Analysis of SEC's Proposal to Update the Regulation of Funds' Use of Derivatives and Other Transactions

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The U.S. Securities and Exchange Commission on November 25, 2019 unanimously approved for publication a three-part rule proposal related to the use of derivatives and certain other transactions by registered investment companies (*i.e.*, open-end funds other than money market funds; closed-end funds; and exchange-traded funds) and business development companies (collectively, funds).[1] The proposal includes: (1) new Rule 18f-4 under the Investment Company Act of 1940 (Proposed Rule); (2) new rules relating to leveraged/inverse funds and vehicles, including sales practices rules under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 and a related amendment to Rule 6c-11 under the 1940 Act; and (3) related fund reporting form amendments and recordkeeping requirements.

The Proposed Rule is a re-proposal of a 2015 Commission rulemaking effort that would have permitted a fund to enter into derivatives transactions and "financial commitment transactions" subject to certain conditions.[2] The 2015 Proposed Rule was the first significant Commission or staff action relating to funds' use of derivatives since the Commission's issuance of a concept release on funds' use of derivatives in 2011.[3]

The proposal would rescind Release 10666[4] and the related "asset segregation" requirements articulated in that release, and the Commission staff may also withdraw related no-action letters and other guidance. As a result, a fund would need to comply with the conditions set forth in the Proposed Rule in order to engage in the applicable transactions or otherwise comply with Section 18 of the 1940 Act.

Further, while presented as an "exemptive" rule, the Proposed Rule would place restrictions on the manner in which many funds currently use derivatives based on existing Commission and no-action guidance. Similar to the 2015 Proposed Rule, if adopted, the Proposed Rule and the related items would represent the most significant change to the way the Commission regulates funds' use of derivatives and the obligations of fund boards since the time that Release 10666 was published.

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1 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 (Proposing Release), SEC Rel. Nos. 34-87607; IA-5413; IC-33704.

2 For further information regarding the 2015 proposed rulemaking, which is referred to herein as the 2015 Proposed Rule, please refer to *Dechert OnPoint*, SEC Proposes Significant New Restrictions on the Use of Derivatives and Other Transactions by Registered Funds and BDCs. For further information regarding the industry response to the 2015 proposed rulemaking, please refer to Industry Response to SEC Derivatives and Senior Securities Rule Proposal, The Investment Lawyer, Vol. 23, No. 6 (June 2016).

3 Use of Derivatives by Investment Companies under the Investment Company Act of 1940, SEC Rel. No. IC-29776 (Aug. 31, 2011) (Concept Release).

4 Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (Apr. 18, 1979) (Release 10666).

The Commission requests comment on all aspects of the Proposed Rule and related items. This *OnPoint* provides a detailed overview of the Proposed Rule and Proposing Release and highlights certain notable requests for comment. The Proposing Release states that comments should be submitted on or before 60 days following the publication of the Proposing Release in the Federal Register. As of the date of publication of this *OnPoint*, the Proposing Release has not been published in the Federal Register.

Background

1940 Act Restrictions on Senior Securities and Current Commission and Staff Guidance

The 1940 Act restricts the ability of funds to issue senior securities. A "senior security," as defined under Section 18(g) of the 1940 Act, includes "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." Sections 18(f)(1) and 18(a)(1)-(2) of the 1940 Act restrict the ability of open-end funds and closed-end funds, respectively, to issue such securities.[5] With certain exceptions, BDCs are also subject to the limitations of Section 18(a) to the same extent as closed-end funds.[6]

The 1940 Act's restrictions on senior securities stem from Congressional concerns at the time of its adoption about the risk to junior security holders resulting from: (1) excessive borrowing by funds and funds issuing excessive amounts of senior securities (the "undue speculation concern"); and (2) funds operating without adequate assets and reserves (the "asset sufficiency concern"), among other concerns.[7]

The Commission and its staff have historically taken positions that investments in many different types of derivatives and other transactions that represent a "contractual obligation to pay in the future for consideration presently received," whether for speculative purposes or for leveraging, fall within the "functional meaning" of an "evidence of indebtedness" for purposes of Section 18 and therefore potentially are senior securities.[8]

In Release 10666, the Commission took the position that a fund could engage in certain trading practices that are the functional equivalent of derivatives transactions that may involve the issuance of senior securities if the fund maintained a segregated account of liquid assets to "cover" the transaction to limit the fund's risk of loss. Since then,

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5 Section 18(f)(1) prohibits an open-end fund from issuing or selling any senior security; however, the fund may borrow from a bank provided that immediately after any such borrowing there is asset coverage of at least 300% for all of the fund's borrowings. Sections 18(a)(1)-(2) prohibit a closed-end fund from issuing or selling any senior security that "represents an indebtedness" unless it has at least 300% asset coverage for all borrowings and a senior security that is a class of stock unless it has at least 200% asset coverage for such stock.

6 *See* Section 61(a). In contrast to closed-end funds, the asset coverage requirements applicable to senior securities issued by BDCs are 200% (or 150% in certain circumstances) rather than 300% regardless of whether the senior security is represented by indebtedness or preferred stock.

7 *Provisions Of The Proposed Bill Related To Capital Structure (Sections 18, 19(B), And 21(C))*, Introduced by L.M.C Smith, Associate Counsel, Investment Trust Study, Securities and Exchange Commission, *Hearings on S.3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Congress, 3rd session (1940); Release 10666 at n. 8. *See also* Sections 1(b)(7)-(8) of the 1940 Act.

8 *See, e.g.,* Release 10666 at text accompanying n.14 (regarding reverse repurchase agreements, firm commitment agreements, and standby commitment agreements); *see also* Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) (Dreyfus) (regarding short selling, futures, certain types of options, forward currency contracts).

the staff of the Commission's Division of Investment Management has provided guidance through no-action relief that allowed funds to cover derivatives transactions in a variety of ways, including through the use of offsetting transactions.[9]

As noted above, more recently, the Commission published the Concept Release in 2011 regarding the use of derivatives by funds and seeking public comment on the same, and the 2015 Proposed Rule that would have permitted a fund to enter into derivatives transactions and "financial commitment transactions" subject to certain conditions. The 2015 Proposed Rule was not adopted by the Commission.

Commission Views on Current Practices

In the Proposing Release, the Commission notes that funds have developed practices for covering derivatives transactions that are based "at least in-part" on staff guidance and no-action letters. The Proposing Release discusses how asset segregation practices vary depending upon the type of derivatives transaction, with funds generally using the notional amount to cover certain derivatives transactions and using a mark-to-market amount to cover certain cash-settled derivatives.[10] Fund practices also vary with respect to the types of assets set aside for coverage. The Commission notes that funds were initially permitted under Release 10666 to cover certain derivatives transactions only with liquid assets—"cash, U.S. government securities, or other appropriate high-grade debt obligations." Subsequent no-action guidance expanded the types of assets funds may use to cover to include "any liquid asset, including equity securities and non-investment grade debt."[11]

The Proposing Release states that the Commission continues to view trading practices that impose on a fund a contractual obligation to pay or deliver assets in the future to a counterparty as involving "the issuance of a senior security for purposes of Section 18." The Proposing Release also states that, while segregation of assets is a way "to address the policy concerns underlying Section 18," asset segregation "does not, by itself, affect the legal question of whether a fund has issued a senior security." The Commission's position that the Proposed Rule is an "exemptive rule" is a departure from its historical approach to trading practices that impose on a fund a contractual obligation to pay or deliver assets in the future under Release 10666 and subsequent letters. Under that line of guidance, the Commission considered appropriately covered derivatives not to be senior securities, whereas the Proposed Rule would provide an exemption from Section 18's prohibitions and restrictions on funds issuing senior securities so long as funds meet the applicable conditions.

The Proposing Release expresses the Commission's concern that the asset segregation practices currently used by funds do not set a practical limit on derivatives use or potential leverage. In particular, the Commission states that the mark-to-market asset segregation measure does not "reflect full investment exposure associated with" a fund's derivatives positions and may result in a fund having insufficient assets to cover its derivatives obligations. The Proposing Release also expresses the Commission's further concern that certain types of assets set aside for cover (other than cash, U.S. government securities, or other appropriate high-grade debt obligations) could decline in value and result in a fund being forced to sell other, non-segregated portfolio securities at inopportune times in order to

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9 *See, e.g.,* Dreyfus (permitting the use of offsetting positions); Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (Merrill Lynch) (permitting the use of "any asset, including equity securities and non-investment grade debt ... so long as the asset is liquid and marked to market daily" when covering derivatives transactions).

10 We have observed guidance provided through exam comments and the staff disclosure review process, in addition to that under no-action letters and other formalized guidance.

11 Merrill Lynch.

meet its derivatives payment obligations.[12] The Proposing Release also notes that certain recent events demonstrate that funds can suffer significant losses resulting from their investments in derivatives absent effective derivatives risk management. In light of these concerns, the Proposed Rule is intended to limit the risks posed by fund derivatives use by creating a board oversight and compliance framework and establishing a limit on fund leverage risk.

Overview of Proposal

Derivatives Transactions

The Proposed Rule would provide that, if a fund satisfies the conditions described below, the fund may enter into derivatives transactions, notwithstanding the requirements of Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the 1940 Act. Derivatives transactions entered into in compliance with the Proposed Rule will not be considered for purposes of computing asset coverage, as defined in Section 18(h) of the 1940 Act.

To rely on the Proposed Rule, a fund transacting in derivatives must comply with the following requirements:

- **Derivatives Condition 1: Derivatives Risk Management Program**. The fund would be required to adopt and implement a written derivatives risk management program including policies and procedures that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund, which would include specific elements (Program).

- **Derivatives Condition 2: Limit on Fund Leverage Risk**. The fund's total leverage as measured by its value at risk (VaR) could not exceed 150% of the VaR of an unleveraged "designated reference index" (relative VaR test). If the fund's derivatives risk manager is not able to identify an appropriate designated reference index taking into account the fund's investments, investment objectives, and strategy, the fund's VaR could not exceed 15% of the value of the fund's net assets (absolute VaR test) (collectively with relative VaR test, the limit on fund leverage risk). The fund would be required to determine its compliance with the applicable VaR test at least once each business day and additional requirements would be triggered if a fund determined that it was not in compliance with its applicable VaR test. Designated reference index disclosure requirements would apply.

- **Derivatives Condition 3: Board Oversight and Reporting**. The fund's board, including a majority of directors/trustees who are not interested persons of the fund, would be required to approve the designation of a "derivatives risk manager," taking into account the derivatives risk manager's relevant experience. The derivatives risk manager would need to provide a written report to the board on or before implementation of the Program and thereafter at least annually providing a representation that the Program is "reasonably designed to manage the fund's derivatives risks" and to incorporate the required Program elements, which may be based on a reasonable belief after due inquiry, and certain other information. The derivatives risk manager must also provide to the board, at a frequency determined by the board, a written report regarding the derivatives risk manager's analysis of any exceedances of risk guidelines, and the results of certain stress testing and backtesting required under the Program, that occurred since the last report to the board.

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[12] The Proposing Release also acknowledges that notional amount segregation is non-risk-sensitive and "could limit funds' ability to engage in derivatives transactions that may not raise the concerns underlying Section 18."

Exception for Funds that are Limited Derivatives Users

A fund would not be required to adopt a Program or comply with the limit on fund leverage risk (and related board oversight and reporting requirements, including the derivatives risk manager requirement), if the fund (1) adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks and (2) either (A) limits its derivatives exposure to 10% of its net assets or (B) uses derivatives transactions solely to hedge certain currency risks.

Alternative Requirements for Leverage/Inverse Fund Transactions in Derivatives

A fund qualifying as a leveraged/inverse investment vehicle would not be required to comply with the limit on fund leverage, provided that the fund (1) discloses in its prospectus that it is not subject to the limit on fund leverage risk and (2) does not to seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse return) of the underlying index. The Program and applicable board oversight and reporting requirements would still apply.

As a related matter, and to address the risk that leveraged/inverse funds might present to retail investors, the Commission is further proposing additional rules that would subject broker-dealers and investment advisers to new sales practices rules requiring due diligence and account approval for a customer or client that is a natural person before accepting or placing such a person's order to buy or sell shares of a leveraged/inverse investment vehicle or approving an account of such a person to engage in such transactions. Finally, the Commission is proposing amendments that would permit leveraged/inverse funds to operate as ETFs pursuant Rule 6c-11 of the 1940 Act.

New Requirements for Reverse Repos and Certain Other Derivatives

The Proposed Rule would permit a fund to enter into reverse repurchase agreements and similar financing transactions and unfunded commitment agreements notwithstanding the requirements of Sections 18(a), 18(c), 18(f)(1) and 61 of the 1940 Act, as applicable, subject to certain requirements.

To enter into reverse repurchase agreements and similar financing transactions the fund would have to: (1) comply with the asset coverage requirements under Section 18 of the 1940 Act; and (2) combine the aggregate amount of indebtedness associated with such transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.

To enter into an unfunded commitment agreement, the fund must reasonably believe, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due, subject to certain limitations and guidelines for forming a reasonable belief and related documentation requirements thereof.

Other Requirements

The Commission is also proposing related recordkeeping requirements and to amend Forms N-PORT, N-LIQUID (which would be re-titled as Form N-RN), and N-CEN "to enhance the Commission's ability to oversee funds' use of and compliance with the proposed rules effectively, and for the Commission and the public to have greater insight into the impact that funds' use of derivatives would have on their portfolios."

Funds Subject to the Proposed Rule

The Proposed Rule would apply to open-end and closed-end investment companies and BDCs. Money market funds regulated under Rule 2a-7 under the 1940 Act and unit investment trusts (UITs) would not be permitted to rely on the Proposed Rule. Notably, because the Commission would rescind Release 10666 and possibly other no-action letters and staff guidance, money market funds and UITs potentially would not be able to engage in the relevant transactions if the Proposed Rule is adopted in its current form.

The Commission requests comment on the exclusion of money market funds and whether money market funds engage in any of the transactions impacted by the Proposed Rule (*e.g.*, reverse repurchase agreements) and, if so, how such transactions would be consistent with Rule 2a-7 under the 1940 Act and what effects the Proposed Rule would have on such funds if it were adopted as proposed.

Derivatives Transactions Covered by the Proposed Rule

The Proposed Rule would define as a "derivatives transaction:"

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. [13]

Although the above definition does not list firm or standby commitment agreements, the Commission indicates in the Proposing Release that the phrase "or any similar instrument" would include such agreements.

The Commission requests comment on whether this definition and its scope, including the fact that it includes short sale borrowings, are appropriate, and whether there are any other transactions that the final rule should address.

Repeal of Existing Commission Guidance

With a view towards creating a comprehensive approach to fund derivatives use, as noted above, the Commission is proposing to rescind Release 10666 and the Commission's staff is considering whether related no-action letters and guidance should be withdrawn in conjunction with the adoption of the final rule. The Proposing Release notes that any guidance that is inconsistent with the final rule would be withdrawn.

Each component of the Proposed Rule and related items are discussed in more detail below.

Derivatives Condition 1: Derivatives Risk Management Program

The Proposed Rule would generally require a fund (other than a limited derivatives user – discussed in further detail below) that enters into derivatives transactions to adopt and implement a written Program, which must include

[13] We have observed there may be instances where money market funds regulated under Rule 2a-7 could engage in transactions that could fall within the scope of the Proposed Rule.

policies and procedures that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the Program from the portfolio management of the fund.

The Proposing Release notes that the Program requirement would institute a standardized risk management framework for funds that engage in more than a limited amount of derivatives transactions, while allowing principles-based tailoring to the fund's particular risks. The Proposing Release states that the Commission believes that a formalized Program is "critical to appropriate derivatives risk management and is foundational to providing exemptive relief under Section 18." The Proposing Release further states that the Program requirement is "drawn from existing fund best practices" and that the Commission believes "it would enhance practices for funds that have not already implemented a derivatives risk management program, while building off practices of funds that already have one in place."

The Proposing Release states that a fund's Program "should take into the account the way the fund uses derivatives, whether to increase investment exposures in ways that increase portfolio risks or, conversely, to reduce portfolio risks or facilitate efficient portfolio management." Accordingly, the Program requirement is designed to result in a Program that is tailored to the derivatives transactions that the fund uses and their risks and impact on the fund's investment portfolio and strategy.

As described in more detail below, a fund's Program would also be required to include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing, (4) backtesting, (5) internal reporting and escalation, and (6) periodic review of the Program. Each required Program element is discussed in detail below.

A chart comparing the required Program elements and related board oversight and reporting requirements, those under the 2015 Proposed Rule, and those under the liquidity risk management program required under Rule 22e-4 under the 1940 Act is included in Appendix A. That chart shows many commonalities among the three sets of programs, and also notable differences such as the fact that there is no requirement for the fund's board to approve the Program under the Proposed Rule.

Program Elements

Risk Identification and Assessment

The first element would require that the Program provide for the identification and assessment of the fund's derivatives risks, taking into account the fund's derivatives transactions and other investments.

The Proposing Release states that "[a]n appropriate assessment of derivatives risks generally involves assessing how a fund's derivatives may interact with the fund's other investments or whether the fund's derivatives have the effect of helping the fund manage risks." Such a holistic assessment would better position a fund to implement a Program that does not over- or under-state the fund's derivatives risks.

In addition to identifying and managing "any other derivatives risks" that a fund's derivatives risk manager deems material, the Proposed Rule would require that the fund's exposure to the following derivatives risks – which the Commission believes are "common to most derivatives transactions" – be specifically identified and managed:

- **Leverage risk**: generally the risk that derivatives transactions can magnify the fund's gains and losses;

- **Market risk**: generally the risk from potential adverse market movements in relation to the fund's derivatives positions, or the risk that markets could experience a change in volatility that adversely impacts fund returns and the fund's obligations and exposures;

- **Counterparty risk**: generally the risk that a counterparty may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty;

- **Liquidity risk**: generally the risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties; [14]

- **Operational risk**: generally the risk related to potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human error; and

- **Legal risk**: generally the risk related to insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract, which the Proposing Release generally identifies as applicable to OTC derivatives.

The Commission requests comment on all aspects of the requirement to identify and assess a fund's derivatives risks, as well as the proposed definition of the term "derivatives risks."

Risk Guidelines

The second element would require that the Program provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks (Guidelines). The Guidelines would be required to specify levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed, and measures to be taken if they are exceeded.

The Proposing Release states that the Commission believes that "many funds today have established risk management guidelines, with varying degrees of specificity" and that the Guidelines would address the fund's derivatives risks that should be monitored routinely as part of the Program, and to help the fund identify when it should respond to changes in those risks.

The Proposed Rule does not set forth specific limits for the Guidelines. However, the Proposing Release states that the Guidelines should "provide for quantitative thresholds that the fund determines to be appropriate and that are most pertinent to its investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure." This would, in turn, require a fund's derivatives risk manager to regularly measure changes in risks and is designed to lead to more timely action to manage that risk.

The Proposing Release states that funds may use a "variety of approaches" in developing Guidelines, and notes that the Guidelines requirement "would draw on the risk identification element of the program and the scope and objectives of the fund's use of derivatives." The Proposing Release explains that in developing the Guidelines, "a fund generally should consider how to implement them in view of its investment portfolio and the fund's disclosure to investors" and "may wish to consider establishing corresponding investment size controls or lists of approved

[14] Notably, the Proposing Release's discussion of liquidity risk does not refer to the liquidity status of the derivatives transaction as a fund investment.

transactions across the fund." In addition, the Proposing Release suggests implementing "appropriate monitoring mechanisms," including quantitative metrics.

The Proposing Release states that the requirement to identify a response to exceeding the Guidelines "would provide the fund's derivatives risk manager with a clear basis from which to determine whether to involve other persons, such as the fund's portfolio management or board of directors, in addressing derivatives risks appropriately" as required under the internal reporting and escalation element. As discussed below, the Proposed Rule would require the derivatives risk manager to report on the analysis of any exceedances of Guidelines to the fund's board.

The Guidelines requirement was not included in the 2015 Proposed Rule. The Commission requests comment on the Guidelines requirement, including, among other things, whether funds currently adopt and monitor compliance with such Guidelines, whether the Guidelines should be required, and whether the Guidelines should require a fund to manage its liquidity risk by "maintaining highly liquid assets to cover potential future losses and other liquidity demands."

Stress Testing

The third element would require the Program to provide for stress testing of the fund's portfolio. The stress testing would have to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties.

The Proposing Release states that the Commission believes that stress testing "would serve as an important complement to the proposed VaR-based limit on fund leverage risk, as well as any VaR testing under the fund's [Guidelines]." The Proposing Release states that the Commission believes that the stress testing requirement would produce valuable results because it would focus testing "on extreme events that may provide actionable information to inform a fund's derivatives risk management." The Proposing Release notes that market risk factors commonly considered for this purpose include liquidity, volatility, yield curve shifts, sector movements or changes in the underlying instrument's price, and should include payments to counterparties.

The Proposed Rule would permit a fund to determine the frequency with which stress tests are conducted, provided that the fund must conduct stress testing at least weekly. In determining testing frequency, a fund must take into account the fund's strategy and investments and current market conditions. The selected frequency should "best position" the derivatives risk manager "to appropriately administer, and the board to appropriately oversee, a fund's derivatives risk management, taking into account the frequency of change in the fund's investments and market conditions." The Commission notes that the weekly testing minimum is intended to balance the benefits of frequent stress testing against the burdens of conducting stress testing.

As discussed below, the Proposed Rule would require the derivatives risk manager to report on the results of the stress testing to the fund's board.

The 2015 Proposed Rule did not include a stress testing requirement, but the Proposing Release notes that certain commenters had stated that stress testing "would serve as an important component of derivatives risk management" and recommended that the Program requirement include stress testing. The Commission requests comment on the Proposed Rule's stress testing requirement, including, among other things, whether funds should be required to conduct such tests, if funds should be required to conduct a particular type of stress testing and whether the Proposed Rule should identify specific stress events to be applied.

Backtesting

In light of the central role of the Proposed Rule's VaR-based limit on fund leverage risk, the fourth element would require the Program to provide for the backtesting of the results of the VaR calculation model used by the fund in connection with the applicable VaR test. Each business day, the Program would need to provide for comparing the fund's actual gain or loss for that day with the corresponding VaR calculation for that day, estimated over a one-day time horizon, and identifying as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss.

The Proposing Release notes that, based on the 99% confidence level (as required under the VaR definition) and one-day time horizon, a fund would be expected to have approximately 2.5 backtesting exceptions per year. The Proposing Release notes that, if a fund were "consistently to experience backtesting exceptions more (or less) frequently, [it] could suggest that the fund's VaR model may not be effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund's investments..."

The Proposing Release acknowledges that while some funds conduct these calculations less frequently, the Commission believes that requiring daily backtesting would enable a fund and its derivatives risk manager "to more readily and efficiently adjust or calibrate its VaR calculation model," which, in turn, would allow for more effective management of the risks associated with the fund's derivatives use. The Proposing Release states that this requirement would "assist a fund in confirming the appropriateness of its model and related assumptions and help identify when funds should consider model adjustments."

As discussed below, the Proposed Rule would require the derivatives risk manager to report on the results of the backtesting to the fund's board.

The Proposing Release notes that the 2015 Proposed Rule did not include a backtesting requirement, but that certain commenters had supported a daily backtesting requirement. The Commission requests comment on various aspects of the backtesting requirement, including, among other things, how frequently funds that use VaR backtest their VaR models, whether requiring backtesting each day is appropriate, and whether less-frequent backtesting would be sufficient.

Internal Reporting and Escalation

The Proposing Release indicates that, in light of the Commission's belief that portfolio managers generally will be responsible for transactions that could mitigate or address derivatives risks as they arise, the fifth element would mandate that the Program identify the circumstances when a fund's portfolio management team will be informed regarding the operation of the Program, including exceedances of Guidelines and the results of required stress testing. Further, to foster an open and effective dialogue and to facilitate board oversight, the fifth element also would require that a fund's derivatives risk manager inform in a timely manner the fund's portfolio management team, and also directly inform the fund's board, as appropriate, regarding material risks arising from the fund's derivatives transactions, including derivatives risks identified by exceedance of a Guideline or by required stress testing.

The Proposing Release notes that, for example, a fund exceeding the risk limits set forth in its Guidelines would provide the fund's derivatives risk manager "with a clear basis from which to determine whether to involve other persons, such as the fund's portfolio management or board of directors." However, the Proposing Release states that this requirement will "provide flexibility for funds to communicate among these groups as they deem appropriate and taking into account funds' own facts and circumstances..." The Proposed Rule would not require a fund's derivatives risk manager automatically to escalate these risks to the fund's board. Instead, the Proposing Release states that the Commission believes that a "fund's derivatives risk manager is best positioned" to make a determination regarding the appropriateness of board escalation, and, accordingly, the Proposed Rule would grant the derivatives risk manager discretion as to when to inform the board of material risks.

The 2015 Proposed Rule included similar internal reporting obligations, but did not specifically require a fund's program to identify the circumstances under which persons responsible for portfolio management would be informed regarding the operation of the program or specify the timing in which those persons would need to be informed. Instead, the 2015 Proposed Rule, would have required a fund's Program to include policies and procedures "[i]nforming persons responsible for portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions."

The Commission requests comment on various aspects of the internal reporting and escalation requirements, including, among other things, whether the requirements are appropriate, whether the Proposed Rule should prescribe the types of internal reporting information that portfolio management or the board should receive, and whether the proposed requirements to escalate material risks to the fund's portfolio management and, as appropriate, the fund's board of directors are appropriate.

Periodic Review of the Program

The sixth element would require a fund's derivatives risk manager to review the Program at least annually to evaluate the Program's effectiveness and to reflect changes in the fund's derivatives risks over time. The Program review must include a review of the VaR calculation model used by the fund, including any backtesting required under the Program, and any designated reference index to evaluate whether the designated reference index remains appropriate.

The Proposing Release notes that requiring a review at least annually "mirrors the minimum period in which the fund's derivatives risk manager would be required to provide a written report on the effectiveness of the program to the board." The Commission believes that the Program review requirement would ensure a "recurring dialogue" between a fund's derivatives risk manager and its board.

The Proposed Rule "would not prescribe review procedures or incorporate specific developments that a derivatives risk manager must consider as part of its review." However, the Proposing Release states that "a derivatives risk manager generally should implement periodic review procedures for evaluating regulatory, market-wide, and fund-specific developments" that would affect a fund's Program.

The Commission requests comment on the Program review requirement, including, among other things, whether the Proposed Rule should require such a review, whether the derivatives risk manager should be required to review the Program more frequently, and whether certain review procedures should be prescribed.

Derivatives Risk Manager

To centralize derivatives risk management and to promote accountability, the Proposed Rule would require that the fund's "derivatives risk manager" be an officer or officers of the fund's investment adviser and be responsible for the day-to-day administration of the fund's Program and related policies and procedures.

The Proposed Rule provides that the derivatives risk manager may not be the fund's portfolio manager, if a single officer serves in the position, and that the derivatives risk manager may not have a majority composed of portfolio managers, if multiple officers serve as derivatives risk manager. The Proposed Rule would require a derivatives risk manager to have "relevant experience regarding the management of derivatives risk."

The Commission believes that requiring a fund's derivatives risk manager to be responsible for the day-to-day administration of the fund's Program, subject to board oversight, is key to appropriately managing derivatives risks and is consistent with many funds' current practice.

The Proposing Release states that the term "adviser" as used in the Proposing Release and the Proposed Rule "generally refers to any person, including a sub-adviser, that is an 'investment adviser' of an investment company as that term is defined in section 2(a)(20)" of the 1940 Act. The Commission believes that allowing multiple officers to serve as a fund's derivatives risk manager would allow "funds with differing sizes, organizational structures, or investment strategies to more effectively tailor programs to their operations." The Proposed Rule also would not permit a third party to serve as a fund's derivatives risk manager, though the derivatives risk manager could obtain assistance from third parties in administering the Program.

The Proposing Release states that the Commission believes that funds today often segregate risk management from portfolio management and that this separation of functions would create important checks and balances. This requirement is designed to "promote objective and independent identification, assessment, and management of the risks associated with derivatives use" and "enhance the accountability of the derivatives risk manager and other risk management personnel and, therefore, to enhance the program's effectiveness." The Proposing Release states that "[b]ecause a fund may compensate its portfolio management personnel in part based on the returns of the fund, the incentives of portfolio managers may not always be consistent with the restrictions that a risk management program would impose." As such, the Proposing Release states that the Commission believes that "[k]eeping the functions separate in the context of derivatives risk management should help mitigate the possibility that these competing incentives diminish the program's effectiveness."

The Proposing Release notes that the experience requirement is "designed to reflect the potential complex and unique risks that derivatives can pose to funds and promote the selection of a derivatives risk manager who is well-positioned to manage these risks." Rather than "identifying a specific amount or type of experience that a derivatives risk manager must have" the Proposing Release states the Proposed Rule is designed to "provide flexibility for a fund's board to take into account a derivatives risk manager's specific experience." [15]

Reasonable Segregation of Program Administration from Portfolio Management

The Proposed Rule would also require that the policies and procedures included in the Program be reasonably designed to reasonably segregate the Program's functions from a fund's portfolio management function.

The Proposing Release notes that this requires a reasonable segregation of functions rather than a more prescriptive approach. It also notes that "funds could institute this proposed requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel." According to

15 The Proposing Release clarifies that a rule "[d]etailing a derivatives risk manager's required experience ... would not be practical, given the numerous ways in which a person could obtain experience with derivatives or risk management [and any] specification in the rule of the specific experience required to serve as a derivatives risk manager likely would be over- or under-inclusive and would not take into account the way that any particular fund uses derivatives."

the Proposing Release, “the reasonable segregation requirement is not meant to indicate that the derivatives risk manager and portfolio management must be subject to a communications ‘firewall.’” Rather, the Proposing Release states that the Commission “recognizes the important perspective and insight regarding the fund’s use of derivatives that the portfolio manager can provide and generally understand that the fund’s derivatives risk manager would work with the fund’s portfolio management in implementing the program requirement.”

The Proposing Release states that the Commission believes that concerns raised by commenters on the 2015 Proposed Rule regarding the requirement for a single derivatives risk manager and the input of portfolio managers are addressed by the Proposed Rule in its allowance for a group or committee to serve as a fund’s derivatives risk manager, a portion of whom could be portfolio managers. The Commission requests comment on the reasonable segregation requirement generally and on whether the requirement would pose particular challenges for funds with smaller advisers.

Economic Analysis

The Proposing Release acknowledges that compliance costs arising out of the Program requirement would vary from fund to fund. but notes that “it is likely that many funds’ current risk management practices may already be in line with many of the [P]roposed [R]ule’s derivatives risk management program requirements or could be readily conformed without material change,” making any additional compliance costs for such funds minimal. The Proposing Release estimates that the one-time costs associated with establishing and implementing a Program under the Proposed Rule would range from “$70,000 to $500,000 per fund, depending on the particular facts and circumstances,” with ongoing annual Program-related costs ranging from 65% to 75% of such one-time costs.

The Proposing Release acknowledges that there is not yet any developed data reflecting how many funds currently have a program in place that would substantially satisfy the Proposed Rule’s requirements and the Proposing Release’s figure of $311,041,500 in estimated total industry costs in the first year assumes that all funds would incur a cost associated with the Program requirement. Accordingly, the Commission is seeking comment on whether most funds do already have programs in place that substantially satisfy the Proposed Rule’s requirements and, if so, how many.

Derivatives Condition 2: Limit on Fund Leverage Risk

The Proposed Rule would generally require a fund (other than a limited derivatives user or a leveraged/inverse fund – discussed in further detail below) that enters into derivatives transactions to comply with an outer limit on fund leverage risk.

Under the limit on fund leverage risk, the VaR of the fund’s portfolio could not exceed 150% of the VaR of the fund’s designated reference index. If, however, the fund’s derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund taking into account the fund’s investments, investment objectives, and strategy, the VaR of the fund’s portfolio could not exceed 15% of the value of the fund’s net assets.[16]

The fund would have to determine its compliance with the applicable VaR test at least once each business day and, if the fund determines that it is not in compliance with the applicable VaR test, the fund would have to come back into compliance with the applicable VaR test within three business days.

16 Rule 18f-4(c)(2)(i); Rule 18f-4(a), definitions of “absolute VaR test”, “relative VaR test” and “Value-at-Risk” or “VaR.”

In such event, if the fund is not in compliance with the applicable VaR test within three business days:

1. The derivatives risk manager would have to report to the fund's board of directors and explain how and by when (*i.e.*, number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance;

2. The derivatives risk manager would have to analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any Program elements, as appropriate to address those circumstances; and

3. The fund could not enter into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days and has satisfied the requirements set forth in (1) and (2) above.

If the fund is complying with the relative VaR test, an open-end fund would have to disclose in its annual report the fund's designated reference index as the fund's "appropriate broad-based securities market index" or an "additional index," and a closed-end fund or BDC would have to disclose its designated reference index in its annual report, together with a presentation of the fund's performance relative to the designated reference index. A fund would not be required to include this disclosure in an annual report if the fund is a "New Fund" or would meet that definition if it were filing on Form N-1A, at the time the fund files the annual report.[17]

The requirements under the limit on fund leverage are significantly different than the portfolio limitations and asset segregation requirements under the 2015 Proposed Rule. A chart comparing the requirements under the limit on fund leverage and the corresponding requirements under the 2015 Proposed Rule (among other things) is included in Appendix B.

Definition of VaR

The Proposed Rule defines the term "VaR" to mean an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a set time horizon and at a specified confidence level. The Proposed Rule would require that any VaR model used by a fund for purposes of determining the fund's compliance with the applicable VaR test would have to:

1. Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as 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;

2. Use a 99% confidence level and a time horizon of 20 trading days; and

3. Be based on at least three years of historical market data.

17 The terms "appropriate broad-based securities market index," "additional index" and "New Fund" are as defined in Form N-1A.

Based on the definitional requirements for VaR, there would be a 1% probability that the value of the fund would decrease by its calculated VaR amount or more during a 20 day period.

Choice of VaR as a Limit on Fund Leverage Risk

The Proposing Release states that the Commission is basing the limit on fund leverage risk on VaR because VaR "enables risk to be measured in a reasonably comparable and consistent manner across diverse types of investments that may be included in a fund's portfolio." The Proposing Release also notes that VaR is a broadly-used industry metric that provides an "overall indication of market risk, including the market risk associated with a fund's derivatives transactions."

The Proposing Release states that VaR calculation tools are widely available and that many advisers using derivatives already use tools that include VaR capability, and that "the proposed relative VaR test is similar to a relative VaR approach that applies to UCITS under European guidelines." However, there are significant differences between the VaR-related requirements under the Proposed Rule. For example, both the absolute and relative VaR percentage thresholds for UCITS are higher than under the Proposed Rule. A chart comparing the Proposed Rule's VaR tests and related requirements to the VaR-based approach that applies to UCITS under European guidelines is included in Appendix C.

Also, the Proposing Release states that different funds "could, and would be required to, tailor their VaR models to incorporate and reflect the risk characteristics of their fund's particular investments."

The Proposing Release acknowledges that "VaR is not itself a leverage measure." However, the Proposing Release states that the VaR tests can be used to analyze whether a fund "is using derivatives transactions to leverage the fund's portfolio" or "with effects other than leveraging the fund's portfolio that may be less likely to raise the concerns underlying Section 18." [18] The Proposing Release also notes that a fund having an extensive derivatives portfolio and also a low absolute VaR or low VaR on a relative basis "would indicate that the fund's derivatives were not substantially leveraging the fund's portfolio."

The Proposing Release also acknowledges that VaR tests do not provide an estimate of a portfolio's maximum loss amount, and VaR does not estimate the extent of the loss in the 1% of the time under the required VaR model parameter of a 99% confidence level. [19] In addition, the Proposing Release acknowledges that VaR tests do not estimate the size of losses that may occur under stressed conditions, on the trading days during which the greatest losses occur (tail risks). However, as noted above, the Proposing Release states that the Commission does not believe that VaR tests should be the sole component of a fund's Program, and that the stress testing required under the Program requirement "would serve as an important complement to the proposed VaR-based limit on fund leverage risk..."

18 The Proposing Release states that VaR tests "are designed to provide a metric that can help assess the extent to which a fund's derivatives transactions raise concerns underlying Section 18."

19 The Proposing Release provides an example for clarity. If a Fund's VaR calculated at a 99% confidence level was $100, this means the fund's VaR model estimates that, 99% of the time, the fund would not be expected to lose more than $100. VaR does not estimate how much the fund would be expected to lose in the other 1% of the time.

The Proposing Release notes that the Commission considered both the relative strengths and weakness of the proposed VaR-based testing method and alternative testing methods.[20] The Proposing Release states that, taking these considerations into account, the Commission is proposing tests based on VaR, "which is commonly used and does not present all of the quantitative challenges associated with stressed VaR and expected shortfall, complemented by elements in the proposed risk management program designed to address VaR's limitations."

The Relative VaR Test and the Designated Reference Index

As noted above, the Proposed Rule would generally require funds to use a relative VaR test unless the fund's derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund, taking into account the fund's investments, investment objectives, and strategy.

The Proposing Release states that the Commission is proposing the relative VaR test "as the default means of limiting fund leverage risk because it resembles the way that Section 18 limits a fund's leverage risk. Section 18 limits the extent to which a fund can potentially increase its market exposure through leveraging by issuing senior securities, but it does not directly limit a fund's level of risk or volatility." The Proposing Release states that the relative VaR test "likewise is designed to limit the extent to which a fund increases its market risk by leveraging its portfolio through derivatives, while not restricting a fund's ability to use derivatives for other purposes." The Proposing Release also notes that allowing funds to use the absolute VaR test where a designated reference index is available may be inconsistent with investor expectations.[21]

The Proposed Rule would define the term "designated reference index" to mean an unleveraged index that is:

1. Selected by the derivatives risk manager and that reflects the markets or asset classes in which the fund invests;

2. Not 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 investment adviser, unless the index is widely recognized and used; and

3. An "appropriate broad-based securities market index" or an "additional index," as defined in the instructions to Item 27 in Form N-1A.

The Proposed Rule would allow a fund to use one or more indexes for this purpose where relevant (blended index). In the case of a blended index, the Proposed Rule provides that none of the indexes that compose the blended index may be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal

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20 The Commission acknowledges academic criticism that the proposed VaR-based testing may underestimate the risk of loss under stressed market conditions, such as during the recent 2007-2009 financial crisis, stating in the Proposing Release that "We also considered proposing tests based on stressed VaR, expected shortfall, or both. Stressed VaR refers to a VaR model that is calibrated to a period of market stress. A stressed VaR approach would address some of the VaR test critiques related to tail risk and underestimating expected losses during stressed conditions. Calibrating VaR to a period of market stress, however, can pose quantitative challenges ... Expected shortfall analysis is similar to VaR, but accounts for tail risk by taking the average of the potential losses beyond the specified confidence level … [however] ... Because there are fewer observations in the tail ... there is an inherent difficulty in estimating the expected value of larger losses..."

21 The Proposing Release notes as an example a short-term fixed income fund with an available designated reference index with a VaR of 4%. In such example, the fund's reliance on the absolute VaR test would allow the fund to have almost four times the VaR of its designated reference index.

underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.

The Proposing Release states that the requirements that the designated reference index would have to be unleveraged and reflective of the markets or asset classes in which the fund invests are “designed to create a baseline VaR that approximates the VaR of the fund’s unleveraged portfolio” for the relative VaR test. If the VaR of a fund using derivatives “exceeds that of the designated reference index, this difference may be attributable to leverage risk” and so the relative VaR test will identify the leveraging effect of derivatives a fund enters into to create leverage.

The Proposing Release states that the Commission recognizes a concern that funds have a potential incentive to select an inappropriate designated reference index, in order to obtain more leverage risk under the relative VaR test. The Proposing Release notes that many of the elements of the definition of designated reference index collectively are designed to promote the effectiveness of the index as a baseline for the relative VaR test and “to prohibit funds from ... selecting indexes solely for the purposes of maximizing the fund’s permissible leverage risk.”

The Proposing Release notes that the 2015 Proposed Rule also would have included a risk-based limit based on VaR, allowing a fund to comply with the 300% portfolio limit condition under the 2015 Proposed Rule if the fund’s full portfolio VaR was less than the fund’s “securities VaR” (*i.e.*, the VaR of the fund excluding derivatives holdings). The Proposing Release states that commenters had noted that securities VaR did not provide an appropriate comparison for certain funds that use derivatives extensively and hold primarily cash, cash equivalents (for margin purposes) and derivatives because their securities VaR would be based on cash and cash equivalents.

Among other things, the Commission requests comment on whether the Proposed Rule’s requirements related to the designated reference index:

- Are appropriate or present challenges to certain funds that may not be contemplated in the Proposed Rule release;
- Should require the designated reference index to be an unlevered index;
- Should further mirror UCITS guidelines requiring the designated reference index to be consistent with the fund’s investment objective, policies and limits;
- Should permit a fund to compare its portfolio VaR to its securities VaR, as proposed in the 2015 Proposed Rule; and
- Present disclosure challenges for closed-end funds and BDCs.

150% VaR Limit Under the Relative VaR Test

As noted above, a fund would satisfy the relative VaR test if the VaR of its entire portfolio does not exceed 150% of the VaR of its designated reference index.

The Proposing Release states that the Commission believes that the proposed 150% VaR limit would provide funds with an appropriate degree of flexibility to use derivatives, while also effectively limiting funds’ derivatives-related leverage risk in a manner similar to the way Section 18 limits funds’ ability to borrow from a bank (or issue other senior securities representing indebtedness, as applicable) via the 300% asset coverage requirement. As an example, the Proposing Release notes that a mutual fund with $100 in assets and no liabilities or senior securities outstanding could borrow $50 from a bank and then invest $150 in securities based on $100 in net assets. The Proposing Release states that such a fund's VaR would be approximately 150% of the VaR of the fund's designated reference index.

The Proposing Release also notes that the Commission considered proposing a different relative VaR test for BDCs, which have greater flexibility to issue senior securities under the 1940 Act. However, based on a review of financial statements of sample BDCs conducted by the Commission staff, the Commission believes that "most BDCs either would not use derivatives or would rely on the exception for limited derivatives users."

Among other things, the Commission requests comment on whether the Proposed Rule's VaR test requirements are appropriate and whether the proposed relative VaR test should be lower or higher than 150% of the VaR of the designated reference index. In the requests, the Commission notes that the relative VaR test applicable to UCITS allows a UCITS to have a relative VaR up to 200% of the VaR of the reference portfolio, and asks for comment on how a rule with a 200% relative VaR test should incorporate investor protection provisions consistent with Section 18. As noted above, a chart comparing the Proposed Rule's VaR tests and related requirements to the VaR-based approach that applies to UCITS under European guidelines is included in Appendix C.

Absolute VaR Test

As noted above, if a fund's derivatives risk manager is unable to identify an appropriate designated reference index, the Proposed Rule would require the use of the absolute VaR test. To comply with this test, the VaR of the fund's portfolio could not exceed 15% of the value of the fund's net assets.

The Proposing Release states, as an example of a fund that might need to use the absolute VaR test, that certain multi-strategy funds that manage their portfolios based on target volatilities but implement a variety of investment strategies may have difficulty identifying a single index or a blended index that would be appropriate.

The Proposing Release states that the Commission is proposing the 15% limit for the absolute VaR test to provide approximately comparable treatment for funds that would rely on the absolute VaR test and funds that rely on the relative VaR test while using the S&P 500 index as their designated reference index (where the VaR of the S&P 500 is approximately equal to its historical mean). The Proposing Release states that many investors may understand the risk inherent in the S&P 500 index or a similar index "as the level of risk inherent in the markets generally." An absolute VaR test set to approximate the level of risk of the S&P 500 "would therefore often approximate the level of risk that investors may understand, and frequently choose to undertake, through investments in funds."

The Proposing Release also states that the proposed absolute VaR test is broadly consistent with the regulatory framework that applies to UCITS in the European Union, although the absolute VaR test for UCITS funds sets a 20% limit. As noted above, a chart comparing the Proposed Rule's VaR tests and related requirements to the VaR-based approach that applies to UCITS under European guidelines is included in Appendix C.

Among other things, the Commission requests comment on whether the absolute VaR test requirement is appropriate and whether the proposed absolute VaR limit should be lower or higher than 15%. For example, 12, 18, 20, or 25%.

Choice of Calculation Model and Parameters for VaR Test

As noted above, the Proposed Rule would require each fund's VaR model to take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments. The definition of VaR under the

Proposed Rule sets forth a non-exhaustive list of market risk factors that a fund must account for in its model, if applicable, as set forth above.

The Proposing Release notes that VaR calculation models often fall within one of three modeling methods, historical simulation, Monte Carlo simulation or parametric models, and that a particular model may be more or less suitable, depending on a fund's strategy, investments and other factors. The Proposing Release states that the Commission believes that the derivatives risk manager should chose the appropriate VaR model for the fund's portfolio.

The Proposing Release further states that the requirement that a fund's VaR model use a 99% confidence level and 20 day time horizon is consistent with market practice and "similar to those in other VaR-based regulatory schemes," including for UCITS. The Proposing Release notes that the use of a relatively high confidence level and longer time horizon requirement means that "the VaR model is designed to measure, and seek to limit the severity of, those less-frequent but larger losses." The Proposing Release also highlights that the 99% confidence level is consistent with the confidence level under the risk-based limit based on VaR under the 2015 Proposed Rule.

The time horizon range would be fixed at 20 trading days rather than being from 10 to 20 trading days as under the 2015 Proposed Rule. The Proposing Release states that the Proposed Rule sets a fixed number of days given that some commenters suggested that the rule should specify a particular number of days and because the Proposed Rule includes an absolute VaR test. The Proposing Release states that the Commission recognizes that certain funds calculate their VaR over a one-day time horizon. The Proposing Release suggests that a fund may use a common VaR model time-scaling technique to convert a one-day VaR to the equivalent VaR for a 20-day time horizon for purposes of the applicable VaR test under the Proposed Rule. However, the Proposing Release also notes that use of this technique may be inappropriate as it may be inaccurate and result in meaningful underestimation of VaR for funds with returns that are not identically and independently normally distributed.

The Proposing Release also states that the requirement under the definition of VaR to use at least three years of historical market data "strikes an appropriate balance" and would permit the fund to base VaR estimates on a meaningful number of observations while recognizing that a longer period could make it too difficult to obtain historical data to estimate VaR.

In addition, the Commission noted in the Proposing Release that unlike the 2015 Proposed Rule, the Proposed Rule would not require a fund to apply its VaR model consistently when calculating the VaR of its portfolio and the VaR of its designated reference index (i.e., the Proposed Rule would not require a fund to use the same model applied in the same way). The Commission altered this aspect of the 2015 Proposed Rule because it came to believe that requiring such VaR model consistency could create significant costs for certain funds that are not outweighed by the marginally greater precision in testing than that in the Proposed Rule. The Proposing Release notes that the approach under the Proposed Rule could allow a fund to calculate the VaR of a designated reference index without having to obtain access to more detailed information about the index constituents, and that a fund would have the flexibility to obtain the VaR from a third-party vendor, each of which may have been precluded by a model consistency requirement.

Among other things, the Commission requests comment on whether the Proposed Rule should:

- Specify a particular VaR model(s) that funds would have to use (*i.e.*, a historical simulation, Monte Carlo simulation, or parametric methodology);
- Require a fund to use a 99% confidence level for its VaR model;

- Require a fund to use a time horizon of 20 trading days for its VaR model; and
- Require a fund's board to approve the VaR model and any material changes to the model (rather than leaving that to the derivatives risk manager).

Implementation – Testing Frequency and Remediation

As noted above, a fund would be required to determine its compliance with the applicable VaR test at least once each business day. If a fund determines that it is not in compliance with its VaR test, it must return to compliance within three business days. If after the three business days the fund remains non-compliant, then requirements regarding board reporting, Program analysis and updating and restrictions on entering into certain derivatives transactions would apply.

The Proposing Release states that these requirements reflect the Commission's view that it would be inappropriate for a fund to purposefully exceed the applicable VaR-based limit, while still allowing funds to take reasonable steps to come back into compliance. Thus, balancing investor protection concerns relating to leverage and the potential harm to a fund and its shareholders if the fund were required to take remediating steps more quickly.

The Proposing Release also notes that the three-business-day period is similar to the remediation approach provided under Section 18(f)(1) for asset coverage compliance with respect to bank borrowings.

Among other things, the Commission requests comment on whether the Proposed Rule's requirements:

- Related to VaR testing on an at least daily basis are appropriate;
- Should be revised to require funds to conduct the proposed daily test at the same time each business day; and
- For a three-business-day remediation period and related requirements are appropriate.

Economic Analysis

In its cost-benefit analysis, the Proposing Release states that the costs that the proposed VaR tests would impose on funds in the form of restrictions on the strategies a fund may employ are balanced against the anticipated benefits of the limit on fund leverage risk to fund investors, "to the extent that it would prevent these investors from experiencing unexpected losses from a fund's increased risk exposure that are prevented by the proposed VaR-based limit on fund leverage risk."

The Proposing Release estimates that "there would only be a very small number of funds, if any, that would have to adjust their portfolios in order to comply with the VaR-based limit on fund leverage risk."

The Proposing Release acknowledges a lack of data on the current expectations of investors as to fund risk and, in turn, on how such expectations would align with the VaR-based limit on fund leverage risk. According to the Proposing Release, the VaR-based limit could potentially attract further investment "if investors become more comfortable with funds' general level of riskiness as a result of funds' compliance with an outside limit on fund leverage risk" but may also lead to reduced investment levels if "investors see funds' general level of riskiness increasing after funds come into compliance with the proposed limits." The Proposing Release observes that one potential effect of the VaR-based limit would be increased investment in "alternative investment vehicles, exchange-traded notes, or structured products" at the expense of investments in registered funds for leveraged market exposure so as to avoid the VaR-based limit on fund leverage risk.

The Proposing Release estimates that the incremental annual cost associated with the VaR testing would range from "$5,000 to $100,000 per fund, depending on the particular facts and circumstances," with total additional annual industry costs estimated at $127,260,000.

Derivatives Condition 3: Board Approval, Oversight and Reporting

Board Approval of the Derivatives Risk Manager

The Proposed Rule would require a fund's board of directors, including a majority of the directors who are not interested persons of the fund, to approve the designation of the derivatives risk manager, taking into account the derivatives risk manager's relevant experience regarding the management of derivatives risk.

The Proposing Release states that the Commission believes that the board approval requirement will "establish the foundation for an effective relationship and line of communication between a fund's board and its derivatives risk manager."

The Proposing Release also states that the requirement that the board consider a derivatives risk manager's relevant experience "is designed to provide flexibility," as opposed to identifying a specific amount or type of experience that a derivatives risk manager would have to have. The Proposing Release further states that the Commission believes "that a fund's board, in its oversight role, is best-positioned to consider a prospective derivatives risk manager's experience based on all the facts and circumstances relevant to the fund when considering whether to approve the derivatives risk manager's designation."

The Commission requests comment on the Proposed Rule's requirement that a fund's board approve the designation of the fund's derivatives risk manager, including, among other things, whether a fund's board should be required to make such an approval, whether the Proposed Rule should permit a board committee to approve the designation, and whether the derivatives risk manager should be removable only by the fund's board.

Board Oversight Role with Respect to Compliance with the Proposed Rule

The Proposing Release states that the requirement that the board-approved derivatives risk manager be responsible for the day-to-day administration of the Program, subject to board oversight, is consistent with the way many funds currently manage derivatives risks. The Proposing Release also notes that the Commission believes that such a requirement is consistent with a board's duty to oversee other aspects of the management and operations of a fund.

The Proposing Release also states that the Commission believes that the board should: (1) "understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program;" (2) "ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation;" and (3) view oversight as an iterative process and therefore should "inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including risks that may change over time."

The Proposing Release notes that the fund's board would also be responsible for overseeing a fund's compliance with the Proposed Rule more generally. The Proposing Release notes that the requirements of Rule 38a-1 under the

1940 Act regarding board approval of fund policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers "would encompass [a board's responsibilities for overseeing] a fund's compliance obligations" with respect to the Proposed Rule.

The Commission requests comment on the board oversight role under the Proposed Rule, including, among other things, whether the Proposed Rule should require a fund's board or committee thereof to approve the Program or any material changes thereto, and, if a committee, whether the committee should be required to be composed of a majority of the directors who are not interested persons of the fund.

Board Reporting

To facilitate the board's oversight role, the Proposed Rule would require the derivatives risk manager to have a direct reporting line to the fund's board and to provide the board with certain required reports.

On or before implementation of the Program, and at least annually thereafter, the derivatives risk manager would have to provide the board a written report that provides a representation that the fund's Program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the Program. This representation may be based on the derivatives risk manager's reasonable belief after due inquiry. The report would have to include the basis for the representation and information that may be reasonably necessary to evaluate the adequacy of the fund's Program and the effectiveness of its implementation. The report also would have to include the derivatives risk manager's basis for the selection of the designated reference index used under the relative VaR test or, if applicable, an explanation of why the derivatives risk manager was unable to identify a designated reference index appropriate for the fund such that the fund relied on the absolute VaR test.

In addition, the derivatives risk manager would have to provide to the board, at a frequency determined by the board, a written report regarding the derivatives risk manager's analysis of any exceedances of the fund's Guidelines and the results of the fund's stress tests and backtesting.

The Proposing Release states that requiring the derivatives risk manager to include a representation regarding the Program and the derivatives risk manager's basis for such representation in the Program implementation and effectiveness in the report reflects the Commission's belief that "the derivatives risk manager—rather than the board—is best positioned to make this determination" and would "reinforce that the fund and its adviser are responsible for derivatives risk management while the board's responsibility is to oversee this activity." Further, the Commission believes that requiring these reports following the initial implementation of the Program will provide the board with "appropriate and useful information so it can exercise its judgment in overseeing the program … in light of its role under Rule 38a-1."

The Proposing Release states that the Commission understands that "many fund advisers today provide regular reports to fund boards, often in connection with quarterly board meetings, regarding a fund's use of derivatives and their effects on a fund's portfolio, among other information." Accordingly, the Proposing Release states that the Proposed Rule's requirement for reporting on exceedances and results "is designed to provide the board with timely information to facilitate its oversight of the fund and the operation of the program." Further, the Proposing Release states that the Commission believes that by requiring the report on exceedances and results to include the derivatives risk manager's analysis, rather than a "simple listing" of testing results, the Proposed Rule aims to ensure the board receives "information in a format, and with appropriate context, that would facilitate the board's understanding of the information."

The Commission requests comment on the proposed board reporting requirements, including, among other things, whether a fund's board should be provided with implementation and effectiveness reports with greater frequency than annually, whether requiring the derivatives risk manager to include a representation in the implementation and effectiveness reports is appropriate, and whether the Proposed Rule should permit a fund's board to determine the frequency of reporting on exceedances and results.

Limited Derivatives User Exception

Under the limited derivatives user exception, a fund would not be required to adopt a Program or comply with the limit on fund leverage risk if:

1. The fund adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risk; and

2. (i) The fund's derivatives exposure does not exceed 10% of the fund's net assets (the "exposure-based exception") or (ii) the fund limits its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held by the fund, provided that the currency derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount (the "currency hedging exception").

Exposure-Based Exception

For the exposure-based exception, "derivatives exposure" is generally defined as the sum of the notional amounts of the fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short. The definition further provides that, in determining derivatives exposure, a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts. [22]

The Proposing Release notes that the Commission recognizes that a notional-based definition "could be viewed as a relatively blunt instrument" when applied across different asset classes, but also states that the threshold is not designed to be precise and rather would serve as an efficient way to identify limited derivatives users. However, the two adjustments to the calculation of a fund's derivatives exposure would address certain limitations on the use of a notional measure for exposure. [23] The Proposing Release explains that the adjustments are "designed to provide for more tailored notional amounts that better reflect the exposure that a derivative creates to the underlying reference asset." The Proposing Release also notes that the adjustments are consistent with the existing reporting requirements for such derivatives transactions in Form ADV and Form PF.

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22 The Proposing Release provides that,"[d]elta 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."

23 The Proposing Release states that permitting funds to convert interest rate derivatives to 10-year bond equivalents is designed to result in adjusted notional amounts that better represent a fund's exposure to interest rate changes and to delta adjust options is designed to provide for a more tailored notional amount that better reflects the exposure that an option creates to the underlying reference asset.

The intention of setting the proposed threshold at 10% is to exclude from the Program requirement and the VaR-based limit on fund leverage risk those funds whose derivatives exposure is truly relatively limited. The Proposing Release states that the proposed 10% exposure threshold is in part based on the DERA staff's analysis of funds' use of derivatives as reported on Form N-PORT for funds other than BDCs and a review of the holdings of a sampling of BDCs.[24] The Proposing Release also notes the DERA staff's finding that increasing the threshold to 25% derivatives exposure, for example, would only slightly increase the overall percentage of funds eligible for the exception.[25]

The Proposing Release notes that the 2015 Proposed Rule also included a limited derivatives user exception from the Program requirement for funds (1) whose notional derivatives exposure do not exceed 50% of net assets and (2) that do not enter into "complex derivatives transactions."

The 2015 Proposed Rule did not permit notional adjustments for interest rate derivatives, although it did include delta adjustments for options. The Proposing Release explains that the Commission believes the currently proposed 10% derivatives exposure threshold, with the proposed adjustments, "would more effectively identify funds whose derivatives may be effectively managed without a fund needing to establish a derivatives risk management program that includes all of the proposed program elements."[26]

Unlike the 2015 Proposed Rule, the Proposed Rule would not prohibit investments in complex derivatives transactions by limited derivatives users. The Proposing Release explains that the risks presented by complex derivatives transactions are appropriately addressed by other means in the current Proposed Rule, noting that: (1) funds relying on the exception would be required to adopt policies and procedures to "manage all of the risks associated with their derivatives transactions, including any complex derivatives transactions;" (2) if a fund invests in complex derivatives transactions and "could not reliably compute the transaction's notional amount, the fund would not be able to confirm that its derivatives exposure is below 10% of the fund's net assets and therefore would not be able to rely on the limited derivatives user exception;" and (3) if a fund's investment in complex derivatives transactions caused the fund to exceed the 10% derivatives exposure threshold, the fund would either have to reduce its derivatives exposure "promptly" or comply with the Program and limit on fund leverage risk requirements.

The Proposing Release notes that the Commission considered other approaches to identify limited derivatives users, including defining limited derivatives users as funds whose "principal investment strategies disclosed in [their prospectuses] do not involve the use of derivatives." The Proposing Release states that the Commission concluded that a "uniform metric of a fund's derivatives exposure" rather than a "facts-and circumstances-based analysis" would more appropriately and consistently identify funds that should qualify for the limited derivatives user exception.

The discussion in the Proposing Release regarding a fund relying on the exposure-based exception that invests in complex derivatives transactions highlights that the Proposed Rule does not include a provision addressing

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24 The Proposing Release acknowledges that smaller fund complexes are not yet required to file Form N-PORT data, but based on a comparison of the results of the DERA staff analysis of N-PORT data compared to its previous analysis of a representative sample studied in connection with the 2015 Proposed Rule, the Proposing Release states that it appears that the relative derivatives use of smaller fund complexes is generally consistent with that of larger fund complexes.

25 The Proposing Release reports that, "DERA staff's analysis showed that 78% of funds have adjusted notional amounts below 10% of NAV; 80% of funds have adjusted notional amounts below 15% of NAV; 81% of funds have adjusted notional amounts below 20% of NAV; and 82% of funds have adjusted notional amounts below 25% of NAV."

26 In this regard, the Proposing Release notes that the approach in the 2015 Proposed Rule "could have permitted some funds to rely on the exception while still taking on significant derivatives risks, while disqualifying other funds whose derivatives transactions may have posed less-significant risks but that had high unadjusted notional amounts."

exceedances of the 10% threshold or remediation. Instead, as noted above, the Proposing Release states that the fund would have to "promptly" reduce its derivatives exposure to the 10% threshold or comply with the Program and limit on fund leverage risk requirements.

The Commission requests comment on whether 10% derivatives exposure is an appropriate threshold and whether the exception should instead be based on a disclosure-based test. In addition, the Commission requests comment regarding its proposed notional adjustments and whether the notional adjustments should be permitted for other types of derivatives or to account for netting and hedging transactions and other related matters. The Commission also requests feedback on certain issues relating to complex derivatives.

Additionally, the Commission requests comment on whether the Proposed Rule should provide a specific time period for taking remedial actions if a fund exceeds the 10% threshold, whether the Proposed Rule should provide that a fund relying on the exposure-based exception should have to adopt a policy that, under normal circumstances, the fund will comply with the 10% threshold, whether the Proposed Rule should prohibit a fund whose derivatives exposure repeatedly exceeds the 10% threshold from relying on the exposure-based exception, and whether additional notional adjustments or adjustments to account for netting and hedging transactions would be appropriate. The Commission also requests comment on whether the Proposed Rule should specify the frequency that a fund calculates its notional amounts and confirms compliance with the 10% threshold.

Currency Hedging Exception

With regard to the currency hedging exception, the Proposing Release states that this exception reflects the Commission's view that a fund's use of currency derivatives for hedging the fund's foreign currency risk does not raise the concerns underlying Section 18. The Proposing Release also notes that, while it is generally difficult to distinguish "most hedging transactions from leveraged or speculative transactions," the Commission believes that currency hedging "is definable because it only involves one risk factor (currency risk) and requires that the derivatives instrument must be tied to specific hedged investments (foreign-currency-denominated investments)." The Proposing Release also notes that the Commission recognizes that currency hedges are not intended to create leverage and could mitigate potential losses.

The Proposing Release explains that the Commission considered allowing a fund to rely on the exposure-based exception if the notional amount of the fund's derivatives transactions, excluding currency hedges, was below 10% of its net assets. The Proposing Release states that the Commission determined instead to adopt two separate bases for qualifying for the limited derivatives user exception "to preclude a fund that is operating as a limited derivatives user from engaging in a broad range of derivatives transactions" that the Commission believes should be addressed through the Program and limit on fund leverage risk requirements. Accordingly, a fund that invests in both currency derivatives and other types of derivatives would only be eligible to rely on the limited derivatives user exception if the total notional amount of its derivatives exposure, including currency derivatives, is below 10% of its net assets.

The Commission requests comment on the currency hedging exception, including whether there are other types of derivatives that are less likely to raise the policy concerns underlying Section 18 such as interest rate derivatives used to hedge fixed income investments, and how they could fit into a hedging exception, whether the Proposed Rule should address situations where the notional value of a fund's currency derivatives exceeds the fund's net assets or what level of exceedance would be "negligible," and whether the Proposed Rule should permit funds relying on the exposure-based exception to exclude currency hedges in assessing compliance with the 10% threshold.

Policies and Procedures Reasonably Designed to Manage Derivatives Risk

As noted above, each fund relying on the limited derivatives user exception would be required to adopt and implement principles-based policies and procedures reflecting "the extent and nature of a fund's use of derivatives" and designed to address all derivatives risks that the fund's investment adviser believes to be material for the fund. The Proposing Release states that requiring limited derivatives users to comply with the Program requirement "could potentially require funds (and therefore their shareholders) to incur costs and bear compliance burdens that may be disproportionate to the resulting benefits."

For these purposes, the definition of derivatives risks in the Proposed Rule would include "any other risks" deemed material by the fund's investment adviser. The Proposing Release notes that this distinction from the definition of derivatives risks as applied to the Program requirement is included in the Proposed Rule "because a fund that is a limited derivatives user would be exempt from the requirement to adopt a program (and therefore also exempt from the requirement to have a derivatives risk manager)."

The Proposing Release notes that the exception for limited derivatives users under the 2015 Proposed Rule would have required funds "to manage derivatives risks by determining (and maintaining certain assets to cover) a 'risk-based coverage amount' associated with the fund's derivatives." By contrast, the Proposing Release states that the current proposed approach with respect to risk management "is designed to require a fund relying on the limited derivatives user exception to manage all of the risks associated with its derivatives transactions, and not just the risks that an asset segregation requirement could address."

The Proposing Release explains the Commission's view that each of the two separate bases for the proposed exposure-based exception and currency hedging exception, together with the requirement to adopt risk management policies and procedures, "would provide both important investor protections and flexibility for funds to use derivatives in a way that is consistent with the policy concerns underlying Section 18."

The Commission requests comment on the policies and procedures requirement, including whether applying the policies and procedures requirement under the limited derivatives user exception, as opposed to the Program and limit on fund leverage risk requirements, would be appropriate, and whether the proposed requirement should be replaced with a tailored version of the Program requirement. The Commission requests comment on whether the policies and procedures requirement should be augmented or replaced by an asset segregation requirement and, if so, what assets could be segregated. The Commission also requests comment on whether the Proposed Rule should require limited derivatives users to publicly disclose this status and any related risks and other matters in their prospectuses, annual reports or websites.

Economic Analysis

The Proposing Release estimates that the one-time costs associated with establishing and implementing the principles-based policies and procedures for funds that are limited derivatives users required under the Proposed Rule would range from "$1,000 to $100,000 per fund per fund, depending on the particular facts and circumstances," with ongoing annual costs ranging from 65% to 75% of such one-time costs. The Proposing Release acknowledges that there is not yet any developed data reflecting how many funds currently have a program in place that would "substantially satisfy the proposed rule's requirement." Accordingly, the Proposing Release is seeking comment on whether most funds do already have policies and procedures in place that substantially satisfy the Proposed Rule's requirements and, if so, how many.

The Proposing Release also notes that funds seeking to avail themselves of the limited derivatives user exception may reduce or forgo their usage of certain derivatives in order qualify as a limited derivatives user. For example, "a fund with derivatives exposure just below 10% of its net assets may forego taking on additional derivatives positions, or a fund with derivatives exposure just above 10% of its net assets may close out some existing derivatives positions."

Alternative Requirements for Leveraged/Inverse Funds Trading in Derivatives

Under the alternative requirements for leveraged/inverse funds, a fund is not required to comply with the limit on fund leverage risk if:

1. the fund meets the definition of a "leveraged/inverse investment vehicle;"
2. the fund discloses in its prospectus that it is not subject to the limit on fund leverage risk; and
3. the fund does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index.

The term leveraged/inverse investment vehicle is defined, in relevant part, as a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.[27]

Unique Structure of Leveraged/Inverse Funds

As described in the Proposing Release, leveraged/inverse funds currently are primarily structured as ETFs. The Proposing Release notes that leveraged/inverse funds are (1) "designed to hedge against or profit from short-term market movements without using margin, and, as such, are generally intended as short-term trading tools," (2) use derivatives extensively and (3) have strategies and use derivatives in a manner "predicated on leverage." The Proposing Release notes that, as a result, leveraged/inverse funds "raise issues that Section 18 is designed to address."

The Proposing Release also identifies unique considerations raised by the fact that a leveraged/inverse fund typically rebalances its portfolio daily so that it can maintain a consistent leverage ratio. The Proposing Release explains that this rebalancing along with "the effects of compounding, can result in performance over longer holding periods that differs significantly from the leveraged or inverse performance of the underlying reference index over those longer holding periods," and that these effects may be magnified during times of market volatility. Consequently, the Proposing Release states that investors who hold their positions in leveraged/inverse funds over an intermediate or

[27] *See Proposed New Exchange Act and Advisers Act Sales Practices Rules* below for the full definition under the sales practices rules.

long-term period " – and who may not evaluate their portfolios frequently – may experience large and unexpected losses or otherwise experience returns that are different from what they anticipated." [28]

The Proposing Release discusses that, because leveraged/inverse funds generally seek to provide leveraged or inverse market exposure of up to 300% of the returns or inverse returns of an index, such funds could not continue to operate as they currently do while also satisfying the relative VaR test of 150% and would not be eligible to use the absolute VaR test. Requiring compliance with the limit on fund leverage risk therefore "effectively would preclude sponsors from offering the funds in their current form." The Proposing Release acknowledges, however, that such funds may be desirable investments for certain "investors who are capable of evaluating these funds' characteristics and their unique risks" and may want to use them to meet certain short-term or other investment objectives.

The Proposing Release states that the Commission is therefore proposing alternative requirements for leveraged/inverse funds "to address the investor protection concerns that underlie Section 18" and maintain investor choice. The Proposing Release further states that the alternative requirements for leveraged/inverse funds are designed to help ensure that retail investors "are limited to those who are capable of evaluating the general characteristics and unique risks" presented and also to limit the amount of leverage that leveraged/inverse funds can obtain to current levels.

The Proposing Release states that the first condition of the alternative requirements would ensure that the sales practices rules apply to help make sure that investors in these funds are capable of evaluating their characteristics and risks. The sales practices rules applicable to leveraged/inverse investment vehicles are discussed in detail under *Proposed New Exchange Act and Advisers Act Sales Practices Rules* below.

The Proposing Release states that the 300% limitation under the second condition of the alternative requirements aligns with "the highest leverage level currently permitted by [the Commission's] exemptive orders for leveraged/inverse ETFs" and "therefore reflects the maximum amount of leverage in these funds with which investors and other market participants are familiar." The Proposing release notes that permitting leveraged/inverse funds to obtain higher levels of leverage would "heighten the investor protection concerns these funds present" notwithstanding the limits on the investor base under the first condition, and would result in a "non-linear increase" of rebalancing activity by such funds that could "have adverse effects on the markets for the constituent securities." The Proposing Release also notes that the Commission does not have experience with leveraged/inverse funds seeking higher levels of return.

With respect to the third condition of the alternative requirements, the Proposing Release explains that the prospectus disclosure requirement "is designed to provide investors and the market with information to clarify that leveraged/inverse funds…are not subject to rule 18f-4's limit on fund leverage risk."

Importantly, a leveraged/inverse fund that satisfies the conditions of the alternative requirements would still need to comply with the other requirements of the Proposed Rule, including the Program, board oversight, reporting and recordkeeping requirements.

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28 The Proposing Release goes on to cite certain alerts issued by the Commission's Office of Investor Education and Advocacy and FINRA in the past and certain comments on the 2015 Proposed Rule highlighting investors that have held such funds for long periods of time, and more recent Commission enforcement actions against investment advisers relating to holding securities of leveraged/inverse funds in client retirement accounts for a long period of time.

The Commission requests comment on each of the conditions of the alternative requirements and, among other things, on whether leveraged/inverse funds operating in compliance with the alternative requirements should, as proposed, be subject to the requirements the Proposed Rule other than the limit on fund leverage, whether any other percent threshold return would be more appropriate than 300%, and whether the scope of leveraged/inverse funds eligible for the alternative requirements should be limited to open-end funds.

Reverse Repurchase Agreements and Similar Financing Transactions

Reverse repurchase agreements and other similar financing transactions would not be treated in the same manner as derivatives transactions or unfunded commitment agreements under the Proposed Rule.

The Proposed Rule would allow a fund to enter into reverse repurchase agreements or similar financing transactions, notwithstanding the requirements of Sections 18(c) and 18(f)(1) of the 1940 Act, if the fund complies with the asset coverage requirements of Section 18 and combines the aggregate amount of indebtedness associated with the reverse repurchase agreement or similar financing transaction with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.

A reverse repurchase agreement is a transaction by which a fund transfers a security to another party in return for cash or other assets in an amount equal to a percentage of the value of the security sold, and then repurchases the transferred security from the other party, at a later agreed-upon date, by paying an amount equal to the proceeds of the initial sale transaction plus interest. The Proposing Release notes that reverse repurchase agreements are used by funds as a means to obtain financing and are economically equivalent to a secured borrowing.

The Proposing Release notes that such transactions can have a leveraging effect on a fund's portfolio to the extent that the proceeds of the transactions are used to purchase additional investments and can raise Section 18 asset sufficiency concerns with respect to the fund's return obligation under the transactions. The Proposing Release states that, because reverse repurchase agreements and other similar financing transactions "achieve effectively identical results" as bank borrowings, the Commission believes that reverse repurchase agreements and other similar financing transactions should be treated for Section 18 purposes like a bank borrowing or other borrowing.

Notably, for funds that are limited derivatives users, reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under relevant limited derivatives user provisions. However, for funds subject to VaR testing, reverse repurchase agreements and similar financing transactions would be included for the purposes of such testing because the proposed VaR tests estimate a fund's risk of loss taking into account all of its investments, including the proceeds of reverse repurchase agreements and similar financing transactions. [29]

The Proposing Release provides the Commission's views on two categories of transactions that may potentially be considered "similar financing transactions" under the Proposed Rule.

- The Commission would not view the obligation to return securities lending collateral as a similar financing transaction "so long as the obligation relates to an agreement under which a fund engages in securities

29 On the other hand, a fund would need to include securities lending activity when calculating its asset coverage ratio if it were to "invest the cash collateral in securities other than cash or cash equivalents," which "may result in leveraging of the fund's portfolio."

lending, the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests cash collateral solely in cash or cash equivalents."

- The Commission believes that determining whether a tender option bond (TOB) financing is a similar financing transaction would depend on the facts and circumstances. "To the extent a fund concludes that there are economic similarities between a TOB financing and a reverse repurchase agreement, the fund should treat obligations with respect to the TOB financing as a similar financing transaction under the proposed rule."

Among other things, the Commission requests comment on whether the Proposed Rule should:

- Treat reverse repurchase agreements and similar financing transactions as economically equivalent to bank borrowings under section 18; or
- Treat reverse repurchase agreements and similar financing transactions as derivatives transactions.

Economic Analysis

The cost-benefit analysis in the Proposing Release notes that the Proposed Rule would require that reverse repurchase agreements and similar financing transactions be combined for purposes of determining a fund's compliance with Section 18's asset coverage requirement. A fund could previously have analyzed these transactions separately. The Proposing Release's cost-benefit analysis notes that this "may have the effect of limiting the overall scale of these transactions." However, the Proposing Release estimates based on Form N-PORT filings that only 45 total funds, representing approximately 0.36% of all funds that would be subject to the Proposed Rule, used these transactions in combined amounts exceeding the asset coverage requirement.

Unfunded Commitment Agreements

Because, among other reasons, the Commission believes that unfunded commitment agreements generally do not have a leveraging effect on a fund's portfolio, unfunded commitment agreements would not be considered derivatives transactions under the Proposed Rule. Unfunded commitment agreements also would not be treated in the same manner as reverse repurchase agreements under the Proposed Rule.

As noted above, an unfunded commitment agreement is a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.

Under the Proposed Rule, a fund would be permitted to enter into an unfunded commitment agreement, notwithstanding the requirements of Sections 18(a), 18(c), 18(f)(1) and 61 of the 1940 Act, if the fund reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as it comes due.

In forming a reasonable belief, the Proposed Rule would require that a fund must:

- Take into account the fund's reasonable expectations with respect to other obligations (including with respect to senior securities or redemptions);

- Not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments; and
- Not take into account cash that may become available from issuing additional equity.

The Proposing Release states that a fund would not be precluded from considering the potential issuance of debt to support a reasonable belief, and notes the Commission's understanding that funds often satisfy their obligations under such agreements through borrowings. In addition, the Proposing Release states that a fund may consider its strategy, the liquidity of its portfolio assets, its borrowing capacity under existing committed lines of credit, and the contractual provisions of its unfunded commitment agreements. In addition, a fund with existing unfunded loan commitments could evaluate the likelihood that borrowers would have to satisfy contractual milestones as a condition to the obligation to fund a loan, informed by the fund's experience with comparable obligations.

The Proposing Release notes that the 2015 Proposed Rule would have treated these agreements as "financial commitment transactions," meaning the fund's obligations under these agreements could not have exceeded the value of the fund's net assets. The Proposing Release acknowledges comments distinguishing these agreements from other categories of financial commitment transactions as defined under the 2015 Proposed Rule, such as reverse repurchase agreements. [30] The Proposing Release states that the Commission agrees that these factors distinguish unfunded commitment agreements from the derivatives transactions covered by the Proposed Rule. The Proposing Release also states that the Commission does not believe that such unfunded commitment agreements generally raise concerns regarding undue speculation underlying the 1940 Act.

However, the Proposing Release notes that an unfunded commitment agreement may potentially raise asset sufficiency concerns underlying the 1940 Act, which is the basis for the proposed condition included in the Proposed Rule. The Proposing Release also notes that the proposed approach reflects the staff's experience in the process of reviewing disclosure regarding unfunded commitment agreements.

Among other things, the Commission requests comment on whether the Proposed Rule's approach to unfunded commitment agreements is appropriate, as well as whether the Proposed Rule should otherwise limit funds' use of unfunded commitment agreements.

Economic Analysis

In its cost-benefit analysis, the Proposing Release states a view that the Proposed Rule's treatment of unfunded commitment agreements would not pose any significant economic effects or represent a change from the current baseline of general market practices, although "there may be some variation in the specific factors applied."

Proposed New Exchange Act and Advisers Act Sales Practices Rules

In tandem with proposing Rule 18f-4, the Commission also proposed new Rule 15*l*-2 under the Exchange Act and new Rule 211(h)-1 under the Advisers Act (together, the sales practices rules). The Proposing Release explains that

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30 The reasons presented by the commenters included (1) a fund often does not expect to lend or invest up to the full amount committed, (2) a fund's obligation to lend is commonly subject to conditions not typically present under the types of agreements described in Release 10666, and (3) unfunded commitment agreements do not give rise to the risks that Release 10666 identified and do not have a leveraging effect because they do not present an opportunity for the fund to realize gains or losses between the commitment date and the date when the other party calls the commitment.

"most" leveraged/inverse funds would be unable to satisfy Rule 18f-4, so the Commission is "proposing a set of alternative requirements" to protect investors and to allow sales of interests in such vehicles to continue. Under the proposed sales practices rules, before a broker-dealer or investment adviser (collectively, firm)[31] could, respectively, accept an order from or place an order for a retail investor (defined below) involving shares of a leveraged/inverse investment vehicle (defined below), the firm would have to "approve the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement," adopt and implement certain policies and procedures and make and maintain certain records.

Under the proposed sales practices rules, a "leveraged/inverse investment vehicle" is defined as "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time."[32] Accordingly, the definition of "leveraged/inverse investment vehicle" for purposes of the proposed sales practices rules would cover a wider range of investment vehicles than those eligible for the alternative requirements available to "leveraged/inverse funds" under the Proposed Rule, in that the definition in the proposed sales practices rules also includes exchange-listed commodity- or currency-based trusts or funds.[33] The Proposing Release states such vehicles are "short-term trading tools" with strategies "predicated on leverage" that are rebalanced daily, such that "performance over longer holding periods" can significantly diverge from the underlying reference index. In particular, the proposed sales practices rules are "designed to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating the risks these products present."

Due Diligence and Account Approval Requirements

Under the proposed sales practices rules, a firm would have to exercise due diligence on a customer or client who is a natural person (or the legal representative[34] of a natural person – together, a retail investor)[35] prior to accepting, placing or approving the retail investor's account to buy or sell leveraged/inverse investment vehicles. The due

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31 The Proposing Release states that the term "firm" "collectively refers to Commission-registered broker-dealers and investment advisers" as well as "associated persons of such broker-dealers" and "supervised persons of such investment advisers."

32 Commodity- or currency-based trust or fund means a trust or other person: (1) issuing securities in an offering registered under the Securities Act of 1933 and which class of securities is listed for trading on a national securities exchange; (2) the assets of which consist primarily of derivatives instruments that reference commodities or currencies, or interests in the foregoing; and (3) that provides in its registration statement under the Securities Act of 1933 that a class of its securities are purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets.

33 Note this definition excludes trusts or funds that hold only commodities and currencies.

34 The Proposing Release includes "non-professional" legal representatives, such as "certain legal entities such as trusts that represent the assets of a natural person," but excludes institutions and certain professional fiduciaries.

35 The proposed sales practices rules do not incorporate by reference or directly track the definition of "retail customer" in Regulation Best Interest or "retail investor" in Form CRS, but introduce a variation of those definitions that is not limited by whether the transaction or account is "primarily for personal, family, or household purposes." In the Commission's companion interpretative release regarding an investment adviser's standard of conduct, the Commission did not define "retail client;" however, the Commission suggested that the nature and scope of duties owed, and how those duties are discharged, require consideration of the client's sophistication (rather than merely whether the client is a natural person). Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669 (July 12, 2019).

diligence requirement provides that a firm "must seek to obtain, at a minimum, certain information" regarding a retail investor's:

- **Financial situation:** employment status (*i.e.*, name of employer, self-employed or retired); estimated annual income from all sources; estimated net worth (exclusive of family residence); and estimated liquid net worth (cash, liquid securities, other); and

- **Investment objective and experience**: investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon; percentage of the retail investor's liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding certain financial products (leveraged/inverse investment vehicles, options, stocks and bonds, commodities).

On the basis of the retail investor's information, the proposed sales practices rules would require a firm to "have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles" and "specifically to approve or disapprove" the retail investor's account to engage in such transactions based on all relevant facts and circumstances. Firms would also be required to issue approvals in writing. Significantly, the proposed sales practices rules would apply without regard to whether a recommendation or investment advice is provided to the retail investor, including to self-directed brokerage transactions.

In the Proposing Release, the Commission analogized the proposed sales practices rules to FINRA's existing options account approval process, which similarly requires initial account-level approval (instead of transaction-by-transaction approvals). The Proposing Release acknowledges that the "approach may provide some efficiencies and reduced compliance costs for broker-dealers that already have compliance procedures in place for approving options accounts, although we recognize that these efficiencies and reduced compliance costs would not apply to investment advisers that are not dually registered as, or affiliated with, broker-dealers subject to FINRA rules." [36] Additionally, the Proposing Release suggests that a firm could determine that it is appropriate to adopt different levels of approvals based on the trading experience, financial sophistication and/or leveraged/inverse investment vehicle itself (*e.g.*, products with lower leverage and volatility).

Consistent with the Commission's approach in Regulation Best Interest, proposed Exchange Act Rule 15*l*-1 would not exclude sophisticated or high net worth investors from the scope of covered customers. Moreover, proposed Advisers Act Rule 211(h)-1 would effectively import the definition of "retail customer" from Regulation Best Interest (and "retail investor" from Form CRS) and would apply this definition to investment advisers' placement or approval of a retail investor's transaction in a leveraged/inverse investment vehicle, "to establish a single, uniform set of enhanced due diligence and approval requirements" for firms. The Proposing Release also states that "[c]ompliance with the proposed rules would not supplant or by itself satisfy other broker-dealer or investment adviser obligations, such as a broker-dealer's obligations under Regulation Best Interest or an investment adviser's fiduciary duty under the Advisers Act."

Among other things, the Commission requested comment on the scope of the sales practices rules, including whether the sales practices rules should apply to retail investors or be narrowed to exclude accredited investors or expanded

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36 In addition, the Proposing Release's cost-benefit analysis explains the estimated total one-time costs for a broker-dealer or investment adviser under these proposed requirements "would range from $9,116 to $15,193," with estimated total ongoing costs ranging "from $2,271 to $3,915 per year."

to include institutional investors, whether the information requested that mirrors FINRA rules should more generally track Regulation Best Interest definition of "retail customer investment profile," whether the standard should be to "seek to obtain" the information instead of obtaining it, and whether the leveraged/inverse investment vehicle definition is appropriate or if additional complex financial products similar to FINRA Regulatory Notice 12-03 should be subject to the same standards. The Commission also requested comment as to whether the same rules should apply to broker-dealers and investment advisers (*e.g.*, to investment advisers with discretionary and non-discretionary authority, and to firms where transactions are client-directed without any recommendation or advice), whether such rules are necessary in light of an investment adviser's fiduciary duty and when a broker-dealer's recommendations are subject to Regulation Best Interest, and how the rules should apply in specific situations (*e.g.*, when a broker-dealer is asked to transact on behalf of an investment adviser's client).

Policies and Procedures and Recordkeeping Requirements

The proposed sales practices rules would require written policies and procedures reasonably designed to achieve compliance with the proposed sales practices rules, but the Commission did not propose to "impose specific requirements." The Proposing Release also states that any multi-tier account approval process should be included in a firm's policies and procedures.

The proposed sales practices rules would require firms to maintain certain records for six years (the first two years in an easily accessible place) following the closing of a retail investor's account, including the: (1) investor information related to the proposed due diligence requirements; (2) written approval of such retail investor's account; and (3) version(s) of the firm's policies and procedures as required under the sales practices rules in place related to the account approval or disapproval.

The requirement that firms maintain such records for at least six years after an account closing is generally inconsistent with the recordkeeping rules governing investment advisers.[37] The requirement is, however, consistent with Rule 17a-4(c) under the Exchange Act, which requires broker-dealers to maintain customer account information for not less than six years after the closing of a customer's account.

Proposed Amendments to Rule 6c-11 under the 1940 Act

Earlier this year, the Commission adopted Rule 6c-11 under the 1940 Act, which permits ETFs that satisfy certain conditions to operate without first obtaining an individual exemptive order from the Commission.[38] In its current form, Rule 6c-11 excludes leveraged/inverse ETFs from its scope.[39] In connection with the Proposed Rule, however, the Commission proposed amendments to Rule 6c-11 that would allow leveraged/inverse ETFs to rely on that rule,

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37 Pursuant to Rule 204-2 under the Advisers Act, investment advisers must maintain records for at least five years from the end of the fiscal year during which the last entry was made on the respective record.

38 For a detailed discussion of Rule 6c-11, please refer to *Dechert OnPoint*, SEC Adopts Final ETF Rule and Issues Related Exchange Act Relief.

39 In the adopting release for Rule 6c-11, the Commission explained that leveraged/inverse ETFs "serve markedly different investment purposes than other ETFs" and raise issues under Section 18 of the 1940 Act that the Commission had been evaluating as part of its "broader consideration of derivatives use by registered funds and [BDCs]." Exchange-Traded Funds, SEC Rel. No. IC-33646 (Sept. 25, 2019).

subject to certain conditions, including those discussed above in *Alternative Requirements for Leveraged/Inverse Funds Trading in Derivatives.*

Because leveraged/inverse ETFs would become eligible to rely on Rule 6c-11, the Commission is also proposing to rescind the exemptive orders previously issued to the sponsors of such ETFs. The Commission has proposed to delay the effective date of the amendments to Rule 6c-11 and the rescission of existing exemptive orders for one year following the publication of any final rule amendments in the Federal Register.

For purposes of Rule 6c-11, "leveraged/inverse ETFs" are defined as ETFs that seek "directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time."

In proposing the amendments to Rule 6c-11, the Commission states that the concerns which formed the basis for excluding leveraged/inverse ETFs from Rule 6c-11 would be sufficiently addressed by the Proposed Rule and the proposed sales practices rules. In addition, the Commission notes that permitting leveraged/inverse ETFs to rely on Rule 6c-11 and rescinding the existing exemptive orders "would promote a level playing field by allowing any sponsor (in addition to sponsors currently granted exemptive orders) to form and launch a leveraged/inverse ETF subject to the conditions in Rule 6c-11 and proposed Rule 18f-4, with transactions in the fund subject to the proposed sales practices rules." In this regard, the proposed amendments represent the first movement on the Commission's part in many years towards allowing sponsors who do not currently offer leveraged/inverse ETFs to begin doing so, as the Commission staff has not granted any new exemptive orders for leveraged/inverse ETFs since 2009.

Amendments to Fund Reporting Requirements

The Commission is proposing amendments to Forms N-PORT, N-LIQUID and N-CEN that are "designed to enhance the Commission's ability to oversee funds' use of and compliance with the proposed rules effectively, and for the Commission and the public to have greater insight into the impact that funds' use of derivatives would have on their portfolios."

Amendments to Form N-PORT

Derivatives Exposure

The proposed amendments to Form N-PORT would add a new reporting item regarding funds' derivatives exposure as of the end of the reporting period.[40] The Commission is not proposing to make any of the derivatives-related information non-public, but this information reported on this monthly reporting form would be publicly available only for the third month of each fund's fiscal quarter. The Commission believes that making this information publicly available "would provide market-wide insight into the levels of funds' derivatives exposure to the Commission, its staff, and market participants" and "would allow the Commission and its staff to oversee and monitor compliance with the proposed rule's exception for limited derivatives users."

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40 *See* proposed Item B.9 of Form N-PORT; *see also* proposed amendments to General Instruction E to Form N-PORT (adding a new definition for "derivatives exposure," as defined in the Proposed Rule, which would permit a fund to convert the notional amounts of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts).

VaR Information

The proposed amendment would also add a new reporting item requiring that funds (other than BDCs, which are not required to file Form N-PORT) that are subject to the proposed VaR-based limit on fund leverage risk report the fund's highest daily VaR during the reporting period and its corresponding date, as well as their median daily VaR for the monthly reporting period. Funds subject to the relative VaR test during the reporting period would report the name of the fund's designated reference index and the relevant index identifier, as well as the fund's highest daily VaR ratio (the value of the fund's portfolio VaR divided by the VaR of the designated reference index) during the reporting period and its corresponding date, and the fund's median daily VaR ratio for the reporting period.

In addition, relevant funds would also have to report the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model. Information reported for the third month of each fund's fiscal quarter on Form N-PORT will be made publicly available 60 days after the end of the fiscal quarter.

The Commission seeks comment on, among other things, whether the proposed requirement that funds report their derivatives exposure and VaR information on Form N-PORT is appropriate, whether there is reason not to make public the information that a fund would report in response to the new derivatives exposure and VaR information Form N-PORT items, and whether any of the proposed N-PORT reporting requirements would be more appropriately reported on other forms.

Amendments to Form N-LIQUID (Form N-RN)

The proposed amendments would retitle Form N-LIQUID as Form N-RN and include new reporting events for funds that are subject to the proposed VaR-based limit on fund leverage risks. Funds that would be required to determine their compliance with the applicable VaR test on at least a daily basis would also be required to file Form N-RN to report information about VaR test breaches under certain circumstances. The Commission proposes that a fund that has determined it is out of compliance with the applicable VaR test and has not returned to compliance within three business days after that determination would be required to file a report on Form N-RN providing certain information regarding its VaR test breaches.

The Commission proposes to require a fund to file a report if the portfolio VaR of a fund subject to the relative VaR test were to exceed 150% of the VaR of its designated reference index for three business days. Such report would have to contain: (1) the dates on which the fund portfolio's VaR exceeded 150% of the VaR of its designated reference index; (2) the VaR of its portfolio for each of these days; (3) the VaR of its designated reference index for each of these days; (4) the name of the designated reference index; and (5) the index identifier. A fund would have to report this information if the fund has determined that its portfolio VaR exceeds 150% of its designated reference index VaR and has not come back into compliance within three business days after such determination, and also would have to file a report on Form N-RN when it is back in compliance with the relative VaR test.

For a fund subject to the absolute VaR test, if such a fund's portfolio were to exceed 15% of the value of the fund's net assets for three business days, the Commission proposes to require that such a fund report: (1) the dates on which the fund portfolio's VaR exceeded 15% of the value of its net assets; (2) the VaR of its portfolio for each of these days; and (3) the value of the fund's net assets for each of these days. A fund would have to report this information if the fund has determined that its portfolio VaR exceeds 15% of the value of its net assets and has not come back into compliance within three business days after such determination, and also would have to file a report on Form N-RN when it is back in compliance with the absolute VaR test.

The Commission is proposing a related amendment to Rule 30b1-10 under the 1940 Act to reflect the proposed requirement that all funds subject to the relative or absolute VaR tests (not just registered open-end funds) file current reports regarding VaR test breaches under the circumstances that Form N-RN specifies. The Commission proposes to amend the general instructions to Form N-LIQUID to reflect the extension of the scope of funds required to respond to the Form. The Commission is proposing to make funds' reporting on Form N-RN regarding VaR test breaches non-public to assuage potential adverse effects that may arise from real-time public reporting of a fund's VaR test breaches.

The Commission seeks comment on, among other things, whether the proposed reporting requirement for funds that are subject to the VaR-based limit on fund leverage risk are appropriate, whether the proposed time period for reporting on Form N-RN is appropriate, and whether there would be a benefit to publicly reporting the above information on Form N-RN, instead of the current proposal for non-public reporting to the Commission.

Amendments to Form N-CEN

The Commission is proposing to amend Item C.7 of Form N-CEN[41] to require a fund to identify whether it relied on the Proposed Rule during the reporting period. In addition, the Commission is proposing amendments to require a fund to identify whether it relied on any of the exceptions from various requirements under the Proposed Rule, including whether they are limited derivatives users or whether they are leveraged/inverse funds that are excepted from the proposed limit on fund leverage risk. Lastly, "a fund would have to identify whether it has entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements, as provided under the proposed rule."

The Commission seeks comment on, among other things, whether the Commission should require that funds identify that they relied on the Proposed Rule, including whether they are excepted from certain requirements, whether funds should identify that they entered into reverse repurchase agreements or similar financing transactions or unfunded commitment agreements, and whether there are other means that funds use to disclose or report information (*e.g.*, prospectus, annual report disclosure, etc.) that would be more appropriate for reporting any of the information that the proposed amendments may require.

BDC Reporting

The Commission is generally not proposing additional reporting requirements for BDCs under the Proposed Rule.[42] It should be noted, however, that BDCs that would not qualify as limited derivatives users under the Proposed Rule would be subject to the proposed new requirement to file current reporting regarding VaR test breaches on Form N-RN.

The Commission seeks comment on, among other things, whether BDCs should be required to report any of the same information on Form 10-K that the Commission is proposing to require registered investment companies to report on Forms N-CEN or N-PORT.

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41 This item of Form N-CEN requires a fund to indicate by "checking a box" whether it has relied on certain 1940 Act rules during a reporting period.

42 The Commission has separately proposed to require BDCs to tag their financial statements using Inline XBRL, a structured, machine-readable format, which would provide structured data about BDCs' derivatives and other investments. *See* Securities Offering Reform for Closed-End Investment Companies, Release No. IC-33427 (Mar. 20, 2019).

Recordkeeping Provisions

The Proposed Rule includes certain recordkeeping requirements designed to provide Commission staff and a fund's compliance personnel the ability to evaluate the fund's compliance with the Proposed Rule's requirements. First, for a fund subject to the Program requirement, the Proposed Rule would require the fund to maintain a written record of its policies and procedures that are designed to manage the fund's derivatives risks.[43] In addition, the Proposed Rule would require a fund to maintain a written record of the results of any stress testing of its portfolio, results of any VaR backtesting it conducts, records documenting any internal reporting or escalation of material risks under the Program and records documenting any periodic reviews of the Program.

Second, the Proposed Rule would require funds to keep records of any materials provided to the fund's board of directors in connection with approving the designation of the derivatives risk manager, any written reports provided to the board of directors relating to the Program and any written reports provided to the board that the Proposed Rule would require regarding the fund's non-compliance with the applicable VaR test.

Third, for funds required to comply with the proposed VaR-based limit on fund leverage risk, the fund would have to maintain records documenting the fund's determination of: the VaR of its portfolio; the VaR of the fund's designated reference index, as applicable; the fund's VaR ratio, as applicable; and any updates to any VaR calculation models used by the fund, as well as the basis for any material changes made to those models.

Fourth, under the Proposed Rule, funds that are limited derivatives users would be required to maintain a written record of their policies and procedures that are reasonably designed to manage their derivatives risk.

Fifth, the Proposed Rule would require a fund that enters into unfunded commitment agreements to maintain a record documenting the basis for the fund's belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements. Funds would be required to make such a record each time they enter into such an agreement.

Lastly, consistent with the period provided in Rule 38a-1(d) and Rule 22e-4 under the 1940 Act, a fund must retain a copy of its written policies and procedures under the rules that are currently in effect, or were in effect at any time within the past five years in an easily accessible place. A fund would also have to maintain all other records and materials that the rule would require the fund to keep for at least five years (the first two years in an easily accessible place).

The Commission seeks comment on, among other things, whether the proposed recordkeeping provisions are appropriate.

Transition Periods and Compliance Dates

As noted above, the Commission proposes to rescind Release 10666 and withdraw any no-action letters and other staff guidance, or portions thereof, addressing derivatives transactions and other transactions covered by the Proposed Rule, that the Division of Investment Management determines should be withdrawn in connection with any adoption of the Proposed Rule.

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[43] The Commission notes that under Rule 18f-4(c)(4), leveraged/inverse funds would be subject to the Proposed Rule's Program requirement and that such funds would therefore also be subject to the related recordkeeping provisions of the Proposed Rule.

The Proposing Release states that the Commission would expect to provide a one-year transition period after the publication of any final rule in the Federal Register, while funds prepare to come into compliance with the Proposed Rule before Release 10666 is rescinded.

In addition, the Commission proposes to provide a one-year compliance period for the sales practices rules to provide time for broker-dealers and investment advisers to bring their operations into conformity with the new rule. The proposed sales practices rules would apply not only to new accounts and transactions established after the rules' compliance date, but also to pre-existing accounts, including with respect to accounts for retail investors that previously invested in leveraged/inverse investment vehicles.

The Commission also proposes to provide a one-year delay to the effective date of the amendments to Rule 6c-11, in order to permit leveraged/inverse ETFs to rely on that rule, and to rescind the exemptive orders the Commission has provided to leveraged/inverse ETF sponsors.

The Commission seeks comment on, among other things, whether a one-year transition period to provide time for funds to prepare to come into compliance with the Proposed Rule and other items is appropriate and whether the Commission should adopt tiered transition periods for smaller entities, such as an additional 6 months for smaller entities (or some other shorter or longer period) in any transition period.

Conforming Amendments

The Commission proposes that under the Proposed Rule, a fund's derivatives transactions and unfunded commitments entered into under the Proposed Rule would not be considered for purposes of computing Section 18 asset coverage. Accordingly, the Commission also proposes to amend Form N-2 to provide that funds relying on the Proposed Rule would not be required to include their derivatives transactions and unfunded commitment agreements in the senior securities table on Form N-2.

Comment Period

As noted above, the comment period for the Proposed Rule will expire 60 days following the publication of the Proposed Rule in the Federal Register.[44] As of the publication of this *OnPoint*, the Proposed Rule had not yet been published in the Federal Register.

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44 While supporting this Commission rulemaking initiative, SEC Commissioners Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee issued a joint statement criticizing the Proposed Rule, citing three aspects they do not believe sufficiently protect investors: there is a "disconnect" between retail investors' "reasonable expectations and the reality" of leveraged/inverse exchange-traded funds; a fund's board is required to approve only the fund's derivatives risk manager, not the Program itself; and "the Commission should consider further measures to ensure that funds' VaR models are reliable and not subject to opportunistic gaming."

The Commissioners urged commenters to address these concerns, specifically asking commenters to: "come forward with evidence about whether [the proposed sales practices rules] are enough to protect ordinary investors from the risks presented by leveraged and inverse funds;" better help the Commission understand the role of a fund's board with respect to derivatives; and provide input as to whether funds' VaR models will reflect the actual risks posed by the funds' use of derivatives, or whether further minimum requirements should be put in place regarding the choice of a designated reference index. Robert J. Jackson Jr. and Allison Herren Lee, Statement on Proposed Rules on Funds' Use of Derivatives (Nov. 26, 2019).

In a speech at the 2019 Investment Company Institute (ICI) Securities Law Developments Conference, Dalia Blass, Director of the Commission's Division of Investment Management, also asked commenters to address four aspects of the Proposed Rule in particular: whether the derivatives risk manager reporting to a fund's board contemplated in the Proposed Rule "effectively leverage[s] and empower[s] the board" and provides the board with the necessary information it needs to oversee fund derivatives use; whether VaR testing along with the other proposed testing requirements would "establish an effective limit on leverage risk … [and] address the potential limitations of the VaR test;" whether there should continue to be an asset segregation requirement applicable to funds in some form in addition to the proposed Program; and whether the Commission should allow leveraged/inverse ETFs to rely on Rule 6c-11. Dalia Blass, Keynote Address to the 2019 ICI Securities Law Developments Conference (Dec. 3, 2019).

Appendix A – Comparison of Required Elements and Related Oversight and Reporting

	Derivatives Risk Management Program and Elements		Liquidity Risk Management Program and Elements
	2019 Proposal	2015 Proposal	2016 Final Rule
Program	**Rule 18f-4(c)(1)** – Adopt and implement a written program with policies and procedures reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from portfolio management; must include required elements	**2015 Rule 18f-4(a)(3)** – Adopt and implement a written program with written policies and procedures reasonably designed to assess and manage the risks associated with the fund's derivatives transactions; must include required elements **2015 Rule 18f-4(a)(3)(i)(C)** – An element requires reasonable segregation of functions associated with the program from portfolio management	**Rule 22e-4(b)** – Adopt and implement a written liquidity risk management program that is reasonably designed to assess and manage its liquidity risk; must include required elements
Assessment of Risk	**Rule 18f-4(c)(1)(i) and "derivatives risks"** – Risk identification and assessment covering specified "derivatives risks"	**2015 Rule 18f-4(a)(3)(i)(A)** – Similar; the specified "derivatives risks" do not specifically include "legal risks"	**Rule 22e-4(b)(1)(i)** – Each fund must assess its "liquidity risk," including consideration of specified factors, as applicable
Management of Risk	**Rule 18f-4(c)(1)(ii)** – Establish, maintain and enforce investment, risk management or related guidelines providing for specified levels of criteria, metrics or thresholds of derivatives risks, and measures to be taken if the levels are exceeded	**2015 Rule 18f-4(a)(3)(i)(B)(1)** – Monitor whether the fund's use of derivatives transactions is consistent with any investment guidelines established by the fund or the fund's investment adviser, the relevant portfolio limitation, and relevant disclosure to investors	**Rule 22e-4(b)(1)(i)** – Each fund must manage its "liquidity risk," including consideration of specified factors, as applicable **Rule 22e-4(b)(1)(iii)(A)(1)** – Any fund that does not primarily hold assets that are highly liquid investments must determine a highly liquid investment minimum (HLIM) based on specified factors, as applicable **Rule 22e-4(b)(1)(iii)(A)(3)** – A relevant fund must adopt and implement policies and procedures for responding to a shortfall of the fund's highly liquid investments below its HLIM (*see also related board reporting requirement discussed under "Reporting and Escalation" below*)

	Derivatives Risk Management Program and Elements		Liquidity Risk Management Program and Elements
	2019 Proposal	**2015 Proposal**	**2016 Final Rule**
Stress Testing	**Rule 18f-4(c)(1)(iii)** – Stress testing (at least weekly) to evaluate potential losses to the fund's portfolio	*No corresponding requirement*	**Rule 22e-4(b)(1)(i)(A)** – *No corresponding requirement*, but required assessment, management and review of liquidity risk must take into consideration certain factors, as applicable, including fund investment strategy and liquidity of portfolio investments during normal and reasonably foreseeable stressed conditions, as well as cash flow projections, during normal and reasonably foreseeable stressed conditions
Backtesting	**Rule 18f-4(c)(1)(iv)** – Daily backtesting of the results of the VaR calculation model used by the fund	*No corresponding requirement – Concept is not applicable to the 150% portfolio limit*	*No corresponding requirement – Concept appears not to be applicable to the program elements*
Reporting and Escalation	**Rule 18f-4(c)(1)(v)(A)** – Derivatives risk manager internal reporting to portfolio management regarding operation of program upon specified circumstances (*e.g.*, exceedances of guidelines and results of stress tests) **Rule 18f-4(c)(1)(v)(B)** – Derivatives risk manager informing portfolio management in a timely manner and directly informing the board, as appropriate, of material risks arising from the fund's derivatives transactions	**2015 Rule 18f-4(a)(3)(i)(B)(2)** – Program must provide for informing portfolio management or the board, as appropriate, regarding material risks arising from the fund's derivatives transactions	**Rule 22e-4(b)(1)(iii)(A)(3)** – A relevant fund's policies and procedures for responding to a shortfall below HLIM must require that program administrator report to the board on shortfalls within specified periods **Rule 22e-4(b)(1)(iv)** – If a fund holds more than 15% of its net assets in illiquid investments that are assets, the program administrator must report such occurrence to the board within 1 business day with a plan to address and, if still above 15% after 30 days, the board must assess whether the plan continues to be in the fund's best interests
Periodic Review of Program	**Rule 18f-4(c)(1)(vi)** – Derivatives risk manager periodic (at least annual) review of the program to evaluate its effectiveness and reflect changes in risks over time. Must include a review of VaR calculation model and designated reference index to evaluate whether it remains appropriate	**2015 Rule 18f-4(a)(3)(i)(D)** – Program must provide for periodic (at least annual) review of program, including models (including any VaR calculation model used), measurement tools, or policies and procedures part of the program, to evaluate their effectiveness and reflect changes in risks over time	**Rule 22e-4(b)(1)(i)** – Fund must periodically review (at least annually) "liquidity risk," including consideration of specified factors **Rule 22e-4(b)(1)(iii)(A)(2)** – Relevant fund must, no less frequently than annually, review the HLIM *See also discussion of Rule 22e-4(b)(2)(iii) under "Board Reporting on Program Implementation and Effectiveness" below*

<table>
<tr><th></th><th colspan="2">Derivatives Risk Management Program and Elements</th><th>Liquidity Risk Management Program and Elements</th></tr>
<tr><th></th><th>2019 Proposal</th><th>2015 Proposal</th><th>2016 Final Rule</th></tr>
<tr><th></th><th colspan="2">Derivatives Risk Manager</th><th>Liquidity Program Administrator</th></tr>
<tr><td>Manager / Administrator</td><td>Rule 18f-4(a) (definitions) – Officer or officers of the fund’s investment adviser; not a portfolio manager or, if multiple officers are derivatives risk manager, may not have a majority composed of portfolio managers; must have relevant experience regarding management of derivatives risk

Rule 18f-4(a) (definitions) – Responsible for administering the program and related policies and procedures

The Proposing Release indicates that a derivatives risk manager is not required for limited derivatives users because they are exempt from the program requirement</td><td>2015 Rule 18f-4(a)(3)(ii)(C) – Employee or officer of the fund or the fund’s investment adviser; not a portfolio manager

2015 Rule 18f-4(a)(3)(ii)(C) – Responsible for administering the program and related policies and procedures

2015 Rule 18f-4(a)(4) – Exception from derivatives risk manager requirements for limited derivatives users</td><td>Rule 22e-4(a)(13) (definitions) – The fund’s investment adviser, officer, or officers (which may not be solely portfolio managers of the fund) responsible for administering the program and its policies and procedures</td></tr>
<tr><td>Approval of Manager / Administrator</td><td>Rule 18f-4(c)(5)(i) – Designation approved by the board, including a majority of independent board members, taking into account experience</td><td>2015 Rule 18f-4(a)(3)(ii)(C) – Designation approved by the board, including a majority of independent board members</td><td>Rule 22e-4(b)(2)(ii) – Designation approved by the board, including a majority of independent board members</td></tr>
<tr><th></th><th colspan="3">Related Board Oversight Requirements</th></tr>
<tr><td>Board Program Approval</td><td>No explicit requirement for board approval of program</td><td>2015 Rule 18f-4(a)(3)(ii)(A) – Initial approval of the program and subsequent approval of material changes by the board, including a majority of independent board members</td><td>Rule 22e-4(b)(2)(i) – Initial approval of the program by board, including a majority of independent board members</td></tr>
</table>

	Derivatives Risk Management Program and Elements		Liquidity Risk Management Program and Elements
	2019 Proposal	**2015 Proposal**	**2016 Final Rule**
	Related Board Reporting Requirements		
Board Reporting on Program Implementation	**Rule 18f-4(c)(5)(ii)** – Derivatives risk manager reporting to the board on program implementation and effectiveness of the program in a written report on or before implementation and at least annually thereafter; report must include representation as to the program's reasonable design to manage the fund's derivatives risks and basis for such representation and for selection of designated reference index (or lack thereof) and other information	**2015 Rule 18f-4(a)(3)(ii)(B)** – The board shall review on at least a quarterly basis a written report prepared by the derivatives risk manager regarding the adequacy of program and effectiveness of implementation	**Rule 22e-4(b)(2)(iii)** – **The** board, including a majority of independent directors, must review, no less frequently than annually, a written report prepared by the program administrator that addresses the operation of the program and assesses its adequacy and effectiveness of implementation, including, if applicable, the operation of the HLIM, and any material changes to the program
Regular Board Reporting	**Rule 18f-4(c)(5)(iii)** – Derivatives risk manager providing to board, at frequency determined by board, a written report regarding analysis of exceedances of guidelines, results of stress testing and results of backtesting, including information reasonably necessary to evaluate fund's response to guidelines and stress testing results	*No corresponding requirement*	*No corresponding requirement, but see discussion of Rule 22e-4(b)(1)(iii)(A)(3) and Rule 22e-4(b)(1)(iv) under "Reporting and Escalation" above*

Appendix B – Limit on Fund Leverage Risk and Exceptions Compared to the 2015 Proposed Rule

	2019 Proposal	2015 Proposal
	Condition to Enter Into Derivatives Transactions: Limit on Fund Leverage Risk	**Condition to Enter Into Derivatives Transactions: Portfolio Limitations**
Limit	**Rule 18f-4(c)(2)** – A fund must comply with the relative VaR test or, if the derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy, the absolute VaR test	**2015 Rule 18f-4(a)(1)** – A fund may enter into derivatives transactions provide that, immediately after entering into any senior securities transaction: the "aggregate exposure" of a fund would not be permitted to exceed either: (1) 150% of the value of a fund's net assets; or (2) 300% of the value of the fund's net assets, provided that the fund's full portfolio VaR is less than the fund's securities VaR
Role of Board	*No specific board approval requirement with respect to selection of the applicable VaR test (but see board reporting requirements)*	**2015 Rule 18f-4(a)(5)** – The fund's board, including a majority of independent members, must approve the portfolio limitation under which the fund will operate
	Condition to Enter Into Reverse Repurchase Agreements, Similar Financing Transactions and Unfunded Commitment Agreements	**Conditions to Enter Into Financial Commitment Transactions**
Limit and Role of Board	**Rule 18f-4(d)** – A fund may enter into a reverse repurchase agreement or similar financing transaction, provided the fund: (1) complies with the asset coverage requirements under Section 18 of the 1940 Act; and (2) combines the aggregate amount of indebtedness associated with such transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio **Rule 18f-4(e)** – A fund may enter into an unfunded commitment agreement, provided the fund reasonably believes, at the time it enters such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due, subject to certain limitations and guidelines for forming a reasonable belief and related documentation requirements thereof *No specific board approval requirement with respect to transactions*	**2015 Rule 18f-4(b)** – A fund may enter into financial commitment transactions if the fund: (1) satisfies the Asset Segregation Requirements *(see description below)*, (2) the fund's board, including a majority of the independent members, has approved written policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, and (3) the fund maintains a written record reflecting the amount of each financial commitment obligation associated with each financial commitment transaction entered into by the fund and identifying the qualifying coverage assets maintained by the fund with respect to each financial commitment obligation, as determined by the fund at least once each business day

	2019 Proposal	2015 Proposal
	Asset Segregation Requirement for Derivatives, Reverse Repurchase Agreements, Similar Financing Transactions and Unfunded Commitment Agreements	**Asset Segregation Requirement for Derivatives and Financial Commitment Transactions**
Limit	*No Asset Segregation Requirement*	**2015 Rule 18f-4(a)(2)** – Asset Segregation Requirements: For **derivatives transactions**, segregate cash and cash equivalents equal to the mark-to-market coverage amount (the net amount currently payable by the fund if the fund exits the derivatives transaction) plus the risk-based coverage amount (a reasonable estimate of the potential amount payable by the fund if the fund were to exit under stressed conditions) with certain reductions for required margin For **financial commitment transactions**, segregate cash or cash equivalents or assets convertible to cash or that will generate cash, with a value at least equal to the value of the fund's obligations under its financial commitment transactions prior to the date of the fund's expected payment obligation
	Exception for Limited Derivatives Users	
Additional Relief	**Rule 18f-4(c)(3)** – A fund is not required to adopt a derivatives risk management program requirements or comply with limit on fund leverage risk	**2015 Rule 18f-4(a)(4)** – A derivatives risk management program is not required
Conditions	**Rule 18f-4(c)(3)** – 1. a fund must adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks; and 2. the fund's derivatives exposure may not exceed 10% of net assets; <u>or</u> the fund would need to limit its use of derivatives transactions to currency derivatives to hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held and the notional amounts of such derivatives does not exceed the value of the hedged instruments (or par value, for fixed-income investments) by more than a negligible amount	**2015 Rule 18f-4(a)(4)(i)** – 1. immediately after entering into any derivatives transaction the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets; and 2. the fund does not enter into complex derivatives transactions

	2019 Proposal	2015 Proposal
Definitions		
Definitions	**Rule 18f-4(a) (definitions)** – Derivatives transaction means (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 **Rule 18f-4(a) (definitions)** – Derivatives exposure means: the sum of the notional amounts of the fund’s derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short. In determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts **Rule 18f-4(a) (definitions)** – The relative VaR test means the VaR of the fund’s portfolio does not exceed 150% of the VaR of the designated reference index **Rule 18f-4(a) (definitions)** – The absolute VaR test means the VaR of the fund’s portfolio does not exceed 15% of the value of the fund’s net assets **Rule 18f-4(a) (definitions)** – Any VaR model used by the fund must: (1) take into account and incorporate all significant, identifiable market risk factors associated with a fund’s investments, including, as applicable: (A) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (B) material risks arising from the nonlinear price characteristics of a fund’s investments, including options and positions with embedded optionality; and (C) the sensitivity of the market value of the fund’s investments to changes in volatility; (2) use a 99% confidence level and a time horizon of 20 trading days; and (3) be based on at least three years of historical market data	**2015 Rule 18f-4(c)(1)** – Complex derivatives transactions means: any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (1) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (2) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price **2015 Rule 18f-4(c)(2)** – Derivatives transaction has the same meaning as under the Proposed Rule, except that it does not include short sale borrowings **2015 Rule 18f-4(c)(2)** – Financial commitment transaction 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) **2015 Rule 18f-4(c)(3)** – Exposure means the aggregate notional amount of the fund’s derivatives transactions, aggregate obligations under the fund’s financial commitment transactions, and the fund’s aggregate indebtedness with respect to other senior securities transactions; netting of directly offsetting derivatives transaction is permitted for purposes of calculating exposure **2015 Rule 18f-4(c)(10)** – Senior securities transaction means any derivatives transaction, financial commitment transaction or any transaction involving a senior security entered into by the fund pursuant to Section 18 **2015 Rule 18f-4(c)(11)** – Securities VaR means the VaR of the fund’s portfolio of securities and other investments excluding any derivatives investments **2015 Rule 18f-4(c)(11)** – The requirements for any VaR model used by the fund are the same as under the Proposed Rule, except that the VaR model must use a time horizon of not less than 10 and not more than 20 trading days, and the requirement to be based on at least three years of historical market data only applied where using historical simulation

Appendix C – Comparison of the Proposed Rule and VaR-Based and Other Limits for UCITS

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
General Limits	**Rule 18f-4(c)(2)(i)** – A fund must comply with the relative VaR test or, if the derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy, the absolute VaR test **Rule 18f-4(c)(2)(ii)** – The fund must determine its compliance with the applicable VaR test at least once each business day	**Section 1, Definition and scope of Global Exposure** – A UCITS must calculate its global exposure on at least a daily basis and comply with global exposure limits. UCITS may calculate global exposure by using the commitment approach, the value at risk approach or other advanced risk measurement methodologies as may be appropriate **Section 3.1 General Principles and general requirement** – A global exposure calculation using the VaR approach should consider all the positions of the portfolio **Section 3.2 VaR Approaches – Relative VaR and the Absolute VaR – The Choice, paragraph 1** – For the purpose of calculating global exposure, a UCITS can use the relative VaR approach or the absolute VaR approach
Choice of Relative VaR vs. Absolute VaR Test	**Rule 18f-4(c)(2)** – As noted above, a fund may use the absolute VaR test rather than the relative VaR test only if the derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy	**Section 3.2 VaR Approaches – Relative VaR and the Absolute VaR – The Choice, paragraph 2** – The UCITS is responsible for deciding which VaR approach is the most appropriate methodology given the risk profile and investment strategy of the UCITS The Guidelines' explanatory text provides that strategies suited to the relative VaR approach are those where a leverage free benchmark is defined for the UCITS, reflecting the investment strategy which the UCITS is pursuing. UCITS investing in multi-asset classes and that do not define the investment target in relation to a benchmark but rather as an absolute return target, are suited to the absolute VaR approach
Quantitative VaR Requirements	**Rule 18f-4(a) (definitions)** – The relative VaR test means the VaR of the fund's portfolio does not exceed 150% of the VaR of the designated reference index **Rule 18f-4(a) (definitions)** – The absolute VaR test means the VaR of the fund's portfolio does not exceed 15% of the value of the fund's net assets	**Section 3.3 Relative VaR approach, paragraph 1** – The VaR of the UCITS portfolio must not be greater than 200% of the VaR of the reference portfolio **Section 3.6.1 VaR approach – Quantitative requirements, Calculation Standards, paragraph 1** – The absolute VaR of a UCITS cannot be greater than 20% of its net asset value **Section 3.1 General Principles and general requirement** – A UCITS should always set the maximum VaR limit according to its defined risk profile.

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
VaR Defined	**Rule 18f-4(a) (definitions)** – VaR means an estimate of the potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level	**Section 3.1, explanatory text, paragraph 38** – The VaR approach is a measure of the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions due to market risk rather than leverage
VaR Calculation Model Parameters	**Rule 18f-4(a) (definitions)** – Any VaR model used by a fund for purposes of determining the fund's compliance with the applicable VaR test must: (1) take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable: (A) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (B) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (C) the sensitivity of the market value of the fund's investments to changes in volatility; (2) use a 99% confidence level and a time horizon of 20 trading days; and (3) be based on at least three years of historical market data. *The Proposing Release recognizes certain funds prefer to calculate their VaR for a one-day holding period, and therefore suggests that funds may convert their one-day VaR to the equivalent VaR for a 20-day holding period for purposes of the test, if appropriate.* *The default calculation parameters for UCITS are largely the same as those stated in the Proposed Rule with a longer required number of years of historical market data.* *However, unlike under the UCITS approach, the Proposed Rule provides no flexibility to reduce the confidence level, change the time horizon or use less than the specified number of years of historical market data.* *In addition, the Proposed Rule does not provide flexibility to scale the maximum absolute VaR test level of 15% based on different confidence level and holding period factors.*	**Section 3.6.1 VaR approach – Quantitative requirements, Calculation Standards, paragraphs 2-4** – The calculation of the absolute and relative VaR should be carried out in accordance with the following parameters: (a) one-tailed confidence interval of 99%; (b) holding period equivalent to 1 month (20 business days); (c) effective observation period (history) of risk factors of at least 1 year (250 business days) unless a shorter observation period is justified by a significant increase in price volatility (for instance extreme market conditions); (d) quarterly data set updates, or more frequent when market prices are subject to material changes; and (e) at least daily calculation A confidence interval and/or a holding period differing from the default calculation in (a) and (b) may be used by the UCITS provided the confidence interval is not below 95% and the holding period does not exceed 1 month (20 days). For UCITS referring to an absolute VaR approach, the use of other calculation parameters goes together with a rescaling of the 20% limit to the particular holding period and/or confidence interval. The rescaling can only be done under the assumption of a normal distribution with an identical and independent distribution of the risk factor returns by referring to the quantiles of the normal distribution and the square root of time rule. The Guidelines' explanatory text states that UCITS may deviate from the default VaR calculation standards (i.e., confidence interval of 99% and holding period of 1 month (20 days)). The text notes, as an example, that a UCITS could use a confidence interval of 95% and a holding period of 5 days in which case the 20% maximum VaR limit should be scaled down to 7%.

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
VaR Calculation Model Parameters		With regard to the relative VaR approach, the Guidelines' explanatory text states that the relative nature of the measure means that no adjustment (i.e., rescaling) is necessary to the VaR limit of 200% in instances where the UCITS deviates from the default VaR calculation standards. **Section 3.6.3 Completeness and accuracy of the risk assessment** – The choice of the appropriate model remains the responsibility of the UCITS. When selecting the VaR model, the UCITS should ensure that the model is appropriate with regard to the investment strategy being pursued and the types and complexity of the financial instruments used. The VaR model should provide for completeness and it should assess the risks with a high level of accuracy. In particular: • All the positions of the UCITS portfolio should be included in the VaR calculation • The model should adequately capture all the material market risks associated with portfolio positions and, in particular, the specific risks associated with financial derivative instruments. For that purpose, all the risk factors which have more than a negligible influence on the fluctuation of the portfolio's value should be covered by the VaR model • The quantitative models used within the VaR framework (pricing tools, estimation of volatilities and correlations, etc) should provide for a high level of accuracy • All data used within the VaR framework should provide for consistency, timeliness and reliability

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
Exceptions to General Limits	**Rule 18f-4(c)(3)** – A fund is not required to adopt a Program or comply with the limit on fund leverage risk if: (1) the fund adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risk; and **(2)** (i) the fund's derivatives exposure does not exceed 10% of the fund's net assets <u>or</u> (ii) the fund limits its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held by the fund, <u>provided that</u> the currency derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount **Rule 18f-4(a)** – Derivatives exposure means: the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short. In determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts	**Section 2 Calculation of Global Exposure using the Commitment Approach** – There is no limited derivatives user exception for UCITS. UCITS may, instead of complying with the above VaR-based test, calculate its global exposure by using the "commitment approach." Under the commitment approach, a UCITS' derivatives notional amounts (taking into account netting and hedging) may not exceed 100% of the UCITS' net asset value. If a UCITS chooses to use the commitment approach then it is limited to a leverage limit of 100% (UCITS may only generate leverage through financial derivative instruments and cannot borrow to create a leveraged investment) **Section 1 Definition and scope of Global Exposure, paragraph 4** – A UCITS must use an advanced risk measurement methodology (supported by a stress testing program) such as the VaR approach to calculate global exposure where: (a) it engages in complex investment strategies which represent more than a negligible part of the UCITS' investment policy; (b) it has more than a negligible exposure to exotic derivatives; or (c) the commitment approach doesn't adequately capture the market risk of the portfolio ESMA's explanatory text states that with respect to the selection of the methodology used to measure global exposure, it expects that the commitment approach should not be applied to UCITS using, to a large extent and in a systematic way, financial derivative instruments as part of complex investment strategies. As a general rule, ESMA expects UCITS to use a maximum loss approach to assess whether the complex investment strategy or the use of exotic derivatives represent more than a negligible exposure

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
Designated Reference Index vs. Reference Portfolio	**Rule 18f-4(a) (definitions)** – A designated reference index is an unleveraged index that: (1) is selected by the derivatives risk manager and that reflects the markets or asset classes in which the fund invests; (2) is not 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 investment adviser, unless the index is widely recognized and used; and (3) is an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N-1A	**Section 3.3 Relative VaR approach, paragraph 2** – The reference portfolio and the related processes should comply with the following criteria: (a) The reference portfolio should be unleveraged and should, in particular, not contain any financial derivative instruments or embedded derivatives, except that: (i) a UCITS engaging in a long/short strategy may select a reference portfolio which uses financial derivative instruments to gain the short exposure (ii) a UCITS which intends to have a currency hedged portfolio may select a currency hedged index as a reference portfolio (b) The risk profile of the reference portfolio should be consistent with the investment objectives, policies and limits of the UCITS' portfolio (c) If the risk/return profile of a UCITS changes frequently or if the definition of a reference portfolio is not possible, then the relative VaR method should not be used (d) The process relating to the determination and the ongoing maintenance of the reference portfolio should be integrated in the risk management process and be supported by adequate procedures. Guidelines governing the composition of the reference portfolio should be developed. In addition, the actual composition of the reference portfolio and any changes should be clearly documented

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
Back-testing	**Rule 18f-4(c)(1)(iv)** – The Program must provide for the backtesting of the results of the VaR calculation model used by the fund in connection with the applicable VaR test by, each business day, comparing the fund's actual gain or loss for that day with the corresponding VaR calculation for that day, estimated over a one-day time horizon, and identifying as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss The Proposing Release notes that, based on the required 99% confidence level and one-day time horizon, a fund would be expected to have approximately 2.5 backtesting exceptions per year. The Proposing Release notes that, if a fund were "consistently to experience backtesting exceptions more (or less) frequently, [it] could suggest that the fund's VaR model may not be effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund's investments" The Proposing Release states that requiring daily backtesting would enable a fund and its derivatives risk manager "to more readily and efficiently adjust or calibrate its VaR calculation model," which, in turn, would allow for more effective management of the risks associated with the fund's derivatives use The Proposing Release states that this requirement would "assist a fund in confirming the appropriateness of its model and related assumptions and help identify when funds should consider model adjustments" **Rule 18f-4(c)(1)(v)** – The derivatives risk manager must provide regular reports on the results of the backtesting to the fund's board	**Section 3.6.4 Back Testing, paragraphs 1-6** – A UCITS should monitor the accuracy and performance of its VaR model (i.e., prediction capacity of risk estimates), by conducting a back testing program The back testing program should provide for each business day a comparison of the one-day value-at-risk measure generated by the UCITS model for the UCITS' end-of-day positions to the one-day change of the UCITS' portfolio value by the end of the subsequent business day The UCITS should carry out the back testing program at least on a monthly basis, subject to always performing retroactively the comparison for each business day The UCITS should determine and monitor the "overshootings" on the basis of this back testing program. An overshooting is a one-day change in the portfolio's value that exceeds the related one-day value-at-risk measure calculated by the model If the back testing results reveal a percentage of overshootings that appears to be too high, the UCITS should review the VaR model and make appropriate adjustments The UCITS senior management should be informed at least on a quarterly basis (and where applicable the UCITS competent authority should be informed on a semi-annual basis), if the number of overshootings for each UCITS for the most recent 250 business days exceeds 4 in the case of a 99% confidence interval. This information should contain an analysis and explanation of the sources of 'overshootings' and a statement of what measures if any were taken to improve the accuracy of the model. The competent authority may take measures and apply stricter criteria to the use of VaR if the 'overshootings' exceed an unacceptable number

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
Stress Testing as a Complement to VaR Tests	**Rule 18f-4(c)(1)(iii)** – The Program must provide for stress testing of the fund's portfolio to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties. A fund may determine the frequency with which stress tests are conducted, taking into account the fund's strategy and investments and current market conditions, provided that the fund must conduct stress testing at least weekly	**Section 3.6.5 – Stress Testing – General Provisions** – Each UCITS using the VaR approach should conduct a rigorous, comprehensive and risk-adequate stress testing program. The stress testing program should be designed to measure any potential major depreciation of the UCITS value as a result of unexpected changes in the relevant market parameters and correlation factors. Conversely, where appropriate, it should also measure changes in the relevant market parameters and correlation factors, which could result in major depreciation of the UCITS value. The stress tests should be adequately integrated into the UCITS risk management process and the results should be considered when making investment decisions for the UCITS **Section 3.6.5 – Stress Testing – Quantitative Requirements** – The stress tests should cover all risks which affect the value or the fluctuations in value of the UCITS to any significant degree. In particular, those risks which are not fully captured by the VaR model used, should be taken into account. The stress tests should be appropriate for analyzing potential situations in which the use of significant leverage would expose the UCITS to significant downside risk and could potentially lead to the default of the UCITS (i.e., NAV <0). The stress tests should focus on those risks which, though not significant in normal circumstances, are likely to be significant in stress situations. **Section 3.6.5 – Stress Testing – Qualitative Requirements** – Stress tests should be carried out on a regular basis, at least once a month, and whenever a change in the value or the composition of a UCITS or a change in market conditions makes it likely that the test results will differ significantly
Remediation	**Rule 18f-4(c)(2)(ii) and (iii)** – If a fund determines that it is not in compliance with its VaR test, it must return to compliance within three business days. If after the three business days the fund remains non-compliant, the requirements regarding board reporting, Program analysis and updates and restrictions on certain derivatives transactions would apply	*See discussion of overshooting under Back Testing above*

	2019 Proposal	CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Guidelines)
Program and VaR Review	**Rule 18f-4(c)(1)(vi)** – The derivatives risk manager must review the program at least annually to evaluate the program's effectiveness and to reflect changes in risk over time. The periodic review must include a review of the VaR calculation model used by the fund (including the required backtesting) and any designated reference index to evaluate whether it remains appropriate	**Section 3.7 – VaR Approach: Qualitative requirements** – The risk management function should be responsible for, among other things, sourcing, testing, maintaining and using the VaR model, supervising the determination of the reference portfolio, adopting the model to the UCITS' portfolio, performing continuous validation of the model, monitoring and controlling VaR limits, and producing on a regular basis reports for senior management Following initial development, and after any significant change to the model, the model should undergo a validation by a party independent of the building process for ensuring that the model is conceptually sound and captures adequately all material risks. The risk management function should perform ongoing validation of the VaR model including back testing as noted above
Disclosure	**Rule 18f-4(c)(2)(iv)** – If the fund is complying with the relative VaR test, an open-end fund must disclose in its annual report the fund's designated reference index as the fund's "appropriate broad-based securities market index" or an "additional index," and a registered closed-end fund or BDC must disclose its designated reference index in its annual report, together with a presentation of the fund's performance relative to the designated reference index. A fund is not required to include this disclosure in an annual report if the fund is a "New Fund" or would meet that definition if it were filing on Form N-1A, at the time the fund files the annual report	**Section 3.8.2(b) 'Disclosure', 'Annual Report', paragraphs 1-4** - The UCITS should disclose in its annual report the method used to calculate the global exposure (i.e., commitment approach, relative VaR or absolute VaR) When using the relative VaR approach, information on the reference portfolio should be disclosed in the annual report The VaR measure of the UCITS should be published in the annual report. In this respect, the information provided should at least include the lowest, the highest and the average utilization of the VaR limit calculated during the financial year. The model and inputs used for calculation (calculation model, confidence level, holding period, length of data history) should be displayed UCITS using VaR approaches should disclose the level of leverage employed during the relevant period

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