SEC PROPOSES NEW LIMITS ON FUNDS' USE OF DERIVATIVES

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Investment Management, Hedge Funds and Alternative Investments Alert

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On December 11, 2015, the Securities and Exchange Commission ("SEC") proposed new Rule 18f-4 under the Investment Company Act of 1940, as amended ("1940 Act") to reduce leverage risks associated with derivatives and to achieve a more standardized treatment of derivatives transactions under the senior securities provisions of 1940 Act Sections 18 and 61.[1] Rule 18f-4 would replace the SEC's decades-old and sometimes ad hoc approach to derivatives regulation with a broadly applicable framework that would impose new overall portfolio limits on the leverage that can be achieved through the use of derivatives and so-called "financial commitment transactions," while also modifying the asset segregation requirements that have long applied to such transactions. The Rule's requirements would apply to mutual funds, closed-end funds (including business development companies) and exchange-traded funds organized as management investment companies (collectively, "funds").

Rule 18f-4 also would impose new board oversight obligations; in some cases, including the adoption of a formal derivatives risk management program overseen by a designated "derivatives risk manager."

The SEC also proposed to amend Forms N-PORT and N-CEN, two reporting forms it originally proposed in May 2015. A fund relying on proposed Rule 18f-4 to invest in derivatives would have to report portfolio-wide and position-level information about its derivatives investments on Form N-PORT, and to identify which of two portfolio limitations on leverage with which the fund has chosen to comply on Form N-CEN.

The SEC recognized in its Proposing Release that compliance with Rule 18f-4 would require some funds to significantly alter their investment strategies and could result in certain funds, particularly managed futures funds or highly leveraged exchange-traded funds, having to choose between altering their investment strategies and deregistering from the 1940 Act. But many fund boards will face new challenges as they are more pointedly tasked with understanding complex risk management concepts and overseeing their application.

The Proposing Release was published in the *Federal Register* on December 28, 2015. Comments to the proposed Rule 18f-4 or the proposed changes to Forms N-PORT and N-CEN are due to the SEC by March 28, 2016.

RULE 18F-4'S REQUIREMENTS FOR DERIVATIVES AND FINANCIAL COMMITMENTS

Rule 18f-4 has three main elements: (1) explicit limitations on portfolio leverage, (2) asset segregation

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requirements, and (3) derivatives risk oversight by fund management and the fund's board. Some of these elements are new, while others modify standards that exist under the current no-action regime.

1. Portfolio Limitations

Under the current regulatory regime, funds are not subject to an explicit cap on the leverage that they can obtain from derivatives and other forward commitments, but instead, are required to segregate sufficient liquid assets to cover their forward obligations. Rule 18f-4 would change that by requiring a fund that enters into any derivatives transaction to comply with one of two alternative leverage limits, which are to be measured at the time the fund enters into any such transaction. The Proposing Release refers to these portfolio limits as “exposure-based” and “risk-based.” However, both are based on the fund's “exposure,” which is defined as the aggregate notional amounts of the fund's derivatives transactions, its total obligations under financial commitment transactions, and the total amount of its indebtedness with respect to other senior securities transactions.[2] Notably, while the portfolio limitations are to be measured by reference to the exposure obtained from all these sources, they would apply only to the fund's ability to enter into derivatives, not to its ability to enter into financial commitments or other senior securities transactions.

A fund's board of directors would have to determine with which of the two portfolio limitations the fund will comply. That choice will depend upon the extent to which, as well as the purposes for which, the fund will use derivatives.

The alternative portfolio limitations are:

- an “exposure-based” limit that would cap a fund's aggregate exposure at 150% of its net assets; and
- a “risk-based” limit that would allow a fund's aggregate exposure to be up to 300% of its net assets but that would be available only if the fund satisfies a “Value at Risk” or “VaR” test showing that the fund's use of derivatives has lowered its overall portfolio risk.[3] The risk-based limit thus is available only to funds using derivatives for risk-reduction—generally, hedging—purposes.

As noted above, Rule 18f-4 would base the calculation of derivatives exposure on the notional amount of the derivatives transaction. The Proposing Release indicates that SEC considers notional amounts to be a more objective and administrable measure than other metrics that are based on fund-specific risk profiles and offsetting positions. Rule 18f-4 would define the “notional amount” of most derivatives transactions as “the market value of an equivalent position in the underlying reference asset …, or the principal amount on which payment obligations under the derivatives transaction are calculated.” However, the Rule would provide separate definitions of notional amount for three types of derivatives for which the SEC believes the normal definition would not accurately measure exposure. The notional amount of a derivative that provides a leveraged return (for example, a total return swap that provides a return based on a multiple of the performance of an underlying stock or index) would be the normal notional amount multiplied by the leverage factor. The notional amount of a derivative for which the underlying reference asset is a managed account or entity formed primarily for the purpose of investing or trading in derivatives or an index reflecting such an account or entity would be determined on a look-through basis reflecting the fund's pro-rata share of the underlying derivatives. For “complex derivatives transactions,”[4] the notional amount would be the aggregate notional amounts of multiple, noncomplex derivatives that together would be expected to offset the market risk of the complex derivative.

2. Asset Segregation Requirements

Rule 18f-4 would replace a patchwork of no-action letter guidance and registration statement review comments to

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prescribe the amount and type of assets that funds engaged in either derivatives transactions or financial commitments must segregate to cover their open positions. Compliance with the asset segregation requirements for both types of transactions has two elements: First, the fund needs to know how much is required to cover a derivative position. Second, the fund needs to know what assets it may segregate to provide such coverage. However, the requirements for both of those elements are different for derivatives transactions than for financial commitments.

Required Asset Coverage

For derivatives transactions, a fund would have to segregate the mark-to-market coverage amount *plus* a risk-based amount, each of which is to be determined daily. The mark-to-market coverage amount represents the amount necessary to unwind a derivative position as of the time of determination. This mark-to-market amount is not intended to reflect the full scope of potential future obligations on a derivative instrument. That is left for the risk-based coverage amount, which is to be a reasonable estimate of what the fund would have to pay in order to exit the derivative position under stressed market conditions. Rule 18f-4 tasks the board, including a majority of its disinterested directors, with approving appropriate policies and procedures for determining the risk-based coverage amount.

Both of these coverage amounts may be computed on a net basis for derivatives that are covered by a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions. In addition, both coverage amounts may be reduced by margin—variation margin with respect to the mark-to-market coverage amount and initial margin with respect to the risk-based coverage amount—posted by the fund. However, such reductions are to be based on the collateral posted with respect to the particular derivatives transaction, not the aggregate collateral posted in connection with multiple transactions even if they are covered by a single netting or other master agreement. In some cases, those transaction-by-transaction amounts may be difficult to determine.

For financial commitment transactions,[5] a fund must segregate the full amount it is conditionally or unconditionally obligated to pay under the transaction or, if the fund's obligation is to deliver a particular asset, the value of that asset. As with derivatives, that amount or value is to be determined daily. However, there is no risk-based component to the segregation requirement for financial commitments. The Rule makes no provision for netting a fund's firm commitment obligations, but as discussed below, it does allow for collateral that is pledged to secure those obligations to be counted toward the fund's segregation requirement.

Qualifying Assets

Rule 18f-4 requires a fund to satisfy its asset segregation requirements by maintaining adequate “qualifying coverage assets.” For derivatives, such assets are limited to cash, cash equivalents, and, with respect to transactions under which the fund's obligations may be satisfied by delivering a particular asset, that asset. This is a major change from the existing asset segregation regime, under which funds may cover their derivatives positions using any liquid asset.

For financial commitments, “qualifying coverage assets” include the foregoing assets plus any assets that either are convertible to cash or can be expected to generate cash in an amount equal to the fund's financial commitment obligation prior to the date on which the obligation is expected to become payable. For example, if a

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fund has a forward financial commitment obligation that becomes due on July 1, 2016, it could segregate bonds that become due prior to that date and that upon maturity would generate principal and accrued interest at least equal to the amount of the financial commitment obligation. Alternatively, the fund could segregate bonds that would generate interest aggregating that amount during the period between the time of determination and that July 1 date. The Proposing Release suggests (but the proposed Rule does not explicitly provide) that an asset also can be considered “convertible to cash” if it is highly liquid and could be sold to generate the requisite cash amount prior to the time that the obligation becomes payable. The proposed Rule would require that an asset's convertibility into, or its ability to generate, the requisite cash and the date on which the financial commitment obligation is expected to be payable are to be determined in accordance with policies and procedures approved by the fund's board.

The Rule would provide that “qualifying coverage assets” for financial commitments also include assets that have been pledged with respect to the related financial commitment obligation, provided that those assets can be expected to satisfy that obligation. While the Proposing Release does not make this clear, this appears to mean that any assets that are so pledged can be used to satisfy this asset segregation requirement, irrespective of their liquidity, but that (unlike variation or initial margin for derivatives) pledged assets cannot be applied to satisfy only part of this segregation requirement—they apparently must be sufficient to satisfy the entire financial commitment obligation.

3. Risk Management Program

Rule 18f-4 would require funds with notional exposure to derivatives of at least 50% of net assets, as well as funds that engage in any “complex derivatives transactions,” (regardless of the amount of exposure) to create a formalized risk management program. A fund's board, including a majority of its disinterested directors, would be required to approve policies and procedures reasonably designed to assess and manage risks associated with derivatives transactions. The functions associated with a fund's risk management program must be reasonably separated from portfolio management in order to mitigate potential conflicts of interest. The risk management program must provide for quarterly updates on material risks of a fund's derivatives positions to the portfolio managers and board. The board would have to review and approve the policies and procedures at least annually. Changes to the risk management program would also require board approval. Further, the board would have to designate a derivatives risk manager to oversee the risk management program. The designated derivatives risk manager would be required to be independent of the fund's portfolio managers. He or she could, but need not, be the chief compliance officer, and would not need to be removable only by the fund's board.

Boards of funds that are not required to maintain the formalized risk management program would nevertheless face oversight responsibilities under Rule 18f-4. Responsibilities would be imposed on such boards by the Rule's portfolio limitation and asset segregation requirements. In addition, such boards would have to install controls to monitor use of derivatives to ensure that the fund does not trigger the formalized risk management program requirement, either through investment in complex derivatives or by exceeding the 50% exposure threshold.

EFFECTIVE DATE; TRANSITION

The SEC did not propose a specific date by which funds must comply with Rule 18f-4, if adopted. Instead, the Proposing Release suggests a transition period during which funds could continue to rely on existing guidance

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while working towards compliance with the new requirements. The SEC would rescind existing guidance at the end of the transition period. The SEC requested comments regarding the duration of the transition period. The Proposing Release identifies the tiered transition period in the recently proposed Rule 22e-4 on liquidity risk management as a potential timeframe for Rule 18f-4. Proposed Rule 22e-4 provides 18 months for larger entities (defined as those with net assets of at least $1 billion) and 30 months for smaller entities to transition to the new standards.

DERIVATIVES ISSUES NOT ADDRESSED BY THE PROPOSED RULE

The Proposing Release leaves open numerous questions regarding the treatment of derivatives under 1940 Act provisions other than Sections 18 and 61. Like the existing guidance applicable to those sections, SEC rules and SEC staff ("Staff") interpretations under these other provisions largely predate, and are not well adapted for, the wide variety of derivatives that funds use today. For example, one question the SEC raised in a 2011 concept release on funds' derivatives use is whether both the counterparty to the derivative contract and the underlying reference entity should be viewed as issuers for purposes of compliance with the diversification (Section 5(b)(1)) and concentration (Section 8) requirements of the 1940 Act. Other issues, such as what value (notional based or marked-to-market) should be ascribed to derivatives investments for purposes of compliance with Rule 35d-1, the "Names Rule," have been addressed by the Staff only through the comment process. While Rule 18f-4 would impose its own portfolio limitations on the use of derivatives, the limitations imposed by these other provisions would still appear to apply. In the absence of definitive guidance, industry practices regarding compliance with those limitations are likely to continue to vary as reasoned judgements result in different approaches.

Notes:

[1] The proposing release is available at www.sec.gov/rules/proposed/2015/ic-31933.pdf ("Proposing Release"). A companion white paper, "Use of Derivatives by Investment Companies," by the SEC's Division of Economic Risk Analysis, is available at www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

[2] Rule 18f-4 defines "derivatives transaction" to include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument that may require payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination. A "financial commitment transaction" is defined to include any short sale, reverse repurchase agreement, firm or standby commitment agreement, or similar agreement. A "senior securities transaction" is defined as any transaction (including derivatives and financial commitments) that involves a senior security and that a fund enters into pursuant to Sections 18 or 61 of the 1940 Act.

[3] More specifically, the fund's "full portfolio VaR," meaning the VaR of the fund's entire portfolio, including its securities, other investments, and derivative positions, must be lower than its "securities VaR," meaning the VaR of its portfolio excluding its derivative positions. Rule 18f-4 does not specify the methodology for measuring VaR. Instead, it defines parameters based on common industry practices. The rule requires that a fund use a consistent methodology for all of its VaR measurements to ensure an apples-to-apples comparison of the fund's portfolio risk.

[4] Rule 18f-4 defines "complex derivatives transactions" as "any derivatives transaction for which the amount payable by either party upon settlement date, maturity, or exercise: (i) is dependent on the value of the underlying

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reference asset at multiple points in time during the term of the transaction; or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising form a single strike price."

[5] As previously noted, financial commitment transactions include firm and standby commitment agreements, as well as any similar agreement. Firm and stand-by commitments are terms that were used in Investment Company Act Release No. 10666 (Apr. 18, 1979), and the Proposing Release apparently intends to give them the same meanings as they were given there. Thus, the Proposing Release states: "A firm commitment agreement is a buy order for delayed delivery under which a fund agrees to purchase a security—a Ginnie Mae, in the example we provided in Release 10666—from a seller at a future date, stated price, and fixed yield; a standby commitment agreement similarly involves an agreement by the fund to purchase a security with a stated price and fixed yield in the future upon the counterparty's exercise of its option to sell the security to the fund." Such transactions, however, seem also to constitute securities forwards and, therefore, to also fall within the definition of "derivatives transaction." Hence, there appears to be some ambiguity as to which aspects of the proposed Rule apply to such transactions.

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