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SEC Proposes Comprehensive Rule Governing Use of Derivatives by Investment Companies

By The Investment Management Practice

Introduction

On December 11, 2015, the Securities and Exchange Commission ("SEC") proposed a comprehensive new rule that would govern the use of derivatives by most types of investment companies. The proposed new rule, Rule 18f-4 under the Investment Company Act of 1940 (the "Act"), would require funds that use derivatives[1] to comply with a host of new restrictions governing such matters as portfolio leverage, asset coverage and segregation, risk management, and board oversight. The proposed rule would also address what are called financial commitment transactions[2] and, if adopted, would replace much of the existing regulatory structure governing derivatives. Through this proposal, the SEC seeks to implement a more comprehensive and updated approach concerning the fund industry's use of derivatives.

The proposed rule would cover mutual funds, exchange-traded funds, closed-end funds and business development companies (each a "Fund" and collectively "Funds"). Under the proposed rule,[3] Funds would generally be permitted to use derivatives subject to either a 150% or 300% "exposure" limitation relative to a Fund's net assets. Fund boards would need to approve which percentage limitation would apply to a Fund. In addition, under the proposed rule, Funds employing derivatives in

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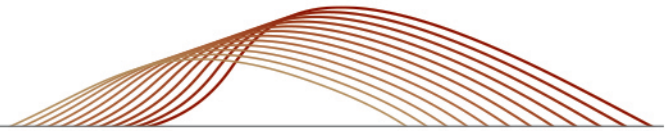
[1] The proposed rule defines a derivatives transaction as any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise.

[2] The proposed rule defines a financial commitment transaction to mean any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement (such as an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner).

[3] Although the proposed rule would not apply to unit investment trusts, these investment vehicles are otherwise subject to the Act's constraints on their ability to manage portfolio assets. As a result, any derivatives transactions in which a unit investment trust enters into when the unit investment trust is formed is generally accompanied either by the assets that would be required for delivery, or cash or cash equivalents serving as collateral thereby addressing the underlying concerns regarding asset coverage and leverage set for the in the proposing release.



their portfolios would need to comply with specified asset segregation requirements, both in terms of the amount and type of assets. Further, those Funds which use derivatives in anything more than a minimal amount would be required to implement and administer a derivatives risk management program, to be overseen by a derivatives risk manager, which among other things would require approval and periodic oversight by a Fund's board.

Comments on the SEC's proposed rule must be submitted no later than 90 days after publication of the proposing release in the Federal Register. We discuss below the highlights of the proposed rule, and will keep you informed as the proposal develops.

I. Overview of Proposed Rule 18f-4

In 1979, the SEC issued Investment Company Act Release 10666 ("Release 10666"), providing guidance with respect to a Fund's investment or other transaction that may result in the creation of a "senior security." Since the issuance of Release 10666, the SEC staff has issued an assortment of no-action letters addressing section 18 with respect to a number of different types of "senior securities." If proposed rule 18f-4 is adopted, the SEC would rescind Release 10666 as well as other no-action letters addressing derivatives and financial commitment transactions.

Proposed rule 18f-4 would primarily seek to:

1. Limit the amount of leverage a Fund may achieve relative to its net assets through the use of derivatives and financial commitment transactions by requiring Funds that use derivatives to adhere to one of two portfolio limitations (the 150% or 300% exposure test). This limitation would place an overall limit on the amount of exposure to underlying assets, and on the amount of leverage a Fund would be able to obtain, through derivatives;

2. Require Funds to manage the risks of derivatives by requiring maintenance of certain assets levels (consisting of cash and cash equivalents and called "qualifying assets") to cover not only a derivatives "mark-to-market" exposure, but also an additional amount designed to be available to cover future potential losses that might arise in stressed market environments; and

3. Except for Funds that engage in only a limited amount of derivatives and that do not use complex derivatives, require a Fund to establish a formalized risk management program administered by a designated derivatives risk manager (which cannot be the portfolio manager).

II. Proposed Limitations on Using Derivatives

The proposed rule would permit a Fund to invest in derivatives and financial commitment transactions subject to compliance with one of two alternative portfolio limitations—an exposure-based portfolio limit of 150% or a risk-based portfolio limit of 300%. The percentage associated with either portfolio limit reflects a cap on the amount of exposure attributable to the Fund's investments in derivatives, financial commitment transactions and other senior securities transactions, relative to the Fund's net assets.[4]

[4] The proposed rules provides that these tests are to be "transaction" tests, so that in the event a Fund's exposure increased beyond its applicable exposure limit at a time subsequent to having entered a derivatives, financial commitment, or senior securities transaction, the Fund would not be required to terminate or otherwise

A. Exposure-Based Portfolio Limit of 150%

Under the exposure-based portfolio limit, a Fund's exposure resulting from its participation in derivatives, financial commitment and senior securities transactions may not exceed 150% of the Fund's total net assets. The proposed rule generally provides that a Fund's exposure would be determined immediately after entering into any such transaction by adding together:

1. The aggregate notional amounts of the Fund's derivatives transactions, netting any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity, and other material terms;[5]

2. The aggregate financial commitment obligations of the Fund; and

3. The aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference) with respect to any other senior securities transaction entered into by the Fund.

The proposed rule would generally define the "notional amount" of a derivatives transaction, subject to certain adjustments,[6] 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 transaction are calculated. The proposed rule details the appropriate method of calculating the notional exposure for a variety of derivative transaction types, including but not limited to, forwards, futures, swaps, and options.

The proposed rule makes no distinction between the use of derivatives to obtain investment exposure or leverage and the use of derivatives for hedging purposes. As a result, Funds entering into derivatives transactions for hedging purposes must nonetheless include the notational value of such derivatives in the 150% exposure-based portfolio limit.

Under this proposed framework, certain alternative mutual funds would likely need to change their investment strategies in order to comply with the 150% exposure-based portfolio limit. In particular, funds following managed futures strategies, absolute-return funds, unconstrained bond funds, currency fund, and leveraged and inverse exchange-traded funds tend to have significant derivatives exposure and stand to be among those Funds potentially most affected by this portion of the proposed rule.

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unwind such transaction, but would be precluded from entering into any new such transaction until the Fund reduces its exposure below its applicable exposure limit.

[5] Importantly, only the offsetting transaction may be netted. The Fund is not permitted to disregard the notional amount of the transaction that the fund is hedging or mitigating. In addition, the netting provision does not apply to transactions that have offsetting characteristics but do not have the same underlying reference asset, maturity and other material terms.

[6] For derivatives that provide a return base on the leveraged performance of an underlying asset, the proposed rule would require the notional amount to be multiplied by the applicable leverage factor. For calculating the notional amount of derivatives transactions for which the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the proposed rule includes a "look-through" provision. Further, the proposed rule contains specific provisions for calculating the notional amount for certain defined complex derivatives transactions.

B. *Risk-Based Portfolio Limit of 300%*

As an alternative to the 150% exposure-based portfolio limit, a Fund may be permitted to obtain exposure up to 300% of its net assets if it can comply with a specially designed valuation at risk or "VaR"-based test[7] (the "VaR test"). VaR is a measure of risk, defined under the rule proposal 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." By extension, the VaR test provides a measure gauging whether a Fund's derivatives transactions, in aggregate, would result in an investment portfolio that is subject to less market risk than if the Fund did not use such derivatives.

In contrast to the exposure-based portfolio limit, this alternative portfolio limit factors in the resulting change in a portfolio's overall risk level resulting from its use of derivatives. Simply put, a Fund would be permitted to choose the 300% portfolio limit if its VaR, inclusive of its derivatives transactions, is calculated to be less than the Fund's VaR as calculated without such derivatives transactions. From a practical standpoint, the VaR calculation would provide a uniform measure of a Fund portfolio's overall market risk, with the VaR test serving as a tool that can be used to assess the effect of adding one or more derivatives positions on the overall market risk of a Fund's portfolio.

C. *Board Role and Oversight*

The proposed rule requires that the Fund's Board, including a majority of its independent directors, approve which of the two alternative portfolio limitations will apply to the Fund.

III. Asset Segregation Requirements for Derivatives Transactions

In addition to placing portfolio exposure limits in connection with derivatives investments, the proposed rule includes requirements pertaining to both the amount and type of assets a Fund must segregate for each derivatives transaction. Generally, the requirements outlined in the proposed rule reflect a more stringent set of asset segregation standards relating to derivatives transactions than those provided by existing SEC guidance.

A. *Amount of Asset Coverage*

The proposed rule would require Funds to account for the exposure attributable to each such instrument, on both a mark-to-market and projected basis. More specifically, the asset coverage amount for each derivatives transaction would be comprised of the sum of two components, both calculated at least once each business day: a "mark-to-market coverage amount" and a "risk-based coverage amount."

The "mark-to-market coverage amount," would be representative of an amount payable by a Fund if it were to exit a derivative transaction at the time of determination. This component is designed to require a Fund to have assets sufficient to meet its obligations under its derivatives transactions, which may include margin or similar payments demanded by a Fund's counterparty as a result of mark-to-market losses, or payments that the Fund may make in order to exit a derivatives transaction.

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[7] For purposes of the VaR test, Funds may make certain choices as to modeling and parameters. The proposed rule would require a Fund's VaR model to take into account all significant, identifiable market risk factors associated with a Fund's investment, and further, would require a Fund to use a minimum 99% confidence interval, a time horizon of not less than 10 and not more than 20 trading days and a minimum of three years of historical data to estimate historical VaR.

The risk-based coverage amount, or second component, would be representative of a reasonable estimate of the potential amount a Fund would pay if it were to exit the derivatives transaction under stressed conditions (the "cushion amount"). This second component essentially provides a cushion to the basic mark-to-market asset coverage convention, addressing the risk that a Fund's indebtedness under a derivative could increase significantly beyond its mark-to-market coverage amount on an intraday basis, potentially resulting in exposure exceeding the value of a Fund's segregated assets.

The proposed rule does not permit assets that are used to cover a derivatives transaction also to be used to cover a financial commitment transaction. In addition, in order to net exposure to a counterparty for segregation purposes, the Fund must enter into a contractual netting agreement, allowing the Fund to net its payment obligations with respect to multiple derivatives transactions. In addition, under the proposed rule, the mark-to-market coverage amount could be reduced by the value of any variation margin or collateral posted by a Fund to cover its mark-to-market loss on a derivatives transaction,[8] while the risk-based coverage amount would be reduced by the value representing initial margin or collateral.

B. Quality of Asset Coverage

The standard of what, under the proposed rule, would qualify as a coverage asset in connection with a Fund's derivatives transactions reflects a more rigid view than that posed by the SEC in its previous guidance on the matter. With certain exceptions, the proposed rule would define qualifying coverage assets for derivatives transactions to mean cash and cash equivalents[9], while a previous SEC no-action letter[10] deemed any liquid asset, including stocks and junk bonds, as a qualifying coverage asset for such transactions. Note that in connection with financial commitment transactions, the proposed rule would also permit the broader universe of liquid securities (*e.g.*, stocks and bonds), as opposed to primarily cash and cash equivalents, to be used as qualifying coverage assets.

Under the proposed rule, qualifying coverage assets refers to Fund assets that are either: 1) cash and cash equivalents or 2) assets with which a Fund may satisfy any delivery obligations with respect to a derivatives transaction. Derivatives providing an offsetting exposure, as opposed to the particular asset that would be required for delivery, would not meet the requirements of a qualifying coverage asset under the framework of the proposed rule. The total amount of qualifying coverage assets may not exceed a Fund's net assets. The qualifying coverage assets corresponding to each derivatives transaction must be identified on the Fund's books and records at least once each business day.

C. Board Role and Oversight

The proposed rule requires Fund boards, including a majority of a board's independent directors, to approve the policies and procedures for asset segregation related to investments in derivatives transactions. In addition, Boards must approve the policies and procedures to be employed to determine the amount of the risk-based coverage, or the "cushion amount."

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[8] As one example posed in the release, if a Fund has invested in a futures contract posts variation margin to settle its daily margin obligations under the futures contract, the Fund would not be required to also segregate qualifying coverage assets for purposes of satisfying the mark-to-market coverage amount.

[9] Generally, cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near maturity that they present insignificant risk of changes in value because of changes in interest rates. Examples of cash equivalents can include Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.

[10] See Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) ("Merrill Lynch No-Action letter"), available at http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf.

IV. Derivatives Risk Management Program

The proposed rule would require that a Fund exceeding a 50% threshold of notional derivatives exposure[11] relative to its net assets adopt a formalized derivatives risk management program ("RMP"). Funds engaging in *any* complex derivatives transactions[12] would also be required to implement an RMP. In the proposed release, the SEC staff expresses its view that since complex derivatives transactions may entail highly asymmetric and unpredictable outcomes, these instruments may pose risks uncorrelated to the size of a Fund's exposure, warranting the assessment and management of such risks through an RMP.

The RMP's requirements would be in addition to requirements already associated with derivatives risk management for Funds. The proposed RMP is intended to enhance practices that many Funds already have in place by requiring Funds to evaluate the risks associated with the Fund's use of derivatives and inform boards of directors about these risks.

A. Four Elements of the Derivatives Risk Management Program

1. Assessment of Risk

Funds would be required to identify and evaluate risks posed by derivatives transactions—both those types of derivatives it currently uses and any potential derivatives transactions it expects to use in the future. Risks associated with derivatives transactions include leverage, market, counterparty, liquidity, and operational risks. This element is meant to provide flexibility for a Fund to customize its RMP so that the scope and related costs are appropriate to manage the anticipated corresponding derivatives risks faced by the Fund.

2. Management of Risk

Funds would be required to have policies and procedures in place to manage and monitor the risks of its derivatives transactions,[13] such as determining whether those risks continue to be consistent with a) any investment guidelines made by the Fund or the investment adviser, b) the Fund's portfolio limitation established under the proposed rule, and c) relevant disclosure to investors. Further, those policies and procedures would be required to include provisions for informing a Fund's portfolio

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[11] The 50% exposure condition could include exposures from derivatives transactions but would not include exposure from financial commitment transactions or other senior securities transactions entered into by the Fund. Funds that do not exceed the 50% threshold, but that enter into derivatives transactions are required to manage risks relating to their derivatives transactions through compliance with other requirements of the proposed rule and under the Act. For example, a Fund would be required to monitor the types of derivatives transactions and notional amounts of the Fund's derivatives transactions as well as the Fund's aggregate exposure to prevent its derivatives exposure from exceeding 50% of net assets and to prevent the Fund from entering into complex derivatives transactions.

[12] The rule proposal defines a complex derivatives transaction to mean any derivatives transaction for which the amount payable by either party upon settlement date, maturity, or exercise is either a) dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction, or b) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.

[13] Funds would have the flexibility to use a variety of approaches in developing such policies and procedures, which may include steps such as reviewing relevant disclosure, establishing written guidelines regarding scope and objective of the Fund's use of derivatives, establishing an approved list of specific derivative instruments or strategies that may be used, establishing corresponding investment size controls/limits for approved transactions, or reviewing existing/establishing new contingency plans in case of adverse market or system events.

management or board, as appropriate, regarding any material risks arising from the Fund's derivatives transactions. In the release, the SEC notes that such communications would be a key part of any risk management to help ensure that this information is regularly shared with parties who can take necessary actions to mitigate risks.

3. Segregation of Functions

The third element of the RMP would require that a Fund segregate the functions associated with the RMP from the portfolio management function to promote objective and independent risk assessment. The SEC notes that this element is not meant to impose a "communications firewall" between the derivatives risk manager and portfolio management—instead, the risk managers are expected to work closely with portfolio management as all aspects of the RMP are implemented.

4. Periodic Review

The final of the four elements would require that the RMP be updated at least annually, including any models (*i.e.*, any VaR models used during the covered period), measurement tools, and the policies and procedures of the RMP used to evaluate their effectiveness. However, the proposed rule would not include specific review procedures or specific developments that a Fund must consider as part of its review.[14]

B. Administration of the Risk Management Program

The proposed rule would require than an RMP be administered by a designated derivatives risk manager and would be tailored by each Fund and its adviser to the particular types of derivatives used by the Fund and how those derivatives relate to its investment portfolio and strategy. The proposed rule also provides that a Fund may, and should, as determined appropriate, expand the RMP beyond the required elements when it would be necessary to ensure effective derivatives risk management.

C. Board Approval and Oversight

The proposed rule would require a Fund to designate an employee or officer of the Fund or of the investment adviser responsible for administering the policies and procedures of the RMP. The risk manager must not be a portfolio manager of the Fund[15] and must be approved by the board of directors, including a majority of the directors who are not interested persons of the Fund. The proposed rule would not require that the risk manager only be removable by a Fund's board, nor would the board need to approve compensation for the manager.

The proposed rule would require a Fund to obtain initial approval of its written RMP from the board, including a majority of independent directors. A Fund's board would also be required to approve any material changes to the RMP. In considering approval or material changes to the RMP, a Fund's board should generally consider the types of derivatives transactions in which the Fund is engaged or plans to engage, the risks associated with these transactions, and whether the RMP sufficiently complies with its investment guidelines, portfolio limitation, and relevant disclosure. Additionally, a Fund's board would be required to review a written report from the risk manager, provided at least quarterly, discussing the adequacy of the RMP and the effectiveness of its implementation.

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[14] The SEC generally suggests that a Fund evaluate regulatory, market-wide, and Fund-specific developments affecting its RMP.

[15] In the case of a small adviser with limited employees/officers who are not portfolio managers of the Fund, the Fund's Chief Compliance Officer might be designated as the risk manager or it may be determined that new personnel must be hired to administer the RMP.

V. Requirements for Financial Commitment Transactions

The proposed rule would require Funds to maintain qualifying coverage assets for each financial commitment transaction with a value equal to at least the amount of the financial commitment obligation associated with the transaction.[16] Further, where a Fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation would equal the value of the asset. The qualifying coverage assets for each financial commitment transaction would be required to be identified on the books and records at least once each business day.

Under the proposed rule, qualifying coverage assets with respect to financial commitment transactions would be Fund assets that are: 1) cash and cash equivalents; 2) with respect to any financial commitment transaction under which the Fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; or 3) assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the Fund can be expected to be required to pay such obligation or that have pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation,[17] determined in accordance with policies and procedures approved by a Fund's board of directors. The total amount of a Fund's qualifying coverage assets could not exceed its net assets.

Board Oversight

A Fund's board, including a majority of directors who are not interested persons in the Fund, would be required to approve the policies and procedures for the Fund's maintenance of qualifying coverage assets in connection with the Fund's financial commitment transactions.

VI. Disclosure Amendments and Reporting

A. Amendments to Proposed Form N-PORT

Proposed Form N-PORT would be further amended to provide that Funds required to implement an RMP report for options and warrants, including options on a derivative, as well as on certain other limited risk metrics.

B. Amendments to Proposed Form N-CEN

Proposed Form N-CEN would be further amended to require each Fund to indicate whether it relied upon proposed rule 18f-4, as well as which portfolio limitation the Fund elected to comply with during the reporting period.

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[16] The proposed rule would require the Fund to maintain qualifying coverage assets to cover the full amount of the Fund's obligation rather than a mark-to-market and risk-based coverage amount because a Fund may be required to actually fulfill its full obligation under a financial commitment transaction. This is in contrast to a derivatives transaction where a Fund generally would not expect to make payments or deliver assets equal to the full notional amount.

[17] Where the Fund can be expected to pay the obligation on a short-term basis, the assets maintained as qualifying coverage assets also would have to be convertible to cash or able to generate cash on a short-term basis.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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