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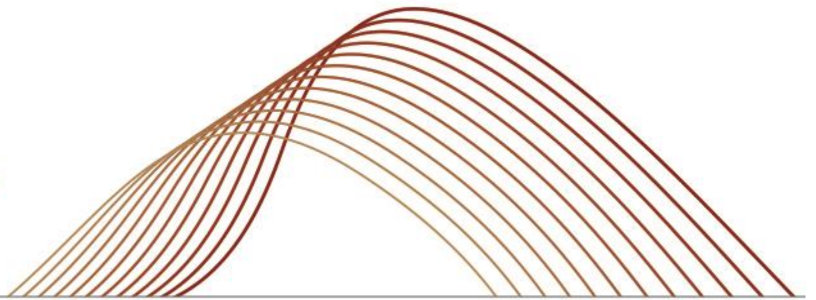

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SEC Proposes to Modernize Regulation of the Use of Derivatives by Registered Investment Companies

By The Investment Management Practice

Introduction

On November 25, 2019, the Securities and Exchange Commission (the "SEC") proposed new rules that would govern the use of derivatives by most types of registered investment companies. Re-proposed new rule 18f-4, an exemptive rule under the Investment Company Act of 1940, as amended (the "Investment Company Act") (the, "proposed derivatives rule"), would permit mutual funds, exchange-traded funds ("ETFs"), registered closed-end funds, and business development companies (collectively, "funds") to enter into derivatives transactions notwithstanding the restrictions under section 18 of the Investment Company Act. The proposed derivatives rule would not be applicable to money market funds or unit investment trusts. The proposal is similar to the rule proposed by the SEC in December 2015, which was later removed from the SEC's formal agenda. Certain provisions from four years ago, such as an asset segregation requirement, are not included in this re-proposal of the derivatives rule.

The proposed derivatives rule would permit funds to engage in broadly defined derivatives transactions, provided that they comply with specified conditions intended to protect investors. These conditions include adopting a derivatives risk management program, appointing a derivatives risk manager and complying with a limit on the amount of leverage-related risk that the fund may obtain, based on the value-at-risk of its entire portfolio. A streamlined set of requirements would apply to funds that use derivatives in a limited way. The proposal also addresses a fund's ability to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions.

The SEC also proposed new sales practices rules,[1] under which a broker, dealer or registered investment adviser would have to exercise due diligence approving retail customers or clients investing in shares of funds that seek to provide leveraged or inverse exposure to an underlying index.

Proposed Derivatives Rule 18f-4 Under the Investment Company Act

The re-proposed rule 18f-4 is an attempt by the SEC to address the risks of a fund's use of derivatives, which represent the purposes and concerns underlying section 18 of the Investment Company Act, with a comprehensive approach reflecting the growth in the volume and complexity over the past decades of "derivatives transactions."[2]

Proposed rule 18f-4 would impose a uniform set of conditions and provide certain exemptions from the Investment Company Act. The conditions include the following:

- *Derivatives Risk Management Program*. The proposed derivatives rule would generally require a fund to adopt a written derivatives risk management program. The program would institute a standardized risk management framework for funds that engage in more than a limited amount of derivatives transactions, while requiring principles-based tailoring by each fund to the fund's particular risks. The program would have to include:
  - risk guidelines;
  - stress testing (at least weekly);
  - backtesting (daily);
  - internal reporting and escalation; and
  - periodic review of the program (at least annually).
- *Derivatives Risk Manager, Board Oversight and Reporting*. A derivatives risk manager (required to be an officer or officers of the fund adviser or sub-adviser), approved by the fund's board of directors, would administer the program. The fund's derivatives risk manager would have to provide regular written reports to the fund's board on the derivatives risk management program's implementation and effectiveness in order to facilitate the board's oversight of the fund's derivatives risk management. The proposal would require a fund to identify and assess its derivatives risks, which would include leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other risk deemed material. In her recent speech, Dalia Blass, Director of the Division of Investment Management, asked for comment regarding board's oversight role. She asked whether the "proposal effectively leverage and empower the board? Does it provide boards with the information and tools they need to appropriately oversee derivatives use by a fund?"
- *Limit on Fund Leverage Risk*. A fund relying on the proposed derivatives rule would generally have to comply with an outer limit on fund leverage risk based on value at risk, or "VaR," of the entire portfolio of the fund. This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index" for that fund, which must be an unleveraged index and (except in certain circumstances) unaffiliated with the fund. The fund's VaR would not be permitted to exceed 150% of the VaR of the fund's designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund's net assets.[3]

- *Exception for Limited Users of Derivatives*. The proposed derivatives rule would except from the program requirement and the VaR-based limit on fund leverage risk for a fund that either: (1) limits its derivatives exposure to 10% of its net assets, or (2) uses derivatives solely to hedge certain currency risks; however, in either case, the fund would also be required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks.

- *Alternative Conditions for Certain Leveraged / Inverse Funds*. The proposed derivatives rule includes a set of alternative conditions for certain leveraged or inverse funds.[4] Such a fund would be excepted from the proposed limit on fund leverage risk, provided that, among other things, it: (1) limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index, (2) discloses in its prospectus that it is not subject to the proposed limit on fund leverage risk, and (3) is a fund to which the additional safeguards of the new proposed sales practices rules would apply. The proposed sales practices rules, as discussed below, would prohibit a retail investor from trading through a broker-dealer or investment adviser unless the broker-dealer or investment adviser were to approve in writing the investor's account for such trading.

- *Recordkeeping*. The proposed derivatives rule would require a fund to adhere to recordkeeping requirements designed to provide the SEC staff, and the fund's board and compliance personnel, the ability to evaluate the fund's compliance with the requirements of the proposed rule.

- *Reverse Repurchase Agreements and Unfunded Commitment Agreements*. The proposed derivatives rule would also permit a fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions. A fund would be permitted to engage in reverse repurchase agreements and similar financing transactions so long as they meet the asset coverage requirements under section 18 of the Investment Company Act. However, unlike reverse repurchase agreements, the proposed rule does not treat a fund's obligation to return securities lending collateral as a financing transaction similar to a reverse repurchase agreement, so long as the obligation relates to an agreement under which a fund engages in securities lending, the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests case collateral solely in cash or cash equivalents. With respect to the tender option bond ("TOB") financings, the proposed rule notes determining whether a TOB is a similar financing transaction as a reverse repurchase agreement would depend on the facts and circumstances.

Proposed Sales Practices Rules and Amendments to Rule 6c-11

The proposed sales practices rules would establish a set of due diligence and approval requirements for broker-dealers and SEC-registered investment advisers (collectively, "firms") with respect to trades in shares of certain leveraged investment vehicles.

Under the proposed sales practices rules, a firm would have to exercise due diligence in determining whether to approve a retail customer or client's account to buy or sell leveraged investment vehicles. A broker-dealer or investment adviser could only approve the account if it had a reasonable basis to

believe that the customer or client have such financial knowledge and experience that may reasonably be expected to be capable of evaluating the risks associated with these products.

The proposed amendments to rule 6c-11 under the Investment Company Act would permit certain leveraged or inverse ETFs to rely on rule 6c-11. The SEC proposed to rescind the exemptive orders previously issued to the sponsors of leveraged or inverse ETFs in connection with any adoption of the proposed amendments.

In their joint public statement on the proposed rule, Commissioners Peirce and Roisman asked for feedback on whether this proposed course regarding sales practices is in fact the "optimal approach." In addition, the Commissioners queried whether the proposed mandate that all broker-dealers and investment advisers require investors seeking to buy or sell geared ETFs to fill out questionnaires is overly proscriptive given that the Commission recently adopted Regulation Best Interest.

Reporting Requirements

The proposal would require a fund to report confidentially to the SEC on a current basis on Form N-LIQUID (to be renamed "Form N-RN") if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than three consecutive business days. The proposal also would amend Forms N-PORT and N-CEN to require funds that are currently required to file these forms to provide information regarding: (1) the fund's exposure to derivatives; (2) the fund's VaR (and, if applicable, the fund's designated reference index) and backtested results; (3) VaR test breaches, to be reported to the SEC in a non-public current report; and (4) certain identifying information about the fund, for example whether the fund is a limited user of derivatives or a leveraged/inverse fund.

Review of Relevant Staff Guidance

In view of the proposal's updated, comprehensive approach to the regulation of funds' derivatives use, the SEC proposed to rescind a 1979 General Statement of Policy (Release 10666), which provides SEC guidance on how funds may use certain derivatives and derivatives-like transactions in light of section 18's restrictions. In addition, Division of Investment Management staff are reviewing certain no-action letters and other guidance addressing funds' use of derivatives and other transactions covered by proposed rule 18f-4 to determine which letters and staff guidance, or portions thereof, should be withdrawn in connection with any adoption of the proposal.

Comment and Transition Periods

The public comment period will remain open for 60 days after publication of the proposed rules in the Federal Register.

The SEC expects to provide a one-year transition period for funds to prepare to come into compliance with proposed rule 18f-4 before Release 10666 is withdrawn. The SEC proposes to provide a one-year compliance period following the publication of any final sales practices rules in the Federal Register.

Conclusion

Re-proposed rule 18f-4 reflects the acknowledgement by the SEC of the benefits that derivatives transactions can provide to fund investors, while addressing the risk to such funds and the protection of their investors when the fund engages in derivatives transactions that create leverage risks and uncertain future payment obligations. Recognizing the disparate practices applied by funds to derivatives transactions, the proposed derivatives rule represents an attempt by the SEC to update the current regulatory framework and level the competitive landscape by imposing consistent

standards on funds. Re-proposed rule 18f-4 represents a determination by the SEC that the VaR limitations imposed on all funds, together with the rule's compliance requirements, are better designed to address the concerns underlying section 18 of the Investment Company Act, than the current asset segregation approach represented by Release 10666. The compliance burden requires funds with significant exposure to derivatives to adopt a derivatives risk management program, overseen by a specified manager with a reporting duty to the board of directors. The derivatives risk manager would bear much of the day to day responsibility for a fund's compliance with the proposed derivatives rule, including the selection of an appropriate designated reference index. The fund's board of directors would not only be subject to specific oversight responsibilities under the proposed rule, but also be responsible under the general compliance obligations of rule 38a-1 of the Investment Company Act.

The proposed sales practices rules, represents a specific implementation of principles, such as know your customer, on broker/dealer and investment adviser firms. The proposed rules would not only apply to new customers but would be applied to additional investments by existing clients as well.

The 2015 derivatives proposal received 200 comment letters which contributed to the significant changes reflected in its 2019 form. The release describing the new proposals includes over 250 enumerated requests for comments and the SEC is likely to receive a substantial number of comment letters responding to the proposed rules.

A copy of the proposed rules can be found here.

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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[1] Rule 15l-2 under the Securities Exchange Act of 1934 and rule 211(h)-1 under the Investment Advisers Act of 1940. In connection with these proposed sales practice rules, the SEC proposes to amend rule 6c-11 under the Investment Company Act to allow certain leveraged or inverse ETFs to operate without obtaining an exemptive order.

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[2] The proposed derivatives rule would define "derivatives transaction" to mean: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin, settlement payment, or otherwise; and (2) any short sale borrowing.

[3] The derivatives risk manager is responsible for choosing an appropriate VaR model, used in determining compliance with either the relative or absolute VaR test, taking into account and incorporating all significant, identifiable market risks associated with the fund's investments. The proposed derivatives rule requires that a fund's VaR model also uses a 99% confidence level and a time horizon of 20 trading days, as well as being based on at least three years of historical market data.

[4] The term "leveraged/inverse vehicle" is defined in the proposed sales practices rules to include "certain entities that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index over a predetermined period of time." The entities covered by the scope of the proposed rules would include registered investment companies and certain exchange-listed commodity-or currency-based trusts or funds.