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SEC PROPOSAL ON INVESTMENT COMPANY USE OF DERIVATIVES – A SOLUTION IN SEARCH OF A PROBLEM?

After 30 years of piecemeal guidance, the Commission has issued proposed Investment Company Act Rule 18f-4, which represents a comprehensive approach to the regulation of derivatives as "senior securities." After discussing the history and current application of Section 18, the author turns to the proposed rule, addressing in detail its coverage, required asset segregation, portfolio limitations, and risk management. She concludes that the new requirements will further restrict, perhaps unnecessarily, the ability of registered funds to invest in derivatives and increase the oversight burden on fund boards.

By Amy R. Doberman *

On December 11, 2015, the Securities and Exchange Commission proposed Rule 18f-4 under the Investment Company Act of 1940 ("1940 Act") providing for a new, exclusive means by which open-end investment companies ("mutual funds"), exchange-traded funds ("ETFs"), closed-end funds, and business development companies or "BDCs" (collectively, "funds") may enter into derivatives, short sales, or other transactions that create conditional or unconditional future payment obligations on the fund.[1] To rely on the proposed rule, funds would be required to comply with leverage restrictions, segregation requirements, substantial board oversight, and, in some cases, the adoption of a formal risk management program. If adopted, Rule 18f-4 stands to rescind and replace over 30 years of (often inconsistent) guidance developed by the Commission and its staff regarding the foregoing transactions and the application of Section 18 of the 1940 Act to those transactions.

I. HISTORY OF SECTION 18

a. 1940 Act Prohibition on Issuance of Senior Securities

Section 18 prohibits funds from issuing any class of "senior security," which is defined in Section 18(g) as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." One of the principal purposes of Section

[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Inv. Co. Act Rel. No. 31933 (2015), 80 Fed. Reg. 80884 ("Proposing Release"). A companion white paper, entitled "*Use of Derivatives by Investment Companies*" ("DERA Analysis"), authored by the Commission's Division of Economic Risk Analysis ("DERA"), is *available at* http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

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18 is "to limit increases in the speculative character of junior securities issued by investment companies."[2] In considering Section 18, Congress expressed concern that funds were routinely issuing debentures (a form of debt) and/or several classes of preferred stock, creating leveraged structures that undermined the interests of common stockholders.[3] In examining losses experienced by holders of common stock of leveraged investment companies from 1929 to 1937, the Commission found that had such funds employed a simple capital structure, a substantial part of the losses sustained by common stockholders would have been avoided.[4] These concerns led to the inclusion in the 1940 Act of Section 18, which generally prohibits the issuance of senior securities by mutual funds, and permits their issuance by closed-end funds within strict limits. Section 18 was, therefore, clearly intended to regulate a fund's capital structure, and not fund investments or trading practices. Notably, but not surprising given the legislative history and plain language of the statute, the Proposing Release focuses more on the public policy considerations underlying Section 18 than the language of the provision itself to justify the proposed rule.

b. Extension of Section 18

In 1979, the Commission published Release 10666, expanding the definition of "senior security" and thus the reach of Section 18 to certain securities trading practices that create leverage. Release 10666 represents the first formal instance where Section 18 was interpreted broadly enough to encompass portfolio investment and trading practices, as opposed to the capital structure, of a fund. Release 10666 addressed the use of: (1) reverse repurchase agreements; (2) firm commitment agreements; and (3) standby agreements (collectively, the "Trading Practices"). Importantly, Release 10666 noted that the Trading Practices were only examples, and if a fund "were to issue a security which affected its capital structure in a manner analogous to the [Trading Practices] and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture."[5]

Release 10666 stated that there is no violation of Section 18 if a fund engaging in any of the Trading Practices maintains a segregated account of "liquid assets" to "cover" the obligation associated with a transaction. Liquid assets included cash, U.S. government securities, and other high grade debt obligations.[6] The purpose of the segregated account was to limit the speculative character of an investment in the fund by reducing the fund's risk of loss and assuring the availability of adequate assets to meet the obligation associated with the transaction.[7]

The ability to cover a transaction, and thus avoid the creation of a senior security, was further extended to the use of various derivatives instruments in a later no-action letter issued to Dreyfus Strategic Investing. In Dreyfus, the Commission's Division of Investment Management indicated that as an alternative to asset segregation, a fund may "cover" a transaction through the use of offsetting positions or transactions, and gave specific examples thereof.[8] Through additional no-action letters, the Division also has stated that "segregated assets" need not be physically segregated from other fund assets, but instead may be designated or earmarked on the fund's books and records.[9] The

[2] *Securities Trading Practices of Registered Investment Companies*, Inv. Co. Act Rel. No. 10666 (1979), 44 Fed. Reg. 25128, 25129 ("Release 10666").

[3] *See* Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. at 790 (1940) ("Senate Hearings") (Statement of E. Merrick Dodd, Jr.). *See also* Senate Hearings at 1025 (memorandum titled, Provisions of the Proposed Bill Relating to Capital Structure, Sections 18, 19(b) and 21(c)).

[4] *Id.* at 1028.

[5] Release 10666 at 25128.

[6] *Id.* at 25132.

[7] *Id.*

[8] Dreyfus Strategic Investing, SEC No-Action Letter, [1983-2003 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 78,472 (June 22, 1987) (the "Dreyfus Letter").

[9] Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "Merrill Letter") and Dear Chief Financial

Division also expanded the universe of assets that may be segregated by a fund, originally limited in Release 10666 to cash, U.S. government securities and high grade debt to include any asset, including equity securities and non-investment grade debt, so long as the asset is liquid and marked-to-market daily.[10] This expansion of coverage assets enabled more extensive use of derivatives because a fund could designate securities normally held in its portfolio (and consistent with its investment strategy) without the requirement to increase cash holdings to satisfy derivatives obligations.

In the years since the publication of Release 10666, the Division has issued many no-action letters further extending the definition of senior security to a variety of derivative contracts and other types of leveraged transactions (*e.g.*, short sales of securities) that it believed were "analogous to" the Trading Practices. In the course of these no-action letters, the Division provided guidance on an instrument-by-instrument basis as to how a fund could avoid violating Section 18 by covering specific types of transactions through asset segregation, offsetting transactions, or a combination of the two.[11] For example, in the Dreyfus Letter, the Division addressed the use of asset segregation and offsetting transactions to cover short sales and certain derivatives transactions, such as the purchase and sale of futures contracts, the sale of options, and the purchase and sale of currencies on a forward basis.[12] The Dreyfus Letter suggested that funds may cover these derivatives transactions by engaging in certain offsetting transactions, or by segregating the full notional amount of the fund's potential obligation under the derivatives contract.[13] In another letter, Robertson Stephens Investment Trust,[14] the Division confirmed that it would not recommend enforcement action if the amount a fund segregates in respect of the short sale of a security is limited to the *current* market value of the security sold short, instead of the market value *at the time the security was sold short*, as historically had been required (in each case, less the amount of collateral deposited with the broker in connection with the short sale, not including short sale proceeds).[15]

Since the Dreyfus Letter, many funds have begun segregating an amount equal to the fund's daily marked-to-market obligation under the derivatives contract, rather than the notional amount of the contract, which obviously greatly expands a fund's ability to use derivatives. This approach has been inferred to be tacitly approved based on disclosure in certain funds' registration statements, or as described implicitly in exemptive applications, but has not been explicitly approved by the Commission or in any no-action letters.[16] The evolution of the use of different types of derivatives in different investment strategies, coupled with the lack of formal guidance as to how to treat these instruments under Section 18, has given rise to inconsistent approaches to asset segregation across the industry.

footnote continued from previous page…

Officer Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (Nov. 7, 1997).

[10] Merrill Letter.

[11] Proposing Release at 80897.

[12] *See also* Emerald Mgmt Co., SEC No-Action Letter (Jan. 21, 1978) (indicating restrictions on the writing of put and call options to prevent the issuance of senior securities) and Hutton Options Trading L.P., SEC No-Action Letter [1983-2003 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 78,906 (February 2, 1989) (indicating restrictions on the purchase and sale of put and call options on specific common stocks, stock indices, and foreign currencies to satisfy the segregation requirements).

[13] Dreyfus Letter at 8.

[14] SEC No-Action Letter (Aug. 24, 1995) ("Robertson Stephens Letter").

[15] *Id.* at 5.

[16] Concept Release and Request for Comments, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Inv. Co. Act Rel. No. 29776 (2011) 76 Fed. Reg. 55237, 55244, *available at* http://www.sec.gov/rules/concept/2011/ic- 29776.pdf (the "Concept Release") and *Comment Letter of Investment Company Institute on Concept Release*, File No. S7–33–11, 10 (Nov. 7, 2011) *available at* https://www.ici.org/pdf/25625.pdf. Moreover, the issuance of exemptive orders to leveraged and inverse ETFs, which do not include relief under Section 18, contemplates the use of marked-to-market segregation requirements, since the funds could not have operated otherwise. *See, e.g.,* ProShares Trust, Inv. Co. Act Rel. Nos. 27323 (May 18, 2006) (notice) and 27394 (June 13, 2006) (order), amended by Inv. Co. Act Rel. Nos. 27609 (Dec. 22, 2006) (notice) and 27666 (Jan. 18, 2007) (order), amended by Inv. Co. Act Rel. Nos. 27975 (Sep. 21, 2007) (notice) and 28014 (Oct. 17, 2007) (order), and further amended by Inv. Co. Act Rel. Nos. 28696 (April 14, 2009) (notice) and 28724 (May 12, 2009) (order); Rafferty Asset Management, LLC, Inv. Co. Act Rel. Nos. 28379 (Sep. 12, 2008) (notice) and 28434 (Oct. 6, 2008) (order) as amended by Inv. Co. Act Rel. Nos. 28889 (Aug. 27, 2009) (notice) and 28905 (September 22, 2009) (order).

c. Current Application

Current practices with respect to derivatives transactions are the product of the piecemeal and cumulative process pursuant to which Commission and Division views have been provided, beginning with Release 10666 and expanding through staff no-action letters, and occasionally the disclosure review process. The definition of adequate "cover" has evolved over time for certain types of transactions and has not been addressed at all for others, leaving a void to be filled by industry practice. The result is that "different funds may treat the same kind of derivative differently, based on their own application of [the] staff's guidance and observation of industry practice."[17] For example, funds reasonably may interpret the requirement to cover derivatives transactions as: (1) the daily mark-to-market value for derivatives transactions that require cash settlement; (2) the notional value for derivatives transactions that permit physical settlement; (3) a particular asset for transactions that permit delivery thereof to satisfy the fund's contractual obligations; or (4) an instrument or transaction that provides "offsetting exposure" to the covered transaction, the interpretation of which also varies.[18]

In March 2010, the Commission announced that the Division would conduct a review to evaluate the use of derivatives by funds and examine what additional protections may be necessary for those funds and their shareholders under the 1940 Act.[19] In August 2011, the Commission published the Concept Release identifying concerns and requesting comments on a wide range of issues concerning funds' increased use of derivatives.[20] Proposed Rule 18f-4 is the result of the Commission's evaluation of the benefits, risks, and costs associated with derivatives transactions, as well as comments received on the Concept Release.[21]

II. PROPOSED RULE 18f-4

If adopted, proposed Rule 18f-4 would supersede Release 10666, and the Commission would rescind the patchwork of staff guidance currently relied upon by funds when entering into derivatives and financial commitment transactions. In place of current practices, funds engaging in a short sale, derivative, or other leveraged transaction would be required to comply with a more comprehensive framework of: (1) asset segregation requirements; (2) portfolio limitation requirements for funds that use derivatives extensively or invest in "complex derivatives transactions"; and (3) formalized risk management requirements, each as described below.

a. Categories of Senior Security Transactions

Proposed Rule 18f-4 introduces new terminology to distinguish between different types of leveraged transactions and imposes different requirements for relying on Rule 18f-4 depending on the type of transaction the fund employs. The proposed rule refers to transactions implicated by Rule 18f-4 collectively as "senior security transactions" and sub-divides them into three categories: (1) "derivatives transactions," which include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument that may require payment or delivery of cash or other assets during the life of the instrument, or at maturity or early termination; (2) "financial commitment transactions," which include any short sale, reverse repurchase agreement, firm or standby commitment agreement, or similar agreement (such as a capital commitment to a private fund that can be drawn at its discretion);[22] and (3) any other senior security entered into by a fund under Sections 18 or 61 of the 1940 Act, including borrowings from banks under the 300% asset-coverage test and, in the case of closed-end funds and BDCs, issuance of debt or preferred stock.[23] Importantly, proposed Rule 18f-4 would not affect the ability of a fund to enter into transactions

[17] Proposing Release at 80897.

[18] *See supra* note 16 and accompanying text. While varying approaches have developed for purposes of covering derivatives transactions, industry practices have generally been more consistent with respect to financial commitment transactions, as defined below.

[19] SEC Staff Evaluating the Use of Derivatives by Funds (March 25, 2010), *available at* https://www.sec.gov/news/press/2010/2010-45.htm.

[20] *See generally*, Concept Release and Baris & Donohue, *SEC Concept Release Tackles Investment Company Use of Derivatives*, 45 Rev. of Sec. & Comm. Reg. No. 3 (February 8, 2012).

[21] Proposing Release at 80885.

[22] *Id.* at 80899-80900. As proposed, securities lending transactions would not be included within the definition of "financial commitment transaction."

[23] This third category would not include temporary borrowings of up to 5%, which are excluded from the definition of "senior security" by Section 18(g).

providing indirect or "economic" leverage, such as purchased options, because these transactions do not create a potential payment obligation and therefore are not considered to involve the issuance of senior securities.[24]

Proposed Rule 18f-4 would require that before a fund enters into even a single derivatives transaction or financial commitment transaction, its board must: (1) approve asset segregation policies and procedures designed to determine "risk-based coverage amounts" for each derivatives transaction and to maintain "qualifying coverage assets" (as such terms are defined below) for all derivatives transactions and/or financial commitment transactions; (2) approve one of two alternative limitations on the fund's aggregate notional exposure to senior securities transactions (that is, a 150% exposure-based portfolio limit or in the alternative, a 300% risk-based portfolio limit); and (3) either approve a formalized risk management program and derivatives risk manager or determine that the fund will monitor compliance with portfolio limitations under which the fund engages in no "complex derivatives transactions" and only a limited amount of derivatives transactions.[25]

b. Asset Segregation

Funds relying on proposed Rule 18f-4 would be required to segregate "qualifying coverage assets" in an amount designed to enable the fund to meet its obligations arising from derivatives transactions and financial commitment transactions.[26] In a dramatic departure from previous guidance, however, adhering to these asset segregation requirements will no longer be sufficient to avoid the creation of a senior security (and thus a violation of Section 18).

Definition of "Qualifying Coverage Assets." Under the rule, coverage assets may still be designated or "segregated" on a fund's books and records (rather than segregated in a separate custodial account or on the custodian's books). However, the types of assets eligible for segregation would be limited to "qualifying coverage assets," which are generally defined as cash and cash equivalents.[27] Subject to two limited exceptions, funds would no longer be able to segregate other types of liquid assets, such as equity and below investment-grade debt securities.[28]

The first exception would be for derivatives transactions and financial commitment transactions that contractually permit a fund to satisfy its obligation by delivering a particular asset. For such transactions, the underlying asset may be segregated as the qualifying coverage asset, even though it is not cash or a cash equivalent. For example, the qualifying coverage asset for a call option written by the fund on a particular stock could be shares of that stock. However, this exception is narrowly defined and would not, for example, permit a fund to designate as the qualifying coverage asset for a derivatives transaction a derivative that merely provides offsetting exposure.[29]

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[24] Proposing Release at n. 508. This position is consistent with the ABA Task Force's view that the distinctions between economic and investment leverage "are appropriate on policy grounds" and the belief that Section 18 does not and should not be interpreted to cover transactions that create economic leverage. ABA Section of Business Law, Committee on Federal Regulation of Securities Report of the Task Force on Investment Company Use of Derivatives and Leverage (July 6, 2010) (the "ABA Derivatives Report") at 9, 20.

[25] Rule 18f-4 would define "complex derivatives transaction" as any derivatives transaction for which the amount payable by either party upon settlement date, maturity, or exercise: (i) depends on the value of the underlying reference asset at multiple points in time during the term of the transaction or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price (which is typical of all standard put and call options).

[26] Proposing Release at 80925, 80945.

[27] *Id.* at 80932. Cash equivalents would be defined by reference to U.S. generally accepted accounting principles, which define them as "short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present an insignificant risk of changes in value because of changes in interest rates." *Id.*

[28] Among the no-action letters that would be rescinded on adoption of Rule 18f-4 is the Merrill Letter, which authorized segregation of "any asset, including equity securities and non-investment grade debt… so long as the asset is liquid and marked-to-market daily." The Commission's decision to revert to the standard in effect before the issuance of the Merrill Letter is inconsistent with the ABA Task Force's recommendation, which noted that "[f]or many funds, holding more than a minimal amount of [cash and cash equivalents] would be inconsistent with the fund's investment objective and policies; thus, the practical consequence of such limitation would be that such funds would be unable to invest in various derivative instruments that otherwise would be appropriate." ABA Derivatives Report at 19.

[29] Proposing Release at 80933. For example, a fund writing a credit default swap ("CDS") on a bond cannot treat a CDS on

The other exception would be for financial commitment transactions where the timing of the fund's payment obligation can be reasonably estimated. A fund would be able to segregate qualifying coverage assets other than cash and cash equivalents if such assets are convertible to cash, or generate sufficient cash before the date on which the fund is required to pay its obligations. A fund also would be able to designate, as the qualifying coverage assets for a financial commitment transaction, assets that have been pledged as to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board.[30]

Amount of Qualifying Coverage Assets to be Segregated. Consistent with current practices, the proposed rule would still permit a fund to calculate the amounts to be segregated once a day,[31] and the amount to be segregated for each financial commitment transaction would still be calculated as the full amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under the transaction (similar to the calculation for these transactions described in Release 10666).[32] However, the calculation would differ from current practices for determining the amount to be segregated for each derivatives transaction. For both physical and cash-settled derivative transactions, the amount to be segregated would equal the sum of: (1) the fund's mark-to-market exposure on the derivatives transaction, reduced by any variation margin or collateral (the "mark-to-market coverage amount")[33] and (2) a reasonable estimate of the potential amount the fund would be required to pay to exit the derivatives transaction under stressed conditions,[34] reduced by any initial margin posted by the fund (the "risk-based coverage amount").[35] Importantly, the calculation would be done separately for: (1) each portion of the coverage amount (*i.e.*, the mark-to-market coverage amount is calculated independently of the risk-based coverage amount) and (2) each derivatives transaction.[36]

Significantly, proposed Rule 18f-4 does not include any exceptions that would permit a fund to reduce the amount of qualifying coverage assets to be segregated by entering into an offsetting transaction. This represents a departure from the Dreyfus Letter, in which the Division permitted funds transacting in futures, forwards, written options, and short sales to reduce or eliminate the amount of assets to be segregated by entering into certain offsetting transactions that were intended to position the fund to meet its obligations under the

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the same bond entered into with a different counterparty as a qualifying coverage asset. The Commission reasons that to do so would be "inconsistent with the purpose of the asset segregation requirement [because] the fund would be exposed to the risk that its counterparty could default or fail to perform its obligation under the purchased CDS, thereby potentially leaving the fund without sufficient assets to satisfy its obligations under the written CDS."

[30] Proposing Release at 80948. *See generally*, *infra* notes 40-41 and accompanying text.

[31] *But cf., infra* Section II(c) (discussing requirement that fund calculate applicable portfolio limit before entering each senior security transaction, not daily as permitted for the fund's calculation of qualifying coverage amounts).

[32] *Id.* at 80926, 80946.

[33] *Id.* at 80926-27.

[34] The Proposing Release offers no definition of "stressed conditions" though the Commission does request comment on whether the term itself is clear and, if not, how it could be made more clear. *Id.* at 80931. The risk-based coverage amount is consistent with the ABA Task Force's recommendation that funds be required to adopt policies and procedures setting forth minimum asset segregation requirements for each type of derivative transaction. ABA Derivatives Report at 17.

[35] *See supra* note 32. Proposed Rule 18f-4 would permit: (1) the mark-to-market coverage amount to be reduced by any variation margin and collateral posted on the derivatives transaction and (2) the risk-based coverage amount to be reduced by any initial margin posted on the transaction. The Rule would not permit mark-to-market coverage amounts to be reduced by initial margin or risk-based coverage amounts to be reduced by variation margin and collateral. In making this distinction, the Commission reasoned that assets representing variation margin, unlike initial margin, are used to satisfy a fund's current mark-to-market liability under a derivatives transaction and are not available to cover potential future liabilities, whereas assets representing initial margin are a security guarantee to cover potential future liabilities and not used to settle or cover the fund's mark-to-market exposure. *Id.* at 80928-30.

[36] For example, a derivatives transaction that is "in the money" with unrealized gains would have a mark-to-market coverage amount of $0 (as opposed to a negative amount), and neither the risk-based coverage amount for that derivatives transaction, nor any coverage amount for another derivatives transaction, could be netted or reduced by such gains. The only exception would permit such reduction of coverage amounts among derivatives transactions subject to a contractual netting arrangement.

derivatives transaction to be covered.[37] In explaining the absence of an exception for offsetting cover transactions, the Commission highlighted that funds' expanded reliance on offsetting transactions to cover complex combinations of derivatives raises concerns regarding whether the risks under such transactions are, in fact, covered.[38] The Commission further reasoned that proposed Rule 18f-4 is already intended to provide flexibility to determine the appropriate risk-based coverage amount and therefore further flexibility to use offsetting transactions is not necessary.[39]

A fund's board, including a majority of independent directors, would be required to approve policies and procedures designed to determine the appropriate "risk-based coverage amounts" for each derivatives transaction, and to maintain qualifying coverage assets for all financial commitment transactions and derivatives transactions in accordance with the above restrictions.[40] Such policies and procedures would be required to consider, as applicable, "the structure, terms, and characteristics of the derivatives transaction, and the underlying reference asset."[41]

c. Portfolio Limitation Requirements

In addition to the asset segregation requirements, any fund that desires to enter into a derivatives transaction or financial commitment transaction in reliance on proposed Rule 18f-4 also would be required to satisfy new aggregate portfolio limitation requirements. The fund's board, including a majority of its independent directors, would have to approve one of two alternative limitations on the fund's senior securities transactions (which, as described above, includes not only derivatives transactions and financial commitment transactions, but also other senior securities entered into under Sections 18 or 61 of the 1940 Act).[42]

Exposure-based Portfolio Limit. The first alternative is an "exposure-based portfolio limit" under which the fund would limit its exposure to 150% of net assets. The Proposing Release notes that the Commission considered various levels of indebtedness both lower and higher than 150%. In explaining the rationale for the 150% limit, the Commission noted that a lower level may unduly limit a fund's ability to use derivatives for hedging and risk-mitigation.[43] Conversely, the Commission noted that a higher limit, "if not tempered by the risk mitigating aspects of the [risk-based portfolio limit's value-at-risk] test . . . could be used to take on additional speculative investment exposures that go beyond what would be expected to allow for hedging arrangements."[44]

Risk-based Portfolio Limit. The second alternative is a "risk-based portfolio limit" pursuant to which the fund would limit its exposure to 300% of net assets and satisfies a value-at-risk ("VaR") test designed to demonstrate that the VaR of the fund's portfolio *with* derivatives transactions is less than *without* derivatives transactions.[45] Proposed Rule 18f-4 would define VaR

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[37] Dreyfus Letter at 8.

[38] Proposing Release at 80915.

[39] *Id.* at 80933. Though the ABA Task Force recommended a flexible approach to determining minimum asset segregation amounts, it did not recommend any change to a fund's ability to use offsetting transactions but rather suggested that the fund's policies and procedures for use of derivatives "should define which transactions would be considered offsetting." ABA Derivatives Report at 17, 19.

[40] *Id.* at 80926. Independent directors are directors who are not "interested persons" of the fund as defined in Section 2(a)(19) of the 1940 Act. The Commission believes that requiring board approval would "appropriately focus the board's attention on the fund's management of its obligations under derivatives transactions and the fund's use of the exemption provided by the proposed rule would be an appropriate role for the board." *See also* ABA Derivatives Report at 18 (recommending that a fund's policies and procedures on asset segregation be approved by the fund's board).

[41] Proposing Release at 80929. The Commission also suggests that in preparing policies and procedures, funds could use financial models as an efficient way to determine the risk-based coverage amounts. *Id*. at 80930.

[42] *Supra* note 40. The ABA Task Force recommended only "a more principles-based and flexible approach" to determine the amount of assets to be segregated. ABA Derivatives Report at 17. However, the Commission rejected limiting the rule to this approach, saying that it "could also implicate a concern . . . that 'different funds could end up with different determinations, perhaps some taking more aggressive positions to allow for greater use of derivatives to drive performance.'" Proposing Release at 80915 (internal citation omitted).

[43] Proposing Release at 80909.

[44] *Id.* at 80910.

[45] A fund using the risk-based portfolio limit would have discretion to select a VaR model, if it incorporates all significant identifiable market risk factors associated with a fund's investments and applies a minimum 99% confidence interval, a time horizon of between 10 and 20 trading days, and a minimum of three years of historical data to estimate historical VaR. *Id.* at 80920.

as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon, and at a given confidence level."[46] While satisfaction of the VaR test generally indicates that the fund's aggregate use of derivatives transactions does not increase the speculative character of the fund, the Commission determined that a risk-based portfolio limit based solely on the VaR test would be inadequate and instead also would require some outer limit (300%) to temper potential speculation under certain market conditions.[47]

To assist the Commission in monitoring funds' use and reliance on proposed Rule 18f-4, the Commission proposed amendments to proposed Form N-CEN requiring funds to disclose whether they relied upon the exposure-based portfolio limit or risk-based portfolio limit during the applicable reporting period.[48]

Under either test, the applicable limit would need to be satisfied immediately after entering into each derivatives transaction or financial commitment transaction, and "exposure" would be defined as the sum of: (1) the aggregate notional value of a fund's derivatives transactions;[49] (2) the aggregate obligations of the fund under its financial commitment transactions; and (3) the aggregate indebtedness (and as to any closed-end fund or BDC, involuntary liquidation preference) under any other senior securities entered into by the fund under Sections 18 or 61. Thus, for certain closed-end funds that issue debt or preferred stock in accordance with Sections 18(a)(1) and (a)(2), respectively, this requirement would severely constrain the ability to use derivatives. In calculating exposure, a fund could deduct the notional amount of any directly offsetting derivatives transactions in the same type of instrument (*e.g.*, option or future) with the same underlying reference asset, maturity, and other material terms. However, this netting provision is intended to cover derivatives transactions entered into for the purpose of closing-out an existing position.[50] As with the asset segregation requirements, there is no exception that would permit a fund to reduce its "exposure" by entering into derivative transactions that merely hedges or provides offsetting exposure without closing out the existing position.[51] Instead, the Commission has taken the view that the alternative tests each provide sufficient flexibility for funds to engage in such transactions.[52]

d. Risk Management Requirements

In addition to the asset segregation and portfolio limitation requirements described above, each fund entering into derivatives transactions (but not funds that exclusively enter into financial commitment transactions) in reliance on Rule 18f-4 also would be required to either: (1) monitor that the fund engages in no complex derivatives transactions and only a limited amount of derivatives transactions (generally defined as derivatives transactions with notional exposure not to exceed 50% of net assets) or (2) adopt a formalized derivatives risk management program with a designated derivatives risk manager separate from the fund's portfolio managers. The fund's board, including a majority of its independent directors, would need to approve the program, any material changes to the program, and the designated risk manager who would be required to administer the program.[53] The designated risk manager must be someone who is generally "sufficiently knowledgeable about the risks and use of derivatives that he or she can effectively fulfill the responsibilities of their position."[54] In addition, the fund's board would be required to review quarterly reports from the risk manager, and annually evaluate the program and any VaR, or other models for updates.

Those funds required to have a derivatives risk management program must have policies and procedures reasonably designed to: (1) assess the risks associated with the fund's derivatives transactions, including an evaluation of applicable potential leverage, market, counterparty, liquidity, operational risks, and any other risks considered relevant; (2) manage the risks of the fund's derivatives transactions, including by monitoring

[46] Proposed Rule 18f-4(c)(11).

[47] Proposing Release at 80923.

[48] *Id.* at 80952. Form N-CEN, initially proposed in June 2015 to replace Form N-SAR, would require funds to annually report certain census-type information to the Commission similar to that in Form N-SAR but updated to replace certain items that are outdated or of limited usefulness with items that the Commission believes to be of greater relevance today. *Investment Company Reporting Modernization*, Inv. Co. Act Rel. No. 31610 (2015), 80 Fed. Reg. 33590, 33594 (the "Reporting Proposal").

[49] *See* Proposing Release at 80902 for a table of common derivatives transactions and the method by which the Commission understands notional value is typically calculated for each.

[50] *Id.* at 80906.

[51] *Id.*

[52] *Id.* at 80915. *See also* supra note 39 and accompanying text.

[53] Proposing Release at 80935.

[54] *Id.* at 80943.

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; (3) reasonably segregate the functions associated with the program from the portfolio management of the fund; and (4) periodically (and at least annually) review and update the program.[55]

To assist the Commission in monitoring price and volatility trends, and fund risk profiles, the Commission also proposed amendments to proposed Form N-PORT, which would require funds implementing a risk management program to disclose certain risk metrics relating to the use of derivatives.[56]

III. PROPOSING RELEASE ANALYSIS

a. DERA Analysis Limitations

Although the Commission asserts that "a substantial majority of funds in the DERA sample did not use derivatives or used derivatives to a limited extent," it remains to be seen how many funds will be materially affected by Rule 18f-4.[57] The DERA Analysis purports to have surveyed a cross section of the industry to evaluate the extent of derivatives use, but those statistics and conclusions by definition are arbitrary and imprecise. The DERA Analysis surveyed only 10% of funds from each of the following categories: non-alternative strategy funds and alternative strategy funds, which include index-based alternative strategy funds, closed-end funds, BDCs, and ETFs.[58] When calculating each fund's derivative exposures under its transactions, financial commitment transactions, and other senior securities transactions, no consideration was given to the reasons the fund uses derivatives, nor could DERA distinguish between derivatives that create potential future obligations and those that do not.[59] Further, one of the key data sources was Form N-SAR, which does not require that funds include information for all types of derivatives and in some instances provides only aggregate data.[60]

b. Extent of Proposed Rule's Impact

The Commission notes that "the portfolio limits under the proposed rule are not expected to affect the investment activities of a majority of funds," [61] but the consequences of the leverage restrictions and asset-coverage requirements could conceivably present a challenge to far more funds than the leveraged ETFs and managed futures products that are referenced throughout the Proposing Release.[62] As noted above, the sample examined by DERA was limited, so the Commission's assumptions about the impact of the proposed rule may prove to be unfounded. For example, how would the proposed rule affect fixed income funds that use interest rate swaps? Will the proposed rule effectively eliminate the ability to use derivatives for closed-end funds that issue preferred stock or debt? To what degree will the limits on coverage assets result in lower investment performance for funds that historically have used portfolio securities to cover derivatives obligations? How will the restrictions on coverage assets impact an ETF's ability to track its benchmark index?

One perhaps unfortunate or at least ironic result of the proposed rule may be to force a large number of funds to choose between liquidating, which would limit investment options for retail investors, and registering as commodity pools, a structure with far fewer investor protections (and regulatory burdens) than registered

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[55] *Id.* at 80935.

[56] *Id.* at 80952. Form N-PORT, initially proposed in June 2015 to replace current Form N-Q, would require monthly reporting of the portfolio holdings information currently contained in Form N-Q reports plus: (1) quantitative risk metrics data for funds with at least 20% notional debt exposure; (2) detailed information about the characteristics and terms of each derivatives contract; (3) information about liquidity, pricing, and fund flows; and (4) information about securities lending transactions and counterparty exposures. Reporting Proposal at Section II.A.

[57] Proposing Release at 80958.

[58] *Id*. at 80910.

[59] DERA Analysis at 5, 9.

[60] *Id.* at 5 (noting that some of Form N-SAR data are coarse).

[61] Proposing Release at 80958.

[62] *See, e.g.*, Proposing Release at 80911 (discussing current use of derivatives and impact on "particular alternative strategy funds and certain leveraged ETFs"). *See generally*, Michael S. Piwowar, Commissioner, SEC, Public Statement, *Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies* (Dec. 11, 2015), *available at* http://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html#_ftnref2. Commissioner Piwowar notes that "[a]s we undertake this effort, however, the Commission must not forget that the current situation is one mostly of its own making. Funds have been engaging in derivatives transactions and pursuing related investment objectives and strategies for decades based on the guidance provided by their regulator, and, while the proposed rule we are considering today is referred to as an 'exemptive rule,' it actually would restrict funds' current practices."

investment companies.[63] Moreover, for funds able to comply with Rule 18f-4 by converting exposure obtained through derivatives to exposure in the cash markets (such as fixed income funds), the result could be less leverage but greater liquidity risk, contrary to another of the Commission's stated concerns.[64]

We also must ask: what problems are being addressed by this proposal?[65] The overall result may be far less use of derivatives by registered funds, but will fund shareholders be better off? The Proposing Release acknowledges that derivatives are beneficial in many ways.[66] If their use is curtailed, as noted above, transaction costs may increase and liquidity may decrease as a result of funds being forced into the cash markets. Moreover, no fund has ever reported being unable to meet its obligations under a derivatives agreement, even under stressed market conditions. The only problems that have appeared thus far from the use of derivatives have resulted from a fund *counterparty's* overuse of leverage, not from a fund's use of leverage, as observed in the course of the Lehman bankruptcy when funds suffered losses under derivatives contracts.[67] Those risks have now been properly addressed through mandatory (and bi-lateral) collateral requirements imposed by rules adopted under the Dodd-Frank Act and can be easily incorporated into a fund's credit risk procedures.[68] Finally, to the extent that funds have suffered losses as a result of using derivatives contrary to a fund's stated investment restrictions or without adequate risk disclosure, the Commission already has tools to deal with those issues.[69]

There were a number of questions raised in the Concept Release pertaining to the regulation of derivatives, including questions concerning valuation, diversification and concentration, and the selection of counterparties, all of which are designed to mitigate risk and for which there are clear statutory mandates. Perhaps the Commission should have started from the standpoint of considering those issues instead of with arbitrary portfolio limits on the use of derivatives and burdensome compliance requirements?

c. Burden on Fund Boards

The burden imposed on fund boards to understand and, in fact, approve the application of concepts such as VaR (as part of a derivatives risk management program) and risk-based coverage amounts for every type of derivative used by a fund requires boards to have and

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[63] Proposing Release at 80961. The Commission acknowledges that "[i]n the event that a fund is unable to operate under the proposed rule's aggregate exposure limit, the fund's sponsor and/or investment adviser may choose to: (1) offer the fund as a private fund or (public or private) commodity pool; (2) liquidate the fund's assets and deregister the fund under the Act; or (3) merge the fund into another fund."

[64] *See generally Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, Inv. Co. Act Rel. No. 31835 (2015), 80 Fed. Reg. 62274.

[65] It is noteworthy that the ABA Task Force opined that the framework adopted under Release 10666 has worked very well and only requested that the Commission provide clarification on certain issues such as the amount and type of assets to be segregated and use of offsetting transactions. To this end, the ABA Task Force suggested that these matters be addressed in a fund's policies and procedures. *See supra notes* 34 and 39.

[66] Proposing Release at 80909.

[67] *See, e.g., Lehman: One Big Derivatives Mess,* Goldstein & Henry, Bloomberg Business (Oct. 7, 2008), *available at* http://www.bloomberg.com/bw/stories/2008-10-07/lehman-one-big-derivatives-mess; *The Specter of Lehman Shadows Trade Partners,* Ng & Spector, Wall St. J. (Sept. 17, 2009), *available at* http://www.wsj.com/articles/SB125313981633417557.

[68] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC*, 81 Fed. Reg. 636 (2016). The Commission has proposed equivalent requirements for security-based swap dealers, but the proposed rules have not yet been adopted. *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Rel. No. 34-68071, 77 Fed. Reg. 70214 (2012).

[69] *See, e.g.,* OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc., Inv. Co. Act Rel. No. 30099, File No. 3-14909 (June 6, 2012) (finding violation of Section 34(b) of the 1940 Act for failure to disclose practice of using total return swaps to obtain leveraged exposure to residential mortgage-backed securities and risks associated therewith); Piper Capital Mgmt, Initial Decisions Release No. 175 (Nov. 30, 2000) (holding that fund misrepresented risks, marketing itself as conservative investment while disproportionately investing in interest rate-sensitive collateralized mortgage obligation derivative securities); In the Matter of Mitchell Hutchins Asset Management, Inc., Inv. Co. Act Rel. No. 22805, File No. 3-9383 (Sept. 2, 1997) (finding fund invested in certain classes of interest-only and principal-only stripped mortgage-backed securities contrary to prospectus language stating it had "no present intention" of doing so). *See also Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests*, IM Guidance Update No. 2013-05 (Aug. 2013) *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf.

maintain an unprecedented level of technical expertise and arguably crosses the line from oversight to management. While the Proposing Release is clear that the board may rely on other experts familiar with derivatives risk, consider best practices used by other funds, and review summaries prepared by the risk manager, legal counsel, or other persons familiar with the program when determining whether to approve the fund's risk management program, making such a determination will inevitably "require more time, resources, and, of course, expertise."[70]

d. Authority for Rule 18f-4 Proposal

As noted above, Section 18 makes no mention of derivatives, was added to the statute at a time when derivative instruments did not exist and were not contemplated, and was designed to simplify a fund's capital structure. Regardless of one's views about the merits of using derivatives, there is a question as to whether it is a "bridge too far" to connect the plain language of Section 18 with a far-reaching, dense, and extremely burdensome set of regulatory requirements as contemplated by Rule 18f-4. By its terms, Section 18 applies to the *issuance of,* not *investment in,* senior securities. Furthermore, the definition of senior security requires the instrument to be, as threshold matter, a security. It is far from obvious that many derivative instruments, such as total return swaps, constitute securities.[71] How can futures contracts be considered securities? And are they "issued" by the fund, or does the fund enter into derivatives agreements as an investment? Nowhere in the legislative history does it appear that Section 18 was intended or designed to govern a fund's portfolio management activities.

e. Interpretation of what constitutes a violation of Section 18

Finally, the proposed rule, fashioned as an exemptive rule, would provide the only means to avoid violating Section 18. It is far more restrictive than the framework developed by prior guidance, which required only that a fund segregate sufficient assets or engage in offsetting transactions in order to avoid a violation of Section 18. Since the portfolio limits are imposed in addition to the coverage requirements, it is implicit that the Commission has bifurcated the need to restrict the use of leverage from that of ensuring that a fund can meet its future obligations to counterparties. If the proposed rule is adopted, it will reflect the interpretation that engaging in even a single derivatives transaction, irrespective of asset segregation, is deemed to create a senior security in violation of Section 18. After almost 30 years of living with a far more flexible interpretation where we have yet to observe any widespread problems in the industry, is such an expansive reading of the statutory language justified?

IV. CONCLUSION

Proposed Rule 18f-4 represents a substantial break with 30 years of Commission and staff guidance. If Rule 18f-4 is adopted as proposed, all funds that use derivatives or financial commitment transactions may face a substantial increase in their compliance obligations, many of which are assigned to fund directors, who may be poorly suited to these responsibilities.[72] Moreover, the subset of funds that have developed investment strategies with substantial leverage in reliance on historic guidance or accepted industry practice may be forced to liquidate or deregister under the 1940 Act if such strategies cannot be modified to comply with the rule. Finally, this proposal is arguably an overreaction in terms of restrictions and compliance burdens, given that significant problems arising from fund use of derivatives have not surfaced, even during the significant financial crisis that began in 2008. ■

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[70] *See, e.g.,* Luis A. Aguilar, Commissioner, SEC, Public Statement, *Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance* (Dec. 11, 2015), *available at* http://www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html.

[71] Title VI of the Dodd-Frank Act established a comprehensive new regulatory framework for swaps and security-based swaps and required the Commission and the CFTC, in consultation with the Federal Reserve Board, to jointly define the terms "swap," "security-based swap," and "security-based swap agreement." The jointly adopted final rules setting forth these definitions provide that total return swaps, if based on a single security or loan, or on a narrow-based securities index generally would be a security-based swap regulated by the Commission while a total return swap based on a broad-based securities index would not be considered a security and instead would be a swap regulated by the CFTC. *See* Section 1(a)(47) of the Commodity Exchange Act (defining swap) and Section 68 of the Securities Exchange Act of 1934 (defining security-based swap). *See also Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, Rel. Nos. 33-9338, 34-67453 (2012), 77 Fed.

footnote continued from previous column…

Reg. 48208. Importantly, the Dodd Frank Act did not amend the 1940 Act definition of security or Section 18.

[72] *See supra* note 70.

CLE QUESTIONS on Doberman, *SEC Proposal on Investment Company Use of Derivatives — A Solution in Search of a Problem?* Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one ethics credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net. The cost is $40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. The SEC's proposed rule 18f-4 would require that before a mutual fund enters into even a single derivatives transaction its board must first, inter alia, approve asset segregation policies designed to determine "risk-based coverage amounts" for each derivatives transaction. **True** **False**

2. Subject to limited exceptions, under the proposed rule, "qualifying coverage assets" would no longer include liquid assets such as equity and below investment-grade debt securities. **True** **False**

3. The proposed rule includes an exception that would permit a fund to reduce the amount of qualifying coverage assets to be segregated by entering into an offsetting transaction. **True** **False**

4. In addition to asset segregation requirements, a fund's board, including a majority of its independent directors, must approve either an "exposure-based portfolio limit" or a "risk-based portfolio limit" on its senior securities transactions. **True** **False**

5. In addition to the asset segregation and portfolio limitation requirements, a fund entering into derivatives transactions must either engage in a "limited amount" of such transactions or adopt a formalized derivatives risk management program with a designated risk manager separate from the fund's portfolio managers. **True** **False**

A F F I R M A T I O N

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