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SEC Proposes New Derivatives Rules for Registered Funds

A rule proposed by the US Securities and Exchange Commission would provide for new limits on the use of derivatives—together with new risk management measures—for SEC-registered investment companies. All funds registered under the US Investment Company Act of 1940 would be covered, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and business development companies.

New proposed Rule 18f-4 would rescind a patchwork of SEC and SEC staff guidance that developed over almost 40 years and, for the first time, would set hard ceilings on market exposures obtained through derivatives. Here are the highlights:

- 150% Exposure Ceiling. This would be wholly new. Gross notional exposure through derivatives, together with leverage undertaken by the fund through bank borrowings and debt or preferred stock issuances plus exposures under the fund's so-called "financial commitment transactions," would be capped at 150% of a fund's net asset value.
- 300% Exposure Ceiling. This also would be wholly new. As an alternative to the 150% ceiling, the same exposures could be capped at 300% of net asset value, if the fund can demonstrate that its full portfolio is less risky (measured on a value-at-risk or "VaR" basis) than is its securities portfolio standing alone without taking into account derivative positions.
- New Asset Segregation Rules. This would be partially new. Under existing guidance, a fund assesses its exposure on a transaction by transaction basis and segregates on its books liquid assets (often called "cover") sufficient to match the fund's liabilities under each derivative. That approach continues, but with three proposed adjustments. First, it is proposed that cover consist only of cash and cash equivalents (today a fund may cover with any liquid assets, including liquid equities). Second, there would no longer be uncertainty as to whether the required cover amount for a given position should be assessed on a notional versus mark-to-market basis, as it is proposed to look only to mark-to-market liabilities. But it also is proposed that a fund should maintain a separate "cushion" of additional risk-based cover (also in cash or cash equivalents) in an amount of its choosing, which must be a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivative transaction under stressed conditions. The rules would, however, credit against the mark-to-market and risk-based requirements any variation or initial margin, respectively, posted by the fund. Third, these cover practices now would be applied in parallel with the proposed exposure ceilings; in other words, if a transaction breaches a ceiling, it is barred even if sufficient cover is available.
- Risk Management Programs. This would be either partially or wholly new depending on your perspective. Funds making more than limited use of derivatives would be required to have a formal derivatives risk management program. While presumably many firms have such a program in some form today, the required version would

include independent board oversight, separation of functions between risk and portfolio management and elements such as policies and procedures reasonably designed to assess the risks associated with the fund's derivative transactions.

The proposed rule is the first concrete SEC action regarding funds' use of derivatives since the agency issued its "Concept Release" that presaged the current rulemaking in 2011.[1] The SEC is soliciting comment on the proposal through March 28, 2016 (so for 90 days following publication in the Federal Register).

SEC Policy Interests and Prospective Public Reaction

In putting forward this proposal, the SEC is reacting to concern that its existing framework—developed around a 40-year old interpretation of a 75-year old statute—has become severely outdated. Given dramatic growth in the volume and complexity of the derivatives market over that period, the SEC says that it now believes that some funds are using derivatives to obtain leverage that is "excessive" relative to policy expectations for regulated investment funds sold to the public.

Nor should the fact of the current rulemaking be a surprise. The agency has been signaling its interest in a comprehensive overhaul since at least 2010 and, as noted, published a detailed concept release in 2011. More recently, the SEC Chair Mary Jo White announced that derivatives rulemaking was an agency priority in a series of speeches starting in December 2014.

That said, elements of the current rulemaking—notably the proposed ceilings and the restriction of permitted cover to cash and cash equivalents—represent a direct reversal of longstanding agency positions and are certain to draw a broad array of public comment. Some commenters will focus on incremental suggested improvements. Given the commercial impact, however, some commenters are likely to be highly critical, asking the agency to specify, for example, a concrete basis for the new rules that is sufficiently clear and quantifiable so as to justify its divergence from longstanding practice. Others might suggest alternative approaches altogether, such as creating a class of registered funds available only to accredited investors that would continue to operate under the current framework.

Historical Perspective

Since derivatives as we know them today are modern financial instruments, the industry's governing statute, the Investment Company Act of 1940, neither referred to nor prohibited their use by funds. The closest analog is that Section 18 of the Act aimed to protect investors from excessive leverage by prohibiting funds from issuing "senior securities." A "senior security" is defined, in part, as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness"[2]—a definition that may or may not reach derivatives since many derivatives will not "constitute a security."

[1] *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Rel. No. 29,776 (Aug. 31, 2011).

[2] 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.

The SEC's first detailed look at leveraging techniques beyond traditional borrowings came in 1979 and related to "financial commitment transactions," such as reverse repurchase agreements and short sales. The agency opined that such investment techniques effectively create "evidence of indebtedness" of a type that Section 18 should regulate but also that these techniques can benefit investors and should be permitted. Accordingly, the SEC issued its Release No. 10666 (widely referred to as Ten-Triple-Six), which provided that a fund would not be in violation of Section 18 if the fund segregates liquid assets to cover potential obligations created by such investment strategies.[3]

Although Release No. 10666 (like Section 18 before it) included no mention of derivatives, it was the forerunner to what would become decades of interpretive positions. All derivatives-related guidance built on the release's model of requiring that funds maintain an appropriate asset coverage base against perceived liabilities for different types of instruments.

Invoking this history, the SEC frames its proposed rule as an exemption that would permit a fund to enter into derivatives transactions, notwithstanding prohibitions on the issuance of "senior securities" under Section 18. Although presented as an "exemption," the rule's various conditions in fact would limit the ways in which many funds currently use derivatives, or the amount of derivatives used, based on previously issued SEC and SEC staff guidance.

Scope of the Rule

The proposed rule governs only "derivatives transactions," which it defines to mean 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.

Note that consistent with prior guidance, this definition does not capture many instruments commonly referred to as derivatives, but that do not require a future payment by the fund. For example, a purchased put or call option that requires no further payment aside from the initial premium is not subject to the definition. The rule similarly would not appear to apply to the purchase of structured notes or similar products with embedded derivatives, so long as no future payments are required. By contrast, the purchase of protection under a credit default swap—which may be thought of by market participants as similar to purchasing a put option—would be included, because such a swap generally requires a continuing stream of future fixed payments.

Proposed Portfolio Limitations (the 150% and 300% Tests)

To rely on the proposed rule, a fund would be required to comply with one of two alternative portfolio limitations when entering into a derivatives transaction. The first alternative is based on the level of a fund's total derivatives exposure while the second alternative takes into account the level of risk arising from the fund's use of derivatives.

- The 150% or exposure based portfolio limit generally would require a fund to limit its aggregate exposure to 150% of the fund's net assets. A fund's "aggregate exposure" for this purpose generally would be calculated as

[3] *See* Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,128 (Apr. 27, 1979).

the sum of the aggregate notional amount of its derivatives transactions, plus obligations under “financial commitment transactions” (defined below), plus other senior securities transactions (such as traditional bank borrowings).

- The 300% or risk-based portfolio limit is an alternative to the 150% limit and generally would permit a fund to limit its exposure under derivatives transactions, financial commitment transactions and other senior securities transactions (i.e., the same sum as under the 150% limit) to 300% of the fund’s net assets, provided that the fund satisfies a risk-based test based on value-at-risk. The risk based test using VaR is intended to evaluate whether the use of derivative transactions results in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.

A “financial commitment transaction”—the obligations of which are summed with derivatives transactions when measuring under either the 150% and 300% limits—means any reverse repurchase agreement, short sale borrowing or any firm or standby commitment agreement or similar agreement (such as an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund’s general partner).

Compliance with the 150% or 300% limit, as applicable, is tested immediately after entering into each new derivative transaction, financial commitment transaction or other senior securities transaction. Compliance with the limits need not take into account fluctuations in value of fund positions unless and until a new transaction is entered into, which has the practical effect of not forcing a fund to close out positions solely to assure compliance with the limits.

Calculation of Exposure for Derivatives Transactions

The proposed rule generally would define the “notional amount” of a derivatives transaction, subject to certain adjustments, as the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions), or the principal amount on which payment obligations under the derivatives transaction are calculated.

Three significant adjustments to the notional amount used to measure exposure for purposes of the 150% and 300% limits deserve note and are likely to draw comment:

- For any derivatives transaction that provides a return based on the leveraged performance of a reference asset, the notional amount for these purposes will be multiplied by the leverage factor;
- For any derivatives transaction for which the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the notional amount for these purposes will be determined by reference to the fund’s pro rata share of the notional amounts of the derivatives transactions of such account or entity (an adjustment that effectively imposes a full look-through and assumes that the underlying data will be available to the fund); and

- For any "complex derivatives transaction," the notional amount for these purposes will be an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction. A "complex derivatives transaction" means any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise (i) is dependent 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.

The proposed rule also includes a netting provision that would permit a fund, in determining its aggregate notional exposure, to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. This definition of netting is much more limited than common commercial understandings of the term and is designed, in the SEC's words, to apply to those types of derivatives transactions for which, due to regulation, transaction structure or market practice, a fund typically would use an offsetting transaction to effectively settle or close out all or a portion of the transaction prior to expiration or maturity, such as in certain futures and forward transactions.

Proposed Asset Segregation Requirements

Derivatives Transactions

The proposed rule would require a fund to manage the risks associated with its derivatives transactions by segregating an amount of "qualifying coverage assets," generally meaning cash and cash equivalents, designed to enable the fund to meet its obligations arising from such transactions. For each derivatives transaction, a fund would be required to maintain qualifying coverage assets with a value equal to the sum of (i) the amount that would be payable by the fund if the fund were to exit the derivatives transaction as of the time of determination, expressed in the rule as the "mark-to-market coverage amount," plus (ii) 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, expressed in the rule as the "risk-based coverage amount." Qualifying coverage assets for derivatives transactions would need to be identified on the books and records of the fund at least once each business day, which in turn means that the fund's mark-to-market and risk-based coverage amounts must be reassessed at least once each day.

The proposed rule takes into account initial and variation margin that a fund posts in connection with a derivative transaction. For cleared derivatives (including futures), funds typically are required to post initial and variation margin. As a result of other regulatory developments, funds also typically will be required to post variation, and in some cases initial margin, to dealer counterparties for over-the-counter, or OTC, swaps.[4] Under the proposed rule:

- For a mark-to-market coverage amount, the proposed rule would allow a fund to reduce the amount by the value of any assets that represent variation margin or collateral to cover the fund's mark-to-market loss with respect to

[4] *See*, e.g., Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (CFTC rule); Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015) (Bank regulator rule).

the transaction. As a result, where a fund posts variation margin, it generally would not have to segregate additional coverage assets to cover mark-to-market exposure. The fund would not reduce its mark-to-market coverage amount by initial margin, however.

- For a risk-based coverage amount, the proposal would allow a fund to reduce the amount by the value of any assets that represent initial margin or collateral with respect to the transaction. As a result, where a fund posts initial margin, it may not need to segregate additional coverage assets for the risk-based coverage amount (unless that coverage amount exceeds the initial margin requirement). The fund would not reduce its risk-based coverage amount by variation margin, however.

If a fund has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, the mark-to-market coverage amount and risk-based coverage amount for all derivatives transactions covered by the netting agreement could be calculated on a net basis, to the extent such calculation is consistent with the terms of the netting agreement.

The SEC has not proposed to require any particular methodology for calculating the risk-based coverage amount. The risk-based coverage amount for each derivatives transaction would be determined in accordance with policies and procedures approved by the fund's board of directors. Under those procedures, a fund could use one or more financial models to determine the risk-based coverage amount, provided that the calculation reflects a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions and takes into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset. Where a fund is required to post initial margin determined pursuant to a defined methodology, that methodology also might suffice for purposes of determining the risk-based coverage amount.

The proposed rule also retains the longstanding principle that with respect to a transaction under which the fund may satisfy its obligations by delivering a particular asset, that asset may be used as cover. For example, if a fund writes a call option on a security it holds, that security may itself serve as cover. While the rule does not explicitly say as much, if a transaction can be fully covered in this manner, then no additional risk-based coverage amount should be required.

Financial Commitment Transactions

The proposed rule also would require a fund that engages in "financial commitment transactions" (as defined above) to segregate qualifying coverage assets with a value equal to at least the amount of the fund's aggregate financial commitment obligations. The proposed rule defines a financial commitment obligation to mean the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction.

Because in many cases the timing of the fund's payment obligations under a financial commitment transaction may be specified under the terms of the transaction or the fund may otherwise have a reasonable expectation regarding the timing of the fund's payment obligations with respect to its financial commitment transactions, the proposed rule would allow the fund to maintain as qualifying coverage assets certain other assets in addition to cash and cash equivalents. As an example of what the SEC contemplates here, if a fund knows that a financial commitment

comes due on a given date, then the fund might include as cover against that commitment an expected payout from a bond due to the fund prior to that date.

Again, the proposed rule retains the principle that with respect to a transaction under which the fund may satisfy its obligations by delivering a particular asset, that asset may be used as cover. An example would be a short sale in which fund owns the security sold short.

Proposed Derivatives Risk Management Program and the Role of the Fund Board

The proposed rule introduces the concept of a formal written derivatives risk management program, which would require funds that engage in more than a limited amount of derivatives transactions to have a program designed to assess and manage risks presented by the fund's derivatives transactions. Generally, this requirement would apply to funds that exceed a 50% threshold of notional derivatives exposure or that use any "complex derivatives transactions" (as defined above). (Of course, a fund relying on these exceptions from the derivatives risk management program requirement must have compliance procedures in place to assure it lives within the exceptions over time and otherwise complies with the other provisions of the rule.)

The proposed risk management program would require 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 monitoring whether the fund's use of derivatives transactions is consistent with the fund's investment guidelines, disclosures to fund investors, and the portfolio limitations applicable to the fund under the proposed rule and 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;
- Reasonably segregate the functions associated with the program from the portfolio management of the fund;
- Periodically (but at least annually) review and update the program, including any models (including any VaR calculation models used during the covered period), measurement tools or policies and procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time.[5]

[5] The rule specifies that any VaR model used by a fund for purposes of determining compliance with the 300% risk-based exposure limit must:

- First, take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable: (i) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (ii) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (iii) the sensitivity of the market value of the fund's investments to changes in volatility;
- Second, use a 99% confidence level and a time horizon of not less than 10 and not more than 20 trading days; and
- Third, if using historical simulation, include at least three years of historical market data.

The program would be administered by a designated derivatives risk manager employed by the fund or the fund's investment adviser.[6] While the role may not be filled by someone who is also a portfolio manager, a derivatives risk manager may have other duties, including, for example, serving as the fund's chief compliance office or chief risk manager (if it has one).

Designation of the derivatives risk manager must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund. The board also would review written reports prepared by the designated derivatives risk manager, at least quarterly, that review the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation.

In addition, a fund's board also would approve the fund's derivatives risk management program and any material changes to the program. In considering whether to approve the program or any material changes to it, the SEC urges boards to consider the types of derivatives transactions in which the fund engages or plans to engage, their particular risks, and whether the program sufficiently addresses the fund's compliance with its investment guidelines, any applicable portfolio limitation and relevant disclosure. The SEC also suggests that boards may wish to consider best practices used by other fund complexes or consult with other experts familiar with derivatives risk management by similar funds or market participants. Directors may satisfy their obligations with respect to the initial approval of the program by reviewing summaries prepared by the fund's derivatives risk manager, legal counsel or other persons familiar with the program.

The breadth of these new requirements for fund boards—and the degree to which they may presume board-level understanding of such complex portfolio and risk management techniques as VaR modeling and position-level stress testing—is another aspect of the rule proposal that is sure to draw comment.

Proposed Reporting Amendments

In May 2015, the SEC proposed two new reporting forms, which have not yet been finalized.[7] New Form N-PORT would require registered management investment companies and ETFs organized as unit investment trusts, other than registered money market funds or small business investment companies, to electronically file with the SEC monthly portfolio investment information. New Form N-CEN would require all registered investment companies, including money market funds but excluding face amount certificate companies, to file census-type information with the SEC.

[6] That the designated risk manager must be employed by the fund or the fund's investment adviser appears to mean that he or she may not be employed by a third party (such as fund's administrator or custodian), at least absent taking steps to dually employ the individual with the fund or investment adviser.

[7] For more information on the SEC's proposed reporting forms please see: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/05/SEC-Issues-Proposed-Investment-Company-Reporting-Rules-IF-052915.pdf

In implementing proposed Rule 18f-4, the SEC intends to amend both proposed forms. For Form N-PORT, the amendments would require a fund to disclose certain risk metrics relating to a fund's use of derivatives. Specifically, funds that are required to implement a formalized risk management program under proposed Rule 18f-4 also would report on the gamma and vega for their options and warrants, including options on a derivative, such as swaptions.[8] For Form N-CEN, the amendments would require the fund to specify the portfolio limitation the fund relied on during the reporting period (i.e., the 150% exposure-based portfolio limit or the 300% risk-based portfolio limit).

Proposed Recordkeeping

It should be no surprise that the rule would generate a battery of new required records. There would be records to document compliance with the portfolio limits and asset coverage requirements, including detailed VaR model records for funds relying on the 300% risk-based portfolio limit. There would be records associated with board reports and determinations under the rule and with changes in the derivatives risk management program over time. There also would be records to document the required periodic reviews of the fund's use of derivatives. Generally, required records would be kept for at least five years (the first two years in an easily accessible place).

CONTACTS

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Bjorn Bjerke
New York
+1.212.848.4607
bjorn.bjerke@shearman.com

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Bill Murdie
London
+44.20.7655.5149
bill.murdie@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Thomas M. Majewski
New York
+1.212.848.7182
thomas.majewski@shearman.com

John D. Reiss
New York
+1.212.848.7669
john.reiss@shearman.com

[8] Gamma measures the sensitivity of delta in response to price changes in the underlying instrument. Vega measures the amount that an option contract's price changes in relation to a one percent change in the volatility of an underlying asset.

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