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Alert

SEC Proposes Rule Governing the Use of Derivatives and Short Sales by Registered Investment Companies and Business Development Companies

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On Dec. 11, 2015, the Securities and Exchange Commission (the "SEC") issued a release proposing the adoption of new Rule 18f-4 under the Investment Company Act of 1940 (the "1940 Act").[1] The proposed rule, if adopted as proposed, will establish new limitations on the use of derivatives by registered investment companies and business development companies (collectively, "regulated funds"). It will also regulate other trading practices of such funds (including short sales of securities) that are deemed to involve the issuance of "senior securities." Hedge funds and other private investment funds will not be subject to the rule. The SEC is soliciting comment on the proposed rule. The deadline for submitting comments is March 28, 2016.

The proposed rule is intended to provide a clearer regulatory framework applicable to the use of derivatives by regulated funds.[2] As explained in the SEC's proposing release (the "Release"), Rule 18f-4 is "designed to address the investor protection purposes and concerns underlying section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions."[3] It will, subject to various conditions, provide regulated funds with an exemption from the restrictions of Section 18 of the 1940 Act governing the issuance of "senior securities" in connection with their effecting transactions in derivatives and entering into "financial commitment transactions."[4] If adopted, the rule will supersede prior guidance of the SEC and its staff relating to these matters.[5]

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015).

[2] In 2011, the SEC issued a concept release soliciting comments on various issues associated with the use of derivatives by registered investment companies. *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) (the "Concept Release"). The Release does not seek to address all of the issues relating to the use of derivatives and financial commitment transactions as to which comment was sought in the Concept Release.

[3] Release at 9.

[4] Generally, Section 18 restricts the issuance of "senior securities" by investment companies. Section 18(g) of the 1940 Act defines a "senior security" as any bond, debenture, note or similar obligation constituting a security and evidencing indebtedness and any stock of a class having priority over any other class as to distribution of assets or payment of dividends (such as preferred stock). The SEC has interpreted this term broadly to include investment transactions and practices that create potential future obligations – generally, any transaction in which a fund has a potential future payment or delivery obligation.

[5] The proposed rule departs from guidance contained in an SEC release on the application of Section 18's restrictions to certain investment practices (Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 18, 1979)

The three primary requirements of Rule 18f-4 are discussed below and relate to:

- Portfolio limitations that are designed to limit the amount of leverage the fund may obtain through derivatives, financial commitments and other senior securities transactions;
- Asset segregation requirements specifying the amount of assets a fund must segregate as coverage for its derivatives transactions and financial commitment transactions; and
- A requirement to adopt a formal risk management program that applies to funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives.

Key Definitions

The proposed rule defines a "derivatives transaction" to mean any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing or any similar instrument under which the 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 a margin or settlement payment or otherwise.[6] This definition is intended to capture derivatives transactions that, in the SEC's view, involve the issuance of a senior security (i.e., transactions that create a potential future payment or delivery obligation).[7] Excluded from the definition are instruments that may commonly be referred to as derivatives, but which do not create a potential future payment or delivery obligation (e.g., the purchase of stock and index options, structured notes and variable rate securities). The term "financial commitment transaction" is defined by the proposed rule as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement (i.e., any conditional or unconditional contractual obligation to pay or deliver assets in the future).[8] Notably, this definition would include unfunded commitments for future acquisitions of portfolio securities, a common practice of business development companies ("BDCs").

Portfolio Limitations

Under the proposed rule, a regulated fund must comply with one of two portfolio limitations (one exposure-based and the other risk-based) that restrict the use of derivatives and the amount of leverage that may be utilized by the fund.[9] The exposure-based portfolio limitation generally restricts the level of a regulated fund's aggregate exposure to underlying reference assets resulting from derivatives transactions (i.e., the notional value of the derivatives), financial commitment transactions and indebtedness to 150 percent of the fund's net assets (the "exposure-based portfolio limit").

The risk-based portfolio limitation requires an assessment of the impact of a regulated fund's use of derivatives on its portfolio risk, based on value-at-risk ("VaR") calculations. A regulated fund may opt to

("Release 10666")), as well as positions taken by the SEC staff in various no-action letters regarding transactions involving Section 18. *See*, *e.g.*, *Dreyfus Strategic Income* (pub. avail. June 22, 1987) (the "Dreyfus Letter"), *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995) and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 1, 1996) (the "Merrill Lynch Letter"). The SEC states in the Release that it would rescind Release 10666 and the various no-action letters issued by the staff if the rule is adopted. Release at 260.

[6] Proposed Rule 18f-4(c)(2).

[7] Release at 58.

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

[9] A fund relying on the proposed rule would be required to comply with the applicable portfolio limitation after entering into any senior security transaction covered by the proposed rule. A fund would not be required to reverse a transaction solely because the fund's exposure subsequently increased beyond the exposure limits of either of the portfolio limitations.

rely on this limitation if its use of derivatives reduces the overall risk of its portfolio. Under this limitation, a fund may have aggregate exposure to derivatives, financial commitment transactions and indebtedness of up to 300 percent of its net assets (the "risk-based portfolio limit").

The board of directors (or board of trustees) of a regulated fund ("board"), including a majority of the directors who are not interested persons of the fund (the "independent directors"), will be required to approve which of the two portfolio limitations will apply to the fund.[10]

Exposure-Based Portfolio Limit
The exposure-based portfolio limit is calculated based on a fund's overall exposure to derivatives transactions, financial commitment transactions and other transactions involving a senior security entered into by the fund pursuant to Section 18 of the 1940 Act (or with respect to BDCs, pursuant to Section 61 of the 1940 Act), without reliance on the exemption provided by Rule 18f-4. (These transactions are collectively referred to in this *Alert* as "senior securities transactions."[11])

A fund relying on the exposure-based portfolio limit must ensure that its aggregate exposure to senior securities transactions, measured immediately after entering into any such transaction, does not exceed 150 percent of its net assets. "Exposure" is defined as the sum of:

- The aggregate notional amounts of the fund's derivatives transactions, subject to certain adjustments;
- The aggregate obligations of the fund under its financial commitment transactions; and
- The aggregate indebtedness of the fund with respect to any other senior securities transactions.

The "notional amount" of a derivatives transaction is defined as the market value of an equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transactions are calculated. However, adjustments must be made to the notional amount of a derivatives transaction in three circumstances:[12]

- When a derivative provides a return based on the leveraged performance of an underlying reference asset, the notional amount must be multiplied by the applicable leverage factor.
- When the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the rule requires a look-through to the notional amounts of the derivatives transactions of each such account or entity.
- When calculating the notional amount for certain defined "complex derivatives transactions."

"Complex derivatives transactions" are defined as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (1) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction, which is

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[10] Proposed Rule 18f-4(a)(5)(i).

[11] Examples of other transactions involving a senior security include bank borrowings and, for a closed-end fund or BDC, the issuance of debt or preferred shares.

[12] Proposed Rule 18f-4(c)(7).

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intended to capture derivatives whose payouts depend on the path taken by the value of the underlying asset during the term of the transaction (e.g., barrier options); or (2) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price (e.g., variance swaps).[13]

Although the SEC acknowledges in the Release that different derivatives transactions can "expose a fund to very different potential investment risks and potential payment obligations,"[14] it notes that notional amount "generally serves as a measure of the fund's economic exposure to the underlying reference asset or metric."[15] The Release includes the following table showing how the notional amounts of various types of transactions should be computed:[16]

Forwards	
FX forward	Notional contract value of currency leg(s)
Forward rate agreement	Notional principal amount
Futures	
Treasury futures	Number of contracts * notional contract size * (futures price * conversion factor + accrued interest)
Interest rate futures	Number of contracts * contract unit (e.g., $1,000,000)
FX futures	Number of contracts * notional contract size (e.g., 12,500,000 Japanese yen)
Equity index futures	Number of contracts * contract unit (e.g., $50 per index point) * futures index level
Commodity futures	Number of contracts * contract size (e.g., 1,000 barrels of oil) * futures price
Options on futures	Number of contracts * contract size * futures price * underlying delta

[13] Proposed Rule 18f-4(c)(1).

[14] Release at 70.

[15] *Id.* at 67.

[16] *Id.* at 69.

Swaps	
Credit default swap	Notional principal amount or market value of underlying reference asset
Standard total return swap	Notional principal amount or market value of underlying reference asset
Currency swap	Notional principal amount
Cross currency interest rate swaps	Notional principal amount
Standardized Options	
Security options	Number of contracts * notional contract size (e.g., 100 shares per option contract) * market value of underlying equity share * underlying delta
Currency options	Notional contract value of currency leg(s) * underlying delta
Index options	Number of contracts * notional contract size * index level * underlying delta

The SEC chose not to permit a fund to reduce the notional amount of its exposure to derivative transactions by taking into account derivatives transactions that are entered into for hedging purposes or for cover transactions.[17] However, the proposed rule will permit a fund, when calculating its aggregate notional exposure, to reduce such exposure by any directly offsetting derivatives transactions that involve the same type of instrument and have the same underlying reference asset, maturity and other material terms.[18]

Under the exposure-based portfolio limit, a fund may be able to achieve gross portfolio exposures in excess of 150 percent of its net assets (assuming it can comply with the asset segregation requirements of the proposed rule, discussed below) since the 150-percent limit is based solely on a fund's exposure to derivatives transactions and other senior securities transactions, and does not include portfolio exposures attributable to long positions in securities and options.

[17] By "cover transaction" the SEC is referring to a transaction that is intended to position the fund to meet its obligations under a derivative transaction to be covered or by holding the asset, or the right to acquire the asset, that the fund would be required to deliver. In the Dreyfus Letter, the SEC staff stated that it would not object to a fund covering its asset segregation obligations by entering into cover transactions. In reversing this position, the SEC noted that commenters on the Concept Release raised "numerous issues that demonstrate the difficulties in identifying transactions that should be viewed as providing adequate coverage." Release at 113.

[18] Proposed Rule 18f-4(c)(3)(i).

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Risk-Based Portfolio Limit
A fund may opt to comply with the risk-based portfolio limit only if its use of derivatives operates to decrease the fund's overall exposure to market risk. In such case, a fund's exposure to derivatives and other senior securities transactions may be as much as 300 percent of the fund's net assets (rather than subject to the 150 percent of net assets exposure limitation applicable under the exposure-based portfolio limit). In order to rely on the risk-based portfolio limit, a fund's full portfolio VaR[19] must be less than its securities VaR, determined immediately after the fund enters into any derivatives or other senior securities transaction.[20] Full portfolio VaR is defined as the VaR of the fund's entire portfolio, including securities, derivatives transactions and other investments.[21] Securities VaR is defined as the VaR of the fund's portfolio of securities and other investments, but excluding derivatives transactions.[22] As a result, funds that hold only cash (or cash equivalents) and derivatives may not be able to rely on the risk-based portfolio limit.

The SEC noted that it believes VaR is an appropriate metric because VaR calculation tools are "widely available"[23] and allow risk to be measured across a diverse range of instruments, enabling the market risks of different instruments to be integrated into a single measurement of overall market risk. It also noted that VaR can be used to assess the effect of the addition of a position on a portfolio's overall market risk.[24]

The VaR calculations required by the rule must take into account "all significant, identifiable market risk factors associated with a fund's investments" and use a minimum 99-percent confidence interval, a time horizon of not less than 10 but not more than 20 trading days and a minimum of three years of historical data to estimate historical VaR. [25] A fund will be required to apply its VaR model consistently when calculating its securities VaR and full portfolio VaR.

Asset Segregation
Funds relying on the proposed rule will have to maintain, for each derivatives transaction, "qualifying coverage assets" consisting of cash and cash equivalents.[26] The value of qualifying coverage assets must equal the amount that would be payable by the fund if it were to exit the derivatives transaction as of the time of determination (the "mark to market coverage amount") plus an additional amount that represents a reasonable estimate of the potential amount that would be payable by the fund if it were to exit the transaction under stressed conditions (the "risk-based coverage amount").[27] Funds may

[19] VaR is defined 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." Proposed Rule 18f-4(c)(11).

[20] Proposed Rule 18f-4(a)(1).

[21] Proposed Rule 18f-4(c)(11)(i)(B).

[22] Proposed Rule 18f-4(c)(11)(i)(A).

[23] Release at 123.

[24] *Id.* at 121.

[25] Proposed Rule 18f-4(c)(11)(ii). The rule provides a non-exclusive list of risk factors that may be relevant to the test in light of a fund's strategy and investments, including (as applicable) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk, as well as material risks arising from the nonlinear price characteristics of a fund's investments. The rule also requires that the VaR model take into account the sensitivity of the market value of the fund's investments to changes in volatility. Proposed Rule 18f-4(c)(11)(ii)(A).

[26] Proposed Rule 18f-4(c)(8). Qualifying coverage assets need to be identified on the books and records of the fund at least once each business day. Proposed Rule 18f-4(a)(2).

[27] Proposed Rule 18f-4(a)(2).

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reduce the required mark to market coverage amount for a derivatives transaction by the value of assets that represent variation margin or collateral and reduce the required risk-based coverage amount by the value of any assets that represent initial margin or collateral.[28] However, because the mark to market coverage amount must be separately calculated for each derivatives transaction, the aggregate required mark to market coverage amount for a fund's derivatives transactions is not reduced by any amounts that would currently be payable to the fund on its derivatives transactions.

The risk-based coverage amount for each derivatives transaction must be determined pursuant to policies and procedures approved by the fund's board, including a majority of the independent directors, and must be determined in accordance with policies and procedures that take into account the structure, terms and characteristics of the transaction and the reference assets.[29] The risk-based coverage amount (unlike the mark-to-market coverage amount) may be determined on a net basis for transactions covered by a netting agreement under which a fund may net its obligations and its rights to payments with respect to multiple transactions.[30] The SEC decided not to prescribe specific segregation amounts or methodologies for determining risk-based coverage amounts, stating that the proposed rule is "designed to allow funds to assess and determine risk-based coverage amounts based on their specific derivatives transactions, investment strategies and associated risks."[31]

The proposed rule would also require a fund that engages in financial commitment transactions to maintain qualifying coverage assets equal in value to the full amount of its obligations under financial commitment transactions.[32] Unlike the asset segregation requirement for derivatives transactions, the rule permits a fund to segregate assets other than cash and cash equivalents as qualifying coverage assets, provided that such assets are convertible to cash or will generate cash prior to the date on which the fund can be expected to pay or satisfy the obligation.[33] Qualifying coverage assets for financial commitment transactions may also include assets that have been pledged with respect to such obligations.[34]

The proposed rule provides that the total amount of a fund's qualifying coverage assets shall not exceed the fund's net assets and that assets maintained as qualifying coverage assets shall not be used to cover both a derivatives transaction and a financial commitment transaction.[35]

As compared to segregation requirements for derivatives set forth in existing SEC staff interpretations, the proposed segregation requirements will likely require regulated funds to segregate a greater amount of their assets (particularly where funds currently segregate only their mark-to-market liability on derivatives transactions) and require funds to hold a greater amount of cash and cash equivalents (particularly where funds have relied on the Merrill Lynch Letter to segregate non-cash liquid assets,

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[28] Proposed Rule 18f-4(c)(6)(ii) and (c)(9)(ii).

[29] Proposed Rule 18f-4(c)(9).

[30] Proposed Rule 18f-4(c)(9)(i).

[31] Release at 167.

[32] The assets must be identified on the books and records of the fund at least once each business day.

[33] Proposed Rule 18f-4(c)(8)(iii). As an example, if a fund owns the security it would be required to deliver under a short sale borrowing (i.e., a short against the box), the fund would satisfy the proposed rule's asset segregation requirement by segregating that particular security.

[34] Proposed Rule 18f-4(c)(8)(iii).

[35] Proposed Rule 18f-4(c)(8).

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including equity and below-investment-grade debt securities). The SEC, however, did not believe that these requirements would have a practical impact, noting that cash and cash equivalents are typically used for posting collateral or margin for derivatives transactions, and that the rule permits margin posted to reduce the amount of assets that are required to be segregated.[36]

Risk Management Program

Under the proposed rule, regulated funds that engage in more than a limited amount of derivatives transactions[37] or that effect certain complex derivative transactions[38] will be required to adopt written risk management programs that are reasonably designed to assess and manage the risks associated with their derivatives transactions.

A fund that is required to adopt a risk management program will be required to implement policies and procedures reasonably designed to:

- Assess the risks associated with the fund's derivatives transactions;
- Manage the associated risks, including by monitoring whether the use of derivatives transactions is consistent with the fund's investment guidelines, any relevant portfolio limitations and relevant disclosure to investors, and by informing those responsible for portfolio management about the material risks arising from the fund's derivatives transactions; and
- Reasonably segregate the risk management function from the portfolio management of the fund.[39]

The proposed rule requires that the risk management program be administered by an employee or officer of the fund or of the fund's investment adviser (a "derivative risk manager") who: (1) may not be a portfolio manager of the fund; and (2) is approved to serve in that role by the board, including a majority of the independent directors.[40] This requirement effectively will prevent funds from outsourcing the risk management function to third parties.

The fund's risk management program must be approved by the independent directors[41] and reviewed and updated at least annually.[42] In addition, the board will be required to review, at least quarterly, a written report prepared by the derivatives risk manager describing the program's adequacy and the effectiveness of its implementation.[43]

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[36] Release at 293.

[37] As described in proposed Rule 18f-4(a)(4), a fund would be engaged in a limited amount of derivatives transactions if the fund complies with a portfolio limitation under which, immediately after entering into a derivatives transaction, the fund's aggregate exposure associated with derivatives transactions does not exceed 50 percent of the value of the fund's net assets.

[38] Proposed Rule 18f-4(c)(1).

[39] Proposed Rule 18f-4(a)(3)(i).

[40] Proposed Rule 18f-4(a)(3)(ii)(C).

[41] Proposed Rule 18f-4(a)(3)(ii)(A).

[42] Proposed Rule 18f-4(a)(3)(i)(D).

[43] Proposed Rule 18f-4(a)(3)(ii)(B).

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The costs of implementing a derivatives risk management program and appointing a derivatives risk manager could be significant; particularly, for smaller funds and fund complexes. Funds that use derivatives in an amount that only nominally exceeds the threshold for implementing a risk management program might seek to avoid these costs by limiting their use of derivatives.

Record-Keeping Requirements

The proposed rule includes certain record-keeping requirements relating to, among other things, a fund's selection and adherence to the portfolio limitation applicable to it and its risk management program, if such a program is required.[44]

Conclusions and Observations

If adopted as proposed, Rule 18f-4 will provide regulated funds that engage in derivatives transactions with a prescribed framework for compliance with the requirements of Section 18 (or Section 61 in the case of BDCs). However, the proposed rule represents a significant departure from existing regulatory guidance established by Release 10666 and various SEC staff no-action letters.[45] Investment advisers of regulated funds should therefore carefully review their funds' investment programs and derivatives trading practices to determine whether they would be permissible under the proposed rule. Fund advisers should assess how their funds would comply with the proposed rule, whether the funds' investment strategies must be altered to achieve compliance, and what the anticipated costs of compliance will be. Fund boards should be engaged in this process and should assure their familiarity with their funds' practices with respect to the use of derivatives and the process for monitoring associated risks.

Boards will have new responsibilities under the proposed rule, including:

- Approval of the applicable portfolio limitation;
- Approval of policies and procedures reasonably designed to provide for maintenance of qualifying coverage assets; and
- If the fund is subject to the risk management program requirement, approval of the program and any material changes to the program, appointment of a derivatives risk manager and review of quarterly reports on the program.

Although the proposed rule, as anticipated by the SEC, is most likely to adversely impact the investment programs of leveraged exchange-traded funds and managed futures funds,[46] the proposed rule will also affect to varying degrees the investment practices of other regulated funds that engage in derivatives and financial commitment transactions. In addition, a possible consequence of the rule's adoption may be that more funds opt to make use of instruments that do not constitute derivatives transactions as defined by the rule (such as structured notes) or to utilize fund-of-funds structures involving

[44] Proposed Rule 18f-4(a)(6).

[45] *See* note 5, *supra*.

[46] Release at 288.

investments in private funds (or invest a portion of their assets in private funds) in order to obtain desired investment exposures.[47]

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[47] While the SEC noted in the Release that an underlying fund that is a regulated fund would be subject to the limitations contained in Section 18 and the proposed rule, it did not address a fund's investment in underlying funds that are not regulated funds and whether such an arrangement would implicate Section 18 or the proposed rule. Indeed, the SEC acknowledged that a fund may use funds-of-funds structures to "help it remain in compliance with the proposed rule, or avoid reliance on the proposed rule altogether." *Id.* at 284.

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