts to hedge itself against foreign currency exchange rate risk for its foreign currency denominated assets and liabilities due to adverse foreign currency fluctuations against the U.S. dollar, and to manage the price risk associated with its commodity portfolio positions.

Forward currency and commodities transactions are contracts or agreements for delayed delivery of specific currencies and commodities in which the seller agrees to make delivery at a specified future date of specified currencies and commodities. Risks associated with forward currency and commodities contracts are the inability of counterparties to meet the terms of their contracts and movements in fair value and exchange rates. Gains and losses on forward currency and commodities transactions are recorded based on changes in fair values and are included with net realized and unrealized gain (loss) on derivative contracts in the statement of operations.

## Swap Contracts

The Fund enters into various swap contracts, including interest rate swaps, total return swaps, and credit default swaps as part of its investment strategies to hedge against unfavorable changes in the value of investments and to protect against adverse movements in interest rates or credit performance with counterparties. Generally, a swap contract is an agreement that obligates two parties to exchange a series of cash flows at specified intervals based upon or calculated by reference to changes in specified prices or rates for a specified notional amount of the underlying assets. The payment flows are usually netted against each other, with the difference being paid by one party to the other.

During the term of the swaps, changes in value are recognized as unrealized gains or losses by marking the contracts to fair value. Additionally, the Fund records a realized gain (loss) when a swap contract is terminated and when periodic payments are received or made at the end of each measurement period, but prior to termination. Unrealized gains (losses), realized gains (losses) and periodic payments are reflected in net realized and unrealized gain (loss) on derivative contracts in the statement of operations.

The fair value of open swaps reported in the statement of condition may differ from that which would be realized in the event the Fund terminated its position in the contract. Risks may arise as a result of the failure of the counterparty to the swap contract to comply with the terms of the swap contract. The loss incurred by the failure of a counterparty is generally limited to the aggregate fair value of swap contracts in an unrealized gain position as well as any collateral posted with the counterparty. The risk is mitigated by having a master netting arrangement between the Fund and the counterparty and by the posting of collateral by the counterparty to the Fund to cover the Fund's exposure to the counterparty. Therefore, the Fund considers the creditworthiness of each counterparty to a swap contract in evaluating potential credit risk. Additionally, risks may arise from unanticipated movements in the fair value of the underlying investments.

The Fund values its swap contracts at their fair values. Management calculates fair value by marking to market the assets and liabilities underlying the swap contracts.

## Interest Rate Swaps

The Fund is exposed to interest rate risk when there is an unfavorable change in the value of investments as a result of adverse movements in the market interest rates. The Fund enters into interest rate swap contracts to protect against such adverse movements in the interest rates.

Interest rate swaps are contracts whereby counterparties exchange different rates of interest on a specified notional amount for a specified period of time. The payment flows are usually netted against each other, with the difference being paid by one party to the other. The Fund's interest rate swap contracts are scheduled to terminate from 2010 through 2015.

## Total Return Swaps

The Fund is subject to equity price risk in the normal course of pursuing its investment objectives. The Fund may enter into total return swaps to manage its exposure to the market or certain sectors of the market, or to create exposure to certain equities to which it is otherwise not exposed.

Total return swap contracts involve the exchange by the Fund and a counterparty of their respective commitments to pay or receive a net amount based on the change in the fair value of a particular security or index and a specified notional amount. The Fund's total return swap contracts are scheduled to terminate from 2010 through 2012.

## Credit Default Swaps

The Fund is subject to credit risk in the normal course of pursuing its investment objectives. The Fund may enter into credit default swaps to manage its exposure to the market or certain sectors of the market, to reduce its risk exposure to defaults of corporate and sovereign issuers, or to create exposure to corporate or sovereign issuers to which it is not otherwise exposed.

Credit default swap contracts involve an arrangement between the Fund and a counterparty which allow the Fund to protect against losses incurred as a result of default by a specified reference entity. The Fund pays a premium and the counterparty agrees to make a payment to compensate the Fund for losses upon the occurrence of a specified credit event. Generally, the Fund pays a premium upfront and the counterparty agrees to make a payment to compensate the Fund for losses upon the occurrence of a specified credit event.

The Fund's credit default swap contracts are scheduled to terminate from 2010 through 2018.

**[See Exhibit 5 for additional disclosures for credit derivatives used for selling credit protection.]**

## Options

The Fund is subject to equity price risk in the normal course of pursuing its investment objectives. The Fund may enter into options to speculate on the price movements of the financial instrument underlying the option, or for use as an economic hedge against certain equity positions held in the Fund's portfolio holdings. Option contracts give the Fund the right, but not the obligation, to buy or sell within a limited time, a financial instrument, commodity or currency at a contracted price that may also be settled in cash, based on differentials between specified indices or prices.

Options written obligate the Fund to buy or sell within a limited time, a financial instrument, commodity or currency at a contracted price that may also be settled in cash, based on differentials between specified indices or prices. Options written by the Fund may expose the Fund to the market risk of an unfavorable change in the financial instrument underlying the written option.

The Fund is exposed to counterparty risk from the potential that a seller of an option contract does not sell or purchase the underlying asset as agreed under the terms of the option contract. The maximum risk of loss from counterparty risk to the Fund is the fair value of the contracts and the premiums paid to purchase its open option contracts. The Fund considers the credit risk of the intermediary counterparties to its option transactions in evaluating potential credit risk.

## Warrants

The Fund may receive warrants from its portfolio companies upon an investment in the debt or equity of a company. The warrants provide the Fund with exposure and potential gains upon equity appreciation of the portfolio company's share price.

The value of a warrant has two components—time value and intrinsic value. A warrant has a limited life and expires on a certain date. As the expiration date of a warrant approaches, the time value of a warrant will decline. In addition, if the stock underlying the warrant declines in price, the intrinsic value of an "in the money" warrant will decline. Further, if the price of the stock underlying the warrant does not exceed the strike price of the warrant on the expiration date, the warrant will expire worthless. As a result, there is the potential for the Fund to lose its entire investment in a warrant.

The Fund is exposed to counterparty risk from the potential failure of an issuer to settle its exercised warrants. The maximum risk of loss from counterparty risk to the Fund is the fair value of the contracts and the purchase price of the warrants. The Fund considers the effects of counterparty risk when determining the fair value of its warrants.

## Credit-risk-related Contingent Features

The Fund's derivative contracts are subject to International Swaps and Derivatives Association ("ISDA") Master Agreements which contain certain covenants and other provisions that may require the Fund to post collateral on derivatives if the Fund is in a net liability position with its counterparties exceeding certain amounts. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a net liability position at December 31, 2009, is \$16,000,000, for which the Fund has posted \$12,000,000 as collateral in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered as of December 31, 2009, the Fund would have been required to post additional collateral of \$6,000,000 to its counterparties. Additionally, counterparties may immediately terminate these agreements and the related derivative contracts if the Fund fails to maintain sufficient asset coverage for its contracts or its net assets decline by stated percentages or amounts. As of December 31, 2009, the termination values of these derivative contracts were approximately \$3,000,000 less than their fair values.

## Exhibit 2

### Sample Disclosure of Volume of Derivative Activities

At December 31, 2009, the volume of the Fund's derivative activities based on their notional amounts <sup>(a)</sup> and number of contracts, categorized by primary underlying risk, are as follows:

(notional amounts in thousands)

Primary underlying risk	Long exposure		Short exposure	
	Notional amounts	Number of contracts	Notional amounts	Number of contracts
<b>Interest rate</b>				
Interest rate swaps	\$ 50,000	250	\$ 20,000	100
<b>Foreign currency exchange rate</b>				
Forward contracts	5,000	800	6,000	1,250
<b>Equity price</b>				
Total return swaps	30,000	3,500	60,000	6,000
Futures contracts	10,000	700	4,000	400
Options <sup>(b)</sup>	4,000	1,000	5,000	2,000
Warrants <sup>(b)</sup>	<u>3,000</u>	<u>1,000</u>	<u>3,000</u>	<u>2,000</u>
	47,000	6,200	72,000	10,400
<b>Commodity price</b>				
Futures contracts	8,000	2,100	3,000	500
<b>Credit</b>				
Purchase protection:				
Credit default swaps			15,000	1,800
Written protection:				
Credit default swaps	<u>50,000</u>	<u>600</u>	<u>        </u>	<u>        </u>
	50,000	600	15,000	1,800
<b>Other risks</b>	1,000	4,500		
	<b>\$161,000</b>	<b>14,450</b>	<b>\$116,000</b>	<b>14,050</b>

(a) Notional amounts are presented net of identical offsetting derivative contracts.

(b) Notional amounts for options and warrants are based on the number of contracts times the fair value of the underlying instruments as-if exercised at December 31, 2009.

## Exhibit 3

### Statement of Financial Condition Tabular Disclosures

The following table identifies the fair value amounts of derivative instruments included in the statement of financial condition as derivative contracts, categorized by primary underlying risk, at December 31, 2009. Balances are presented on a gross basis, prior to the application of the impact of counterparty and collateral netting. Total derivative assets and liabilities are adjusted on an aggregate basis to take into consideration the effects of master netting arrangements and have been reduced by the application of cash collateral receivables and payables with its counterparties.

(in thousands)

Primary underlying risk	Derivative assets	Derivative liabilities
<b>Interest rate</b>		
Interest rate swaps	\$250	\$100
<b>Foreign currency exchange rate</b>		
Forward contracts	800	1,250
<b>Equity price</b>		
Total return swaps	3,500	6,000
Futures contracts	700	400
Options	1,000	2,000
Warrants	<u>1,000</u>	<u>2,000</u>
	6,200	10,400
<b>Commodity price</b>		
Futures contracts	2,100	500
<b>Credit</b>		
Purchase protection:		
Credit default swaps	1,000	1,800
Written protection:		
Credit default swaps	<u>600</u>	<u>1,800</u>
	1,600	1,800
<b>Other risks</b>	4,500	
<b>Gross derivative assets and liabilities</b>	15,450	14,050
Less: Master netting arrangements	(12,500)	(12,500)
Less: Cash collateral applied		(1,000)
<b>Net derivative assets and liabilities</b>	<b>\$2,950</b>	<b>\$550</b>

**Exhibit 4****Statement of Operations Tabular Disclosures**

The following table identifies the net gain and loss amounts included in the statement of operations as net gain (loss) from derivative contracts, categorized by primary underlying risk, for the year ended December 31, 2009.

(in thousands)

<b>Primary underlying risk</b>	<b>Amount of gain (loss)</b>
<b>Interest rate</b>	
Interest rate swaps	\$ 125
<b>Foreign currency exchange rate</b>	
Forward contracts	(900)
<b>Equity price</b>	
Total return swaps	3,000
Futures contracts	(7,000)
Options	(1,000)
Warrants	<u>(800)</u>
	(5,800)
<b>Commodity price</b>	
Futures contracts	1,400
<b>Credit</b>	
Purchase protection:	
Credit default swaps	2,500
Written protection:	
Credit default swaps	<u>1,000</u>
	3,500
<b>Other risks</b>	300
<b>Net gain (loss) from derivative contracts</b>	<b>\$ (1,375)</b>

## Exhibit 5

### Additional Disclosures for Credit Derivatives Used for Selling Credit Protection

Alternatively, when the Fund sells a credit default swap (“credit default swaps sold”), it receives premium payments in exchange for assuming the credit risk of the specified reference entity. The counterparty pays a premium to the Fund and the Fund agrees to make a payment to compensate the counterparty for losses upon the occurrence of a specified credit event.

Although contract-specific, credit events generally include bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default, or repudiation/moratorium. Upon the occurrence of a defined credit event, the difference between the value of the reference obligation and the swap’s notional amount is recorded as realized gain (for protection written) or loss (for protection sold) in the statement of operations.

In the event that certain specified credit events occur, the maximum potential amount of future undiscounted payments that the Fund would be required to pay under its credit default swaps sold would be approximately \$50,000,000. However, if the Fund was required to make payments under its credit default swaps sold, it would be entitled to certain assets owned by the entities that collateralize the reference obligations.

At December 31, 2009, the open credit default swaps sold by the Fund were referenced to corporate debt and asset backed securities, and are summarized as follows:

(in thousands)

	Single name credit default swaps		Credit default swap indexes		Total
	Corporate debt	Asset backed securities	Corporate debt	Asset backed securities	
<b>Fair value amounts</b>	\$ 800	\$ 200	\$ 400	(\$ 1,200)	\$ 200
<b>Maximum potential amount of future undiscounted payments</b>	35,000	2,000	10,000	3,000	50,000
<b>Recourse provisions with third parties</b>	20,000	500			20,500
<b>Collateral held by the fund</b>	5,000				5,000

## [Sample presentation of payment/performance risk using external credit ratings.]

The notional amounts of the credit default swaps sold, classified by the expiration terms and the external credit ratings of the reference obligations underlying the credit default swaps sold at December 31, 2009, are summarized as follows:

(in thousands)

	Less than 1	1 - 3 years	3 - 5 years	Over 5 years	Total
<b>Single-name corporate debt</b>					
Investment grade <sup>(a)</sup>	\$ 20,000	\$ 10,000	\$ 5,000	\$ 2,000	\$ 37,000
Non-investment grade <sup>(b)</sup>	5,000	3,000			8,000
<b>Asset backed securities</b>					
Investment grade	4,000				4,000
Non-investment grade	1,000				1,000
	<b>\$ 30,000</b>	<b>\$ 13,000</b>	<b>\$ 5,000</b>	<b>\$ 2,000</b>	<b>\$ 50,000</b>

(a) The Fund considers ratings of BBB- or higher as meeting the definition of investment grade.

(b) Includes non-rated credit derivative instruments.

## [Sample presentation of payment/performance risk using external credit spreads.]

The notional amounts of the credit default swaps sold, classified by the expiration terms and the external credit spreads of the reference obligations underlying the credit default swaps sold at December 31, 2009, are summarized as follows:

(in thousands)

Credit spread (basis points) <sup>(a)</sup>	Less than 1	1 - 3 years	3 - 5 years	Over 5 years	Total
<b>Single-name corporate debt</b>					
0 - 250	\$ 15,000	\$ 10,000	\$ 5,000	\$ 1,000	\$ 31,000
251 - 500	5,000			1,000	6,000
501 - 1,000					
1,001 - 1,500	1,000	3,000			4,000
1,501 - 2,000	4,000				4,000
	25,000	13,000	5,000	2,000	45,000
<b>Asset backed securities</b>					
0 - 250	3,000				3,000
251 - 500	1,000				1,000
501 - 1,000					
1,001 - 1,500					
1,501 - 2,000	1,000				1,000
	5,000				5,000
	<b>\$ 30,000</b>	<b>\$ 13,000</b>	<b>\$ 5,000</b>	<b>\$ 2,000</b>	<b>\$ 50,000</b>

(a) Credit spreads on the underlying contracts obtained from counterparties, together with the period of expiration, are indicators of payment or performance risk. The likelihood of payment or performance risk is generally greater as the credit spread on the underlying and the period of expiration increases.

# Frequently Asked Questions

## A. General

### **1. What is the scope of the guidance provided by SFAS 161?**

The scope of SFAS 161 is generally identical to the scope of SFAS 133. SFAS 161 applies to all entities (including investment companies) which hold or transact in derivative instruments.

### **2. Do the disclosure requirements of SFAS 161 apply to option contracts and warrants?**

Generally, options and warrants will meet the defining characteristics of a derivative instrument for purposes of applying the scope of SFAS 133. As a result, most options and warrants will be subject to SFAS 161 disclosure requirements. While a common industry practice has been to classify options and warrants within Investments in Securities for purposes of financial statement presentation, we recommend reclassifying options and warrants from Investments in Securities to Derivative Contracts for consistency in presentation and disclosure to other derivative contracts.

### **3. Does the scope of SFAS 161 apply to embedded derivatives included in another financial instrument?**

An embedded derivative that is bifurcated from a nonderivative host contract and accounted for separately at fair value is subject to the disclosure requirements of SFAS 161. However, the nonderivative host contract which is separated from an embedded derivative is not subject to the disclosure requirements of SFAS 161. In addition, a hybrid financial instrument containing both an embedded derivative and a host contract, and is measured at fair value in its entirety, is not included in the scope of SFAS 161.

For example, a liability for deferred management and performance fees is structured as a host debt instrument with an embedded derivative feature which is indexed to the investment fund's rate of return. Since industry practice results in the presentation of deferred fee liabilities in their entirety at fair value, the scope of SFAS 161 does not apply.

**4. Are the disclosure requirements of SFAS 161 effective for financial statements for fiscal years ended June 30, 2009?**

The answer depends on whether quarterly interim financial statements are issued within that fiscal year. Investment funds with June 30 fiscal year-end dates which issue only annual financial statements do not need to adopt SFAS 161 until the fiscal year ending June 30, 2010.

However, an investment fund with a June 30 year-end which issues quarterly financial statements is required to include the disclosures for its March 31st quarterly financial statements. This same investment fund will also need to include SFAS 161 disclosures in its annual financial statements for the year ended June 30, 2009, but it may omit information relating to the quarterly periods prior to the adoption of SFAS 161 as long as it specifies the periods covered by the disclosures.

**5. Do the provisions of SFAS 161 affect the accounting or measurement of derivative instruments?**

SFAS 161 amends and expands the disclosure guidance for derivative instruments, but it does not otherwise change the accounting measurement, or the financial statement classification of derivative instruments. The adoption of SFAS 161 does not require any presentation changes in the statement of financial condition, statement of operations, and schedule of investments. However, investment funds should consider updating their financial statement templates for conforming changes to the newly adopted SFAS 161 disclosures in the notes to the financial statements to enhance consistency in the financial statements as a whole.

**6. How should an investment fund apply the disclosure requirements relating to hedged items?**

Generally, investment funds will not need to apply the hedge accounting rules of SFAS 133 since its investment activities are accounted for at fair value. If an investment fund does not have any designated and qualifying hedge accounting transactions, then it should treat all of its derivative activities as non-hedging transactions for purposes of applying the disclosure requirements of SFAS 161.

## B. Qualitative Disclosures

### 1. Should investment funds provide qualitative disclosures in the context of the different types of derivative instruments used?

The minimum requirement for reporting entities in providing qualitative disclosures is to present their disclosures in the context of their primary underlying risk exposure categories. The different types of primary underlying risks listed in the Statement include interest rate risk, credit risk, foreign currency exchange rate risk, commodity price risk, and equity price risk. We recommend that investment funds include additional detail of the nature of the types of derivative instruments used within each primary underlying risk discussed, as it can better convey how the different types of derivative instruments used by investment funds are utilized within the context of their investment strategies.

## C. Volume of Derivative Activities

### 1. How should the volume of derivative activities be determined for options and warrants?

For “plain vanilla” options and warrants, we recommend determining the notional value on an “as-if exercised” basis, in which the number of common shares that would be received upon exercise is multiplied by the fair value of the common shares as of the financial statement date. As with any derivative instrument, the individual facts and circumstances should be considered when determining an appropriate method to communicate the volume of derivative activity to the users of the financial statements.

### 2. Is the number of derivative contracts an appropriate basis for presenting the volume of derivative activities?

It depends. When an investment fund transacts primarily in commodity contracts denominated in standardized quantities, the number of contracts can be a meaningful basis for measuring the volume of its derivative activity. However, in many situations, investment funds transact in large amounts of over-the-counter derivative transactions where the various contracts are not fungible. Under those circumstances, the number of contracts in itself is not a meaningful measure of the volume of an investment fund’s derivative activities.

**3. If a financial statement issuer has no derivative holdings at year end, does that relieve the issuer from having to provide the volume of derivative activity?**

No. While certain early adopters have satisfied the volume disclosure requirement by using tables showing quantitative notional amounts or number of contracts held as of year end, facts and circumstances may require an issuer to provide annual volume or average volume information. Additionally, qualitative disclosure in narrative format rather than tabular format may satisfy this requirement.

## **D. Quantitative Disclosures**

**1. Is an alternative method to the tabular presentation of the quantitative disclosure requirements acceptable?**

SFAS 161 explicitly prescribes the use of a tabular format to present the location and fair value amounts of derivative instruments reported in the statement of financial condition, as well as the location and amount of the gains and losses reported in the statement of operations. The FASB's view is that the tabular format improves the transparency of accounting for derivatives and helps financial statement users understand their effects on financial position, results of operations, and cash flows. We do not feel that an alternative presentation to the tabular format is appropriate as it would not be consistent with the FASB's objective to provide more transparent information as to an investment fund's extent and use of derivative instruments.

**2. What is the level of aggregation required in the tabular disclosure summarizing the fair value of derivative instruments?**

The FASB prescribes the following:

- a. Derivative positions should be presented on a gross basis, even if they are subject to master netting arrangements and qualify for net reporting on the statement of financial position. Individual positions in unrealized gain positions as of the financial statement date should be classified as asset positions. Individual positions in unrealized loss positions as of the financial statement date should be classified as liability positions.
- b. Cash collateral receivables and payables associated with derivative instruments should be excluded.
- c. Fair value amounts should be presented as separate asset and liability values.

**3. What is the level of aggregation required in the tabular disclosure summarizing the amounts of gains and losses from derivative instruments?**

The FASB prescribes disclosure of net gains and losses by primary underlying risk. The gains and losses by primary underlying risk are not required to be bifurcated into realized and unrealized components within the tabular disclosures.

**4. Can the tabular disclosures required by SFAS 161 be included within the condensed schedule of investments?**

Yes, but we do not recommend that approach. To the extent possible, we recommend including the disclosures relating to derivative activities within a single footnote in the financial statements. There are other disclosures that are required by SFAS 161 that would not be able to be included within the condensed schedule of investments.

## **E. Other Disclosures**

**1. Are the disclosures about the existence and nature of contingent features applicable to non-credit specific events, such as price triggers or knockout provisions?**

The intent of the FASB is to capture information about the credit-risk-related contingent features for derivatives that are in a net liability position at the end of the reporting period. Information relating to other contingent features applicable to non-credit events is not required to be disclosed.

**2. When an investment fund has a credit-risk-related contingent feature which can be triggered by a decline in net assets in excess of a stated percentage, should the investment fund disclose the threshold amount which would result in the trigger, or would a general disclosure of the circumstances in which the contingency would be triggered be sufficient?**

While a general disclosure may be adequate, an investment fund should consider more specific information based on the facts and circumstances. If at the financial statement date, the investment fund is in a precipitous status with respect to its compliance with its credit-risk-related contingent features, the investment fund should consider disclosing the quantitative net asset value threshold to provide more transparent information of that status to financial statement users.

**3. Are investment funds required to disclose the effects of credit-risk-related contingent features based on declines in net asset value which can require the termination of derivative positions in a net asset position?**

While the requirements of SFAS 161 only requires disclosure of credit-risk-related contingent features with respect to net liability derivative positions at the financial statement date, we recommend that investment funds include transparent disclosures of any significant potential impact from the termination of net asset derivative positions.

**4. Can the disclosure of credit-risk-related contingent features be omitted when an investment fund enters into OTC derivatives during the period, but has no open contracts at the financial statement date?**

We recommend that investment funds include general discussion of the existence of any contingent features with derivative counterparties which they transact with on a recurring basis. With the exception of liquidation basis financial statements, we feel that this disclosure provides valuable information of an investment fund's credit-related risk factors which can exist during the course of a reporting period.

## **F. Disclosures for Credit Derivatives**

**1. Do the disclosure requirements of FSP FAS 133-1 and FIN 45-4 apply to all credit derivatives?**

The disclosure requirements of the FSP only apply to credit derivatives for which the reporting entity is engaged in the selling of credit protection through credit derivatives. The disclosure requirements of the FSP are not applicable to investment funds which engage in purchasing credit protection only.

**2. How should investment funds present the current status of the payment/performance risk of their credit default swaps sold?**

The FSP does not prescribe a specific method for presenting this disclosure, and instead provides the reporting entity with the discretion for determining the information which is the most meaningful to the users of the financial statements. We have observed the use of external credit ratings and credit spreads as the primary practices used within the industry. Internally developed groupings may be an acceptable alternative when external information is not readily available, timely, or more meaningful than other internally used measurements. When internal groupings are used, the financial statement disclosures should describe how such groupings are determined and used to manage risk.

**3. Can the disclosure of the maximum potential amount of future payments under the credit derivatives be presented net of expected recovery from recourse provisions and/or purchased credit protection with identical underlyings?**

The disclosure of maximum potential amount of future payments should not be netted by the effect of any recourse or collateralization provisions, nor should the amounts be netted against offsetting contracts of purchased credit protection. However, the effects of these potential recoveries may be presented on a gross basis within the disclosures.

## Glossary

### Credit derivative

A derivative instrument in which one or more of its underlyings are related to the credit risk of either a specified entity or an index based on the credit risk of a group of entities, and that exposes the seller to potential loss from specified credit-risk-related events.

### Credit-risk-related contingent features

Contractual features enforceable by an entity's derivative counterparties, which can require an entity to settle its derivative instruments, or to post additional collateral upon the occurrence of a specified credit event.

### Current status of payment/performance risk

The status of the risk of nonpayment or nonperformance associated with the reference obligation underlying a credit derivative as of the financial statement date, based on a metric determined and used by the reporting entity. The current status can be based on either externally derived market data, or through the use of internally developed groupings used by the credit protection seller to manage its risk.

### Derivative instrument

SFAS 133 defines a derivative instrument as a financial instrument or other contract with all three of the following characteristics:

- a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

### Embedded derivative

Implicit or explicit terms within a contract that in its entirety is not a derivative, which affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument, based on the performance of one or more underlyings.

## Financial instrument

An instrument consisting of cash, evidence of an ownership interest in an entity, or a contract which a) conveys on one party the right to receive cash or a financial instrument from another party, and b) imposes the obligation on the other party to deliver cash or a financial instrument.

## Hybrid financial instrument

A type of financial instrument which combines the characteristics of multiple types of instruments, and generally contains both an embedded derivative and a nonderivative host contract (usually a debt instrument) in the combined instrument. The combined instrument will typically include both debt and equity features, although other underlying types may be included in the embedded derivative component.

## Master netting arrangement

A contractual agreement entered with a single counterparty that provides for the net settlement of all contracts through a single payment and in a single currency in the event of default on or termination of any one contract.

## Notional amount

A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Frequently, this will represent the hypothetical basis which determines the payment streams exchanged by counterparties to the derivative contract.

## Reference obligation

A debt instrument, usually a corporate bond or sovereign government bond, of which its associated credit risks are used in reference to the terms of a credit derivative contract.

## Underlying

The type of price, rate, or other variable of an asset or liability of which the derivative instrument is indexed to, but not the asset or liability in itself.

## About the Author

**Richard Sumida, CPA**, is a senior manager in the Rothstein Kass quality control department. He is extensively involved in the research and consultation of complex accounting and auditing issues relating to the alternative investment industry, including various fund structures, hard-to-value investments, and emerging accounting pronouncements. Rich is also an active contributor to Rothstein Kass' Best Practices initiatives, and is a frequent speaker on advanced technical topics.

## About the Editor

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## About Rothstein Kass

Rothstein Kass provides audit, tax, accounting and advisory services to hedge funds, fund of funds, private equity funds, broker-dealers and registered investment advisers. The firm is recognized nationally as a top service provider to the industry through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, tax, operational and regulatory issues. The firm also advises on fund structure both inside and outside the U.S., on compliance and financial reporting, as well as on tax issues from a federal, state, local and international perspective. Rothstein Kass has offices in New York, New Jersey, California, Colorado, Texas and the Cayman Islands. [www.rkco.com](http://www.rkco.com)

## Publications

### **Beyond Performance: How Hedge Funds Can Strengthen and Build Their Affluent Client Base**

As competition in the hedge fund sector intensifies, it will be more important than ever before for hedge fund professionals to complement strong investment results with a thorough recognition of the priorities and expectations of their client base. Authors Russ Alan Prince and Hannah Shaw Grove share the research they have conducted with wealthy individuals and families that invest regularly, and significantly, in hedge funds and funds of funds. Their findings will help hedge fund firms understand the most effective ways to reach, cultivate and retain high-net-worth investors.

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