SEC Re-Proposes Regulations Governing the Use of Derivatives and Other Transactions by Registered Funds and BDCs

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The Securities and Exchange Commission (the "SEC") recently proposed a revised version of new Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"),[1] which it originally proposed in December 2015 (the "2015 Proposal").[2] The Proposed Rule would permit mutual funds (other than money market funds), exchange-traded funds ("ETFs"), closed-end funds and business development companies ("BDCs") (collectively, "funds") to enter into derivatives transactions,[3] notwithstanding the prohibitions and restrictions on the issuance of senior securities under Section 18 (and, for BDCs, Section 61) of the 1940 Act, provided that a fund complies with the conditions of the Proposed Rule.

In re-proposing new Rule 18f-4, the SEC noted its consideration of industry comments to the 2015 Proposal as well as subsequent SEC staff engagement with fund complexes and investor groups. As a result, the Proposed Rule departs from the 2015 Proposal in notable respects that were the source of significant industry comment, including the removal of proposed asset segregation requirements and notional cap limitations, modification of proposed treatment of unfunded commitments and reverse repurchase agreements, and modification of certain primary elements of the re-proposed derivatives risk management program, including material changes to the approval and oversight requirements of a fund's board of directors. The new proposed framework for derivatives regulation also would eliminate current requirements for funds to segregate assets to "cover" derivatives transactions to avoid subjecting those transactions to compliance with the asset coverage requirements of Section 18 of the 1940 Act.

Related to the Proposed Rule, the SEC also proposed amendments to Forms N-CEN, N-PORT and N-LIQUID (to be renamed Form N-RN) to impose new reporting requirements designed to assist the SEC in overseeing funds' use of derivatives and other transactions and enhance public disclosure about the impact that those transactions have on a fund's portfolio.

The Proposing Release also included a series of proposed new rules and rule amendments with respect to leveraged/inverse investment vehicles,[4] which would be subject to different limitations on leverage risk than other funds. The SEC also proposed to amend the recently-adopted ETF rule to allow fund sponsors to launch leveraged and inverse ETFs without obtaining exemptive relief. Finally, the SEC proposed two new rules that would require SEC-registered broker-dealers and investment advisers to exercise due diligence before accepting or placing orders for leveraged/inverse investment vehicles (together, the "Proposed Sales Practices Rules").[5]

The SEC requested comment on essentially all aspects of the Proposed Rule. The public comment period is open until 60 days after the publication of the Proposed Rule in the Federal Register, which has not yet occurred as of the date of this Client Alert.

Scope of the Proposed Rule

The Proposed Rule would permit a fund to engage in derivatives transactions, notwithstanding the requirements of Sections 18 and 61 of the 1940 Act, and derivatives transactions entered into in compliance with the Proposed Rule will not be considered for purposes of computing asset coverage under Sections 18 and 61 of the 1940 Act, provided that the fund:

- complies with one of two value-at-risk ("VaR")-based limits on fund leverage risk—a default test based on relative VaR (the "Relative VaR Test") or, if applicable, an exception to the default test based on absolute VaR (the "Absolute VaR Test");[6] and
- adopts and implements a written derivatives risk management program (a "Program") administered by a board-approved derivatives risk manager (a "DRM").

In addition to the requirements applicable to funds, the Proposed Rule contains several fund board oversight and reporting requirements, as discussed below.

Limit on Fund Leverage Risk

To rely on the Proposed Rule, when engaging in derivatives transactions, a fund must comply—and determine compliance at least once each business day—with the Relative VaR Test or, if applicable, the Absolute VaR Test.

The Relative VaR Test would require a fund to calculate the VaR of its portfolio and compare it to the VaR of a "designated reference index," which would be an unleveraged index (which may be a blended index) that: (1) is selected and reviewed periodically by the DRM; (2) reflects the markets or asset classes in which the fund invests; (3) is not administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used; and (4) is an "appropriate broad-based securities market index" or an "additional index" (each as defined in Form N-1A, the registration statement form for mutual funds). A fund would not be permitted to exceed 150% of the VaR of its designated reference index. A fund would have to disclose its designated reference index in its annual report, together with a presentation of the fund's performance relative to the index.

A fund may not pick, or alternate, which VaR test to comply with for any particular derivatives transaction. A fund would be required to comply with the default Relative VaR Test *unless* the DRM were unable to identify a designated reference index that is appropriate for the fund, taking into account the fund's investments, investment objective(s) and strategies. For example, as noted in the Proposing Release, certain multi-strategy funds that manage their portfolios based on target volatilities across a variety of investment strategies could find it difficult to identify a single index (even a blended index) that would be appropriate for purposes of the Relative VaR Test. In such a scenario, a fund would be required to comply with the Absolute VaR Test, under which the VaR of the fund's portfolio would not be permitted to exceed 15% of the value of the fund's net assets.

If a fund were to determine that it is not in compliance with the applicable VaR test, the Proposed Rule would require the fund to come back into compliance "promptly"—that is, within no more than three business days after the determination. If the fund's non-compliance were to exceed three business days:

- the DRM must (1) report to the fund's board and explain how and by when (*i.e.*, number of business days) the DRM reasonably expects that the fund will come back into compliance and (2) analyze the circumstances that caused the fund to be out of compliance and update any Program elements as appropriate to address those circumstances; and

- the fund may not enter into any derivatives transactions (other than those that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance for three consecutive business days and has satisfied the other foregoing requirements.

The 2015 Proposal would have required funds to comply with one of two alternative portfolio limitation tests immediately after entering into any derivatives transactions. These two portfolio limitation tests, which were the subject of significant industry opposition, were replaced in the Proposed Rule with the default Relative VaR Test and exception-based Absolute VaR Test. In addition, the 2015 Proposal would have required a fund to segregate sufficient assets (defined in the 2015 Proposal as "qualifying coverage assets") to enable the fund to meet its obligations arising from its derivatives transactions. The Proposed Rule does not include any specific asset segregation requirement.

Derivatives Risk Management Program

The Proposed Rule, similar to the 2015 Proposal, contains requirements for funds to adopt a Program and have a DRM. However, certain of the foundational elements of the Program required by the Proposed Rule are new—namely, the requirements to adopt risk guidelines, stress test a fund's portfolio and backtest the results of the VaR calculation model[7] used by the fund.

Program Elements. The Program must include policies and procedures that are reasonably designed to manage a fund's derivatives risks. In addition, the Program must be designed to reasonably segregate the functions associated with the Program from the portfolio management of a fund.[8] The Program also must include the following elements:

- *Risk Identification and Assessment*. The Program must provide for the identification and assessment of a fund's derivatives risks. This assessment must take into account the fund's derivatives transactions and other investments. The Proposed Rule would define the derivatives risks that must be identified and managed to include leverage, market, counterparty, liquidity, operational and legal risks, as well as any other risks the DRM deems material.

- *Risk Guidelines*. The Program must provide for the establishment, maintenance and enforcement of investment, risk management or related guidelines that provide for quantitative or otherwise measurable criteria, metrics or thresholds of a fund's derivatives risks. These guidelines must specify levels of the given criterion, metric or threshold that the fund does not normally expect to exceed, and measures to be taken if they are exceeded. The Proposed Rule, however, would not impose specific risk limits for these guidelines. Instead, it would require a fund to adopt guidelines that provide for quantitative thresholds that the fund determines to be appropriate and that are most pertinent to its investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure. Funds may use a variety of approaches in developing guidelines that comply with the Proposed Rule.
- *Stress Testing*. The Program must provide for stress testing to evaluate potential losses to a fund's portfolio—that is, of *all* of the fund's investments, not just the fund's derivatives transactions. The frequency with which the stress testing is conducted—at least weekly—must take into account the fund's strategy and investments and current market conditions.[9] A fund's stress tests would be required to (1) evaluate potential losses to the fund's portfolio in response to extreme, but plausible, market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio and (2) take into account correlations of market risk factors and resulting payments to derivatives counterparties.
- *Backtesting*. The Program must provide for backtesting of the results of the VaR calculation model used by a fund in connection with the Relative VaR Test or the Absolute VaR Test. Specifically, the Proposed Rule would require that, each business day,[10] a fund compare its actual gain or loss for that business day with the VaR the fund had calculated for that day. A fund would be required to identify, as an exception, any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss.
- *Internal Reporting and Escalation*. The Program must identify the circumstances under which a fund's portfolio management team will be informed regarding the operation of the Program, including breaches of the risk guidelines discussed above and the results of the stress tests conducted under the Program. In addition, the DRM must, in a timely manner, inform the fund's portfolio management team—and directly inform the fund's board, as appropriate, as determined by the DRM—of material risks arising from the fund's derivatives transactions, including risks identified by the fund's exceedance of its risk guidelines or by the stress testing.
- *Periodic Review of the Program*. The DRM must conduct a review of the Program, including each of the specific elements above, at least annually to evaluate the Program's effectiveness and to reflect changes in a fund's derivative risks over

time. The periodic review also would cover the VaR model used by a fund to comply with the proposed VaR-based limit on fund leverage risk. The Proposed Rule, however, would not prescribe review procedures or incorporate specific developments that a DRM must consider as part of its review.

Derivatives Risk Manager. The Proposed Rule provides that a DRM will be responsible for administering the Program and the policies and procedures adopted thereunder. The Proposed Rule states that a DRM must be an officer or officers of a fund's investment adviser—but not a portfolio manager of the fund—and must have relevant experience regarding the management of derivatives risk generally. Although not permitted to serve as a DRM, third parties may provide assistance to the DRM in administering the Program.

Board Oversight and Reporting

The Proposed Rule contains certain fund board oversight and reporting requirements, including:

- approval by a fund's board, including a majority of the directors who are not interested persons of the fund ("independent directors"), of the DRM, taking into account the DRM's relevant experience regarding derivatives risk management;
- written reporting to the board by the DRM, at least annually, regarding the Program's implementation and effectiveness;[11] and
- certain regular written reporting to the board by the DRM (at a frequency to be determined by the board) regarding (1) the DRM's analysis of any exceedances of the risk guidelines set forth in the Program and (2) the results of the stress testing and backtesting conducted pursuant to the Program.

A fund's board also would be responsible for overseeing the fund's compliance with the Proposed Rule as part of the board's broader obligations with respect to the fund's compliance program adopted pursuant to Rule 38a-1 under the 1940 Act. In a notable change from the 2015 Proposal, the Proposed Rule does *not* require that a fund's board approve the Program initially or any material changes to the Program. The SEC noted in the Proposing Release, however, that "board oversight should not be a passive activity," and that "directors should understand the [P]rogram and the derivatives risks it is designed to manage as well as participate in determining who should administer the program . . . [and] should ask questions and seek relevant information regarding the adequacy of the [P]rogram and the effectiveness of its implementation." In addition, the SEC stated that directors "should view oversight as an iterative process," and that the board "should inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including as those risks may change over time."

Exceptions and Alternative Requirements

Limited Derivatives User Exception. A fund that is a "limited" derivatives user is not required to adopt a Program or otherwise comply with either of the VAR tests if it adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks. A fund would qualify as a "limited" derivatives user under the Proposed Rule if (1) the fund's derivative exposure[12] does not exceed 10% of the fund's net assets or (2) the fund uses derivatives transactions solely to hedge certain currency risks.

In the Proposing Release, the SEC stated its belief that most BDCs either would continue to not use derivatives or would rely on the exception for limited derivatives users. Similarly, many ETFs may be able to conclude that they can rely on this exception.

Leverage Risk Requirements for Leveraged/Inverse Investment Vehicles. Under the Proposed Rule, a fund that is a leveraged/inverse investment vehicle would not be required to comply with the VaR tests so long as (1) the fund discloses in its prospectus that it is not subject to this condition and (2) the fund does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or the inverse of the return) of the underlying index. Such a fund would still have to comply with other parts of the Proposed Rule, including proposed conditions with respect to a Program and DRM, board oversight and reporting, and recordkeeping.

Proposed Sales Practices Rules; Amendments to ETF Rule 6c-11

The Proposed Sales Practices Rules would require broker-dealers and investment advisers to engage in certain due diligence[13] before accepting or placing an order for a customer or client that is a natural person (defined in the Proposing Release as a "retail investor") to trade a leveraged/inverse investment vehicle, or approving a retail investor's account for such trading. Under the Proposed Sales Practices Rules, a broker-dealer or investment adviser could approve a retail investor's account to transact in shares of a leveraged/inverse investment vehicle only if the firm had a reasonable basis to believe that the retail investor is capable of evaluating the risks associates with those products.[14] Broker-dealers and investment advisers would be required to adopt and implement policies and procedures reasonably designed to achieve compliance with the Proposed Sales Practices Rules.

The Proposing Release includes a proposed amendment to Rule 6c-11 under the 1940 Act, which permits ETFs that satisfy certain conditions to operate with obtaining an exemptive order from the SEC, to remove the provision contained therein excluding leveraged/inverse ETFs from the scope of that rule. In addition, the SEC proposed to rescind the exemptive orders previously issued to leveraged/inverse ETFs.

Treatment of Reverse Repurchase Agreements and Unfunded Commitments

Reverse Repurchase Agreements. In the Proposing Release, the SEC reiterated its view that reverse repurchase agreements and other similar financing transactions are the equivalent of the use of borrowings by a fund to obtain additional cash that can be used for investment purposes. Accordingly, under the Proposed Rule, a fund may engage in reverse repurchase agreements and other similar financing transactions so long as they are subject to the relevant asset coverage requirements of Section 18.[15]

While reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under the limited derivatives user provisions of the Proposed Rule, if a fund were unable to qualify as a limited derivatives user due to its other investment activity, any portfolio leveraging effect of reverse repurchase agreements or similar financing transactions would be included and restricted through the applicable VaR test.

Notably, the SEC did not propose to treat securities lending arrangements, which the SEC noted are not dissimilar from reverse repurchase agreements, as "similar financing transactions" subject to Section 18 compliance when (1) a fund does not sell or otherwise use the non-cash collateral received for loaned securities to leverage the fund's portfolio and (2) the fund invests cash collateral received for loaned securities solely in cash or cash equivalents. Tender option bonds, however, may be subject to compliance with the asset coverage requirements of Section 18 depending on the facts and circumstances.

Unfunded Commitment Agreements. As discussed in the Proposing Release, the SEC believes that unfunded commitment agreements may be treated differently from derivatives transactions because they are not used for speculative purposes or to leverage a fund's portfolio. The SEC noted, however, that unfunded commitment agreements could raise asset sufficiency concerns. As a result, the Proposed Rule would permit a fund to enter into unfunded commitment agreements—notwithstanding the asset coverage requirements of Sections 18 and 61 of the 1940 Act—if the fund reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due (a "reasonable belief"). This is a notable change from the 2015 Proposal, which would have treated unfunded commitment agreements as "financial commitment transactions" and, therefore, a fund's obligations under unfunded commitment agreements could not have exceeded the fund's net asset value, with certain limited exceptions. This could have significantly, and adversely, impacted closed-end funds that invest in underlying private equity and private credit funds, and certain funds, including BDCs, that make unfunded commitments to provide additional funding to one or more of their portfolio companies.

The Proposed Rule prescribes certain specific factors that a fund must take into account when forming its reasonable belief, the basis for which must be documented and maintained in the fund's records—namely, a fund:

- must consider its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions);
- may not consider cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments; and
- may not consider cash that may become available from issuing additional equity. [16]

To have a reasonable belief, a fund could consider its investment strategy, portfolio liquidity and borrowing capacity, as well as the contractual provisions of its unfunded commitment agreements.

Recordkeeping; Proposed Amendments to Reporting Requirements

The Proposed Rule requires a fund to adhere to certain recordkeeping requirements that are designed to provide the SEC's staff, and the fund's board and compliance personnel, the ability to evaluate the fund's compliance with the Proposed Rule's requirements. A fund would be required to maintain records relating to the following: (1) the fund's Program and designation of the DRM; (2) the fund's determination of its VaR and any VaR calculation models; (3) for funds that are limited derivatives users, the fund's written record of its policies and procedures designed to manage its derivative risk; and (4) the basis for the fund's belief regarding its ability to meet its obligations with respect to its unfunded commitment agreements.

In addition, the SEC proposed amendments to Forms N-PORT, N-LIQUID (proposed to be re-titled Form N-RN) and N-CEN, which would require a fund to provide certain information regarding: (1) the fund's use of derivative transactions, reverse repurchase agreements or similar financing transactions and unfunded commitment agreements; (2) the fund's VaR (and, if applicable, the fund's designated reference index) and backtesting results; (3) VaR test breaches, to be reported to the SEC in a non-public current report; and (4) certain identifying information about the fund (*e.g.*, whether the fund is a limited derivatives user or a leveraged/inverse investment vehicle). BDCs, unlike other funds, would not be required to report on Forms N-PORT or N-LIQUID.

Effect on Existing Guidance; Transition Period

Similar to the 2015 Proposal, the SEC proposed to rescind a 1979 interpretive release that permits funds to engage in derivatives transactions and certain financial commitment transactions if the fund fully "covers" its payment obligations by segregating cash or cash equivalents in a segregated account, thereby limiting the risks associated with the transaction.[17] In addition, the SEC's Division of Investment Management is reviewing no-action letters and other guidance addressing derivatives transactions and other transactions covered by the Proposed Rule to determine which letters and other staff guidance, or portions thereof, should be withdrawn in connection with adoption of the Proposed Rule.

The Proposing Release stated that the SEC would expect to provide funds a one-year transition period while funds, broker-dealers and investment advisers prepare to come into compliance with the Proposed Rule, after which Release 10666 would be rescinded.

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[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers*' *Transactions in Certain Leveraged/Inverse Investment Vehicles*, Investment Company Act Release No. 33704 (Nov. 25, 2019) (the "Proposing Release"), available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933 (Dec. 11, 2015), available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf. The Proposing Release supersedes the 2015 Proposal, which never was adopted by the SEC.

[3] Under the Proposed Rule, "derivatives transaction" means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and (2) any short sale borrowing. Because the Proposed Rule addresses funds' use of reverse repurchase agreements and unfunded commitment agreements separately from funds' use of derivatives, the proposed definition of "derivatives transaction" does not include those instruments. In addition, although firm commitment agreements and standby commitment agreements are not specifically included in the definition of "derivatives transaction," the Proposing Release states that each may be considered a "similar instrument" under the definition depending on the facts and circumstances.

[4] "Leveraged/inverse investment vehicle" is defined in the Proposing Release as a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.

[5] Rule 15*l*-2 under the Securities Exchange Act of 1934, as amended, and Rule 211(h)-1 under the Investment Advisers Act of 1940, as amended.

[6] VaR is defined in the Proposed Rule as an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level. The Proposing Release provides the following illustration of VaR: if a fund's VaR calculated at a 99% confidence level was $100, this means the fund's VaR model estimates that, 99% of the time, the fund would not be expected to lose more than $100. However, 1% of the time, the fund would be expected to lose more than $100; notably, VaR does not estimate the extent of this loss.

[7] The SEC would provide flexibility in developing a VaR calculation model, but would require that the model use a 99% confidence level, a time horizon of 20 trading days and be based on at least three years of historical market data. The Proposed Rule also would require that VaR calculation models take into account and incorporate "all significant, identifiable market risk factors associated with a fund's investments." A non-exhaustive list of common market risk factors is included in proposed Rule 18f-4(a).

[8] As it did in the 2015 Proposal, the SEC noted that the reasonable segregation requirement should not result in a communications "firewall" between the DRM and portfolio management.

[9] In the Proposing Release, the SEC stated that a fund *should* stress test its portfolio with a frequency that would best position the DRM to appropriately administer, and the board to appropriately oversee, the fund's derivatives risk management.

[10] The Proposed Rule would require funds to conduct backtests with such frequency so that a fund and its DRM could "more readily and efficiently adjust or calibrate its VaR calculation model" and, therefore, could "more effectively manage the risks associated with its derivatives use." For purposes of the backtesting requirement, the VaR would be estimated over a one-trading day time horizon.

[11] The reports must include, among other things: (1) a representation from the DRM that the Program is reasonably designed to manage the fund's derivatives risks; (2) the basis for the representation; (3) information as may be reasonably necessary for the board to evaluate the adequacy of the Program; and (4) the DRM's basis for selecting the designated reference index or, if applicable, an explanation as to why the DRM was unable to do so.

[12] For this purpose, "derivatives exposure" means the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the assets sold short. The proposed definition of "derivatives exposure" would, however, include two permissible adjustments—namely, a fund may (1) convert the notional amount of interest rate derivatives to 10-year bond equivalents and (2) delta-adjust the notional amounts of options contracts.

[13] Broker-dealers and investment advisers must have a reasonable basis for believing that a retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of transacting in leveraged/inverse investment vehicles, and must seek to ascertain certain facts relative to the investor and the investor's financial situation and investment objectives, including, at a minimum, the information specified in paragraphs (b)(2) of proposed Rules 15*l*-2 and 211(h)-1.

[14] As noted in the Proposing Release, these proposed requirements are modeled after the FINRA options account approval requirements for broker-dealers.

[15] This provision in the Proposed Rule would not provide any exemptions from the requirements of Section 61 of the 1940 Act for BDCs, because Section 61 does not limit a BDC's ability to engage in reverse repurchase agreements or similar transactions.

[16] A fund, however, would not be precluded from considering the issuance of debt (*e.g.*, borrowings from financial institutions or the issuance of debt securities) to support a reasonable belief that it could fund an unfunded commitment. Any borrowings by funds would be subject to the requirements and limitations of the 1940 Act, which would limit the extent to which a fund's belief regarding its ability to borrow would allow the fund to enter into unfunded commitment agreements.

[17] *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666, 44 FR 25128 (April 27, 1979) ("Release 10666"). The analysis contained in Release 10666 has served as the foundation for the SEC staff to provide subsequent no-action guidance involving a wide array of derivatives transactions and their treatment under Section 18 of the 1940 Act. A select bibliography of the subsequent SEC staff no-action letters is available at http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.