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Client Alert Commentary

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SEC Proposes Rules on the Use of Derivatives by Funds

The proposal would place restrictions on certain investment funds to limit their use of derivatives and require certain risk management procedures.

On December 11, 2015, the US Securities and Exchange Commission (SEC) proposed a new Rule 18f-4 (the Proposed Rule) under the Investment Company Act of 1940 (ICA) to limit the use of derivatives and other leveraged transactions by mutual funds, exchange-traded funds, closed-end funds and business development companies (BDCs) (collectively, Funds).[1] Private funds that are excluded from regulation under section 3(c)(1) or 3(c)(7) of the ICA would not be subject to the Proposed Rule.

The Proposed Rule would require reporting and disclosure of certain information regarding a Fund's derivatives activities, and would only permit a Fund to enter into "derivatives transactions" if the Fund satisfies each of the following conditions:

- Complies with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through derivatives and other senior securities transactions
- Manages the risks associated with the Fund's derivatives transactions by maintaining a certain amount of assets, defined in the Proposed Rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under its derivatives transactions
- In certain circumstances, establishes a formalized derivatives risk management program

The Proposed Rule would also require Funds that engage in "financial commitment transactions," including reverse repurchase agreements, short sale borrowings, or any firm or standby commitment agreement, to maintain qualifying coverage assets equal in value to the Fund's full obligations under such transactions.

Notably, the Proposed Rule follows a previous concept release from the SEC regarding investment companies' use of derivatives[2]. The Proposed Rule is part of a broader set of initiatives designed to address the asset management industry's increasingly complex portfolio composition and operations. The SEC also posed a number of questions to market participants in the Proposed Rule, and the comment period for the rulemaking will be open until March 28, 2016.

Existing Regulatory Framework

Section 18 of the ICA imposes various limitations on the capital structure of Funds by, among other things, restricting the ability of Funds to issue "senior securities,"[3] which are defined, in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness"[4] (Section 18 Restriction). While not technically "securities" for all purposes under the federal securities laws, the SEC has, through various interpretative releases and no-action letters, applied the Section 18

Restriction to many types of transactions involving derivatives and other financial commitment transactions. The SEC reasons that because such instruments may impose future payment obligations — conditional or unconditional — they qualify as an evidence of indebtedness that is a senior security under Section 18 of the ICA.[5] In light of the existing approach, which is a compilation of interpretative releases and no-action letters, the Proposed Rule is intended to provide a more comprehensive and concise approach to the regulation of Funds' use of derivatives transactions and financial commitment transactions, and clearly address the investor protection purposes and concerns underlying Section 18 of the ICA.[6]

Scope of the Proposed Rule

The Proposed Rule would impose restrictions on Funds entering into the following types of instruments:

- **"*Derivatives transactions*,"** which would include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar 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.[7] Notably, the SEC recognizes that not every derivative will involve the issuance of a "senior security" for purposes of Section 18 of the ICA because not every derivative imposes a future payment obligation on the Fund. A Fund that purchases an option, for example, generally will make a non-refundable premium payment to obtain the right to acquire (or sell) securities under the option, but generally will have no subsequent obligation to deliver cash or assets to the counterparty unless the Fund chooses to exercise the option. Accordingly, the SEC notes that these types of instruments would not trigger the requirements of Section 18 of the ICA.[8]

- ***"Financial commitment transactions,"*** which would include any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement.[9] A "similar agreement," for purposes of this definition, is an agreement under which a Fund has obligated itself, conditionally or unconditionally, to provide a loan to a company or to invest equity in a company, including through a capital commitment to a private fund that can be drawn at the discretion of the Fund's general partner (often referred to as "unfunded commitments").[10]

The restrictions under the Proposed Rule vary depending on whether the Fund enters into a derivatives transaction or a financial commitment transaction.

Portfolio Limitations for Derivative Transactions

Under the Proposed Rule, a Fund that engages in derivatives transactions would be required to comply with one of two alternative portfolio limitations immediately after entering into any senior securities transaction.

Exposure-Based Portfolio Limit

The first alternative (the Exposure-Based Portfolio Limit) would limit the Fund's exposure to 150% of the registered fund's net assets. "Exposure" would be calculated as (i) the aggregate notional amount of the Fund's derivatives transactions, and (ii) obligations under financial commitment transactions (such as reverse repurchase agreements, short sale borrowings, and firm or standby commitment agreements), and other transactions involving a senior security the Fund enters into pursuant to Section 18 or 61 of the ICA.[11] A Fund relying on the Exposure-Based Portfolio Limit would be required to operate so that the Fund's aggregate exposure under senior securities transactions, measured immediately after entering into any such transaction, does not exceed 150% of the Fund's net assets.[12] The Exposure-Based Portfolio Limit is designed to impose an overall limit on the amount of exposure,[13] and thereby the amount of potential leverage, that a Fund could obtain through derivatives and other senior securities transactions.

Risk-Based Portfolio Limit

The second alternative (the Risk-Based Portfolio Limit) would focus primarily on a risk assessment of the Fund's use of derivatives. It would permit a Fund to obtain exposure in excess of that permitted under the Exposure-Based Portfolio Limit if the Fund's derivatives transactions, in the aggregate, result in an investment portfolio that is subject to less market risk than if the Fund did not use such derivatives, evaluated using a value-at-risk (VaR) based test.[14] Specifically, a Fund would be permitted to obtain exposure up to 300% of the Fund's net assets, provided the total VaR of the Fund's portfolio with derivatives exceeds the total VaR of the Fund's portfolio without derivatives. According to the SEC, the Risk-Based Portfolio Limit's principal benefit is recognizing that Funds may use derivatives to not only seek higher returns through increased investment exposures, but also as means to reduce or mitigate risks associated with the Fund's portfolio.[15]

The Proposed Rule would define VaR as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in US dollars, over a specified time horizon and at a given confidence level."[16] A Fund would have flexibility in the selection of a VaR model and the model's parameters for purposes of the Risk-Based Portfolio Limit. However, the Proposed Rule would require a Fund's VaR model to satisfy certain minimum requirements, including to: (i) take into account and incorporate all significant, identifiable market risk factors associated with a Fund's investments; (ii) use a minimum 99% confidence interval, a time horizon of not less than 10 and not more than 20 trading days, and a minimum of three years of historical data to estimate historical VaR; and (iii) apply consistently when calculating securities VaR and full portfolio VaR.[17]

As noted above, whether a Fund satisfies one of the two alternative portfolio limitations is assessed immediately after the Fund enters into any senior securities transaction. Accordingly, a Fund may have flexibility in determining whether it would utilize the Exposure-Based Portfolio Limit or the Risk-Based Portfolio Limit on a transaction-by-transaction basis.

Asset Segregation for Derivatives Transactions

In addition to requiring Funds to comply with one of the two alternative portfolio limitations described above, the Proposed Rule would require a Fund that enters into derivatives transactions to segregate an amount of certain qualifying assets (defined in the Proposed Rule as "qualifying coverage assets"), to enable the Fund to meet its obligations arising from such transactions.[18]

For each derivatives transaction, a Fund would be required to maintain qualifying coverage assets with a value equal to:

- The amount that would be payable by the Fund if the Fund were to exit the derivatives transaction as of the time of determination (the "mark-to-market coverage amount")
- An additional amount that represents a reasonable estimate of the potential amount payable by the Fund if the Fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount")[19]

Qualifying coverage assets for derivatives transactions would need to be identified on the Fund's books and records at least once each business day and, with certain exceptions, would only include cash and certain cash equivalents (such as Treasury bills, agency securities, bank deposits, commercial paper and shares of money market funds).[20] Moreover, with respect to any derivatives transaction under which a Fund may satisfy its obligations by delivering a particular asset, the Proposed Rule would allow the Fund to segregate that particular asset as a qualifying coverage asset — for example, if the Fund were to write a call option on a particular security that the Fund owns, then the security could be considered a qualifying coverage asset in respect of the written option.[21]

Derivatives Risk Management Program

The Proposed Rule would require any Fund whose use of derivatives transactions is not limited to an aggregate exposure of 50% or less of the Fund's net asset value, or that uses complex derivatives transactions,[22] to adopt and implement a formalized derivatives risk management program.[23] The formalized risk management program would require a Fund to have in place policies and procedures that:

- 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 monitoring the Fund's use of derivatives transactions and informing the Fund's portfolio management or board of directors, as appropriate, regarding material risks arising from the Fund's derivatives transactions
- Reasonably segregate the functions associated with the derivatives risk management program from the portfolio management of the Fund, to promote objective and independent risk assessment to complement and cross-check portfolio management
- Periodically (but at least annually) review and update the program

The Proposed Rule would require general oversight by the board of directors of the risk management program. Specifically, a Fund's board would be required 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 (provided such person is not also a portfolio manager of the Fund).[24]

Financial Commitment Transactions

With respect to financial commitment transactions, a Fund would be required to maintain qualifying coverage assets for each financial commitment transaction in an amount equal to the value of the "financial commitment obligation" associated with the transaction — *i.e.*, the amount of cash or value of other assets that the Fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction.[25] As an example, if a Fund commits to return a security at a later time under a short sale borrowing, the Fund would be required to maintain qualifying coverage assets in an amount equal to the value of the security, determined at least once each business day.[26]

Under the Propose Rule, qualifying coverage assets for financial commitment transactions would include: (i) cash and cash equivalents; (ii) with respect to any financial commitment transaction under which the Fund may satisfy its obligations by delivering a particular asset, that particular asset; or (iii) assets that (a) are convertible to cash or will generate cash in an amount equal to the financial commitment obligation prior to the date on which the Fund can be expected to be required to pay such obligation, or (b) that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the Fund's board of directors.[27]

Reporting Requirements

In May 2015, the SEC proposed two additional reporting forms, Form N-PORT and Form N-CEN, which have not yet been finalized. The Proposed Rule would amend Form N-PORT to require those Funds that are required to adopt a derivatives risk management program to provide additional metrics regarding the Fund's use of derivatives. Similarly, the Proposed Rule would amend Form N-CEN to require disclosure as to which of the portfolio limitations the Fund is relying on under the Proposed Rule.

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Endnotes

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Proposed Rule, 80 Fed. Reg. 80884 (Dec. 11, 2015) [hereafter, the Proposed Rule].

[2] *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 FR 55237 (Sept. 7, 2011).

[3] Section 18(f)(1) of the ICA prohibits an open-end fund from issuing or selling any "senior security" other than borrowing from a bank and subject to a requirement to maintain 300% "asset coverage." Section 18(a)(1) of the ICA similarly prohibits a closed-end fund from issuing or selling any "senior security that represents an indebtedness" unless it has at least 300% "asset coverage," although closed-end funds' ability to issue senior securities representing indebtedness is not limited to bank borrowings, and closed-end funds also may issue senior securities that are a stock, subject to limitations in section 18. A BDC is also subject to the limitations of section 18(a)(1)(A) to the same extent as if it were a closed-end investment company, except that the applicable asset coverage amount for any senior security representing indebtedness is 200%.

[4] *See* Section 18(g) of the ICA. The definition of senior security in section 18(g) also includes any stock of a class having priority over any other class as to the distribution of assets or payment of dividends, and excludes certain limited temporary borrowings.

[5] *See* Proposed Rule at p. 80888.

[6] *See* Proposed Rule at p. 80892.

[7] *See* Proposed Rule at p. 80899.

[8] *See* Proposed Rule at p. 80892.

[9] *See* Proposed Rule at p. 80899.

[10] *See* Proposed Rule at p. 80900. The definition would not include a transaction under which a fund merely is required to deliver cash or assets as part of regular-way settlement of a securities transaction (rather than a forward-settling transaction or transaction in which settlement is deferred).

[11] *See* Proposed Rule at p. 80901.

[12] *See id*.

[13] The Proposed Rule would define a Fund's "exposure" as the sum of: (i) the aggregate notional amounts of the Fund's derivatives transactions, subject to certain adjustments; (ii) the aggregate obligations of the Fund under its financial commitment transactions; and (iii) the aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the Fund pursuant to section 18 or 61 of the ICA.

[14] *See* Proposed Rule at p. 80915. To satisfy the VaR test under the Risk-Based Portfolio Limit, a Fund's "full portfolio VaR" would have to be less than the fund's "securities VaR" immediately after the fund enters into any senior securities transaction. A Fund's "full portfolio VaR" would be defined as the VaR of the fund's entire portfolio, including securities, derivatives transactions and other investments. A fund's "securities VaR" would be defined as the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions.

[15] *See* Proposed Rule at p. 80965.

[16] *See* Proposed Rule at p. 80916.

[17] *See* Proposed Rule at p. 80920-80921.

[18] *See* Proposed Rule at p. 80925.

[19] *See* Proposed Rule at p. 80929.

[20] *See* Proposed Rule at p. 80932.

[21] *See* Proposed Rule at p. 80933.

[22] "Complex derivative transaction" means any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise is: (i) dependent on the value of the underlying reference asset at multiple points in time

during the term of the transaction; or (ii) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.

[23] *See* Proposed Rule at p. 80934.

[24] *See* Proposed Rule at p. 80944.

[25] *See* Proposed Rule at p. 80946. In various instances in the Proposed Rule, the SEC requested comment on whether haircuts should apply with respect to non-cash qualifying coverage assets.

[26] *See id*.

[27] *See* Proposed Rule at p. 80947.