FUND BOARD VIEWS

Viewpoints

Derivatives rule proposal: More work for overburdened fund directors

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The Securities and Exchange Commission's proposals to modernize its regulation of fund use of derivatives and leverage again increase the scope and complexity of the responsibilities of investment company fund directors. If you're a fund director, here's what you need to know about the SEC's proposals and how they could affect you:

What did the SEC propose?
The SEC proposed rules that would substantively limit the amount of leverage that investment companies could obtain through use of certain types of derivative instruments. Among other things, the rules would broaden the role of directors who oversee funds that make extensive use of derivatives or that invest in certain "complex derivatives."

What exactly is a derivative?
A derivative generally is a financial instrument that derives its value from another reference asset. Reference assets can include, among other things, stocks, bonds, currencies, interest rates, market indices or other assets. Some types of derivatives involve leverage, which magnifies the amount of gains or losses on an investment.

Would the rule apply to all types of derivatives?
No. The rule would apply only to derivatives that involve a continuing obligation of a fund to pay anything during the life of the instrument or at maturity or early termination, as would typically be the case with derivatives involving explicit leverage. The proposed rule would not affect the ability of a fund to invest in securities providing indirect or "economic" leverage that do not involve an ongoing potential obligation to pay money to a counterparty.

Why did the SEC propose these rules?
In a nutshell, the SEC is concerned that the growing use of derivatives by investment companies may involve degrees of leverage that create the potential for speculation and abuses that Congress wanted to prevent when it designed the Investment Company Act of 1940.

Of course, prior to 1940, no one ever heard of derivatives. It should come as no surprise, then, that the ’40 Act, as amended, does not refer to derivatives or prohibit their use by funds. Rather, back then, leverage came in the form of capital structures that allowed funds to borrow money without limitation, either from banks or through issuing debt securities.

So, to address the concerns about protecting investors from excessive leverage, Section 18 of the ’40 Act included a prohibition on investment companies from issuing “senior securities.” A senior security includes “any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness,” but does not include borrowing from a bank.

Nearly 40 years later, derivatives, as we know them today, had not yet been invented. But, funds were obtaining *de facto* leverage through certain investment techniques, including “reverse repurchase agreements,” firm commitment agreements and standby commitment agreements.

In 1979, the SEC issued guidance for funds that use these investment techniques. The SEC said at the time that while these techniques may not be securities for purposes of the federal securities laws, they may be “evidence of indebtedness” that Section 18 was designed to prevent. Recognizing that these investment techniques may benefit investors, however, the SEC said that it would not consider funds in violation of Section 18 if the funds segregated liquid assets to “cover” potential obligations created by these would-be senior securities. The 1979 guidance, Release No. 10,666 (affectionately referred to as “Release Ten-Triple-Six”) contained no mention of derivatives.

Alas, the ’40 Act and its rules could not keep up with changes in the market and the innovation of new investment techniques. So, in the years following 1979, the staff of the SEC published a string of “no-action” letters and other guidance that effectively extended the scope of Release Ten-Triple-Six to include modern-day derivatives. The SEC now believes that the resulting confusing mish-mash of staff interpretations went too far, and allows funds to obtain more leverage than Congress originally intended when it adopted the ’40 Act.

What did the SEC propose?
On Dec. 11, 2015, the SEC proposed Rule 18f-4. While the proposed rule is only 11 double-spaced pages long, the proposing release included more than 400 pages and 864 footnotes of background, commentary and economic analysis, and is accompanied by a 97-page white paper authored by the SEC’s Division of Economic Risk Analysis (DERA). The SEC also proposed further amendments to two forms that require investment companies to report information about their portfolios and operations.

Substantive Limitations

As proposed, Rule 18f-4 would limit the ability of investment companies (including open-end, closed-end and exchange-traded funds) and business development companies (BDCs) to enter into "derivatives transactions"—meaning any swap, futures contract, forward contract, option under which the fund *is or may be required to make payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination.* The rule refers to these types of instruments as "derivatives instruments."

Rule 18f-4 would allow funds to enter into "derivatives transactions" if they comply with three conditions:

1. *Alternative portfolio limitations.* Funds would be required to comply with one of two alternative portfolio limitations designed to impose limits on leverage that funds may obtain through derivative transactions, financial commitment transactions and senior securities transactions:
   - **Exposure-based portfolio limit.** A fund's "aggregate exposure" to a derivative instrument may not exceed 150% of the fund's net assets immediately after entering into a derivative transaction or financial commitment transaction. The exposure-based limit is designed to impose an overall limit on the amount of exposure, and thus limit a fund's potential leverage, through derivatives and other senior securities transactions, including borrowing and other indebtedness.
   - **Risk-based portfolio limit.** A fund would be able to limit exposure under derivatives transactions, financial commitment transactions and other senior securities transactions to 300% of the fund's net assets, provided its investments are subject to less market risk than if the fund did not use those derivatives, evaluated using valuation at risk (VaR). VaR attempts to quantify the amount an investor can lose over a period of time, based on historical probability levels. The proposed rule defines it as "an estimate of the potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level."
2. *Asset segregation requirement for derivatives transactions.* Rule 18f-4 would require funds that enter into derivatives transactions to manage associated risks by maintaining an amount of "qualifying coverage assets" to allow the fund to cover obligations arising from those transactions. Funds would be required to segregate amounts, to be determined at least once a day, with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and a "cushion" of risk-based coverage. Fund directors would be required to approve asset segregation policies and procedures. The requirement is designed to "address the undue speculation" concern reflected in the '40 Act.
3. *Derivatives risk management program.* Funds that use more than a limited amount of derivatives transactions would be required to establish a formalized derivatives risk management program and designate a derivatives risk manager approved by fund directors. Generally, this requirement would apply to funds that exceed a 50% threshold of notional derivatives exposure.

Risk Management

Of course, the SEC notes, all funds that enter into derivatives transactions (even a single transaction) in reliance on the proposed rule would be required to manage risks. This program would be in addition to the requirements related to risk management that already apply to funds, including determination of risk-based coverage amounts and monitoring of compliance with portfolio limits.

A fund would not need a formalized program if the board determines that the fund will comply and monitor compliance with a portfolio limitation under which the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its net asset value and does not use any “complex derivatives” without regard to the 50% threshold.

Specifically, the derivatives risk management program would require a fund to have policies and procedures reasonably designed to:

- Assess the risks associated with the fund’s derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant;
- Manage the risks of the fund’s derivatives transactions, including by (i) monitoring the fund’s use of derivatives transactions to ensure they are consistent with the fund’s investment guidelines and portfolio restrictions, and (ii) informing portfolio management of the fund or the fund’s board of directors, as appropriate, regarding material risks arising from the fund’s derivatives transactions; and
- Reasonably segregate the functions associated with the program from the portfolio management of the fund.

The derivatives risk management program would be administered by a designated derivatives risk manager, who may be an officer or employee of the fund or the fund’s investment adviser (but who may not be a portfolio manager). The SEC contemplates that the derivatives risk manager could also wear the hat of a chief compliance officer or chief risk manager.

Financial Commitment Transactions

The rule also would limit a fund’s ability to enter into reverse repurchase agreements, short sale borrowing, or firm or standby commitment agreements, known as “financial commitment transactions.” Funds can enter into these types of arrangements provided that they segregate an amount equal to the fund’s aggregate financial commitment.

How would Rule 18f-4 affect fund directors?

To be sure, Rule 18f-4 would increase the role of fund directors and add to the complexity of the issues that fund boards must consider. For example, if adopted, the rule would impose requirements on fund directors in the following areas:

- *Approval of portfolio limitation amounts.* The rule would require fund directors, including a majority of the disinterested directors, to approve the particular portfolio limitation under which a fund would operate. That is, the board must determine whether the fund will comply with the 150% exposure-based limit or the alternative 300% risk-based portfolio limit.
- *Determination of risk-based coverage amounts for each derivatives transaction.* The SEC has adopted a principles-based approach that would require fund directors to approve a risk-based coverage amount for each derivatives transaction. Directors would be required to take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset, and “any other relevant factors” in determining a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. This may include, for example, an assessment of the derivative’s terms and the fund’s intended use of the

derivative in connection with the investment strategy. With the board's approval, directors could adopt policies that include stress testing or use a "stressed VaR model to estimate potential loss the fund would incur."

- *Derivatives risk management program.* The adopting release flags derivatives use as an area of potential conflicts between investment managers and funds, requiring scrutiny by fund directors. Thus, the rule would require fund directors, including a majority of the disinterested directors, to approve the fund's derivatives risk management program, any material changes to the program, and the designation of the fund's derivatives risk manager. The proposing release includes a laundry list of specific factors that fund directors should consider when approving a derivatives risk management program. The SEC said fund directors could satisfy their obligations with respect to initial approval by reviewing summaries of the derivatives risk management program prepared by the derivatives risk manager, legal counsel, or other persons familiar with the program. The rule would require fund directors to review and update the program at least annually, including any models (such as VaR calculation models used by the fund during the period in question). Fund directors would be required to review at least quarterly, written reports prepared by the derivatives risk manager, to review the adequacy of the fund's derivatives risk program and its effectiveness. Fund directors, including a majority of the disinterested directors, would be required to approve the derivatives risk manager. Unlike Rule 38a-1, however, Rule 18f-4 would not provide that the derivatives risk manager is removable only by the board, nor would the board need to approve the derivative risk manager's compensation.
- *Financial commitment transactions.* For funds that enter into financial commitment transactions, the fund's directors, including a majority of the disinterested directors, would be required to approve policies and procedures designed to provide for the fund's maintenance of "qualifying coverage assets."

What are the implications for fund directors?

If a fund invests in derivatives, said Commissioner Luis Aguilar at the Dec. 11 open meeting, "it is only appropriate to require that its board also take on the responsibilities" outlined in the proposed rule. But, he said he "consider[s] whether boards are prepared and equipped to take on those added responsibilities, which seem only to increase in number and complexity over time."

The SEC's proposing release reminds directors that investments in derivatives are not for the faint of heart or for the uninitiated. "As the spectrum of risk increases, the overall supervision of risk management will become even more crucial to fulfilling a board's obligations," Aguilar said.

For example, the rule would require fund directors to approve a derivatives risk management program, unless the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its NAV and does not use "complex derivatives" without regard the 50% threshold. In order to carry out this responsibility, a director must know whether the fund invests in "complex derivatives." The rule would define complex derivatives, generally, as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise (i) depends on the value of the underlying reference asset at multiple points in time during the term of the transaction, or (ii) is a "non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price."

Say what?

This is not your father's (or grandfather's) mutual fund. Rather, this proposed definition underscores how the role of fund directors has quickly and dramatically evolved to require directors to grasp complex concepts before they can delegate responsibilities to investment advisers and derivatives risk managers. It may not be long before "vega notional" measures of volatility will join liquidity and fair valuation as dinner topics of conversation.

In any event, the proposed rules on derivatives risk illustrate that fund directors will see their responsibilities grow over the coming months as the SEC continues down the path of increased prudential regulatory proposals.

"Accordingly, I urge fund boards to be proactive in foreseeing the challenges and opportunities that lie ahead, and to how best to navigate them," Commissioner Aguilar said. "To this end, fund boards must continue to evaluate—such as through periodic reviews—whether its members, collectively, have the requisite skills, experience, time, and resources that are needed as a fund's operations, objectives, and investment strategies change over time."

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