SEC Proposes New Framework for Regulating Funds' Use of Derivatives and Leverage

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On December 11, 2015, the Securities and Exchange Commission (Commission) proposed a rule that, if adopted, would rescind nearly 30 years of Commission and staff guidance that is currently relied upon by most mutual funds, closed-end funds and business development companies or "BDCs" (collectively, funds) when entering into derivatives, short sales or other transactions that create conditional or unconditional future payment obligations on a fund.[1] As proposed, Rule 18f-4 under the Investment Company Act of 1940 (1940 Act) would become the exclusive means by which funds may enter into such transactions. In order 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, among other obligations.

Specific requirements for relying on Rule 18f-4 differ depending on the type of leveraged transaction in which the fund engages. The proposed rule refers to transactions implicated by Rule 18f-4 as "senior security transactions" and subdivides them into three categories:

- "***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;
- "***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);[2] and
- any other senior security entered into by a fund pursuant to 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.[3]

In all cases, proposed Rule 18f-4 would require that, before a fund enters into even a single derivatives transaction or financial commitment transaction, its board first must:

- approve asset segregation policies and procedures designed to determine "risk-based coverage amounts" for each derivatives transaction and maintain "qualifying coverage assets" (as such terms are defined below) for all derivatives transactions and/or financial

commitment transactions;
- 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
- either: (a) approve a formalized risk management program and derivatives risk manager; or (b) determine that the fund will monitor compliance with portfolio limitations under which the fund engages in no "complex derivatives transactions"[4] and only a limited amount of derivatives transactions.

Proposed Rule 18f-4 would not, however, affect the ability of a fund to enter into transactions providing indirect or "economic" leverage that do not involve a potential obligation to pay money to a counterparty. The Proposing Release also includes further amendments to Forms N-PORT and N-CEN, which were proposed by the Commission in May 2015 and would require investment companies to report information about their portfolios and operations.

Background

Section 18 of the 1940 Act prohibits investment companies from issuing "***senior securities***," which it defines as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." Historically, funds have entered into derivatives transactions and financial commitment transactions in reliance on guidance, initially issued by the Commission in 1979 as Release No. 10,666 ("Release 10666")[5] and subsequently developed by the staff through no-action letters (and occasionally the disclosure review process), which provides that no violation of Section 18 occurs if a fund fully "covers" its payment obligation with offsetting transactions or the segregation of liquid assets (including equity and below investment-grade debt securities).

The definition of adequate "cover" has evolved over time with respect to certain types of transactions, and has not been addressed at all with respect to others, leaving a vacuum that has led to inconsistent interpretation and application across the industry. Under the current guidance, many funds 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. Proposed Rule 18f-4 would supersede the Commission and staff guidance underlying these practices for both derivatives transactions and financial commitment transactions, and would instead require compliance with a more comprehensive framework of: (1) asset segregation requirements; (2) portfolio limitation requirements; ***and*** (3) formalized risk management requirements, each as described below.

Asset Segregation Requirements

What assets may be segregated and where?

Under the proposed rule, assets may still be designated or "segregated" on a fund's books and records (rather than segregated in a separate custodial account). However, the types of assets eligible for such segregation would be limited to "***qualifying coverage assets***" which are generally defined as cash and cash equivalents. Funds would no longer be able to segregate other types of liquid assets, such as equity and below investment-grade debt securities,[6] subject to the following two limited exceptions:

- One exception would be provided for derivatives transactions and financial commitment transactions that contractually permit a fund to satisfy its obligations by delivering a particular asset. For such transactions, that particular asset may be segregated as the qualifying coverage asset, even though the asset is not cash or a cash equivalent (such as writing a covered call on a single 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.
- Another exception would be provided for financial commitment transactions where the timing of the fund's payment obligation can be reasonably estimated. There, a fund relying on the proposed rule would be able to segregate as the qualifying coverage asset (instead of cash and cash equivalents) other assets that are convertible to or that generate sufficient cash prior to the date on which the fund is required to pay its obligations. A fund would also be able to designate, as the qualifying coverage asset for a financial commitment transaction, assets that have been pledged with respect 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.

What amount must be segregated?

The proposed rule would still permit a fund to calculate the amounts to be segregated once per day, 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 described in Release 10666). However, the amount to be segregated for each derivatives transaction (be it physical or cash-settled) would be calculated as the sum of: (1) the mark-to-market exposure, reduced by any variation margin or collateral (the "***mark-to-market coverage amount***"); and (2) a reasonable estimate of the potential amount the fund would be required to pay to exit the derivatives transaction under stressed conditions, reduced by any initial margin posted by the fund (the "***risk-based coverage amount***"). There is no definition of "stressed conditions." Crucially, the calculation must 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. 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 offset or reduced by such gains. The only exception would permit such offsetting of coverage amounts among derivatives transactions subject to a contractual netting arrangement.

As noted above, under proposed Rule 18f-4, the fund's board, including a majority of disinterested directors, must 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.

Portfolio Limitation Requirements

Separate and apart from the asset segregation requirements, any fund that wishes to enter into a derivatives transaction or financial commitment transaction in reliance on proposed Rule 18f-4 would also be required to satisfy new aggregate portfolio limitation requirements. These include a requirement that the fund's board, including a majority of its disinterested directors, must approve one of two alternative limitations on the fund's senior securities transactions (including derivatives transactions, financial commitment transactions and other senior securities entered into under Sections 18 or 61 of the 1940 Act):

- an "***exposure-based portfolio limit***" pursuant to which the fund limits its exposure to 150% of net assets; or
- a "***risk-based portfolio limit***" pursuant to which the fund limits 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.[7]

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; (2) the aggregate obligations of the fund under its financial commitment transactions;[8] and (3) the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) under any other senior securities entered into by the fund pursuant to Sections 18 or 61. In calculating exposure, a fund would be permitted to 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 and generally would not be available for other hedging activities.

Formalized Risk Management Requirements

A third set of requirements would apply to funds entering into derivatives transactions in reliance on Rule 18f-4.[9] In addition to the requirements described above, funds entering derivatives transactions 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 disinterested directors, would need to approve the program, any material changes to the program and the designated risk manager. 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.

Form N-PORT and Form N-CEN

The Proposing Release also recommended amendments to Form N-PORT and Form N-CEN, which were proposed by the Commission in May 2015 and, if adopted, would replace current Form N-Q and Form N-SAR, respectively. Under the proposed amendments, Form N-PORT would require funds that implement a derivatives risk management program to disclose certain risk metrics relating to the use of derivatives, and Form N-CEN would require funds to disclose whether they relied upon the exposure-based portfolio limit or risk-based portfolio limit during the reporting period.

Unintended Consequences?

It remains to be seen the number of funds that will be significantly impacted by Rule 18f-4. Although the Proposing Release indicates that DERA surveyed a cross section of the industry to evaluate the extent of derivatives use, those statistics and conclusions by definition are imprecise. The leverage restrictions and asset coverage requirements could conceivably present a challenge to far more funds than the leveraged exchange traded funds and managed futures products that are referenced throughout the Proposing Release. One perhaps unfortunate result of the 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 than registered investment companies. For funds able to comply with Rule 18f-4 by altering their strategies 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. Finally, 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, including “complex derivatives transactions,” requires boards to have and maintain an unprecedented level of technical expertise and arguably crosses the line from oversight to management.

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 trustees who may be poorly suited to these responsibilities.[10] 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.

[1] The proposing release, which spans 420 pages and 865 footnotes, is available at www.sec.gov/rules/proposed/2015/ic-31933.pdf ("Proposing Release"). A companion white paper, entitled "Use of Derivatives by Investment Companies," authored by the Commission's Division of Economic Risk Analysis ("DERA"), is available at www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

[2] As proposed, securities lending transactions would not be included within the definition of "financial commitment transaction."

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

[4] 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) is dependent 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).

[5] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 FR 25128 (April 27, 1979).

[6] Among the no-action letters that would be rescinded upon adoption of Rule 18f-4 is *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter (July 2, 1996), 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."

[7] A fund using the risk-based portfolio limit would have discretion to select a VaR model, provided 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.

[8]*See* page 69 of the Proposing Release for a table of common derivatives transactions and the method by which the staff understands notional value is typically calculated for each.

[9] These requirements would not, however, attach to funds that only wish to enter financial commitment transactions with no derivatives transactions.

[10]*See*, *e.g.*, Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, Public Statement, Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance (Dec. 11, 2015), available at www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html.

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