

January 28, 2016

SEC Proposed Rule 18f-4 Would Severely Restrict Use of Derivatives by Investment Companies

On December 11, 2015, the Securities and Exchange Commission proposed a new rule, Rule 18f-4, under the Investment Company Act (ICA), to regulate certain types of financial commitments made by investment companies, including mutual funds and exchange-traded funds, closed-end funds, and business development companies. The types of commitments covered in the proposed rule are “derivatives transactions” (swaps, futures and forwards) and “financial commitment transactions” (reverse repurchase agreements but not repos), short sale borrowings or any other firm or standby financial commitment). While presented as an “exemptive” rule, the proposed rule would materially restrict the manner in which many funds currently use derivatives based on existing guidance. Moreover, the proposed rule would impose many new risk management requirements on funds that use derivatives, as well as impose significant new obligations on the directors of such funds.

The comment period for the proposed rule expires on March 28.

The proposed rule raises many important questions, which are addressed in this advisory, including:

1. How does the proposed rule change current SEC guidance?
2. Would the proposed rule protect or harm investors?
3. Is the SEC authorized to adopt the proposed rule?
4. Is the proposed rule inconsistent with recent SEC proposals on derivatives?
5. Did the SEC conduct a proper cost-benefit analysis of the proposed rule?
6. What did the Derivatives White Paper add to the proposing release?
7. What are the next steps in the process of reviewing the proposed rule?

Summary of the Proposed Rule

1. The proposed rule imposes the following conditions on a fund’s use of a derivatives transaction:
 - compliance with one of two alternative portfolio limitations (exposure not to exceed 150 percent of net assets, or exposure not to exceed 300 percent of net assets if the value at risk (VaR) for the portfolio is less than the VaR for the fund’s securities)
 - daily maintenance of an amount of “qualifying coverage assets” (which must generally be cash or cash equivalents) with respect to each derivatives transaction that is at least equal to the sum of the aggregate mark-to-market and “risk-based” coverage amounts for the transaction;

For more information, please contact any of the following members of Katten’s **Financial Services** practice.

Richard D. Marshall
+1.212.940.8765
richard.marshall@kattenlaw.com

Peter J. Shea
+1.212.940.6447
peter.shea@kattenlaw.com

- if the fund engages in derivatives transactions with a combined notional value of at least 50 percent of a fund's net assets, or transacts in "complex derivatives," establishment of a formalized derivatives risk management program; and
 - approval by the fund's board of the fund's choice of portfolio limitation, its asset coverage policies and procedures, and its derivatives risk management program, if applicable.
2. The proposed rule imposes the following conditions on use of a financial commitment transaction:
 - daily maintenance of an amount of qualifying coverage assets at least equal to the aggregate amount of all financial commitment transactions; and
 - board approval of policies and procedures reasonably designed to provide for the required asset coverage.
 3. The proposed rule would add recordkeeping requirements related to the use of derivatives and financial commitment transactions.
 4. Proposed but not yet adopted Forms N-PORT and N-CEN would require registered investment companies to report additional information regarding their derivatives and financial commitment transactions.

Background

Section 18 of the ICA has been interpreted to place significant restrictions on the ability of registered investment companies to issue "senior securities." The provision was intended to protect fund investors from the risks of excessive leverage, which, at the time the ICA was enacted, could typically only be achieved by issuing debt securities or obtaining bank loans.

In recent decades, with the advent of derivatives, reverse repurchase agreements and other transactions through which funds are able to achieve leverage, the SEC has broadly interpreted Section 18's restrictions against "senior securities" as being implicated by such transactions. In 1979 the SEC issued a statement of policy in Investment Company Act Release No. 10666 ("Release 10666") providing that funds engaging in certain such transactions, in particular reverse repurchase agreements, firm commitment agreements and standby commitment agreements, would not violate Section 18 provided they segregated liquid assets in an amount sufficient to "cover" their potential obligations, thereby limiting the risk of loss from such transactions. The asset coverage requirement was intended to "assure the availability of adequate funds to meet the [fund's] obligations" from such activities and serve as "a practical limit on the amount of leverage which [a registered] investment company can undertake and on the potential increase in the speculative character of its outstanding common stock."

This approach was later applied to new types of derivatives and other leverage-producing instruments, and other ways to "cover" funds' potential obligations, in a series of more than 30 no-action letters and SEC releases.

In 2011, the SEC published a concept release which discussed and requested comments on various issues relating to the use of derivatives by investment companies. In her opening remarks at the SEC meeting to vote on the proposed rule, Chair White stated that she had concluded from the SEC's review that existing SEC guidance no longer effectively protects investors from the risks of excessive leverage. In particular, Chair White noted the ability of funds under existing guidance to be exposed to large potential losses because "mark-to-market segregation" currently permits a fund to segregate liquid assets only in an amount equal to the current liability, if any, of a derivatives transaction.

Proposed Rule 18f-4 would supersede existing guidance concerning funds' use of derivatives and financial commitment transactions. The existing guidance would be rescinded if the proposed rule is adopted.

I. Portfolio Limitations for Derivatives Transactions

Proposed Rule 18f-4 would permit mutual funds, exchange-traded funds (ETFs), closed-end funds and companies that have elected to be treated as business development companies ("fund") to engage in "derivatives transactions" by providing an exemption from sections 18 and 61 of the ICA.

"Derivatives transaction" would be defined as "any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination." This definition would not encompass types of derivatives (such as fully paid for call options) that do not impose a payment obligation on the fund beyond its investment.

Funds seeking to utilize the exemption and engage in derivatives transactions would be required to comply with one of two alternative portfolio limitation rules—an “exposure-based portfolio limit” or a “risk-based portfolio limit”—both of which are designed to reduce leverage by imposing an overall limit on the amount of exposure to underlying reference assets, and thus potential leverage.

1. Exposure-Based Portfolio Limit

Under the exposure-based portfolio limit, a fund would be required to limit its overall exposure to (1) derivatives transactions, (2) financial commitment transactions and (3) other transactions involving senior securities entered into other than in reliance on Rule 18f-4 (collectively, “senior securities transactions”), so that such exposure does not exceed 150 percent of the fund’s net assets, measured immediately after entering into any such transaction. The fund’s “exposure” for purposes of this limit would be calculated as the sum of (1) the aggregate notional amounts of the fund’s derivatives transactions (subject to certain exceptions), (2) the aggregate obligations of the fund under its financial commitment transactions, and (3) the fund’s aggregate indebtedness with respect to any other senior securities transactions.

For three types of derivatives transactions, the proposed rule requires certain methods for calculating the transaction’s exposure:

- for derivatives that provide a return based on the leveraged performance of an underlying reference asset, Rule 18f-4 would require the notional amount to be multiplied by the applicable leverage factor;
- for derivatives transactions for which the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives, or an index that reflects the performance of such a managed account or entity, the rule requires a “look-through”, “requiring the fund to calculate the notional amount of such transaction by reference to its pro rata portion of the notional amounts of derivatives transactions of the underlying reference vehicle”; and
- for “complex derivatives transactions,” which is defined as derivatives providing for payments that are dependent on the value of a reference asset at multiple points in time, or on a non-linear function of the value of the reference asset, the notional amount would be equal to the aggregate notional amount of other, non-complex derivatives transactions which, taken together, would in the fund’s reasonable estimation offset substantially all of the market risk of the complex derivatives transaction at the time it was entered into.

In determining aggregate notional exposure, a fund would be permitted to net any directly offsetting derivatives transactions in the same type of instrument and having the same underlying reference asset, maturity and other material terms. Such netting would be permitted even if the transactions were not with the same counterparty.

2. Risk-Based Portfolio Limit

As an alternative to the exposure-based portfolio limit, under Rule 18f-4 funds could comply with a risk-based portfolio limit. The risk-based portfolio limit would permit a fund to obtain exposure of up to 300 percent of its net assets, provided it satisfies a VaR test designed to measure whether the fund’s derivatives transactions, in aggregate, have the effect of reducing the fund’s exposure to market risk. The risk-based portfolio limit option is designed to permit hedging, which reduces a fund’s exposure to market risks.

Value at risk is defined in Rule 18f-4 as “an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in US dollars, over a specified time horizon and at a given confidence level.” To satisfy the VaR test, a fund’s “full portfolio VaR” (defined as the VaR of its entire portfolio, including all holdings) must be less than the fund’s “securities VaR” (defined as the VaR of all holdings other than derivatives transactions) immediately after the fund enters into any derivatives transaction or other senior securities transaction. A fund would have flexibility under Rule 18f-4 to select a VaR model (including historical, Monte Carlo or parametric models) and to determine the parameters for the test, provided that the VaR analysis must:

- take into account all significant, identifiable market risk factors associated with a fund’s investments, including but not limited to equity price risk, interest rate risk, credit spread risk, foreign currency risk, commodity price risk and market sensitivity;
- utilize a minimum 99 percent confidence level;
- utilize a time horizon of at least 10 and not more than 20 trading days;

- utilize a minimum of three years of historical data to estimate historical VaR; and
- be implemented consistently when calculating both securities VaR and full portfolio VaR.

3. When Portfolio Limitations Would Be Applied

When a fund elects to engage in derivatives transactions under Rule 18f-4, the fund's board of directors, including a majority of independent directors, would be required to approve the fund's choice as to which of the two alternative portfolio limit rules will apply to the fund. Compliance with the applicable limit would be measured immediately after entering into any derivatives transaction or other senior securities transaction. A fund would not be required to terminate or unwind a transaction that was permitted under the portfolio limitation when entered into solely because the fund's exposure increased after the fund entered into such transaction.

II. Asset Coverage Requirements

Under Rule 18f-4, funds also would be required to comply with asset coverage requirements. Portfolio limitations are designed to limit the amount of leverage a fund may achieve; asset coverage requirements are designed to ensure that funds have sufficient assets to meet their payment obligations under such transactions.

Rule 18f-4 would require a fund to maintain a certain amount of "qualifying coverage assets" for each derivatives transaction, determined pursuant to policies and procedures approved by the fund's board, including a majority of independent directors. Funds would be required to determine, and identify on their books and records, the qualifying coverage assets for their derivatives transactions at least once each business day. With certain exceptions, only cash and cash equivalents would be considered qualifying coverage assets for derivatives transactions.

Under Rule 18f-4, the amount of qualifying coverage assets for any derivatives transaction would be equal to (1) the amount that would be payable by the fund if it were to exit the transaction at the time of determination (the "mark-to-market coverage amount") and (2) a reasonable estimate of the potential amount payable by the fund if the fund were to exit the transaction under stressed conditions (the "risk-based coverage amount"). The risk-based coverage amount addresses the risk that the mark-to-market coverage amount may be significantly less than the fund's ultimate payment obligations under a transaction.

A fund would be required to calculate its risk-based coverage amounts in accordance with policies and procedures approved by the fund's board, which must take into account the structure, terms and characteristics of each derivatives transaction and the underlying reference asset. A fund also could take into account additional considerations, such as (1) the fund's ability to terminate the trade or otherwise exit the position under stressed conditions, and (2) if the fund's policies and procedures under its derivatives risk management program include stress testing, the results of such stress testing. Alternatively, a fund's policies and procedures could provide for the use of a stressed VaR model to estimate the risk-based coverage amount of certain types of derivatives transactions.

In calculating the mark-to-market and risk-based coverage amounts, Rule 18f-4 would only allow a fund to net derivatives positions if the fund is party to a netting agreement that provides for the netting of its payment obligations under such transactions. In addition, a fund could subtract from the mark-to-market coverage amount the amount of any variation margin it has posted to cover its mark-to-market losses on derivatives transactions, and also could subtract from the risk-based coverage amount the amount of any initial margin to cover the fund's future potential payment obligations. These provisions recognize that, by posting margin, funds have already segregated an amount, the margin posted, to cover exposure under the derivatives position.

The total amount of a fund's qualifying coverage assets, including any such assets being maintained with respect to financial commitment transactions, may not exceed the fund's net assets.

Derivatives Risk Management Program

Funds that enter into derivatives transactions with an aggregate notional exposure greater than 50 percent of the fund's net assets, or that use "complex derivatives transactions," would be required to adopt and implement a formalized derivatives risk management program ("Program"). Rule 18f-4 would require a Program to include policies and procedures reasonably designed to:

- assess the risks associated with the fund's derivatives transactions, including by evaluating potential leverage, market, counterparty, liquidity and operational risks, as applicable, in addition to any other factors considered relevant;

- manage the risks of the fund's derivatives transactions, including by (1) monitoring whether the fund's use of derivatives is consistent with the fund's investment guidelines, the applicable portfolio limitation under the rule and relevant disclosure to investors, and (2) 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 separate the functions associated with the Program from the portfolio management of the fund; and
- periodically, but at least annually, review and update the Program, in accordance with procedures adopted for this purpose, which must include a review of any models, measurement tools, or policies and procedures used in the Program, and any additional considerations the fund considers appropriate.

The Program must be administered by a designated derivatives risk manager, who may not be a portfolio manager of the fund, and whose designation must be approved by the fund's board, including a majority of independent directors.

The fund's board of directors (including a majority of independent directors) would be required to approve the adoption of and any material changes to the Program. The board also would be required to review a written report from the derivatives risk manager on at least a quarterly basis reviewing the adequacy of the Program and the effectiveness of its implementation. Although the proposing release emphasizes the role of a fund's independent directors in overseeing the Program, independent directors may satisfy their obligations with respect to initial approval of the Program by reviewing summaries of the Program prepared by the fund's derivatives risk manager, legal counsel or other persons familiar with the Program.

Financial Commitment Transactions

Rule 18f-4 also would address funds' use of "financial commitment transactions," defined as any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement or other similar agreement. Under Rule 18f-4, funds that enter into financial commitment transactions would be required to maintain qualifying coverage assets equal in value to the full amount that the fund is conditionally or unconditionally obligated to pay under each of the financial commitment transactions. The qualifying coverage assets with respect to financial commitment transactions would be required to be determined and recorded on the fund's books and records at least once each business day.

The types of qualifying coverage assets would be broader with respect to financial commitment transactions than derivatives transactions. Cash and cash equivalents would be qualifying assets but, in addition, in the case of a financial commitment transaction that may be settled by delivering a particular asset, that particular asset also would be permitted to satisfy the coverage requirement.

Under Rule 18f-4, a fund's board, including a majority of independent directors, would be required to approve policies and procedures "reasonably designed to provide for the fund's maintenance of qualifying coverage assets" with respect to financial commitment transactions. The total amount of a fund's qualifying coverage assets, including any such assets being maintained with respect to derivatives transactions, would not be permitted to exceed the fund's net assets.

Recordkeeping, Disclosure and Reporting Requirements

Rule 18f-4 includes certain recordkeeping requirements related to the fund's compliance with the proposed rule. Funds must maintain, for at least five years, written records of board determinations with respect to the fund's selection of a portfolio limitation, copies of the policies and procedures required under the rule, copies of any materials provided to the board relating to the Program, records documenting the periodic reviews and updates required under the rule and written records demonstrating compliance with the applicable portfolio limitation and asset coverage requirements with respect to each senior securities transaction entered into by the fund.

The proposing release includes amendments to proposed but not yet adopted Form N-PORT and Form N-CEN that would require additional disclosure and reporting regarding fund use of derivatives and risk calculations. Proposed Form N-PORT would be amended to require any registered investment company that is required under proposed Rule 18f-4 to implement a Program to disclose on its schedule of portfolio investments the "gamma" and "vega" for options and warrants. Proposed Form N-CEN would be amended to require that a registered investment company disclose which of the two alternative portfolio limitations the fund has elected to comply with.

Responsibilities of Fund Directors Under the Proposed Rule

Rule 18f-4 would add significant new responsibilities for fund directors, who would be required to approve, oversee and review numerous aspects of a fund's compliance with the rule. To the extent a fund elects to engage in derivatives transactions in reliance on the proposed rule, the fund's board, including a majority of independent directors, would be required to:

- approve the fund's choice of which of the two alternative portfolio limit rules will apply to the fund;
- approve policies and procedures for determining the proper amount of qualifying coverage assets for each derivatives transaction, including the fund's procedures for calculating the risk-based coverage amounts;
- monitor the fund's derivatives transactions, and, if the notional amount of those transactions exceeds 50 percent of the fund's net assets or the fund engages in any complex derivatives transactions, approve the fund's adoption of a Program, appoint a derivatives risk manager to oversee the Program, review written reports produced by the derivatives risk manager on at least a quarterly basis, and engage in a thorough periodic review and update of the Program on at least an annual basis, including a review of any models, measurement tools or policies and procedures used in the Program; and
- with respect to financial commitment transactions, approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, including specific guidance regarding the fund's use of non-cash or cash-equivalent assets as coverage for such transactions.

To the extent a fund does not intend to use derivatives transactions in excess of the 50 percent aggregate exposure threshold or engage in complex derivatives transactions, the fund would not be required to establish a formalized Program provided that the fund's board of directors determines that the fund will comply, and monitor its compliance, with a portfolio limitation, under which the fund limits its aggregate exposure to derivatives transactions to no more than 50 percent of its net asset value and does not use complex derivatives transactions.

Comparison With Current Requirements

The proposed rule would materially change current practices relating to investments in derivatives. Current regulation was summarized by the ABA Task Force on Investment Companies Use of Derivatives and Leverage as follows:

“Rather than prohibiting funds from engaging in derivative transactions, the SEC staff has established an interpretive approach pursuant to which funds may enter into offsetting transactions or by segregating fund assets in amounts that would cover some amount of the fund's potential liabilities under the instruments.”¹

The proposed rule would address three elements of this approach.

First, current SEC guidance is old, somewhat inconsistent, and often ambiguous.² This has led to questions about how to apply the SEC guidance to individual positions. The proposed rule would attempt to update, unify, and clarify the old SEC guidance so that investment companies can have clear answers to interpretative questions that are now ambiguous.

Second, as noted in the proposing release, “[t]oday . . . , many funds apply the mark-to-market segregation approach to certain net cash-settled derivatives, and some funds use this form of asset segregation extensively. Under this approach, funds segregate an amount equal to the fund's daily mark-to-market liability on the derivative, if any.” In contrast to this approach, the proposed rule

¹ Available [here](#).

² For example, the ABA Task Force identified the following ambiguities in current guidance:

First, the SEC has never explicitly endorsed the staff's policies concerning segregation of assets and offsetting transactions with respect to derivatives, and, to our knowledge, the staff has not addressed in writing the appropriate treatment of all of the various kinds of derivative instruments.

Second, existing formal and informal guidance is not theoretically consistent. In the case of certain instruments, funds apparently are expected to segregate assets that are equivalent in value to the notional value of the instrument; in other cases, however, it is sufficient to segregate only an amount equal to the daily marked-to-market value of the obligation.

Third, some have expressed concerns that the staff's position in the Merrill Lynch Letter, which greatly broadened the types of fund assets that could be segregated in order to satisfy Section 18, could expose a fund to the possibility that it would not have sufficient assets to meet its obligations under the derivative contract (as those segregated assets could have declined significantly in value).

Fourth, there are other open issues as well, such as what constitutes an “offsetting transaction.”

would require segregation of the notional exposure created by the derivative, which is almost always dramatically larger than the mark-to-market exposure currently used by many funds. The alternative approach that would permit investment companies to limit exposure to 300 percent of the fund's net assets would still be based on notional exposure and would not even be available unless the investment company could meet a rigorous VaR test, showing risk reduction by entering into the derivatives transaction.

Finally, as noted in the proposing release, “[i]n addition to the smaller amount of segregated assets under the mark-to-market approach, funds now segregate various types of liquid assets, rather than the more narrow range of high-quality assets described in Release 10666, in reliance on a no-action letter issued by our staff. A fund that segregates any liquid asset may be able to obtain greater leverage than a fund that segregates only the types of assets we described in Release 10666 [generally cash or cash equivalents], especially when the fund also is applying the mark-to-market segregation approach. This is because a fund segregating only the types of assets we described in Release 10666 would be more constrained in its ability to enter into transactions requiring asset coverage by the requirement to maintain those kinds of high-quality assets. A fund that segregates any liquid asset, in contrast, may invest in various types of securities, consistent with its investment strategy, while potentially also using a large portion of its portfolio to cover transactions implicating section 18.” Under the proposed rule, “covering assets” would be limited either to cash or cash equivalents, or to the exact instrument that would be delivered if the derivative position was settled through physical delivery.

The cumulative impact of these proposed changes would be dramatically to reduce the ability of investment companies to enter into derivatives positions.

Questions Raised by the Proposed Rule

Would the Proposed Rule Protect or Harm Investors?

The proposed rule would restrict investments in derivatives by investment companies. This approach is different from one advocated by many commentators, which emphasizes enhanced disclosure and suitability obligations in connection with investments in derivatives. For example, the ABA Task Force concluded that “we emphasize that there is significant merit to the SEC’s and the industry’s traditional approach to many matters relating to derivatives, i.e., relying on individual funds to determine limits and practices appropriate to their investors and then to summarize clearly those limits, practices and related risks. Accordingly, in lieu of setting some of the specific limits contemplated as options above, the SEC or its staff could further develop disclosure expectations as they relate to these substantive areas.” With respect to suitability, for example, in 2009 FINRA reminded its members of their suitability obligations in the sale of leveraged and inverse ETFs. These on-going initiatives have the benefit of affording funds flexibility in their use of derivatives, with disclosure and suitability obligations ensuring that knowledgeable investors avoid funds that are viewed as too risky.

In fact, risk is not itself bad. Every investment involves risk and prudent use of derivatives may enhance returns at an acceptable level of risk. Thus, some would argue that the relevant question is not whether funds incur risks by investing in derivatives, but rather whether the returns potentially generated justify the risks. As the Investment Company Institute noted in its *Task Force Report, Board Oversight of Derivatives* (July 2008):

Relative to comparable cash securities, derivatives’ potential benefits include the ability to:

- gain or reduce exposure to a market, sector, security, or other target exposure more quickly and/or with lower transaction costs and portfolio disruption;
- precisely target risk exposures;
- benefit from price differences between cash securities and related derivatives;
- gain access to markets in which transacting in cash securities is difficult, costly, or not possible; and
- gain exposure to commodities as an asset class (subject to certain tax tests).

On the other hand, to the extent derivatives expose funds to excessive risks that investors do not understand, the potential exists for serious harm to investors. The proposed rule is premised on the belief that derivatives are bad for investors and, therefore, that limiting their use is good for investors.

Is the SEC Authorized to Adopt the Proposed Rule?

The “requirement” relating to derivatives derives from Section 18(f) of the Investment Company Act, which basically says that an investment company can only have one class of securities. The subsection is part of a section of the Investment Company Act entitled “Capital Structure.” The SEC has interpreted this prohibition to restrict, but not prohibit, investment companies from entering into investments that have a leverage element on the theory that such positions are like debt, which would be a class of security senior to the equity which every investment company issues. In apparent recognition that Section 18 does not unambiguously authorize the SEC to limit derivatives, the proposing release repeatedly refers to the preamble to the Investment Company Act, which does not expressly mandate or prohibit any particular conduct by investment companies.³

There is a serious question whether the SEC has the authority to regulate investments by investment companies in derivatives. As an example of a successful challenge to SEC rule-making based on the SEC’s lack of authority to adopt the rule, in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), the court found “in excess of the Commission’s authority” its Rule 19c-4, which barred SROs from listing the stock of “a corporation that takes any corporate action with the effect of nullifying, restricting or disparately reducing the per share voting rights of [existing common stockholders].” Declaring that Rule 19c-4 “directly interferes with the substance of what the shareholders may enact,” the court reasoned that it was impermissible for the SEC to promulgate a rule that “directly controls the substantive allocation of powers among classes of shareholders,” which is normally in the purview of state corporate law.

Applying a somewhat similar analysis, in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), at issue was the SEC’s rule requiring that hedge fund investors be counted as fund clients for purposes of an exemption that exempted investment advisers with fewer than 15 clients from registering under the Investment Advisers Act. The court invalidated the rule for conflicting with statutory purpose. The court wrote that although no official definition existed for “client,” “[t]he lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous.” The court also highlighted that the definition the SEC sought to apply inexplicably diverged from the SEC’s own prior definition, rendering it “completely arbitrary.” And finally, because the new rule/definition “create[d] a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act,” the court held that the rule was arbitrary.

Similarly, in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), the SEC had attempted to exempt broker-dealers from the requirements of the Investment Advisers Act when they receive special compensation for their services. The court found that the Investment Advisers Act was not ambiguous as to the definition of “investment adviser.” Consequently, the SEC’s rule exceeded its authority and the SEC was held to lack the power to craft new exemptions under the Investment Advisers Act.

Is the Proposed Rule Inconsistent With Recent SEC Proposals on Derivatives?

Commissioner Piwowar noted this issue in opposing the proposed rule:

I strongly believe that the Commission should first adopt the Investment Company Reporting Modernization Proposal before proposing a new leverage limit on funds. Adoption of that proposal would provide investors and the Commission with a much better understanding of funds’ derivatives use and exposures, which should address many of the concerns regarding funds use of derivatives for leveraging purposes. In addition, it would provide the Commission with much needed data that can be analyzed, in accordance with our current guidance on economic analysis in rulemakings, to determine whether there is any need to further limit funds’ use of derivatives. If the data supported further limits, it could then be used to determine what such limits should be in a thoughtful, empirically driven manner.

* * *

³ The proposing release primarily relies upon Sections 1(b)(7) and (8) of the Investment Company Act: “it is hereby declared that the national public interest and the interest of investors are adversely affected— . . . (7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or (8) when investment companies operate without adequate assets or reserves.”

The preamble does state that “[i]t is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.” However, other than the Securities Act of 1933, all of the federal securities laws contain similar preambles which have never been relied upon as a source of rule-making authority.

The Commission should also adopt the Liquidity Risk Management Program Proposal before proposing a leverage limit or a specific derivatives risk management program for funds. The Liquidity Risk Management Program Proposal would require open-end funds (other than money market funds) to, among other things, classify their derivatives investments into one of six categories based on the number of days within which a fund's position would be convertible to cash. The proposal would also require funds to specifically consider the liquidity of derivatives instruments when making these liquidity classification determinations. The proposal would further require funds to assess their liquidity risk, including the potential effects of the use of borrowings and derivatives on their liquidity risk. As part of their liquidity risk management programs required under the rule, funds would have to set a three-day liquid asset minimum requirement. In setting the liquid asset minimum, funds would have to consider their use of derivatives. If adopted, these requirements could reduce the risks associated with a fund's use of derivatives by ensuring that funds account for their derivatives exposures in formulating and implementing their liquidity risk management programs.

Did the SEC Conduct a Proper Cost-Benefit Analysis of the Proposed Rule?

The SEC does not dispute that the proposed rule would change how investment companies invest in derivatives. Noting that “[a]lthough much of the following discussion is qualitative in nature,”⁴ the SEC purports to analyze the cost of the proposed rule and its benefits and concludes that the benefits exceed the costs. The question is whether this analysis meets legal standards. Shockingly, even the direct, quantifiable costs of the proposed rule are estimated by the SEC to be almost \$200 million over a three year period.

In *Chamber of Commerce of U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005), the court invalidated an SEC rule that required mutual funds to have no less than seventy-five percent independent directors and an independent chairman. While the court found that the SEC had authority to promulgate the rule under the ICA and that the rule was not arbitrary or capricious under the Administrative Procedures Act, it faulted the SEC for its failure under the ICA to consider the impact of the rule on efficiency, competition, and capital formation.

Recognizing the difficulty of preparing reliable empirical studies, the court wrote that “uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation . . .” In addition, the SEC, in explaining why it had adopted the rule, did not address an alternative to the rule put forward during the notice and comment period and raised by two dissenting Commissioners. The court found that this was equally fatal to the rule's promulgation, because while the “Commission is not required to consider ‘every alternative . . . conceivable by the mind of man . . . [.]’” that particular alternative was “neither frivolous nor out of bounds and the SEC therefore had an obligation to consider it.”

Similarly, in *American Equity Life Insurance Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2009), the SEC rule at issue classified fixed indexed annuities offered by insurance companies as non-annuity contracts, thus requiring that they be subject to regulation under the Securities Act of 1933. While the court held that the SEC's classification of such instruments was not unreasonable, it found that the SEC had “failed to consider the efficiency, competition, and capital formation effects of the new [r]ule” and invalidated the rule under the Administrative Procedures Act.

In its analysis, the court criticized the SEC's claim that the rule would enhance competition because of the ambiguity that the absence of a rule on the matter had created. “The SEC cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear in the absence of any rule.” Rather, the court said, the Administrative Procedures Act requires “an analysis of whether the specific rule will promote efficiency, competition and capital formation.” The court held insufficient the SEC's entire cost-benefit analysis, as it was largely based on the weak foundation of the “rule clarity” rationale.

Similarly, in *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), the court overturned a proxy access rule promulgated by the SEC, Rule 14a-11, aimed at allowing shareholders to more easily and cheaply nominate non-incumbent candidates for corporate

⁴ “Because we do not know to what extent the current regulatory framework for derivatives may have been influencing funds' use of derivatives—for example, the extent to which differences in the two approaches to asset segregation may have been distorting funds' choices of products in the current market—we do not know to what extent funds would change existing positions, or would enter into different positions going forward, under the proposed rule. Accordingly, we cannot quantify this potential effect.”

boards. Had it been upheld, Rule 14a-11 would have “require[d] a company subject to the [1934] Act proxy rules . . . to include in its proxy materials ‘the name of a person or persons nominated by a [qualifying] shareholder or group of shareholders for election to the board of directors.’” In invalidating the rule, the court held that the SEC had “acted arbitrarily and capriciously for having failed . . . adequately to assess the economic effects of a new rule.” The Court held that the SEC “inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to the substantial problems raised by commenters.”

What Did the Derivatives White Paper Add to the Proposing Release?

The proposing release refers to a white paper prepared by the SEC’s Division of Economic and Risk Analysis (DERA) staff entitled, *Use of Derivatives by Registered Investment Companies*. Granular information on the extent to which funds currently use derivatives is not generally available. The paper analyzes the use of derivatives by a random sample generated by DERA of 10 percent of all registered funds. The paper presents data on their derivatives positions, financial commitment transactions, and certain other transactions.

The paper reports that some funds use derivatives extensively, with notional exposures ranging up to approximately 950 percent of net assets, while most funds either do not use derivatives or do not use a substantial amount. The paper also presents figures showing that since 2010 some fund investment categories (especially managed futures mutual funds and inverse or leveraged ETFs) that make greater use of derivatives have received a disproportionately large share of inflows.

The white paper appears directed to a court decision which invalidated an SEC rule on the grounds that an inadequate cost benefit analysis had been conducted of the proposed rule. *Chamber of Commerce of U.S. v. SEC*, 443 F.3d 890 (D.C. Cir. 2006), held that the SEC’s rule-making process was flawed because the SEC “failed to comply with section 553(c) of the APA, 5 U.S.C § 553(c), by relying on materials not in the rulemaking record without affording an opportunity for public comment, to the prejudice of the Chamber.” The court further held, “[t]he Commission’s extensive reliance upon extra-record materials in arriving at its cost estimates, and thus in determining not to modify the two conditions [at issue in Chamber of Commerce I]. . . required further opportunity for comment.”

What Are the Next Steps in the Process of Reviewing the Proposed Rule?

The proposed rule is subject to a 90 day comment period, which will expire on March 28. Once the comment period expires, the SEC staff must analyze and address the comments. After this is completed, the SEC Commissioners can meet in an open meeting to vote on whether to approve the proposed rule as currently proposed or in a modified form. There must be at least 10 days advance notice to the public before the Commission meeting to vote on the proposed rule. If the rule is adopted, challenges can be filed in federal court, along the lines described above; such challenges would probably not be decided for many months. If the rule is adopted and survives any court challenges, it will become effective on the date set by the SEC in the adopting release. Significant rules, which would probably include the proposed rule, cannot become effective until at least 60 days after publication in the Federal Register.

It is impossible to predict whether the proposed rule will be adopted by the SEC Commissioners and whether, if adopted, the rule will be challenged in court and, if challenged, whether it would survive such a challenge. One of the Commissioners who voted to propose the rule, Commissioner Aguilar, resigned on December 31, 2015, and therefore will not vote on the adoption of the proposed rule. Two Commissioners have been nominated by the President to fill vacancies on the Commission, but neither has been confirmed by the Senate. Commissioner Stein and Chair White voted in favor of proposing the rule and seem inclined to support its adoption. Commissioner Piowar voted against proposing the rule, but could be persuaded to vote favorably on the adoption of the rule.

Katten

www.kattenlaw.com

Katten Muchin Rosenman LLP

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2016 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.