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UNDERSTANDING THE SEC'S PROPOSAL ON REGISTERED FUNDS' USE OF DERIVATIVES AND FINANCIAL COMMITMENT TRANSACTIONS

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INTRODUCTION

On December 11, 2015, the US Securities and Exchange Commission (SEC) voted 3–1 in favor of proposing a new rule—Rule 18f-4 (Proposed Rule) under the Investment Company Act of 1940 (1940 Act). If adopted, the rule will have a significant effect on the use of swaps, security-based swaps, futures contracts, forward contracts, options, and other derivative instruments and financial commitment transactions by registered investment companies (i.e., mutual funds, exchange-traded funds (ETFs), and closed-end funds) and business development companies (BDCs).[1] In this White Paper, we refer to these entities generally as "funds."

The Proposed Rule is the SEC's third significant proposed rulemaking for the registered fund industry within the last year[2] and, together with the other rulemakings, represents a noteworthy departure from the SEC's traditional approach to regulating both derivatives and registered funds in general.[3] The Proposed Rule comes more than four years after the SEC issued its Concept Release on registered funds' use of derivatives[4] and would replace a patchwork of SEC staff positions that have developed over the last 35-plus years with comprehensive regulation that would change funds' use of derivatives and financial commitment transactions compared to current practices.

This White Paper provides details on the various aspects of the Proposed Rule and discusses its potential implications for the registered fund industry.

BACKGROUND

The Patchwork Quilt of Derivatives Regulation Under the 1940 Act

Virtually none of the derivative instruments commonly used today existed at the time that the 1940 Act was enacted. Many types of derivatives did not come into use until the 1980s, but then there was a wave of derivatives innovation that took place at a fast pace. Since then, derivatives have incrementally become more commonly used by registered funds, both for risk management and investment purposes. As was the case generally with the regulation of derivatives, the SEC and its staff did not promulgate comprehensive regulations and guidance under the 1940 Act on funds' use of derivatives. Instead, through a series of releases, no-action letters, and interpretive letters, the SEC and its staff sought to apply the existing framework of the 1940 Act and the rules thereunder to these new transactions and financial techniques. As a result, the current regulatory landscape with respect to funds' use of derivatives can be thought of as a "patchwork quilt" that does not comprehensively address many of the 1940 Act implications of investments in every type of derivative instrument and leaves a number of open questions and inconsistencies, which we summarize below.

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1. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 31,933 (Dec. 11, 2015) (Proposing Release). The proposal relies significantly on a white paper from the SEC's Division of Economic and Risk Analysis titled Use of Derivatives by Registered Investment Companies (DERA White Paper), which was released in tandem with the Proposing Release. Morgan Lewis previously prepared a LawFlash on this topic. A draft copy of Rule 18f-4 based on the text set forth in the Proposing Release is also available. In support of its proposal, the SEC cited the need to protect investors and a concern for potential losses in funds that make extensive use of derivatives, as well as the desire to implement a more comprehensive approach to the regulation of funds' use of derivative transactions.

2. *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31,835 (Sep. 22, 2015) (Liquidity Risk Management Proposal); *See also* Investment Company Reporting Modernization, Investment Company Act Rel. No. 31,610 (May 20, 2015) (Reporting Modernization Proposal). For more information on the Liquidity Risk Management Proposal and the Reporting Modernization Proposal, see our September 2015 LawFlash "SEC Proposes Liquidity Risk Management Rules for Open-End Funds" and our May 2015 LawFlash "SEC Proposes Rules Affecting Funds and Advisers."

3. *See* Speech by SEC Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014).

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

Section 18—Senior Securities

The use of derivatives by registered funds has been substantively regulated by the SEC and its staff under various provisions under the 1940 Act, even though most derivatives were not contemplated at the time that Congress enacted the 1940 Act. The most direct source of regulation is section 18 of the 1940 Act, which limits a registered investment company's ability to issue "senior securities" (defined in section 18(g) to include any bond, debenture, note, or similar obligation or instrument that evidences indebtedness, and any class of stock that has priority over any other class as to the distribution of assets or payment of dividends). As a result of section 18, open-end registered investment companies (i.e., mutual funds) cannot issue senior securities but may borrow from banks as long as they maintain an asset-to-debt coverage ratio of at least 300% (where amounts borrowed are counted as assets) at all times during the borrowing.[5] Because derivative instruments may result in an obligation to pay in the future for consideration received at the inception of the transaction, they traditionally have been interpreted as an evidence of indebtedness and thus a "senior security" subject to section 18(g), despite not being "securities" for many purposes of the US federal securities laws.

In 1979, the SEC provided guidance on how a registered fund could avoid creating a "senior security" for purposes of section 18 in the context of three types of transactions that involve future payment obligations of a fund: reverse repurchase transactions, firm commitment agreements, and standby commitments.[6] In addition to discussing these transactions, the SEC also indicated that Release 10,666 was intended to apply to "all comparable trading practices" that affect fund capital structures in an analogous way. This statement, coupled with a lack of subsequent formal guidance from the SEC, has resulted in the registered fund industry applying the principles set forth in Release 10,666 to a broad and diverse range of derivative instruments.

In Release 10,666, the SEC articulated the general principle that, to avoid the application of the senior security requirements in section 18, a fund must segregate or "cover" its future payment obligations by establishing a segregated account with liquid assets equal in value to those obligations. At the time, such liquid assets could include cash, US government securities, or other appropriate high-grade debt obligations. (Subsequently, the SEC staff permitted any type of liquid assets to be used for coverage purposes.[7]) Release 10,666 also explained that segregated assets could be replaced with other appropriate nonsegregated assets of equal value, that the assets must be "marked to the market" daily, and that additional assets must be placed in an account whenever the account's total value falls below the amount to be covered.

Funds have taken different approaches with respect to the amount of assets segregated for different types of derivative transactions. In Release 10,666 and subsequent no-action letters, the SEC and its staff generally indicated that funds should segregate assets equal to the full amount of the potential obligation under the derivative, where that amount is known at the outset of the transaction, or the full market value of the underlying reference asset for the derivative. Funds generally have applied this approach to, among other transactions, futures, forward contracts, and written options that permit physical settlement and credit default swaps regardless of whether physical settlement or cash settlement is contemplated. However, based on comments provided by the SEC staff in the context of its review of certain funds' registration statements, funds began to segregate amounts equal to their daily mark-to-market liability for interest-rate swaps, cash-settled futures, and nondeliverable forwards, and some funds now apply the

5. Section 18 is slightly less onerous for closed-end registered investment companies, which are permitted to issue and incur debt, but are still subject to coverage requirements and other restrictions.

6. *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 (Apr. 18, 1979) (Release 10,666).

7. *See* Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996). This no-action letter also permitted funds to treat assets as segregated if they were earmarked as such on a custodian's books and records and not physically segregated. Subsequent relief permitted funds to segregate assets on their own books and records and not the custodian's books and records, and provided fund administrators with greater flexibility in meeting the asset segregation requirements. *See* "Dear Chief Financial Officer" Letter, from Lawrence A. Friend, Chief Accountant, Division of Investment Management (Nov. 7, 1997).

mark-to-market approach to all derivatives that are required by their terms to be cash-settled. In addition, market practice has developed whereby a fund treats a physically settled futures contract as cash-settled for coverage requirements where the fund has entered into a contractual arrangement with a futures commission merchant (FCM)[8] whereby the fund has a right to instruct the FCM on how to settle the fund's position.

Limitations on Illiquidity

Pursuant to SEC guidelines, open-end funds cannot invest more than 15% of their net assets in illiquid securities (or 5% in the case of money market funds).[9] An instrument is considered "liquid" if it can be sold in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument for purposes of calculating the fund's net asset value.[10] Although exchange-traded derivatives are generally considered to be liquid, the status of over-the-counter (OTC) derivative instruments remains an open issue.[11]

Concentration and Diversification

The 1940 Act requires each registered investment company to disclose in its registration statement any policy to concentrate its investment portfolio in a particular industry or group of industries.[12] A fund cannot deviate from its concentration policy without shareholder approval.

Somewhat similar to concentration, a fund must also be either diversified or nondiversified, as those terms are defined in section 5(b) of the 1940 Act. For a fund to be diversified, with respect to 75% of its investment portfolio, no single issuer can represent more than 5% of the fund's total assets and the fund cannot own more than 10% of the outstanding voting securities of any single issuer.

Further, for both concentration and diversification purposes, the use of derivatives by funds raises questions about whether the derivative counterparty or the underlying reference instrument, or both, should be considered when applying a fund's policies.

Section 17(f)—Custody of Fund Assets

Section 17(f) of the 1940 Act requires a registered investment company to maintain its assets with a bank or broker-dealer or, in very limited circumstances, the fund itself. Because of the conditions imposed by the rules promulgated under section 17 on the use of a broker-dealer as a fund's custodian, most funds custody their assets with a qualifying bank, which, unlike a broker-dealer, may impose a lien against a fund's assets to secure obligations owed by the fund to it or to a third party. To comply with

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8. A futures commission merchant solicits or accepts orders to buy and sell futures contracts, options on futures, and retail off-exchange foreign exchange contracts or swaps and accepts money or other assets from customers in connection with such orders. Futures commission merchants are regulated by and registered with the Commodity Futures Trading Commission (CFTC) and the National Futures Association.

9. *See* Revisions to Guidelines to Form N-1A, Investment Company Act Rel. No. 18,612 (Mar. 12, 1992) (amending prior limitation of 10% as set forth in Statement Regarding "Restricted Securities," Investment Company Act Rel. No. 5847 (Oct. 21, 1969)). In September 2015, the SEC proposed Rule 22e-4 under the 1940 Act, which would codify this standard and create other requirements designed to promote effective liquidity risk management for open-end funds. *See* Liquidity Risk Management Proposal, *supra* note 1. Money market funds cannot invest more than 5% of their net assets in illiquid securities. *See* Rule 2a-7(d)(4) under the 1940 Act.

10. The Liquidity Risk Management Proposal would also require funds to measure the portions of their portfolios with three-day liquidity.

11. The SEC staff has previously determined OTC options to be illiquid. *See* Delta Gov't Options Corp., SEC No-Action Letter (July 21, 1989). A fund's board of directors could determine whether a particular OTC instrument is illiquid based on the fund's liquidity guidelines, the current market conditions, and the particular facts and circumstances surrounding the instrument.

12. *See* Item 4(a) and Item 9(b) of Form N-1A (registration form used by open-end investment companies); Item 8 of Form N-2 (registration form used by closed-end investment companies).

the custody rules promulgated under section 17, funds that engage in derivatives transactions typically hold posted collateral in a special custody account at the custodial bank that is administered under a tri-party control agreement among the fund, the custodian, and the fund's counterparty to the derivative transaction. Assets held in the special custody account are owned by the fund for purposes of calculating the fund's net asset value, but if the fund defaults on an obligation, the counterparty can foreclose on the posted collateral. Until a default or other similar condition or event occurs with respect to the fund, the counterparty is generally unable to use the posted collateral for its own purposes, due to the restrictions included in the tri-party agreement designed to comply with the section 17 custody requirements.

There is some additional flexibility for certain centrally cleared derivatives transactions executed through FCMs. For funds that invest in exchange-traded futures and options on futures,[13] Rule 17f-6 under the 1940 Act permits a fund to maintain cash, securities, and similar investments with an unaffiliated FCM. By its terms, Rule 17f-6 under the 1940 Act does not provide relief for other types of derivatives, such as swaps. The SEC staff, however, has expanded the availability of Rule 17f-6 on a temporary basis to various types of cleared swap transactions. [14] Under the Rule, the fund must enter into a written agreement with the FCM that obligates the FCM to transfer gains in excess of a *de minimis* amount to the fund on the business day following the day such gains are received.

Rule 35d-1 Under the 1940 Act—Fund Names

Rule 35d-1 under the 1940 Act requires an investment company to invest at least 80% of its net assets (plus any borrowings used for investment purposes) in the types of investments suggested by a fund's name if certain terms or words are included in the fund's name. In adopting Rule 35d-1, the SEC stated that a fund may include in its 80% basket a "synthetic instrument" if the circumstances are appropriate and the instrument has economic characteristics similar to the securities in the basket.[15] Since this guidance was provided, funds have developed a range of practices with respect to counting derivative instruments toward their 80% tests, which the SEC staff has at times sought to pare back through the registration statement comment process.

Disclosure of Investment Strategies and Risks

All investment companies are required to disclose to shareholders their principal investment strategies and related risks. Although the SEC staff provided guidance about disclosure of funds' use of derivatives in 1994,[16] a July 2010 letter from the SEC staff to the Investment Company Institute is widely regarded as the SEC staff's current view with respect to derivatives disclosure requirements.[17] In the 2010 letter, the SEC staff noted that it had observed funds using generic disclosures about derivatives that provided limited usefulness to investors and that disclosures ranged from highly abbreviated to overly long and technical. Accordingly, the staff recommended that all funds that invest in derivatives should assess the "accuracy and completeness" of a fund's disclosure, including whether the disclosure is written in plain English. The staff also stated that principal investment strategy and risk disclosure with respect to derivatives should be tailored specifically to the types of derivatives used by the fund, the extent of their use, and the purpose for using the derivatives.

13. *See, e.g.*, Chicago Mercantile Exchange, SEC No-Action Letter (July 10, 2013) (permitting a registered fund or its custodian to place cash and/or certain securities in custody of Chicago Mercantile Exchange or FCM clearing member for certain cash-settled commodity index swap contracts and foreign currency swap contracts cleared by Chicago Mercantile Exchange).

14. Under Rule 17f-6, a futures commission merchant cannot serve as an FCM to an affiliated fund unless it uses a tri-party custodian account pursuant to CFTC Financial and Segregation Interpretation No. 10-1.

15. *See* Investment Company Names, Investment Company Act Rel. No. 24,828 (Jan. 17, 2001) at n.13. The SEC specified that a fund could look through a repurchase agreement to the underlying collateral and apply the repurchase agreement to its 80% basket for purposes of the Rule.

16. *See* Letter to Registrant from Carolyn B. Lewis, SEC No-Action Letter (Feb. 25, 1994).

17. *See* Letter to Karrie McMillan, Investment Company Institute, from Barry D. Miller (July 30, 2010).

Rule 22c-1 under the 1940 Act—Valuation

Rule 22c-1 under the 1940 Act prohibits an open-end investment company from selling or redeeming its shares at a price other than the current net asset value per share, calculated after receipt of the purchase or redemption order. Mutual funds (other than government and retail money market funds) must use the market value for those portfolio assets for which market quotations are readily available and must use fair value, as determined in good faith by a fund's board of directors, for those portfolio assets for which market quotations are not readily available. For derivative instruments, particularly OTC derivatives, funds and fund boards must evaluate the reliability of prices provided by pricing services, taking into account the nature of the market for the particular instrument.

Section 12(d)(3)—Investments in Issuers in a Securities-Related Business

Section 12(d)(3) of the 1940 Act prohibits a registered investment company from purchasing any securities issued by "or any other interest in the business of" a broker, dealer, underwriter, investment adviser, or investment company. In the case of OTC derivatives, if a fund's counterparty is a securities-related issuer, the fund's transaction with the counterparty may represent the acquisition of a security issued by, or an interest in, that issuer. Rule 12d3-1 under the 1940 Act provides an exemption from the general prohibition in section 12(d)(3), subject to certain conditions, but the language of the Rule is limited to "securities" and does not extend to the "other interests" included in section 12(d)(3). Accordingly, a fund could rely on Rule 12d3-1 to engage in an OTC derivative transaction with a securities-related issuer only if the derivative could be categorized as a "security." Also, similar to the issues regarding concentration and diversification, the question arises about whether the derivative counterparty or the issuer of an underlying reference instrument should be considered.

Prelude to Changes in Regulation

The SEC first formally announced that it was evaluating the use of derivatives by registered investment companies in March 2010.[18] However, the SEC's interest in funds' use of derivative transactions predates the financial recession of 2007–2008 and includes an industry study conducted in 1994.[19] The SEC's current efforts have been most recently informed by a 2010 report from an American Bar Association task force and a 2011 Concept Release from the SEC (including information received from the marketplace in response).[20]

ABA Task Force Report (2010)

In April 2009, Andrew J. Donohue, then director of the SEC's Division of Investment Management, challenged the Subcommittee on Investment Companies and Investment Advisers of the American Bar Association's Section of Business Law's Committee on Federal Regulation of Securities (Subcommittee) to address concerns about whether funds' technical compliance with the 1940 Act and rules thereunder still allowed for outcomes that could fall outside the 1940 Act structures designed to protect investors.[21] Specifically, Mr. Donohue asked the Subcommittee to consider whether registered funds should have procedures in place with respect to their use of derivatives beyond disclosure to investors, whether funds should address both "implicit" and "explicit" leverage with respect to their use of derivatives, and whether funds should address diversification from the perspective of investment exposure instead of the amount

18. *See* SEC Staff Evaluating the Use of Derivatives by Funds, SEC Press Release 2010-45 (Mar. 25, 2010).

19. In 1994, the staff conducted a study on mutual funds and derivative instruments, focusing on, among other things, funds' use of derivatives to obtain leverage and related disclosures to investors. *See* Memorandum from the SEC Division of Investment Management on Mutual Funds and Derivative Investments (Sep. 26, 1994).

20. In 2008, an Independent Directors Council Task Force Report was also published that set forth the role of registered funds boards in overseeing derivative transactions entered into by funds.

21. *See* Andrew J. Donohue, Speech by SEC Staff: Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality? (Apr. 17, 2009).

of money invested. In response to Mr. Donohue's remarks, the Subcommittee formed the Task Force on Investment Company Use of Derivatives and Leverage (Task Force), which published a report on its findings on July 6, 2010.[22]

The Task Force recommended a principles-based approach to the regulation of derivatives. Among other items, the Task Force suggested that the SEC require funds to establish board-approved written policies that would set forth minimum asset segregation requirements using risk-adjusted segregation amounts that would be tailored to each instrument category, address the types of instruments that could be used as segregated assets, and describe offsetting transactions. The Task Force also recommended that these policies be described in a fund's statement of additional information and that segregation not be required where a fund does not use explicit leverage (i.e., where it carries leverage through an investment in another fund).

SEC Concept Release (2011)

On August 31, 2011, the SEC issued a Concept Release on the regulatory framework governing the use of derivatives by investment companies under the 1940 Act.[23] The 2011 Concept Release, which referred extensively to the Task Force report, solicited comments on a broad range of topics relating to the use of derivatives by registered investment companies in connection with a comprehensive review by the SEC and its staff. The purpose of the review was to help determine whether regulatory guidance or changes were needed and, if so, what type of changes would be appropriate. At the open meeting during which the Concept Release was approved, then-Chair Mary Schapiro stated that the regulatory framework surrounding funds' use of derivatives had been developed on an ad hoc basis and that the Concept Release would help the SEC determine whether and how the regulatory framework surrounding funds' use of derivatives needed to be updated.

In the Concept Release, the SEC explained that its staff had explored a number of issues related to the use of derivatives by funds, including:

- the benefits, risks, and costs of using derivatives;
- whether current market practices were consistent with the leverage, concentration, and diversification provisions of the 1940 Act;
- whether funds that relied substantially on derivatives maintained and implemented adequate risk management procedures;
- whether fund boards were providing appropriate oversight of the use of derivatives by the funds that they oversaw;
- whether existing rules sufficiently addressed pricing and liquidity determinations with respect to derivative investments;
- whether existing prospectus disclosures adequately addressed the particular risks associated with investing in derivatives; and
- whether funds' use of derivatives should be subject to any special reporting requirements.

Although the SEC staff had been exploring fund investments in derivatives for some time, the Concept Release marked the first formal instance of the SEC itself soliciting information from industry participants on the topic.

22. *See* Committee on Federal Regulation of Securities, American Bar Association Section of Business Law, Report of the Task Force on Investment Company Use of Derivatives and Leverage (July 6, 2010).

23. *See* Concept Release, *supra* note 4.

The Concept Release began with a discussion of the broad use of derivatives by funds and a summary of the existing regulatory framework under the 1940 Act, and then focused on senior security issues under section 18 of the 1940 Act and solicited comments about whether the current asset segregation approach used to address senior security issues continued to be appropriate. In this area, the Concept Release suggested that mark-to-market exposure and notional value might not be the most complete or suitable measures of the financial risks associated with funds' derivatives usage. The SEC suggested that approaches that entail weighing the risks involved (e.g., "value-at-risk" calculations) or approaches used by foreign regulators[24] and those suggested by the Task Force in its 2010 report might be more appropriate.

The Concept Release also addressed other issues under the 1940 Act that are implicated by the use of derivatives by funds, and discussed above, including diversification, concentration, investing in securities-related issuers, and valuation.[25] These issues, however, were not addressed in the Proposing Release.

SEC White Paper on Use of Derivatives by Registered Investment Companies (2015)

In tandem with the Proposing Release, the SEC Division of Economic and Risk Analysis (DERA) released a white paper discussing its assessment of the use of derivatives by registered investment companies.[26] The DERA White Paper was based on data collected from 1,188 funds, representing approximately 10% of US registered funds. The DERA White Paper noted that many funds did not use derivatives, even if their investment policies permitted them to do so, and that 32% of sampled funds held one or more derivative instruments, the most common of which were currency forwards, equity futures, and interest rate futures. The staff also found that, of the funds sampled, the average gross notional exposure to derivatives was 20% of net asset value and that 96% of all funds sampled had aggregate exposure below 150%. Although the DERA White Paper refrained from making any conclusions about the need for changes in the regulation of investment companies' use of derivatives, it stands as one of the foundations on which the Proposing Release is based.

The DERA White Paper presents a data-heavy presentation of what the DERA staff determined to be representative of current market practices, but there are potential shortcomings with the approach. First, DERA acknowledges that the funds for which data was collected represent only 10% of US funds, meaning that approximately 90% of US funds are not directly represented. A significant number of funds may exist that use derivatives in ways different from those funds included in the market sample. Second, DERA analyzed data provided by Morningstar and distilled from fund annual and semiannual report filings, but the SEC's proposal to enhance fund reporting requirements with respect to derivatives transactions seems to indicate an acknowledgement on the part of the SEC that the current available data is insufficient, which would seem to indicate that DERA's conclusions based on such data should also be considered in light of the possibility that certain market practices are not captured by available data. This would also be consistent with initial, informal reactions from the marketplace, which views the DERA White Paper as understating the expected impact on the registered fund industry in terms of the number of funds affected.

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24. The approaches used by the European Securities and Markets Authority (formerly the Committee of European Securities Regulators), the Monetary Authority of Singapore, the Central Bank of Ireland, the Canadian Securities Administrators, and the Securities and Futures Commission of Hong Kong were discussed at length in the Concept Release.

25. Several other 1940 Act issues relating to funds' use of derivatives, namely custody issues, liquidity limitations, compliance with Rule 35d-1, and tax issues, were not expressly addressed in the Concept Release, although the Concept Release did include a general request for comments.

26. *See* DERA White Paper, *supra* note 1.

PROPOSED RULE

Overview

The Proposed Rule would function as an exemption from the general prohibition from entering into senior securities transactions under section 18 of the 1940 Act (and section 61, for BDCs). Under the Proposed Rule, "derivatives transactions" would be broadly defined to include swaps, security-based swaps, futures contracts, forward contracts, and options, as well as any combination of those instruments and any similar instrument under which a fund is or may be required to make any payment or delivery of cash or other assets. In addition, the proposal would regulate funds' entry into "financial commitment transactions," which would include reverse repurchase agreements, short sales, and any firm or standby commitment agreements or similar agreements (including promises to make a loan or capital commitments). Thus, the Proposed Rule's scope extends well beyond the rules relating to swaps and security-based swaps mandated under Title VII of the Dodd-Frank Act, which did not cover most options on securities, forward contracts, repurchase agreements, short sales, or standby agreements.

The proposal would regulate funds' use of derivatives and financial commitment transactions in three ways: (i) by imposing certain portfolio limitations, (ii) by requiring assets to be segregated, and (iii) by requiring certain funds to adopt derivatives risk management programs. Funds would also face new recordkeeping and reporting requirements. All of these proposed requirements, as well as market implications and open issues, are discussed in greater detail below.

Effect on Existing Guidance

If the Proposed Rule is adopted, the SEC will rescind Release 10,666 as well as the SEC staff's no-action letters and other guidance that addresses derivatives and financial commitment transactions, and funds will then only be permitted to enter into derivatives and financial commitment transactions as permitted by Rule 18f-4, or section 18 or 61 of the 1940 Act, absent additional relief from the SEC or its staff.

However, until the proposed changes are adopted, the SEC's current guidance set forth in Release 10,666 (as well as no-action letters and other guidance from the SEC staff) will remain in place. The SEC indicated that it expects to provide the market with a transition period during which funds would move from the current regulatory framework to the effective rule, but funds would be permitted to operate in accordance with the effective rule as soon as they are able to comply with the rule's conditions. The SEC has requested comment on whether a transition period would be appropriate and, if so, how long such a period should be.

PORTFOLIO LIMITATIONS

Summary

As proposed, any fund that desires to rely on the exemption from section 18 afforded by Proposed Rule 18f-4 would be required to comply with one of two alternative portfolio limitations—the exposure-based portfolio limit or the risk-based portfolio limit. The portfolio limitations are intended primarily to address the concern articulated in section 1(b)(7) of the 1940 Act that the leveraging of a fund's portfolio through the issuance of senior securities and borrowing magnifies the potential for gain or loss on amounts invested, and, therefore, results in an increase in the speculative character of the fund's outstanding securities. Many derivatives and financial commitment transactions involve some degree of embedded leverage, and the SEC's view is that, although these instruments may not be "securities" or "borrowing" for all purposes, derivatives and financial commitment transactions, when used for speculative purposes or to attain leverage, fall within the legislative purposes of section 18's prohibition on senior securities. Therefore, Proposed Rule 18f-4 limits the amount of leverage that a fund could obtain through derivatives transactions, financial commitment transactions, and transactions involving senior securities entered into pursuant to section 18 (or section 61 for BDCs) (collectively, "senior securities transactions").[27]

Exposure-Based Portfolio Limit

Under the exposure-based portfolio limitation, a fund would be required to limit its aggregate exposure to senior securities transactions to 150% of its net assets, calculated immediately after entering into any senior securities transaction. Notably, however, if a fund's exposure increased beyond the 150% exposure limitation (or the Risk-Based Portfolio Limit discussed below) subsequent to such calculation, the Proposed Rule would not require the fund to unwind or terminate a senior securities transaction to reduce the fund's exposure.[28] The fund, however, would not be permitted under the Proposed Rule to enter into any additional senior securities transaction, unless it could comply with the portfolio limitation immediately after entering into that transaction.

Calculation of Exposure

A fund's aggregate exposure would be calculated as the sum of (i) the aggregate notional amount of its derivatives transactions, (ii) the aggregate amount of its obligations under financial commitment transactions, and (iii) the aggregate indebtedness with respect to any transactions involving senior securities entered into by the fund pursuant to section 18 or 61 of the 1940 Act.

Under the Proposed Rule, the "notional amount" of a derivatives transaction is defined as the market value of an equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transaction are calculated. These definitions generally assume that the notional amount of the derivatives transaction is being fully leveraged. However, this is not always the case. At one end of the spectrum, a plain vanilla share total return swap with a purchase price equal to the current market price of the stock and no upfront payments by either counterparty can be thought of as providing a "fully leveraged" investment in the underlying stock. At the other end of the spectrum, a forward contract on the same share of stock with a purchase price at the same level but that has been paid upfront can be thought of as providing an unleveraged or "fully funded" investment in the underlying stock.

Thus, depending on the nature and size of the upfront payments, derivatives can be unleveraged or partially leveraged to a greater or lesser degree. In the Proposing Release, the SEC acknowledged that the notional value of a derivatives transaction is not a perfect metric in all respects and that leverage can be calculated in a number of different ways,[29] but emphasized its belief that, on balance, notional value would be the most "effective and administrable means of limiting potential leverage from derivatives."[30] Nonetheless, the SEC did address some of these issues. For example, in an illustrative table in the preamble to the Proposed Rule that demonstrates the calculation of notional amount for certain commonly used derivatives transactions, the SEC clarified that the notional amount for an option would reflect the "delta" of the option. Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. The delta-adjusted notional value of options is needed to have an accurate measurement of the exposure that an option creates to the underlying reference asset.

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27. The Proposed Rule clarifies that the term "senior securities transaction" would mean any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by a fund pursuant to section 18 of the 1940 Act without regard to the exemption provided by the rule. *See* Proposed Rule 18f-4(c)(10).

28. The SEC noted that "this aspect of the proposed rule was to prevent a fund from having to unwind or terminate a senior securities transaction that the fund was permitted to enter into under the proposed rule at a later time when terminating or unwinding the transactions may be disadvantageous to the fund." *See* Proposing Release, *supra* note 1 at 80924.

29. For example, the SEC noted that the notional value of a derivatives transaction is not reflective of the way in which a fund uses the derivatives transaction or the risk associated with the derivatives transaction. *See* Proposing Release, *supra* note 1 at 80903.

30. See id.

The SEC also expressed its preliminary view that derivatives that do not impose a future payment obligation on a fund, such as purchased options, would not involve a senior security transaction for purposes of section 18 and therefore would not be subject to the portfolio limits. The SEC noted, however, that such instruments "can increase the volatility of a fund's portfolio and thus cause an investment in a fund to be more speculative than if the fund's portfolio did not include such instruments" and sought comment on whether such instruments should be included in the calculation of exposure.[31]

Because of the SEC's concerns that the notional amount may not reflect the extent of a fund's exposure under certain transactions, the Proposed Rule provides for the use of an adjusted notional amount when calculating the exposure-based portfolio limit in the following circumstances:

- First, for a derivative with returns based on the leveraged performance of a reference asset, the notional amount of the derivative would be multiplied by the leverage factor applicable to the reference asset. For example, if a fund invested in a swap designed to provide two times the performance of the S&P 500 Index, that fund's exposure from the swap would equal the market value of an equivalent position in the constituents of the S&P 500 Index times two.
- Second, for derivatives with reference assets that are (i) managed accounts or entities formed or operated primarily for the purpose of investing in or trading derivatives transactions or (ii) indices reflecting the performance of such accounts or entities, the notional amount would include the fund's pro rata portion of the notional amounts of the derivative transactions of the underlying reference account or entity, which in turn would be calculated in accordance with the Proposed Rule. The SEC noted that this adjustment would apply, for example, to swaps on leveraged ETFs.
- Third, for complex derivatives transactions, the notional value would be equal to the aggregate notional amounts of other noncomplex derivative instruments "reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction at the time the fund enters into the transaction."[32] Under the Proposed Rule, "complex derivatives transactions" are defined as any derivatives transaction for which the amount payable by either party upon the settlement date, maturity, or exercise: (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction (e.g., barrier options and Asian options) or (ii) is a nonlinear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price (e.g., a variance swap). With respect to barrier options, the SEC notes that a combination of standard put and call options may be used to offset substantially all of the market risk of a barrier option.

The Proposed Rule would allow for netting derivatives transactions with offsetting exposures to lessen a fund's aggregate notional exposure, but in a limited fashion. Netting would be permissible only when the derivatives transactions were directly offsetting, which means that the offsetting derivatives transactions must be the same type of instrument and have the same underlying reference assets, maturity, and other material terms. The Proposed Rule would not require that offsetting derivatives transactions have the same counterparties. The SEC stated that the netting provision is meant to apply to derivatives transactions (a) where a fund would generally use an offsetting transaction to settle all or a portion of a transaction prior to maturity due to reasons relating to regulation, transaction structure or market price, and (b) where a fund is looking to eliminate or reduce its economic exposure under a transaction without terminating the transaction. As may be expected, certain key issues around netting remain open, including whether funds may offset positions with the same duration even though the stated maturity of each position may be different.

31. *See id.* at 80908.

32. *See id.* at 80905.

The Proposed Rule states that to accurately determine a fund's exposure, in addition to the adjusted aggregate notional amount of the fund's derivatives transactions, the calculation also must include (a) a fund's aggregate financial commitment obligations and (b) the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any transaction involving senior securities entered into by the fund pursuant to section 18 or 61 of the 1940 Act without regard to the exemption provided by the Proposed Rule (i.e., senior securities transactions engaged in by a fund in reliance on the requirements of those provisions, rather than in reliance on the exemption that would be provided by the Proposed Rule).[33] The SEC has proposed to define a "financial commitment obligation" as the amount of cash or other assets that a fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction, as adjusted daily to reflect changes in market values.

Why 150%?

In fashioning the exposure limits, the SEC was faced with the issue that, although the fundamental rationale for exposure limits was to curtail funds' use of derivatives involving leverage, it had to be acknowledged that "funds use derivatives for a range of purposes that may not, or may not be expected to, result in additional leverage for the fund."[34] For example, funds may use derivatives for hedging or risk-reduction purposes. A more finely tuned approach would have been to permit funds to determine whether particular derivatives create additional leverage and the extent of this leverage and/or whether they are used for hedging or other risk-reduction purposes. The SEC rejected this approach because it believed that it would be too difficult to create objective standards that could be easily administered and policed. Instead, the SEC opted for a highly administrable approach that applies one-size-fits-all exposure limits to all derivatives. To set the level of these limits, the SEC looked to existing limits and market activity.

On the one hand, the SEC considered the 50% limit implied by the 300% asset coverage requirement for indebtedness in section 18 and the 100% limit based on the approach suggested in Release 10,666 (namely, that by permitting a fund to use noncash assets to cover transactions like reverse repurchase transactions, this approach effectively permits the use of up to 100% of the fund's net assets). The SEC found the foregoing limits too restrictive because they could limit a fund's ability to use derivatives for purposes other than leveraging its portfolio that may be beneficial to the fund and its investors. On the other hand, the SEC did not want to set the limits too high (e.g., 200–250%) because it was concerned that this could conflict with the concerns regarding undue speculation and asset sufficiency expressed in sections 1(b)(7) and 1(b)(8) of the 1940 Act. After taking into account these concerns, the SEC proposed an exposure-based portfolio limit of 150%.

As part of the evaluation process to determine the appropriate portfolio limitation, the SEC reviewed an analysis conducted by DERA that included a random sample of mutual funds, closed-end funds, BDCs, and ETFs. The study showed that a majority of funds, including most ETFs (excluding certain leveraged ETFs), already comply with the 150% exposure limitation and therefore would be deemed compliant without modifying their portfolios. In addition, although certain alternative strategy funds might need to modify their portfolios to meet the exposure limitation, most would generally be able to continue operations as management investment companies registered under the 1940 Act. Therefore, according to the SEC, "almost all existing types of investment strategies" could be managed in compliance with the proposed 150% exposure limitation.[35] Perhaps not surprisingly, the SEC singled out funds that pursue managed futures strategies and currency strategies as categories of funds most likely to be unable to limit their exposures to less than 150%. For funds that would be unable to comply with the proposed portfolio limitations or that would prefer to not rely on the exemption afforded by the Proposed Rule, the SEC noted that such funds "may wish to consider deregistering" under the 1940 Act and instead offer

33. Proposed Rule 18f-4(c)(3).

34. *See* Proposing Release, *supra* note 1 at 80909.

35. *See id.* at 80911.

their strategies as private funds or public or private commodity pools.[36] The SEC devoted little attention in the Proposing Release to this possibility, belying the complexity of such a decision.

Risk-Based Portfolio Limit

Under the risk-based portfolio limitation, a fund would be permitted to obtain derivatives exposure up to 300% of its net assets, provided that the fund satisfies a risk-based test that would be calculated using a value-at-risk (VaR) methodology. This limit would be an alternative to the exposure-based limit discussed above and would permit a fund complying with the VaR-based limitations to obtain exposure in excess of the exposure-based portfolio limit. The Proposing Release explained that the risk-based portfolio limit is designed to provide an alternative portfolio limitation that focuses primarily on risk assessment of a fund's use of derivatives. Further, the risk-based limit reflects the SEC's belief that if a fund's use of derivatives, in the aggregate, can reasonably be expected to result in a portfolio that is subject to less market risk, then the fund's derivatives use is also less likely to implicate the undue speculation concern expressed in section 1(b)(7) of the 1940 Act.

VaR Test

Under the Proposed Rule, VaR would be defined as an estimate of potential losses (on either a particular instrument or an entire portfolio) over a specified time horizon and at a given confidence interval, expressed in US dollars. To satisfy the VaR test, a fund's full portfolio VaR (i.e., the VaR of the fund's entire portfolio, including securities, derivatives transactions, and other transactions) would have to be less than the fund's securities VaR (i.e., the VaR of the fund's securities and other investments, excluding any derivatives transactions) immediately after the fund enters into any senior security transaction. The SEC noted that the term "securities VaR" is also intended to encompass instruments that are not considered "securities" under the federal securities laws, such as direct holdings of non-US currencies, and derivatives instruments that are otherwise excluded from the Proposed Rule, such as purchased options. Whether it is feasible for a fund to perform this test each time it has entered into such a transaction—and maintain written records of such for each transaction—remains an open question. If a fund satisfies the VaR test, the fund may obtain exposure under its derivatives and other senior securities transactions of up to 300% of its net assets.

The SEC believes that VaR is the appropriate method for calculating a fund's risk exposure for various reasons. First, the SEC believes that the VaR test generally enables risk to be measured in a comparable and consistent manner across diverse types of instruments, which allows the market risk associated with different instruments to be integrated into a single number that provides an overall indication of the fund's market risk. Second, the SEC prefers the VaR test because it can be used to evaluate the effect of adding a position (or multiple positions) on the portfolio's overall market risk. According to the SEC, an additional benefit of using VaR as the risk-measurement tool is that the VaR calculation tools are readily available and already have been implemented by many advisers. While acknowledging the similarities between the VaR test under the Proposed Rule and the "relative" VaR approach used by some foreign public funds (e.g., UCITS funds), the SEC outlined its views regarding the advantages of the proposed VaR test, including the ability for a fund to use its own portfolio of investments as the baseline comparison. That aspect of VaR testing would, in the SEC's view, remove the difficulty associated with having the fund select an appropriate benchmark to act as the baseline comparison.

The SEC also addressed commenters' concerns that VaR does not adequately reflect "tail risks" (i.e., the size of losses that may occur on the trading days during which the greatest losses occur) and that VaR calculations may underestimate the risks of loss in stressed markets. In this regard, the SEC clarified that the VaR test in the Proposed Rule is focused primarily on the relationship between a fund's securities VaR and its full portfolio VaR rather than the absolute magnitude of an investment's potential loss. In addition, the VaR test is coupled with an exposure limit, which is an independent limit on a fund's use of

36. *See id.* at 80912.

senior securities transactions. In the Proposing Release, the SEC cautioned funds that the VaR test is not intended to be a substitute for other measures that funds typically would consider in connection with managing risk related to their derivatives use.

Choice of Model and Parameters for the VaR Test

The SEC views the definition of VaR under the Proposed Rule as broad enough to encompass most methods of calculating VaR and to allow funds certain flexibility in the way that they calculate VaR. Under the Proposed Rule, VaR models can vary from fund to fund, but a fund must apply its chosen VaR model in a consistent manner when calculating the fund's securities VaR and full portfolio VaR. A fund's VaR model must incorporate all significant, identifiable market risk factors associated with the fund's investments, such as equity price risk, interest rate risk, credit spread risk, foreign currency risk, and commodity price risk.

Further, the VaR model must

- use a 99% confidence interval,
- use a time horizon (a single horizon must be used for the VaR calculations) of at least 10 but not more than 20 trading days,
- use a minimum of three years of historical data to estimate historical VaR if the fund is using historical simulation, and
- take into account all material risks arising from nonlinear price characteristics of the fund's investments and the sensitivity of the market value of such investments to changes in volatility.

Additionally, the Proposed Rule would require a fund subject to the requirement to have a formalized derivatives risk management program to, among other things, review and update its VaR calculation models at least annually to evaluate their effectiveness and reflect changes in risk over time.

300% Exposure Limit

A fund that chooses to comply with the risk-based portfolio limitation would be required to limit its aggregate exposure to senior securities transactions to 300% of its net assets, rather than 150%, as would be required under the exposure-based portfolio limit. This 300% exposure limit places an outside limit on a fund's exposures that is independent of VaR and other risk-based assessments. The SEC believes that this outside limit is important because it addresses concerns regarding the effectiveness of the VaR test in all possible circumstances and market conditions (in particular, in periods of market stress).

Further, the SEC believes that the 300% exposure limit is consistent with the undue speculation concern expressed in section 1(b)(7) of the 1940 Act. Importantly, the SEC notes that the 300% limit is proposed to act as an adjunct limitation, as the VaR test would be the most important aspect of the risk-based portfolio limitation. In the Proposing Release, the SEC discussed its considerations in proposing the 300% exposure limit, including the consideration of the extent to which funds included in the DERA sample with exposures exceeding the 150% exposure-based portfolio limitation appeared to satisfy the VaR test. The analysis found that managed futures funds and other funds that use derivatives to obtain market exposure (which in some cases had exposures of 500% to 950%) generally would not satisfy the VaR test. However, the analysis found that other alternative strategy funds (e.g., unconstrained bond and multialternative strategy funds) with exposures exceeding 150% (generally between 175% and 350%) could potentially use derivatives in a manner that would satisfy the VaR test. Based on the foregoing, the SEC stated that setting the exposure limit above 300% would not further the purposes of the risk-based portfolio limit.

Related Board Requirements

If a fund elects to rely on the Proposed Rule, its board of directors, including a majority of the directors who are not interested persons of the fund, would have to approve the portfolio limitation that the fund would use (as well as any change in a limitation previously chosen). The portfolio limitation selected would then determine the specific compliance requirements and board oversight applicable to the fund under the Proposed Rule. Depending on the nature of the funds in the fund complex overseen by a particular board of directors, the Proposed Rule could require directors to not only become more familiar with the regulatory requirements applicable to funds' use of derivatives, but also to develop a more detailed understanding of the types, investment objectives, and economics of the derivatives used by the funds that they oversee, the extent of the funds' use of derivatives, and the relationship between the funds' derivatives and other portfolio assets.

ASSET SEGREGATION

The Proposed Rule would also require a fund to manage the risks associated with its derivatives transactions by, among other things, segregating assets to ensure that the fund has sufficient assets to meet its obligations under those transactions. Funds would be required to implement board-approved policies and procedures through which they would maintain a required amount of qualifying coverage assets.

Asset Segregation Requirements for Derivatives

In addition to the two alternative portfolio limitations—and to address concerns relating to asset sufficiency and undue speculative activity[37]—the Proposed Rule would require a fund to manage the risks associated with its derivatives transactions by maintaining, and identifying on its books and records, an amount of certain asset types (qualifying coverage assets) designed to ensure that the fund will be able to meet its obligations under the derivatives transactions.[38] The amount of qualifying coverage assets would be determined each business day on a transaction-by-transaction basis pursuant to policies and procedures approved by a fund's board of directors. A fund would be required to maintain qualifying coverage assets with a value equal to at least the sum of (i) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination (mark-to-market coverage amounts) and (ii) an amount reflecting a reasonable estimate of the potential amounts payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (risk-based coverage amounts).[39] Under the Proposed Rule, the total amount of a fund's coverage amounts could not exceed the fund's net assets.[40] Unlike the either/or test set forth with respect to portfolio limitations, a fund would be required to maintain **both** the mark-to-market and risk-based coverage amounts.

Mark-to-Market Coverage Amount

The Proposed Rule would require each fund to calculate and maintain qualifying coverage assets in an amount equal to, at any time, "the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time"[41] based on market values and conditions existing at the time of determination. If such amount would be payable to the fund (i.e., it is "in the money" on the transaction), then the mark-to-market coverage amount would be equal to zero. The SEC states that funds could readily calculate such mark-to-market coverage amount because they already calculate such

37. *See* Proposing Release, *supra* note 1 at 80890.

38. *See id.* at 80925.

39. *See id.* at 80926.

40. *See id.* at 80934.

41. Proposed Rule 18f-4(c)(6)

amounts to determine their net asset value.[42] However, this formulation diverges from the industry-standard approach to mark-to-market valuation, which seeks to determine the midmarket value of the position on a daily basis under existing trading agreements. For example, under the Credit Support Annex to the standard ISDA Master Agreement, the mark-to-market value of a transaction (known as "Exposure") is calculated as the midmarket replacement value of the transaction.[43] This is determined on the basis of market quotations received from dealers for a replacement transaction that would preserve the economics to the parties of the transaction being valued, assuming no termination of the transaction.[44] Compliance with the calculation methodology suggested in the Proposed Rule could require registered investment companies to rework existing valuation processes and systems.

Similar to the margin regulations for uncleared swaps, a fund would be permitted under the Proposed Rule to calculate its mark-to-market coverage amounts on a net basis with respect to all derivatives transactions for which payments may be netted pursuant to a netting agreement.[45] This aspect of the Proposed Rule is designed so that the mark-to-market coverage amount more accurately reflects the fund's current net amounts payable with respect to the derivatives transactions covered by such netting agreements and is consistent with existing netting practices.[46] For example, the ISDA Master Agreement includes an election that permits parties to engage in cross-transaction netting, meaning that payments due on the same date in the same currency with respect to two or more transactions (regardless of the types of assets underlying the transactions) under the ISDA Master Agreement may be netted.[47] In addition, upon termination of transactions under an ISDA Master Agreement due to an event of default or termination, the amounts payable with respect to each transaction are effectively netted into a single payment obligation.[48]

Funds may also enter into "master netting agreements," which are agreements that permit netting of amounts owed under transactions governed by different agreements, including multiple ISDA Master Agreements and other types of trading agreements between the same parties and, often, between their affiliates. For example, a fund may have arrangements with different affiliates of the same financial institution for OTC derivatives, cleared derivatives, options, and futures. Some master netting agreements permit netting on a regular basis (monthly or quarterly, for example), while others permit netting only when the underlying master or other agreements are terminated. Although such contractual cross-affiliate netting arrangements may not be enforceable in bankruptcy, they are generally understood to be enforceable in other contexts. As currently proposed, there is no requirement that such netting agreements must be enforceable in the insolvency of the counterparty, thus leaving open the possibility that funds could take advantage of such cross-affiliate master netting arrangements to reduce the amount of required mark-to-market coverage amounts. However, the precise scope of this netting reduction under the Proposed Rule is not clear.

The Proposed Rule allows funds to reduce the amount of mark-to-market coverage amounts by the value of assets posted as variation margin or collateral.[49] The rule proposal states,

42. *See* Proposing Release, *supra* note 1 at 80927.

43. *See* ISDA, 1994 Credit Support Annex (Security Interest-New York law) at paragraph 12 (1994).

44. *See id.* Consistent with this approach, both the CFTC and the banking regulators in their final rules for margin for uncleared swaps clarified that the mark-to-market margin will be based on midmarket prices, to the extent that is consistent with the agreement of the parties. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636, 664 (Jan. 6, 2016) (CFTC Uncleared Margin Final Rule); Margin and Capital Requirements for Covered Swap Entities 80 Fed. Reg. 74840, 74867 (November 30, 2015) (Prudential Regulators Final Rule).

45. *See* Proposing Release, *supra* note 1 at 80927.

46. *Id.*

47. *See* ISDA, Master Agreement, §2(c).

48. *See id.*, §6(e).

49. *See* Proposing Release, *supra* note 1 at 80,927. Note, only amounts posted as variation margin (i.e., not initial margin) can be used to reduce the mark-to-market coverage amount. In accordance with the requirements of section 17(f) of the 1940 Act,

> For example, if a fund that has entered into an OTC swap and has delivered collateral equal to its mark-to-market loss on the OTC swap, the fund generally would not also be required to segregate qualifying coverage assets with respect to the swap's mark-to-market coverage amount, because the collateral delivered would equal the amount payable by the fund, based on market conditions, if the fund were to exit the transaction at that time.[50]

As discussed above, there may not be equivalence between amounts posted as the "Exposure" or "variation margin" and the mark-to-market coverage amounts because it appears that these amounts may be calculated differently. Without further clarification from the SEC, this may be a trap for the unwary as the midmarket calculation of Exposure could result in a lower amount of margin posted than would be required to be segregated under the calculations provided for in the Proposed Rule. In addition, this "credit" is only available for margin or collateral posted with respect to a particular transaction. This may raise issues for funds that use portfolio margining or where margin is calculated on the basis of aggregated risks or positions, because the Proposed Rule does not prescribe a method for allocating the variation margin among transactions.[51]

Risk-Based Coverage Amount

In addition to the mark-to-market coverage amount, the Proposed Rule would require a fund to segregate an additional risk-based coverage amount, calculated each business day, representing "a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions."[52] Rather than prescribing any specific methodology for calculating this amount, the Proposed Rule requires that it be determined in accordance with policies and procedures approved by the board of directors of the fund that are tailored to assess the appropriate risk-based coverage amount for specific derivatives transactions, taking into account, as relevant, the structure, terms, and characteristics of the derivatives transaction and the underlying reference asset.[53] The SEC states that this may include, for example, consideration of the fund's ability to terminate the trade or to otherwise exit the position under stressed conditions.[54] In developing such policies and procedures, a fund could use one or more financial models to determine the risk-based coverage amount. For example, a fund could employ stress testing or, for certain types of derivatives, a stressed VaR model.[55]

Although this approach may preserve flexibility for a fund, it also may also lead to some uncertainty about the adequacy of a fund's methodologies for determining the risk-based coverage amount because the Proposed Rule does not contain any parameters for quantifying levels of market stress. In contrast, margin regulations for uncleared swaps generally require that any model used to calculate initial margin

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funds use tri-party control agreements to post margin in a segregated account with a custodian for the benefit of their counterparties. See, e.g., *In the Matter of Water Island Capital, LLC*, Release No. 31455, Feb. 12, 2015 (requiring Water Island Capital, LLC to cease and desist pursuant to section 9(f) of the 1940 Act from posting collateral directly to its broker-dealer counterparties in connection with certain total return and portfolio return swaps, as such practice was considered to be in violation of section 17(f)(5) of the 1940 Act.).

51. Proposing Release, *supra* note 1 at 80927–28.

51. The goal of portfolio margining is to align margin requirements with the overall risk of the portfolio, thus taking into account positions with risk offsets or hedges, and can result in lower margin requirements than under traditional rules. As a result, portfolio margin could allow for leverage ratios of amounts greater than the 2:1 provided for in Federal Reserve Board Regulation T (12 CFR Part 220).

52. *See* Proposing Release,*supra* note 1 at 80926.

53. Proposed Rule 18f-4(c)(9).

54. For example, the SEC notes that "if a fund has a derivatives transaction that is not traded or has an underlying reference asset that is not traded (or, in either case, is not traded on a regular basis) or the fund does not have the ability to terminate the transaction, then the fund's policies should consider whether the risk-based coverage amount should, in certain circumstances, be increased to reflect the full potential amount that may be payable by the fund under the derivatives transaction." *See* Proposing Release *supra* note 1 at 80929–30.

55. *See* Proposing Release *supra* note 1 at 80930.

be approved by the relevant regulator or, alternatively, that the amount of initial margin be based on a look-up chart with prespecified formulae for determining the required amount, based on factors including the type of asset underlying the derivative.[56] The SEC acknowledges that margin regulations for uncleared swaps may provide a benchmark to assist a fund in the evaluation of its risk-based coverage amount. It notes, however, that if the fund determines that its risk-based coverage amount is greater than the amount of initial margin it would be required to post, the fund would need to maintain qualifying coverage assets in such greater amount to comply with the Proposed Rule.[57] Among the many requests for comments, the SEC asks, "is the term stressed conditions clear?"[58] This may be a point worth clarifying.

The Proposed Rule permits a fund to calculate risk-based coverage amounts on a net basis for all derivatives covered by a netting agreement.[59] Netting is not restricted by asset class, counterparty, or enforceability in bankruptcy. So, as with the mark-to-market coverage amount, it may be permissible for a fund to take into account cross-product and cross-affiliate netting, although the precise scope of this reduction is not clear from the Proposed Rule. Importantly, a fund's exposure for purposes of the portfolio limitation tests permits netting of directly offsetting derivatives transactions regardless of counterparty, but the coverage tests require a netting agreement to exist. This means that netting is limited to positions open with a particular counterparty (and presumably affiliates of the counterparty covered by the netting agreement). Each fund also would be permitted to reduce the amount of the risk-based coverage amount for a transaction by the amount of initial margin or collateral posted by the fund.[60] It is unclear whether "excess margin" (i.e., amounts held by a derivatives counterparty or FCM or clearing house in excess of required amounts of margin) would be available to reduce the risk-based coverage amount. The Proposed Rule also provides that the reduction to risk-based coverage amount is only permissible for the specific derivatives transaction for which initial margin or collateral was posted.[61] However, in certain arrangements, margin is collected on the basis of aggregated positions or risk, and as discussed above, the Proposed Rule does not provide guidance on how to allocate such margins among transactions.

Qualifying Coverage Assets

With one important exception, qualifying coverage assets must be cash or cash equivalents for both mark-to-market and risk-based coverage amounts.[62] This aspect of the Proposed Rule would significantly narrow the assets available for segregation as compared to those currently used under available SEC staff guidance, which has been generally understood to permit funds to segregate any liquid asset. For this purpose, cash equivalents generally include certain US Department of the Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.[63] The SEC's reason for this approach is that cash and cash equivalents, unlike other types of instruments, are not likely to decline in value at times when the obligations of a fund are increasing in value, leaving the fund unable to meet its obligations.[64] In support of this cash or cash equivalent requirement, the SEC cites the 2015

56. CFTC Uncleared Margin Final Rule *supra* note 44 at 649; Prudential Regulators Final Rule *supra* note 44 at 74843-4.

57. *See* Proposing Release *supra* note 1 at 80931.

59. *Id.*

59. Proposed Rule 18f-4(c)(9)(i).

60. *See* Proposing Release, *supra* note 1 at 80930.

61. *Id.*

62. Proposed Rule 18f-4(c)(8)

63. *See* Proposing Release, *supra* note 1 at 80932.

64. *Id.*

ISDA Margin Survey for the proposition that cash and cash equivalents are commonly used for posting collateral or margin for derivatives transactions.[65]

Funds may have a contrary view. Final margin rules of the CFTC and the prudential regulators permit the posting of a broad range of asset types, subject to haircuts appropriately reflecting the liquidity and volatility of an asset, as collateral for both variation margin and initial margin.[66] Initially, proposals for these margin rules contemplated that only cash would be permissible for variation margin, but in response to significant industry advocacy, the regulators expanded eligible collateral for variation margin.[67] Interestingly, it appears that amounts representing initial and variation margin posted to counterparties would be credited against the mark-to-market coverage amount or risk-based coverage amount even if the collateral posted is in a form other than cash or cash equivalents. Moreover, it is arguable that the risk of a decline in the value of segregated assets that concerns the SEC would already be reflected in the calculation of risk-based coverage amounts, because the calculation of these amounts is required to reflect stressed market conditions. This issue could be particularly important for registered investment companies because the segregation of cash and cash equivalents may result in a material drag on performance or tracking error as these amounts would be unavailable for investment in the fund's strategy.

In one case, qualifying coverage assets need not consist of cash or cash equivalents: qualifying coverage assets include "with respect to any derivatives transaction or financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset."[68] The SEC states, for example, that if a fund sells a call option on a security, the subject security would be a qualifying coverage asset.[69] Presumably, this means that if a fund sells a call option on 100 shares of common stock of Company XYZ at a specified strike price, then shares of Company XYZ common stock would be a qualifying coverage asset. Often, such options could be settled, at the election of one or both counterparties, by physical or cash settlement. In physical settlement, the fund would deliver 100 shares against receipt from the counterparty of the aggregate strike price. In cash settlement, the fund would be obligated to deliver a cash amount equal to the amount by which the price of the shares at settlement exceeded the strike price multiplied by 100 shares. It is possible that at any time prior to expiration of the option, the sum of the mark-to-market and risk-based coverage amounts would be less than the value of the full number of shares deliverable in physical settlement of the option, and that using the shares as qualifying coverage assets would cause the fund to segregate more assets than would be required by the Proposed Rule.

RISK MANAGEMENT PROGRAMS

In many cases, a fund would also be required to adopt and implement a written derivatives risk management program that is reasonably designed to assess and manage the risks associated with its derivatives transactions. Consistent with other recent proposals from the SEC, this portion of the Proposed Rule would shoulder boards of directors with additional responsibility.[70] It would also create a new risk management position within the fund.

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65. *Id.*

66. *See* CFTC Uncleared Margin Final Rule, *supra* note 44 at 666-7; Prudential Regulators Final Rule, *supra* note 44 at 74844-5.

67. *See* CFTC Uncleared Margin Final Rule, *supra* note 44 at 666; Prudential Regulators Final Rule, *supra* note 44 at 74869-70.

68. *See* Proposing Release, *supra* note 1 at 80932.

69. *See id.* at 80933.

70. For example, changes to Rule 2a-7 that take effect in October 2016 will require boards of directors for certain money market funds to determine whether to impose liquidity fees and/or redemption gates when their funds' portfolios approach certain liquidity thresholds. Similarly, rules proposed in September 2015 would require a more active role from certain registered fund boards with respect to the oversight of portfolio liquidity and liquidity management, including an annual review and approval of a fund's liquidity risk management program. *See* Liquidity Risk Management Proposal, *supra* note 1.

Overview of Risk Management Programs Proposal

Funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives transactions would be required to adopt and implement a formalized derivatives risk management program (Program). Under such a Program, a fund would have to adopt and implement written policies and procedures reasonably designed to

- assess the risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant;
- manage the risks of the fund's derivatives transactions, including by monitoring the fund's use of derivatives transactions and informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions;
- reasonably segregate the functions associated with the Program from the portfolio management of the fund; and
- periodically (but at least annually) review and update the Program.[71]

The Program would be administered by a designated derivatives risk manager and include administration and oversight requirements. The Program would be expected to be tailored by each fund and its adviser to the particular types of derivatives used by the fund and the manner in which those derivatives relate to the fund's investment portfolio and strategy.

A fund's board would be required to approve the Program, any material changes to the Program, and the fund's designation of the fund's derivatives risk manager (who cannot be a portfolio manager of the fund). The board also would be required to review written reports prepared by the designated derivatives risk manager, at least quarterly, that review the adequacy of the fund's Program and the effectiveness of its implementation. A fund would not need to adopt a Program if its board determines that the fund will comply with certain portfolio limitations (as discussed below), so long as the board monitors the fund's compliance on an ongoing basis.

Funds That Are Required to Have a Program

Funds that exceed a 50% threshold of notional derivatives exposure or engage in any complex derivatives transactions would be subject to the Program requirement.[72]

The 50% Threshold

The SEC proposed a threshold for the Program requirement because it believes the risks and potential impact of derivatives transactions on a fund's portfolio generally increase as the fund's level of derivatives usage increases. The SEC arrived at the 50% threshold by analogy to section 18 of the 1940 Act, which permits a mutual fund to borrow (and a closed-end fund to issue certain other senior securities), provided that the amount of such borrowings (or other senior securities) does not exceed one-third of the fund's total assets, or 50% of the fund's net assets. A threshold analogous to the statutorily defined threshold for senior securities under section 18, in the SEC's view, represents a level of derivatives use, which, if exceeded, should be managed through a derivatives risk management program. Importantly, the threshold would be triggered only by the notional exposure of a fund's derivatives transactions, and would not include the exposure to a fund's financial commitment transactions or other senior securities transactions. The SEC's excluded financial commitment transactions and other senior securities

71. Proposed Rule 18f-4(a)(3).

72. Proposed Rule 18f-4(a)(4).

transactions from the 50% threshold because, unlike derivatives transactions, a fund's payment obligations under such transactions may be largely known and fixed at the time that they are entered into.

Complex Derivatives Transactions

Funds that engage in **any** complex derivatives transaction would be required to implement a Program. The SEC views complex derivatives transactions as posing special risk management challenges in light of their complicated structure and the difficulties that they can pose in evaluating their impact on a fund's portfolio. The SEC reiterated that a complex derivatives transaction may expose a fund to greater risk of loss and can have market risks that are difficult to estimate. The SEC believes that those risks should be assessed and managed through a formalized derivatives risk management program overseen by a risk manager and a fund's board.

While the SEC expects that a Program would be tailored to the scale of a fund's derivatives usage, as well as the particular risks of the derivatives used by the fund, the SEC made clear that all of the Program elements specified by the Proposed Rule would apply equally to all funds that exceed the 50% threshold or that use complex derivatives transactions. Based on SEC staff research and analysis, approximately 10% of the open-end funds and approximately 9% of the closed-end funds sampled by the staff would be required to adopt a Program.

Required Elements

Under the Proposed Rule, a derivatives risk management program must include, at a minimum, the following four specified elements.

Element 1—Assessment of Risks

This element would require a fund to have written policies and procedures reasonably designed to assess the risks associated with the fund's derivatives transactions, including an evaluation of, as applicable, (i) potential leverage risk, (ii) market risk, (iii) counterparty risk, (iv) liquidity risk, (v) operational risk, and (vi) any other risks considered relevant. Under this element, a fund would identify the types of derivatives it uses or proposes to use and then evaluate the risks of engaging in those transactions.[73]

- **Leverage risk.** A fund would be required to have policies and procedures reasonably designed to evaluate the potential leverage risks associated with its derivatives transactions, which includes the risk associated with potential magnified effects on a fund resulting from changes in the market value of assets underlying its derivatives transactions where the value of the underlying assets exceeds the amount paid by the fund under the derivatives transactions. The SEC observed that leverage can be calculated in different ways, and the appropriateness of a leverage metric used by a fund, if any, to assess leverage risk may depend on various factors, such as a fund's strategy, the fund's particular investments and investment exposures, and the historical and expected correlations among the fund's investments.
- **Market risk.** A fund would be required to have policies and procedures reasonably designed to evaluate the market risk associated with its derivatives transactions, which includes the risk related to the potential that markets may move in an adverse direction in relation to the fund's derivatives positions and adversely affect fund returns and the fund's obligations and exposure. The SEC encouraged funds to consider market risk together with leverage risk because leveraged exposures can magnify such effects. The SEC also suggested that a fund could evaluate market risk by employing scenario or stress testing or by examining any models or metrics used to measure and monitor market movements, by reviewing historical

73. Proposed Rule 18f-4(a)(3)(i)(A).

market movements to help develop an understanding of the potential impact of future market movements, and by assessing the method and sources for receiving information about current events that may have market impacts.

- **Counterparty risk.** A fund would be required to have policies and procedures reasonably designed to evaluate counterparty risk, which includes the risk that the counterparty on a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, as well as the related risks of having a concentration of transactions with any one such counterparty. Such an evaluation could involve reviewing the creditworthiness or financial position of significant derivatives counterparties, understanding the level of counterparty concentration in the fund, and assessing contractual provisions, such as collateral or margin requirements, netting agreements, and termination rights.
- **Liquidity risk.** A fund would be required to have policies and procedures reasonably designed to evaluate liquidity risk. Assessing liquidity risk could involve understanding the secondary market liquidity of the fund's derivatives positions; whether the fund has the right to terminate a particular derivative transaction or the ability to enter into offsetting transactions; the relationship between a particular derivative transaction and other portfolio positions of the fund, including whether the transaction is intended to hedge risks relating to other positions; and the potential effect of market stress events on the liquidity of the fund's derivatives transactions. The liquidity of the fund's derivatives positions should be assessed under both normal and stressed scenarios. A liquidity risk evaluation also should include the potential liquidity demands that may be imposed by the Proposed Rule's qualifying coverage asset requirements and the margin or collateral requirements of the fund's derivatives transactions.[74]
- **Operational risk.** A fund would be required to have policies and procedures reasonably designed to assess the operational risks associated with the fund's derivatives transactions. These risks encompass a wide variety of possible events, including risks related to potential documentation issues, settlement issues, systems failures, inadequate controls, and human error. Policies and procedures for evaluating such risks could include, for example, assessments of the robustness of relevant systems and procedures and reviews of training processes.
- **Other relevant risks.** The risk assessment element would not be limited to an examination of only those risks identified above. The SEC noted that other risks associated with derivatives transactions, to the extent applicable, could be evaluated, such as the legal risk associated with the potential that a bespoke OTC contract or netting agreement might not be held to be legally valid or binding or compliant with other legal requirements or have provisions that may be one-sided or difficult to enforce in the event of a counterparty's default.

Element 2—Management of Risks

This element of the Program would require a fund to have written policies and procedures reasonably designed to manage, but not necessarily eliminate, the risks of its derivatives transactions, including by (i) monitoring whether those risks continue to be consistent with any investment guidelines established by the fund or the fund's adviser, the fund's portfolio limitation established under the Proposed Rule, and relevant disclosure to investors, and (ii) informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions.[75]

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74. The SEC recently proposed a comprehensive set of reforms addressing funds' liquidity management processes. *See* Liquidity Risk Management Proposal, *supra* note 1. If adopted, the SEC expects those reforms, including the requirement to implement a liquidity risk management program, would serve as a complement to the proposed derivatives risk management program and that a fund might assess and monitor liquidity risk in a holistic way, consistent with the individual requirements of each program.

75. Proposed Rule 18f-4(a)(3)(i)(B).

The SEC stressed that a fund, to manage its derivatives risks effectively, should review its current and planned use of derivatives as well as any relevant limitations (including internal limitations established by the fund's adviser) and develop risk management tools and processes effectively tailored to its own circumstances. In the Proposing Release, the SEC identified a number of potential risk management and monitoring mechanisms as examples of techniques that funds might consider including in their policies and procedures to manage the risks of their derivatives transactions.

A fund's policies and procedures under this element would require the portfolio manager or board to be informed of risks associated with the fund's derivatives transactions. The SEC believes that such communication would generally be a key part of any risk management and monitoring program, because information about relevant risks should not remain solely with the derivatives risk manager but should be shared "up the chain" as needed so that appropriate action to address risks can be taken if warranted.

Element 3—Segregation of Functions

This element of the Program would require a fund to have written policies and procedures reasonably designed to reasonably segregate the functions associated with the Program from the portfolio management of the fund.[76] The SEC believes that independence of risk management from portfolio management should promote objective and independent risk assessment to complement and cross check portfolio management, and that maintaining separation of these functions should enhance the protections provided by the Program. The SEC observed that, because fund management personnel may be compensated in part based on the returns of the funds that they manage, the incentives of portfolio managers may not always be consistent with the restrictions imposed by a Program.

The SEC made clear that segregation of functions is not meant to indicate that the derivatives risk manager and portfolio management should be subject to a communications "firewall." The SEC recognizes that a portfolio manager can provide perspective and insight to a fund's use of derivatives and expects that the derivatives risk manager would work closely with portfolio management in implementing the Program. Indeed, the SEC believes that regular communication between the risk manager and portfolio management should be a part of any well-functioning Program.

The SEC also recognizes that the segregation requirement may pose challenges for organizations that have a limited number of employees. Nevertheless, in such cases, a fund should still have policies and procedures designed to reasonably segregate the functions of the Program from portfolio management. The SEC reiterated that the Proposed Rule would require reasonable segregation, not complete segregation of functions. Moreover, as discussed below, the derivatives risk manager would not be permitted to be a portfolio manager of a fund, which the SEC believes is likely to encourage reasonable segregation of functions as a result of such separation of roles.

Element 4—Periodic Review

This element of the Program[77] would require a fund to have written policies and procedures reasonably designed to periodically, but at least annually, review and update the Program, including any models (including any VaR calculation models used during the covered period[78]), measurement tools, or policies and procedures that are part of, or used in, the Program to evaluate their effectiveness and reflect changes in risks over time. The SEC believes that periodic review of a fund's Program is necessary to determine whether, in light of current circumstances, risks are appropriately being addressed.

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76. Proposed Rule 18f-4(a)(3)(i)(C).

77. Proposed Rule 18f-4(a)(3)(i)(D).

78. Because of the importance of VaR calculations in the Proposed Rule for funds that operate under the risk-based portfolio limitation, this element would specifically require that any VaR models used by a fund during the covered period be included as part of this periodic review and update.

Although annual review is a minimum requirement, a fund should consider whether more frequent reviews are appropriate depending on the circumstances. The SEC expects that such a review and update should take place frequently enough to take into account the particular risks that may be presented by the fund's use of derivatives, including the potential for rapid or significant increases in risks in changing market conditions.

Administration

The Proposed Rule would require a fund to designate an employee or officer of the fund or the fund's adviser (who may not be a portfolio manager of the fund) to be responsible for administering the policies and procedures of the Program, whose designation must be approved by the fund's board of directors, including a majority of the independent directors.[79] The derivatives risk manager may also have other roles, including, for example, serving as the fund's chief compliance officer or chief risk manager (if it has one). Under the Proposed Rule, the derivatives risk manager must be an employee or officer of the fund or its adviser (or subadviser), but may not be a portfolio manager for the fund.

The SEC recognizes that some small advisers may have a limited number of employees or officers who are not portfolio managers. In such a case, the fund's chief compliance officer might be designated as the Program's risk manager (with assistance from third parties as appropriate), or the fund or adviser may determine that additional personnel should be hired to administer the Program. Regardless, the SEC explained that a derivatives risk manager should be sufficiently knowledgeable about the risks and use of derivatives that he or she can effectively fulfill the responsibilities of the position. The SEC observed that designation of a specific person to administer the Program would differ from the approach taken in its liquidity rulemaking proposal, which would instead allow the designation of the fund's adviser or multiple employees to administer the liquidity risk management program.

For the same reasons discussed above regarding the separation of functions from portfolio management, the SEC believes that independence of the derivatives risk manager is important for a well-functioning Program. The SEC is concerned that if a derivatives risk manager were a person making portfolio management decisions, the risk manager may be influenced to selectively apply or otherwise weaken or not fully comply with the Program's requirements if the restrictions of the Program potentially conflict with the preferred investment strategy of the portfolio manager.

Unlike the requirements for a chief compliance officer under Rule 38a-1 of the 1940 Act, the Proposed Rule would not require that a derivatives risk manager only be removable by a fund's board of directors, nor would the board need to approve the derivatives risk manager's compensation. Although a derivatives risk manager is expected to play an important role, the SEC does not believe that the manager's removal or compensation would in all cases be so central to a fund's investment activities or compliance function to require that risk managers should be appointed or removed only by the board.

Board Approval and Oversight

In light of the oversight function performed by a fund's board of directors, the SEC believes that boards should understand the Program and the risks it is designed to manage. Thus, the Proposed Rule would require a fund to obtain initial approval of, as well as approval of any material change to, its written Program from the fund's board, including a majority of independent directors.[80] The SEC designed this requirement to facilitate scrutiny of the Program by the board because there may potentially be conflicts of interest between the adviser and the fund relating to its use of derivatives.

In considering whether to approve the Program or any material changes to it, the SEC encourages boards to consider the nature of the fund's derivatives risk exposures as well as the types of derivatives

79. Proposed Rule 18f-4(a)(3)(ii)(C).

80. Proposed Rule 18f-4(a)(3)(ii)(A).

transactions in which the fund engages or plans to engage, their particular risks, and whether the Program sufficiently addresses the fund's compliance with its investment guidelines, any applicable portfolio limitation, and relevant disclosure. The SEC also suggests that boards consider the adequacy of the Program from time to time in light of past experience and recent compliance and other experiences regarding the fund's use of derivatives. Directors are permitted to satisfy their obligations with respect to the initial approval by reviewing summaries of the Program prepared by the fund's derivatives risk manager, legal counsel, or other persons familiar with the Program. The summaries might familiarize directors with the salient features of the Program and provide them with an understanding of how the Program addresses the fund's use of derivatives.

The fund's board would be required to review a written report from the fund's derivatives risk manager, provided no less frequently than quarterly, that reviews the adequacy of the fund's Program and the effectiveness of its implementation.[81] Regular reporting to the board should assist boards in being adequately informed about the effectiveness and implementation of the Program. According to the SEC, regular reporting will also help reduce the risk that issues are not addressed promptly and increase the likelihood that the derivatives risk manager is actively involved in addressing issues as they arise. The SEC believes that this reporting should take place on at least a quarterly basis, rather than an annual one, in light of the significant impact that derivatives transactions can have on a fund over a short period of time. Although the derivatives risk manager should consider whether significant issues should be reported to the adviser or board more quickly than in the quarterly report, to the extent that a serious compliance issue arises under the Program, the Proposing Release indicates that the issue should be brought to the board's attention promptly.

FINANCIAL COMMITMENT TRANSACTIONS

Under the Proposed Rule, a fund may enter into financial commitment transactions notwithstanding sections 18 and 61 of the 1940 Act, provided that the fund, pursuant to policies and procedures approved by the fund's board of directors, maintains qualifying coverage assets identified on the books and records of the fund and determined at least once each business day with a value equal to the fund's aggregate financial commitment obligations.[82]

A "financial commitment transaction" is defined to be any reverse repurchase agreement, short sale borrowing, or 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).

A "financial commitment obligation" is the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction. Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation shall be the value of the asset, determined at least once each business day.

The Proposed Rule effectively limits a fund's use of financial commitment transactions because it requires the fund to maintain qualifying coverage assets equal in value to the fund's full obligations under such transactions, and the total amount of a fund's qualifying coverage assets could not exceed the fund's net assets. Mark-to-market and risk-based coverage amounts would not be permitted for financial commitment transactions, even though they are permitted for derivatives transactions as described earlier in this White Paper. However, in addition to the qualifying coverage assets for derivatives transactions, qualifying coverage assets for financial commitment transactions include assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation,

81. Proposed Rule 18f-4(a)(3)(ii)(B).

82. Proposed Rule 18f-4(b).

prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation. The approach of the Proposed Rule is consistent with the current practice of most funds.

OTHER IMPLICATIONS

Recordkeeping

The Proposed Rule would also result in onerous recordkeeping obligations for funds. Funds would be required to maintain a written record of each determination made by the board that the fund would comply with either the exposure-based or risk-based portfolio limitation, including the board's initial determination and any subsequent determinations to change the limitation.[83] Funds would also be required to maintain a written copy of the policies and procedures approved by the board regarding the fund's maintenance of qualifying coverage assets.[84] Perhaps the most intensive recordkeeping obligation of those proposed, a fund would also be required to maintain a written record that demonstrates that the fund complied with the applicable portfolio limitation test as of the time of each senior securities transaction.[85] This record would have to reflect the fund's aggregate exposure, the value of its net assets, and, if applicable, the fund's full portfolio VaR and its securities VaR.

For each derivatives transaction, a fund would also be required to maintain a written record reflecting the mark-to-market coverage amount and the risk-based coverage amount and identifying the qualifying coverage assets maintained by the fund with respect to the fund's aggregate mark-to-market and risk-based coverage amounts.[86] Similarly, for each financial commitment transaction, a fund would be required to maintain a written record reflecting the amount of each financial commitment obligation associated with each transaction and identifying the qualifying coverage assets maintained by the fund with respect to each financial commitment obligation.[87]

For those funds required to implement a derivatives risk management program, there would be additional recordkeeping requirements. Specifically, a fund would have to maintain a written record of the policies and procedures adopted by the board in connection with the Program[88] and would have to keep any materials provided to the board in connection with its approval of the Program and any written reports provided to the board "relating to" the Program.[89] In addition, funds would have to maintain records documenting any periodic updates or reviews required under the Program.[90]

The SEC indicates in the Proposing Release that the written records that would be required under the Proposed Rule will play an important role in the SEC examination staff's evaluation of a fund's compliance with the conditions of the Proposed Rule, and specifically enable the staff to test whether identified assets are actually qualifying coverage assets for the particular transactions in question. With this clear indication that the SEC staff plans to fully use and test fund records, fund complexes, particularly those with derivatives risk management programs, should consider the need for any potential enhancements to existing recordkeeping processes in place. Fund complexes should also consider seeking to ensure that they have strong lines of communication set up among their portfolio management, compliance, derivative risk management, and administrative and recordkeeping teams, so that any changes to fund

83. Proposed Rule 18f-4(a)(6)(i).

84. Proposed Rule 18f-4(a)(6)(ii).

85. Proposed Rule 18f-4(a)(6)(iv).

86. Proposed Rule 18f-4(a)(6)(v).

87. Proposed Rule 18f-4(b)(3)(ii).

88. Proposed Rule 18f-4(a)(6)(iii)(A).

89. Proposed Rule 18f-4(a)(6)(iii)(B).

90. Proposed Rule 18f-4(a)(6)(iii)(C).

strategies are not only tracked by compliance and risk management, but also captured in the documentation and recordkeeping process.

Changes to Reporting Forms

In addition to the recordkeeping requirements set forth in the Proposed Rule, there would be several new reporting requirements. To fully understand the proposed reporting requirements, one must first go back to May 20, 2015, when the SEC unanimously approved proposals intended to modernize and enhance the monitoring and regulation of the asset management industry and registered funds in particular.[91] The Reporting Modernization Proposal discusses various ways in which registered funds would be required to report information on, among other things, their use of derivatives. This would include information on derivatives counterparties, asset and issuer type, and changes or losses in value. Funds would also have to report certain risk metrics with respect to their investments in derivatives, including the delta for derivatives instruments with optionality, the portfolio's interest rate risk, and the portfolio's credit spread risk. It was proposed that the information be reported by type of derivative exposure. Fund financial statements would also have to include new enhanced and standardized disclosures relating to derivatives and securities lending activities.

All of these changes set forth in the Reporting Modernization Proposal would be implemented through two new reporting forms. First, Form N-PORT would be filed monthly and would replace current Form N-Q, which is filed quarterly. Form N-PORT information would only be made publicly available for the third month of the fund's fiscal quarter, and on a 60-day lag. Second, Form N-CEN would be filed annually and would replace current Form N-SAR, which includes census-type information used by the SEC staff in its oversight functions and is filed semiannually.

As further modified in the Proposing Release, Form N-PORT would now also require a fund to disclose, on a monthly basis, still more information about risk metrics associated with the fund's use of derivatives. Specifically, those funds that are required to implement a derivative risk management program under the Proposed Rule would now also be required to report gamma (which would provide a position-level estimate of sensitivity to underlying price movements) and vega (which would provide a position-level estimate of sensitivity to volatility). Form N-CEN would now also require disclosure of whether a fund relied on the Proposed Rule during the reporting period and the particular portfolio limitation applicable to the fund (i.e., exposure-based or risk-based). This requirement is designed to prevent funds from selectively changing between the portfolio limitations as one becomes preferable to the other.

These new reporting obligations are consistent with the SEC's ongoing trend of requiring greater amounts of more sophisticated data from market participants, which the SEC staff—particularly the economists and quantitative analysts in DERA—then analyze to identify market trends and outliers. The increased level of detail that is proposed for those funds that will have to implement a derivatives risk management program underscores the need for compliance personnel who are able to understand and navigate the information being collected and reported, in addition to being able to evaluate the related policies and procedures.

Public Comments

Comments on the proposal are due by March 28, 2016, although the SEC staff historically has considered comment letters that are submitted within a reasonable time after the cut-off period. Several significant industry participants are in the process of preparing comment letters and many academics, individual investors, and representatives of various firms and financial services companies have submitted comments already.

91. *See* Reporting Modernization Proposal, *supra* note 1.

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