Newsletter/Bulletin
December 2019

SEC Re-Proposes New Rule Governing Funds' Use of Derivatives

Juan M. Arciniegas
Deborah B. Eades
Nathaniel Segal
Tyrique J. Wilson

VedderPrice

SEC Re-Proposes New Rule Governing Funds' Use of Derivatives

On November 25, 2019, the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") re-proposed a new exemptive rule under the Investment Company Act of 1940, as amended (the "1940 Act")—Rule 18f-4 (the "Proposed Rule")[1]—which was initially proposed by the Commission in December 2015.[2] If adopted, the Proposed Rule represents a comprehensive overhaul of the current regulatory framework governing the use of derivatives by registered investment companies. The Proposed Rule would supersede historical guidance provided by the Commission and its staff. The Commission's latest iteration of the Proposed Rule, along with rule proposals under Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Investment Advisers Act of 1940, as amended (the "Advisers Act") as well as related form amendments (collectively, the "2019 Proposal"), include an accommodation for inverse and leveraged funds – a notable difference from the Commission's 2015 proposal.

Overview of the 2019 Proposal

The Proposed Rule would permit a fund to enter into derivatives transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under Section 18 of the 1940 Act, subject to the following conditions:

- *Derivatives Risk Management Program.* A fund must appoint a derivatives risk manager (a "DRM") and must adopt a written derivatives risk management program (a "DRMP") with, among other things, risk guidelines reflecting how the fund's use of derivatives may affect its investment portfolio and overall risk profile.
- *Limit on Fund Leverage Risk.* A fund engaging in derivatives transactions must comply with an outer limit on leverage based on a comparison of the fund's value at risk ("VaR") to the VaR of a "designated reference index" for that fund. If the fund's DRM is unable to identify an appropriate designated reference index, the fund's VaR could not exceed 15% of the value of the fund's net assets – referred to as the "absolute VaR test."
- *Board Oversight and Reporting.* A fund's board of directors must approve the fund's designation of a DRM who would be responsible for administering the fund's DRMP. The fund's DRM would have to report to the fund's board on the implementation and effectiveness of the DRMP and the results of the fund's stress testing.

Other elements of the 2019 Proposal include:

- *Exception for Limited Derivatives Users.* Limited derivatives users – i.e., a fund that either **(A.)** limits its derivatives exposure to 10% of its net assets or **(B.)** uses derivatives transactions solely to hedge certain currency risks – would be excepted from the DRMP requirement and from the VaR-based limit on fund leverage risk.
- *Alternative Requirements for Certain Leveraged/Inverse Funds.* An exception on the limit on fund leverage risk would be provided for certain leveraged/inverse funds in light of a new sales practices rule that requires broker-dealers and investment advisers exercise due diligence on retail investors before permitting transactions in these types of funds.

Summary of the 2019 Proposal

Scope. The Proposed Rule would apply to a "fund," defined as a registered open-end or closed-end investment company or a business development company ("BDC"), including any separate series thereof. Therefore, the Proposed Rule would apply to mutual funds, ETFs, registered closed-end funds, and BDCs. However, money market funds and unit investment trusts would not be permitted to rely on the Proposed Rule. Importantly, the Proposed Rule would provide an exception from the limit on fund leverage risk for certain leveraged/inverse funds.

Covered Transactions. The 2019 Proposal would define a "derivatives transaction" to mean:

1. any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or

any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and

2. any short sale borrowing.

Limited Derivatives Users. The 2019 Proposal would except limited derivatives users from the derivatives risk management program requirement and from the VaR-based limit on fund leverage risk. The limited derivatives user exception is available to a fund that either:

1. limits its "derivatives exposure" to 10% of its net assets; or
2. uses derivatives transactions solely to hedge currency risks;[3] and

in either case, that also adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks.

The proposed definition of "derivatives exposure" for purposes of the foregoing would include two adjustments designed to address limitations associated with measures of market exposure that use derivatives' notional amounts without adjustment. Specifically, the Proposed Rule would permit a fund to (1) convert the notional amount of interest rate derivatives to 10-year bond equivalents; and (2) delta adjust the notional amount of options contracts.[4]

Derivatives Risk Management Program

Program Requirement Generally

The Proposed Rule would require funds that are users of derivatives—other than limited derivatives users—to have a formalized risk management program with certain specific elements. A fund would have to adopt and implement a written DRMP, which would include policies and procedures reasonably designed to manage the fund's derivatives risk. The elements of the program include:

- *Risk Identification and Assessment.* The DRMP would have to provide for the identification and assessment of a fund's derivatives risks, which would take into account the fund's derivatives transactions and other investments.
- *Risk Guidelines with Discrete Metrics.* A fund must establish, maintain and enforce derivatives risk guidelines with discrete metrics or other measurable criteria or thresholds that a fund does not normally expect to exceed and the measures to be taken if they are exceeded. The Proposed Rule does not impose specific risk limits. Instead, the quantitative thresholds should be those that are "most pertinent to [the fund's] investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure."[5]
- *At Least Weekly Stress Testing.* A fund would be required to undertake at least weekly stress testing to evaluate potential losses to the fund's portfolio.
- *Daily Backtesting.* A fund would also be required to backtest the results of its VaR calculation model used in connection with the relative VaR or absolute VaR test, as applicable. Specifically, each business day the fund would need to compare its actual gain or loss for that business day with the VaR the fund had calculated for that day. The backtesting would require a 99% confidence level over a one-day time horizon.
- *Internal Reporting and Escalation.* The Proposed Rule would require communication between the DRM and portfolio management regarding the operation of the program. The Proposed Rule also would require the DRM to communicate "in a timely manner" material risks—including any material risks identified by exceedances of the fund's guidelines or stress testing—to the fund's portfolio management and, as appropriate, its board of directors.
- *Periodic Review of the Program.* A fund's DRM would be required to review the DRMP, including each of the required program elements, at least annually to evaluate its effectiveness and to reflect changes in the fund's derivatives risks over time.

Derivatives Risk Manager and Program Administration

- *Derivatives Risk Manager.* A fund adviser's officer or officers would be required to serve as the fund's DRM, responsible for the day-to-day administration of the fund's DRMP, with the designation of such individual(s) subject to approval by the fund's board of directors. A fund's portfolio manager may not serve as the sole DRM. However, if a fund has multiple

officers designated as DRM, then portfolio managers may serve in this capacity so long as a majority of the officers are not portfolio managers (e.g., if a committee acts as DRM).[6] In other words, a group or committee could serve as a fund's DRM, a portion of whom could be portfolio managers.

- *DRM Qualifications.* Serving as DRM would require "relevant experience" regarding derivatives management, as determined by the fund's board of directors.
- *Segregation of DRMP from Portfolio Management.* In order "to promote objective and independent identification, assessment, and management of the risks associated with derivatives use," a fund would be required to "reasonably segregate" the functions of the DRMP from portfolio management. However, the Proposed Rule explains that strict protocols regarding communication between specific fund personnel—such as a "firewall"—are not required.

Board Oversight and Reporting

- *Board Approval of Derivatives Risk Manager.* The Proposed Rule would require a fund's board to approve the designation of the fund's DRM, taking into account the DRM's relevant experience regarding the management of derivatives risk.
- *Initial and Annual Reports on DRMP Implementation and Effectiveness.* The DRM would be required to provide to the fund's board, on or before the implementation of the DRMP and at least annually thereafter, a written report including a representation that the DRMP is reasonably designed to manage the fund's derivatives risk and to incorporate the required elements of the program as well as the basis for the representation.
- *Required Elements of the Initial and Annual Written Reports.* The Proposed Rule would require that the reports include:
  - the basis for the DRM's representation[7] and information reasonably necessary to evaluate the adequacy of the fund's DRMP and—for reports following the initial implementation of the program—the effectiveness of its implementation; and
  - the basis for the DRM's selection of the designated reference index used under the proposed relative VaR test or, if applicable, an explanation of why the DRM was unable to identify a designated reference index appropriate for the fund such that the fund relied on the proposed absolute VaR test instead.[8]
- *Regular Board Reporting and Required Elements.* The Proposed Rule would also require a DRM to provide to the fund's board,[9] at a frequency determined by the board, a written report analyzing any exceedances of the fund's risk guidelines and the results of the fund's stress testing and backtesting. The report must include such information as may be reasonably necessary for the board to evaluate the fund's responses to any exceedances and the stress testing and backtesting results.

Proposed Limit on Fund Leverage Risk

The VaR-Based Test

- *The Relative VaR Test.* The Proposed Rule would generally require funds engaging in derivatives transactions in reliance on the Rule to comply with a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index." A fund would satisfy the proposed relative VaR test if the VaR of its entire portfolio does not exceed 150% of the VaR of its designated reference index.
- *Designated Reference Index.* A fund's designated reference index must be unleveraged and reflect the markets or asset classes in which the fund invests. The index may not be administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter, or created at the request of the fund or its adviser, unless the index is widely recognized and used. In addition, the index must either be an "appropriate broad-based securities market index" or an "additional index" as defined in Item 27 of Form N-1A.[10] A blended index that satisfies the proposed requirements for a designated reference index may be used for this purpose. A fund would have to disclose its designated reference index in the annual report, together with a presentation of the fund's performance relative to the designated reference index.
- *The Absolute VaR Test.* If the DRM is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed

15% of the value of the fund's net assets.

- *Exception for Leveraged/Inverse Funds.* A fund that is a leveraged/inverse investment vehicle, as defined in the proposed sales practices rules, would not be required to comply with the proposed VaR-based limit on fund leverage risk.
- *Exception for Limited Derivatives Users.* The Proposed Rule also would provide an exception for funds that use derivatives to a limited extent or only to hedge currency risks.
- *VaR Model Requirements.* The Proposed Rule would require that a fund's VaR model use a 99% confidence level and a time horizon of 20 trading days. The VaR model must be based on at least three years of historical data. In addition, the model must incorporate all significant identifiable market risk factors associated with the fund's investments.[11] The Proposed Rule would also require that VaR calculations comply with the same proposed VaR definition and its specified model requirements. Unlike the European Union regulatory regime that applies to UCITS funds, the Proposed Rule does not require third-party validation of a fund's chosen VaR model.[12] Notwithstanding these parameters, a fund's DRM is free to choose among the VaR model types referenced in the Rule — historical simulation, Monte Carlo simulation, or parametric models.[13]
- *VaR Testing Frequency.* The Proposed Rule would require a fund to determine its compliance with the applicable VaR test at least once each business day at the time that is most efficient, based on each fund's facts and circumstances.
- *VaR Test Remediation.* If a fund determines that it is not in compliance with the applicable proposed VaR test, then the Proposed Rule would require the fund to come back into compliance promptly and within no more than three business days after such determination.
- *Failure to Remediate within Three Business Days.* If the fund is not in compliance within three business days, then:
  - the DRM must report to the fund's board and explain how and by when (i.e., the number of business days) the DRM reasonably expects that the fund will come back into compliance;
  - the DRM must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any DRMP elements as appropriate to address those circumstances; and
  - the fund may not engage in derivatives transactions (other than those that, individually or in the aggregate, are designed to reduce the fund's VaR)[14] until the fund has been back in compliance with the applicable VaR test for three consecutive business days and satisfies the board reporting and program analysis and update requirements.

Alternative Requirements for Certain Leveraged/Inverse Funds and Proposed Sales Practice Rules

Accommodation for Certain Leveraged/Inverse Funds

The Proposed Rule would include an alternative approach for certain funds that seek to provide leveraged or inverse exposure to an underlying index, generally on a daily basis.

- *Scope of Proposed Alternative Approach under the Proposed Rule*. The alternative approach would be available for a registered investment company that is a "leveraged/inverse investment vehicle," as defined in proposed Rule 15l-2 under the Exchange Act and proposed Rule 211(h)-1 under the Advisers Act (referred to collectively as the proposed "sales practices rules").
- *Broader Scope of Proposed Sales Practices Rules.* The proposed sales practices rules would require broker-dealers and investment advisers to engage in due diligence before accepting or placing an order for a customer or client that is a natural person ("retail investor") to trade a leveraged/inverse investment vehicle, or approving a retail investor's account for such trading. The definition of "leveraged/inverse investment vehicle" included in the scope of the proposed sales practices rules would include registered investment companies (referred to as "leveraged/inverse funds") and certain exchange-listed commodity- or currency-based trusts or funds (referred to as "listed commodity pools").

- *Alternative Provision for Leveraged/Inverse Funds under the Proposed Rule.* Under the Proposed Rule, a fund would not have to comply with the proposed VaR-based leverage risk limit if it:
  - meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules;
  - limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index; and
  - discloses in its prospectus that it is not subject to the Proposed Rule's limit on fund leverage risk.
- *Applicability of Other Proposed Rule Conditions.* A leveraged/inverse fund that satisfies the foregoing conditions still would be required to satisfy all of the additional conditions in the Proposed Rule, other than the VaR tests, including the proposed conditions requiring a DRMP, board oversight and reporting, and recordkeeping.

Proposed Sales Practices Rules for Leveraged/Inverse Investment Vehicles

- *Proposed Rule 15l-2 under the Exchange Act.* Would require a broker-dealer (or any associated person of the broker-dealer) to exercise due diligence to ascertain certain essential facts about a customer who is a retail investor before accepting the customer's order to buy or sell shares of a leveraged/inverse investment vehicle, or approving the customer's account to engage in those transactions.[15]
- *Proposed Rule 211(h)-1 under the Advisers Act.* Would require an investment adviser (or any supervised person of the investment adviser) to exercise due diligence to ascertain the same set of essential facts about a client who is a retail investor before placing an order for that client's account or buying or selling shares of a leveraged/inverse investment vehicle, or approving the client's account to engage in those transactions.
- *Reasonable Basis Requirement.* Under both of the proposed sales practices rules, a firm could approve the retail investor's account to buy or sell shares of leveraged/inverse investment vehicles only if the firm had a reasonable basis to believe that the investor is capable of evaluating the risks associated with these products.
- *Policies and Procedures.* The proposed rules would require a firm to adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rules.
- *Required Due Diligence.* The proposed due diligence requirement provides that a firm must exercise due diligence to ascertain the essential facts relative to the retail investor, his or her financial situation, and investment objectives.[16]
- *Required Record Retention.* Broker-dealers and investment advisers would be required to maintain written records of investor information obtained pursuant to the due diligence requirement, the firm's written approval of the retail investor's account for transacting in leveraged/inverse investment vehicles (if applicable), and the policies and procedures that were in place when the firm approved or disapproved the investor's account. These records must be retained for at least six years (the first two years in an easily accessible place) after the date of the closing of the investor's account.

Our Take: Potential Impact of the 2019 Proposal

The Proposed Rule represents a comprehensive overhaul of the framework for the regulation of derivatives transactions by registered funds and would replace a patchwork of current guidance that has evolved over the last 40 years through various SEC staff positions, no-action letters, and the disclosure process. The rule would (i) level the playing field so that all registrants are subject to the same rules and (ii) seek to modernize the regulatory framework to keep pace with market developments. Importantly, once the Proposed Rule is made final, the Commission will rescind all current guidance and funds will then be permitted to enter into derivatives and financial commitment transactions only as permitted by Rule 18f-4, or Section 18 of the 1940 Act, absent additional relief from the SEC or its staff. However, until the Proposed Rule is finalized and in effect, the current regulatory landscape will remain in place.

Given the breadth of the 2019 Proposal, we believe that industry efforts to implement its components effectively will require thoughtful and careful consideration. In particular, areas of focus include:

- *Process.* Significant technological and process

enhancements may be necessary to capture the data necessary to implement, monitor, test and report on the new VaR-based requirements and other risk metrics required by the Rule. Closely associated with that are internal reporting and escalation procedures, which will depend on automated and systemic reporting which could mitigate or address derivatives risks as they arise.

- *People*. While the level of board oversight and the extent of reporting requirements represent a significant relaxation from those included under the 2015 proposal, board members will need to understand various aspects of the DRMP, including the adequacy of the program and the effectiveness of its implementation. Some fund groups may need to seek external expertise to meet the requirements of the DRM.
- *Products*. For funds that rely on the heavy use of derivatives, fund groups will need to evaluate whether each strategy remains viable in its current form or whether strategies and investment guidelines will need to be modified to comply with the new VaR-based parameters.
- *Documentation.* For funds that issue debt or preferred securities or have borrowing facilities, the current asset coverage limits under Section 18 may be embedded in the fabric of credit facilities and other documentation governing such leverage. Fund sponsors will need to undertake a comprehensive review of such documents to ensure that they continue to comply with both leverage documentation, which may be based on the old regulatory regime, and the new limits based on Rule 18f-4.

Comments on the 2019 Proposal are due within 60 days of publication in the Federal Register.

The Proposing Release is available here.

1 See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Release No. IC-33704 (Nov. 25, 2019)(the "Proposing Release").

2 See Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015).

3 Under this exception, a fund could use currency derivatives to hedge currency risk associated only with specific foreign currency-denominated equity or fixed-income investments in the fund's portfolio. Proposing Release at 164. In addition, the notional amount of the currency derivatives the fund holds could not exceed the value of the instruments denominated in the foreign currency by more than a negligible amount.

4 Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta. Proposing Release at n.276.

5 Proposing Release at 60. Funds may use a variety of approaches in developing guidelines that comply with the Proposed Rule.

6 Proposing Release at 51. While the DRM could obtain assistance from third parties in administering the DRMP, the Proposed Rule would not permit a third party to serve as DRM. Proposing Release at 49.

7 The DRM's representation may be based on "reasonable belief after due inquiry." Proposing Release at 85. The Proposing Release suggests that a DRM could form its reasonable belief based on an assessment of the DRMP and taking into account input from fund personnel, including the fund's portfolio management, or from third parties.

8 The Proposing Release clarifies that the Proposed Rule would not limit a DRM from receiving input from the fund's portfolio managers or others regarding the fund's designated reference index. Proposing Release at n.174.

9 The board could designate a committee of directors to receive the report. Proposing Release at n.164.

10 Although Form N-2 does not require closed-end funds to disclose a benchmark index for comparing a fund's performance, a closed-end fund seeking to satisfy the relative VaR test would have to disclose the fund's designated reference index in its annual report, together with a presentation of the fund's performance. Proposing Release at 102.

11 The Proposed Rule includes the following non-exhaustive list of market risk factors that a fund must account for in its VaR model, if applicable: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility.

12 A UCITS fund may, instead of complying with the European Union's VaR-based test, satisfy a "commitment approach" under which a UCITS fund is in compliance with leverage limits if its derivatives notional amounts (taking into account netting and hedging) do not exceed 100% of the fund's net asset value. The Commission considered but did not include a similar exposure-based test under the Proposed Rule. See Proposing Release at 143 and n.264.

13 Proposing Release at 118-119.

14 Recognizing that forced transactions could harm investors, such as by requiring the fund to realize trading losses, the Proposed Rule would not require the fund to exit its derivatives transactions or make other portfolio adjustments if it fails to come back into compliance within three business days. Proposing Release at 130.

15 The approval and due diligence requirements under the proposed rules are modeled after current FINRA options account approval requirements for broker-dealers. See Proposing Release at 183 and notes 324 and 325.

16 At a minimum, a firm must seek to obtain the following information about its retail investors: (1) investment objectives (e.g., safety of principal, income, growth, trading profits, speculation) and time horizon; (2) employment status (name of employer, self-employed or retired); (3) estimated annual income from all sources; (4) estimated net worth (exclusive of family residence); (5) estimated liquid net worth (cash, liquid securities, other); (6) percentage of the retail investor's liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and (7) investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities and other financial instruments. Proposing Release at 188.

ABOUT THE INVESTMENT SERVICES GROUP

The Investment Services group at Vedder Price has experience in all matters related to the design, organization and distribution of investment products. We can assist with investment company and investment adviser securities regulation and compliance matters, derivatives and financial product matters, and ERISA and tax matters.

You can expect to work with a highly experienced team that has extensive knowledge in structural, operational and regulatory matters, and is dedicated to quality, responsive service.

Our attorneys provide a full range of services to diverse financial services organizations, including: Broker/Dealer, Closed-End Funds, Fund Formation, Hedge Funds, Independent Directors, Investment Advisors, Mutual Funds and ETFs.

Juan M. Arciniegas
Shareholder
+1 (312) 609 7655
jarciniegas@vedderprice.com

Deborah B. Eades
Shareholder
+1 (312) 609 7661
deades@vedderprice.com

Nathaniel Segal
Counsel
+1 (312) 609 7747
nsegal@vedderprice.com

Tyrique J. Wilson
Associate
+1 (312) 609 7689
twilson@vedderprice.com