



Ohio Public Employees Retirement System

**Derivatives Policy
March 2021**

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Revision History

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I. SCOPE

This Policy applies to the use of derivatives within the Ohio Public Employees Retirement System (“OPERS”) Defined Benefit Fund (“DB Fund”) and Health Care 115 Trust Funds (“HC Fund”).

II. PURPOSE

This Policy provides the broad strategic framework for managing the Funds’ financial derivatives (“derivatives”) in internally and externally managed portfolios. Derivatives shall only be used to manage asset and risk exposures consistent with this Policy and other approved Investments Policies and portfolio guidelines.

III. LEGAL AUTHORITY

The investment powers and fiduciary responsibilities of the OPERS Retirement Board (“Board”) are established by Section 145.11 of the Ohio Revised Code (“ORC”). Section 145.11(A) states; in part:

The members of the public employees retirement board shall be the trustees of the funds created by section 145.23 of the Revised Code. The board shall have full power to invest the funds. The board and other fiduciaries shall discharge their duties with respect to the funds solely in the interest of the participants and beneficiaries; for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the public employees retirement system; with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims; and by diversifying the investments of the system so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

OPERS Investment Staff (“Staff”) and others, who are involved in the management of the Funds’ assets, are subject to the same fiduciary standards as the Board.

IV. PHILOSOPHY

A derivative is an asset or forward investment commitment, the value of which is derived from, or depends on, the value of an underlying asset, reference rate or index.

Derivatives may be used to manage asset exposures and risks in a prudent, timely and cost-effective manner and not for speculative purposes. Derivatives are considered speculative if their use is inconsistent with investment philosophy, objectives, strategies, portfolio guidelines, or any other governing documents.

V. OBJECTIVES

The objective of using derivatives is to enhance returns and manage risks. For example, derivatives may be used to facilitate cost-effective and timely investments, for risk management purposes, for implementation efficiency (i.e. speed of trade execution and lower cost), to achieve exposures that could otherwise be achieved with physical securities or to manage strategies described in Section VI.

VI. STRATEGIES USING DERIVATIVES

Derivatives can be used to assist in achieving investment goals within a particular investment strategy such as managing the overall asset allocation of a Fund or portfolio, including rebalancing activities, transitioning assets between managers, and equitizing or bondizing cash balances. In addition, they can be used to hedge or manage exposure to equity markets, commodities, currencies, duration, total return, yield or credit, interest rates, sectors, sub-sectors and/or countries, risk/return profiles of individual securities or portfolios.

VII. PERMISSIBLE INSTRUMENTS

OPERS may invest in all types of derivatives instruments in accordance with the applicable Asset Class, Sub-Asset Class, portfolio guideline or comparable operative documents. Within this Policy, derivatives are grouped into three categories defined by OPERS as follows:

Category I derivatives are securities-based. Examples of Category I equity derivatives include Exchange Traded Funds, rights, warrants, convertibles and depositary receipts. Examples of Category I fixed income derivatives include asset-backed securities, commercial mortgage backed securities, residential mortgage backed securities, dual currency bonds, Treasury strips, inflation linked securities, interest only and principal only securities, callable and putable bonds, convertibles, yield curve notes and equity or commodity linked bonds.

Category II derivatives are non-securities-based, cleared instruments. An example of a Category II derivative is a futures contract on the S&P 500. Common characteristics of Category II derivatives are that they are generally standardized instruments which are exchange-traded, cleared through a clearinghouse and subject to regulation.

Category III derivatives are non-securities-based, non-cleared instruments. An example of a Category III derivative is a total return swap on an equity index. These types of derivatives are customized, rather than standardized, for the parties engaged in a transaction and are not cleared through a clearinghouse.

Category I derivatives are very similar in many respects to other securities such as stocks and bonds and as such are excluded from this Policy. The risks and risk management associated with Category I derivatives are covered by the Statement of Investment Objectives and Policies for the DB and HC Funds as well as in the asset class and sub-asset class Policies, all of which are approved by the Board. In addition, many of the risk management activities described in the following material also apply to Category I derivatives. The Chief Investment Officer (“CIO”) may elect to subject any Category I derivative to the risk management regime associated with Category II and III derivatives.

VIII. RISK MANAGEMENT

The primary approach to managing risks associated with derivatives usage is to establish and monitor both qualitative and quantitative constraints and through usage of standardized processes.

Given the nature of and the risks associated with Category II and III derivatives, the risk management activities are more extensive. Prior to, and on an ongoing basis, any use of a strategy (outlined in Section VI) in each internally or externally managed portfolio that employs Category II and III derivatives requires:

- Identification and assessment of the derivative specific risks
- Derivative and counterparty guidelines, controls and monitoring reports or equivalent risk management structure
- Operational procedures for control and monitoring of activity
- Staffing resources for effective management and oversight
- Appropriate enabling documents and/or written investment guidelines
- Approval by the CIO (Portfolio guidelines for separate accounts shall set forth whether or not derivatives are permitted within the Portfolio.)

Risks associated with derivatives use include:

A. Market Risk

Market risk may result when market conditions develop differently than expected or when there are mismatches between actual market exposure and the market exposure from the derivative. These risks are primarily mitigated through the usage of tracking error constraints which are defined in applicable Asset class or Sub-Asset Class Policies and portfolio guidelines.

B. Leverage Risk

Leverage risk results when derivatives instruments are used to create a condition in which the economic or market exposure of an investment exceeds the total capital. These risks and the associated controls are further described in the Leverage Policy.

C. Counterparty Risk

Counterparty risk is the risk that a counterparty to a derivative position is unwilling or unable to honor their obligation. Derivative counterparties are subject to the Broker-Dealer Policy which includes requirements for counterparty approval, selection, and monitoring.

- Counterparties utilized by internally managed portfolios for OTC transactions must be rated at least investment grade by the applicable nationally recognized statistical rating agency(ies).
- Activity limits for counterparties utilized by internally managed portfolios for OTC transactions are required.

D. Operational Risk

Operational risk is the risk of inadequate or failed internal processes, people or systems. Operational risks are mitigated through the usage of procedures, Staff oversight and effective usage of technology resources.

- For internally managed portfolios, a written assessment of the operational risks associated with derivatives must be completed prior to the usage of new Category II or III derivatives.

E. Complexity Risk

A derivative may behave differently than expected. Complexity risk is mitigated through the identification and assessment of risks associated with the usage of derivatives.

- For internally managed portfolios, a written assessment of the risks associated with derivatives prior to the usage of new Category II or III derivatives.

F. Liability/Recourse Risk

The capital or funding requirements associated with transacting derivatives may result in leverage, which is a condition where the market exposure exceeds the supporting capital. In addition to controls and limits described in the Leverage Policy, account structures are used to mitigate this exposure.

- When conducted in separate accounts (whether internally or externally managed under an agency relationship), the usage of derivatives may result in an exposure and potentially in a liability against the assets of the Funds. Strict controls, as described above in section VIII, for the authorization and the usage of derivatives are used to mitigate this risk.
- When it is determined that the total potential losses in an investment, including losses cause by investments in derivatives, should be limited to the amount of assets initially invested or committed, OPERS shall endeavor to utilize a limited liability structure for such investment, such as a limited liability partnership or a limited liability company, with terms designed to limit the total potential loss for such investment to the amount initially invested or committed by OPERS. This includes all assets within the Private Equity, Private Market Real Estate, Risk Parity, and Hedge Funds Asset and Sub-Asset classes. Operating documents, which include partnership agreements, subscription agreements, and similar documents, govern the usage of derivatives in these investments.

G. Legal and Regulatory Risk

Legal risk is the risk of inadequate or deficient legal documentation. Appropriate enabling documentation is required.

- For internally managed portfolios, Category III derivatives must be executed pursuant to ISDA Master Agreements with approved counterparties. Usage of “long-form” trade confirmations must be approved by the CIO.
- For internally managed portfolios, applicable foreign exchange and derivative transactions must be approved by a duly authorized OPERS “Qualified Independent Representative” (“QIR”) as described in the Dodd-Frank Wall Street Reform and Consumer Protection Act and regulatory rules adopted pursuant thereto.
- For internally managed portfolios, in order to ensure that OPERS is not the “reporting party”, under parts 43, 45, and 46, of the Commodity Futures Trading Commission (“CFTC”) regulations, swaps, forward foreign exchange transactions, and foreign exchange swaps may only be transacted with persons that are fully Registered Swap Dealers or Provisionally Registered Swap Dealers with the CFTC.

H. Liquidity Risk

Liquidity risk may result from the usage of derivatives, depending on the type of derivative and its characteristics. In order to manage overall Fund liquidity (Category III) and to balance the Fund-level usage of derivatives versus physical securities (Category II), the following limits will apply to public market assets held in separate accounts:

- The gross notional exposure of Category III derivatives will not exceed 10% of the total net asset value of public market assets held in separate accounts, excluding foreign exchange derivatives used for hedging purposes. Additional portfolio level restrictions may apply.
- The combined gross notional exposure of Category II and Category III derivatives will not exceed 25% of the total net asset value of public market assets held in separate accounts, excluding foreign exchange derivatives used for hedging purposes. Additional portfolio level restrictions may apply.
- Currency forwards shall be one year or less in tenor unless approved by the CIO.

IX. ROLES AND RESPONSIBILITIES

A. OPERS Retirement Board

The Board is responsible for reviewing and approving this Policy and any changes to it.

In addition, the Board is responsible for reviewing reports related to this Policy.

B. Investment Staff

The Board delegates authority to the CIO to implement this Policy and act as OPERS QIR. The CIO shall also ensure that OPERS adopts written procedures appropriate to manage its Derivative activities. Staff is responsible for monitoring the Policy and recommending changes to the Board. Staff is also responsible for managing the derivatives activities within the framework of the Board-approved Policies and within the goals and objectives adopted by the Board in the Annual Investment Plan.

All members of Staff are accountable to the CIO. The CIO is responsible for all Staff actions relative to the management of OPERS' investments. In this regard, it is the responsibility of the CIO to satisfy himself/herself that all Policies and directives of the Board are implemented.

C. Investment Compliance

The Investment Compliance area of Investment Accounting, Operations and Compliance ("IC") is responsible for monitoring compliance with this Policy, including guidelines established pursuant to it. If IC determines that an exception to this Policy has occurred, IC shall notify Staff, the CIO, the Executive Director and the Board.

D. Investment Advisor

The role of the Investment Advisor is specified in the Fund Policies.

X. MONITORING AND REPORTING

On a quarterly basis, or more frequently if appropriate, Compliance Staff will provide a report to the Board on compliance, including exceptions, with this Policy.