SEC proposes sweeping changes to the use of derivatives and financial commitment transactions by registered funds and BDCs

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Abstract

Purpose – *To describe and analyze a proposed rule recently issued by the US Securities and Exchange Commission ("SEC") that would overhaul the use of derivatives and financial commitment transactions by registered investment companies and business development companies.*

Design/methodology/approach – *This article summarizes the various aspects of the proposed rule, discusses the elements of the proposed rule in greater detail, explains the effect of the proposed rule on existing guidance from the SEC and its staff, and notes the potential transition period for any final rule.*

Findings – *While the proposed rule is subject to public comment and subsequent consideration by the SEC and its staff, if the proposed rule is adopted in its current form it would result in sweeping changes for registered investments companies and business development companies.*

Originality/value – *This article contains a detailed overview of a recent SEC rule proposal regarding the use of derivatives by registered investment companies and business development companies and practical guidance from experienced asset management lawyers.*

Keywords *Securities and Exchange Commission (SEC), Registered investment companies, Business development companies (BDCs), Derivatives, Financial commitment transactions, Rule proposal*

Paper type *Technical paper*

Recognizing the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds, on December 11, 2015, the SEC proposed a new rule[1] seeking to limit the amount of leverage that registered investment companies ("RICs")[2] and business development companies ("BDCs")[3] may incur when investing in derivatives and financial commitment transactions, and addressing the associated risks of those investments. Proposed Rule 18f-4 (the "Proposed Rule") under the 1940 Act, if adopted as proposed, would overhaul the regulation of derivatives and financial commitment transactions entered into by RICs and BDCs (together, "funds"). According to the SEC, the Proposed Rule reflects the SEC's intention "to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives" and other transactions that may involve the issuance by funds of a senior security subject to the prohibitions and asset coverage requirements of Section 18 of the 1940 Act[4]. Along with the proposal, the SEC's Division of Economic and Risk Analysis issued a white paper addressing how funds use derivatives, which is designed to provide a basis for the proposal.

The SEC issued its seminal guidance on transactions that may involve the issuance of a "senior security" in 1979, and the staff of the SEC's Division of Investment Management (the "Staff") has been addressing funds' use of derivatives on an instrument-by-instrument basis over the past thirty-five years[5]. The SEC states that if it adopts the Proposed Rule it would rescind both Release 10666 and the Staff's no-action letters and other guidance addressing derivatives and financial commitment transactions. In their place, the Proposed Rule would create a broader framework encompassing the following key features:

- *Exposure limitations*: The Proposed Rule would impose a new requirement for funds to cap their aggregate "exposure" to the notional amount, as may be adjusted, of senior securities transactions, including derivatives transactions, financial commitment transactions and outstanding borrowings that are senior securities, at a percentage of the value of the fund's net assets. Funds would have to comply with either a 150 per cent exposure-based limit or a 300 per cent risk-based limit on all senior securities transactions when transacting in derivatives.
- *Asset segregation and permissible coverage assets*: The Proposed Rule would allow for mark-to-market valuation of a fund's coverage amount, including a risk-based cushion, but would limit the types of assets that are available to segregate and "cover" a fund's obligations under a derivatives transaction, restricting "qualifying coverage assets" for derivatives transactions to cash and cash equivalents (or the asset that satisfies the fund's delivery obligation under the derivatives transaction). Qualifying coverage assets may not exceed the fund's net assets.
- *Formalized derivatives risk management program*: Funds that engage in derivatives transactions above a threshold amount or that use complex derivatives transactions would be required to establish a formalized derivatives risk management program. A person responsible for administering the derivatives risk management program would need to be designated by a fund's board. The person could not be a portfolio manager of the fund.
- *Increasing responsibilities for fund boards*: Fund boards would be responsible for approving certain parameters pursuant to which the fund would operate under the Proposed Rule and, if applicable, boards would be responsible for approving and overseeing a fund's derivatives risk management program.
- *Financial commitment transactions*: For funds that engage in financial commitment transactions, the Proposed Rule would also impose separate asset segregation and "qualifying coverage assets" requirements based on the fund's aggregate financial commitment obligations. As is the case for derivatives transactions, qualifying coverage assets may not exceed the fund's net assets.

The SEC recognizes in the Proposing Release that certain existing funds – identified as managed futures funds and leveraged ETFs – may be unable to comply with the Proposed Rule (unless grandfathered) and, consequently, would need to liquidate and/or deregister under the 1940 Act if the Proposed Rule is adopted in its current form[6]. The SEC clearly suggests that certain strategies are too speculative to be offered to retail investors in mutual fund form.

The SEC approved the Proposed Rule in a 3-1 vote, with Commissioner Michael S. Piwowar dissenting. Despite his "strong support for [SEC] action in this area," Commissioner Piwowar stated that he believes the SEC is obligated to "not propose any changes to the existing framework unless they are both based on high quality analyses of comprehensive data, and take into consideration other recent regulatory actions impacting the use of derivatives by funds."[7] According to Commissioner Piwowar, some of the recommendations under consideration in the Proposing Release "fail this basic standard."[8]

Request for comment

The SEC is soliciting comment on the Proposed Rule and the proposed amendments to proposed Form N-PORT and proposed Form N-CEN, specific issues discussed in the Proposing Release, and other matters that may have an effect on the Proposed Rule and proposed forms. *The deadline for submitting comments is March 28, 2016*.

Summary of Proposed Rule

The Proposed Rule would significantly alter the regulation of funds' use of "derivatives transactions" and "financial commitment transactions." If adopted in its current form, the Proposed Rule would replace the guidance issued by the SEC and the Staff on derivatives over the course of the last 35 years, which would be rescinded following a transition period after the adoption of the Proposed Rule[9]. In support of its proposed changes, the SEC states that mandating both portfolio exposure limitations and asset segregation requirements for derivatives transactions "would be more effective than an approach focusing only on asset segregation, particularly when it is coupled with a formalized risk management program for funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions."[10] This section briefly summarizes the Proposed Rule. More detail is provided below under the "Detailed Discussion of the Proposed Rule" section.

1. *Definition of derivatives transaction*: The Proposed Rule defines the term "derivatives transaction" to mean "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 a margin or settlement payment or otherwise."[11] This proposed definition describes those derivatives transactions that, in the SEC's view, involve the issuance of a "senior security" for purposes of Section 18 of the 1940 Act, "because they involve a future payment obligation, that is, an obligation or potential obligation of the fund to make payments or deliver assets to the fund's counterparty."[12] Under this definition, purchased options, structured notes and other derivatives that are fully paid by the fund are excluded.
2. *Definition of financial commitment transaction*: The Proposed Rule defines the term "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)."[13] This definition would not include a transaction under which a fund merely is required to deliver cash or assets as part of regular-way settlement of a securities transaction (rather than a forward-settling transaction or transaction in which settlement is deferred)[14]. Although not included in the definition of "financial commitment transaction" in the Proposed Rule, the SEC asks for comment on whether it should include a fund's obligation to return securities lending collateral as a financial commitment transaction or, alternatively, whether it should require funds to include the obligation to return securities lending collateral for purposes of the Proposed Rule's exposure limits[15]. The former approach would eliminate the current limit of one-third of total assets on securities loans, while the latter would increase a fund's exposure under the Proposed Rule and could require funds that engage in derivatives transactions, as well as securities lending, to adjust their operations to stay within the applicable exposure limit.

3. *Aggregate exposure limits*: Under the Proposed Rule, a fund that engages in derivatives transactions would be subject to one of two alternative aggregate percentage limits on the value of the fund's net assets that are exposed to derivatives transactions, financial commitment transactions and other transactions involving a senior security entered into by the fund pursuant to Section 18 or, in the case of a BDC, Section 61 of the 1940 Act (*e.g.*, indebtedness and, for closed-end funds and BDCs, senior securities that are stock) without regard to the exemption provided by the Proposed Rule. Funds would have to comply with either a 150 per cent exposure-based limit or a 300 per cent risk-based limit that must be approved by a fund's board, including a majority of the directors who are not interested persons of the fund within the meaning of the 1940 Act ("Independent Directors")[16], and disclosed publicly[17]. The risk-based limit is designed for funds that mainly use derivatives transactions to reduce risk. These exposure limits are discussed in detail below under the "Portfolio Limitations for Derivatives Transactions" section. According to the SEC, the Proposed Rule may cause certain funds to liquidate and/or deregister under the 1940 Act if it is adopted in its current form[18]:

   - *Calculation of the "exposure" percentage*: In calculating "exposure" under either limit, a fund would add (i) the aggregate notional amounts of the fund's derivatives transactions (subject to certain adjustments)[19], (ii) the aggregate obligations of the fund under its financial commitment transactions and (iii) the fund's aggregate indebtedness with respect to any other senior securities transactions. Borrowings under a fund's credit facility that are senior securities for purposes of Section 18 would count towards a fund's exposure limits under the Proposed Rule and, thus, could limit a fund's ability to engage in derivatives transactions[20].

4. *Asset coverage for derivatives transactions*: A fund that enters into derivatives transactions in reliance on the Proposed Rule would be required to maintain an amount of "qualifying coverage assets" (as defined in the Proposed Rule) with a value equal to:

   - a "mark-to-market coverage amount," which would be the amount that would be payable by the fund if the fund were to exit the derivatives transaction as of the time of determination[21]; and
   - an additional "risk-based coverage amount," which would be an amount in addition to the mark-to-market coverage amount that represents a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures (which must take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset) approved by the fund's board, including a majority of the Independent Directors[22].

A minimum amount is not prescribed in the Proposed Rule, nor is the use of a specific methodology or model prescribed to calculate the amount. It is noteworthy that neither coverage amount requires asset segregation of the full notional amount of a derivative in contrast with current market practice and Staff guidance for certain instruments. The Proposed Rule is designed to provide a flexible framework and to eliminate distinctions between cash-settled derivatives, with respect to which funds generally segregate assets equal to the mark-to-market exposure rather than the full notional amount, and physically-settled derivatives, with respect to which funds generally segregate the full notional amount[23].

5. *Limited netting*: A fund's ability to net derivatives transactions under the proposed asset coverage requirements differs from the netting calculation for the proposed exposure limits and does not appear to allow for netting or set off with financial commitment transactions or other senior securities transactions. In both contexts

the ability to net is limited. Under the exposure limits, a fund's aggregate notional exposure would be reduced by a directly offsetting derivatives transaction on the *same* instrument with the *same* underlying reference asset, maturity and other materials terms[24]. The two transactions may be with different counterparties for this purpose[25]. For asset coverage, however, netting is only permitted pursuant to a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions[26]. In that case, the mark-to-market coverage amount for those derivatives transactions may be calculated as the net amount that would be payable by the fund, if any, with respect to all derivatives transactions covered by the netting agreement[27].

6. *Asset coverage for financial commitment transactions*: The Proposed Rule would require funds that engage in "financial commitment transactions" to maintain "qualifying coverage assets" with a value equal to at least the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under the financial commitment transaction (*i.e.*, the "financial commitment obligation")[28].
7. *Qualifying coverage assets*: Qualifying coverage assets for purposes of covering a fund's obligation under the Proposed Rule differ depending on whether the obligation stems from a derivatives transaction or a financial commitment transaction. Unlike current practice under the Merrill Lynch Letter, "qualifying coverage assets" for derivatives transactions under the Proposed Rule would be limited to cash and cash equivalents (or the asset that satisfies the fund's obligation under a derivatives transaction). Under current guidance, cash or any liquid securities can be used for this purpose, including equity securities and non-investment grade debt[29]. For financial commitment transactions under the Proposed Rule, "qualifying coverage assets" would include any asset convertible to cash by the date the fund must meet its obligation under the transaction as determined under board-approved policies and procedures, in addition to cash and cash equivalents (or the asset that satisfies the fund's obligation under the financial commitment transaction).
8. *Derivatives risk management program*: The Proposed Rule would require funds that engage in derivatives transactions with an aggregate exposure of more than 50 per cent of the value of the fund's net assets or that enter into complex derivatives transactions to implement a derivatives risk management program[30]. A fund that enters into "complex derivatives transactions"[31] would be required to implement a derivatives risk management program, regardless of the fund's aggregate exposure to derivatives transactions[32].
9. *Derivatives risk manager*: The day-to-day implementation of a fund's derivatives risk management program (if required) would be handled by a derivatives risk manager whose designation is approved by the fund's board, including a majority of the Independent Directors. The Proposed Rule would require that the risk manager be an employee of the fund or its investment adviser who is sufficiently knowledgeable about the risks and use of derivatives to effectively fulfill the position's responsibilities[33]. The person may not be a portfolio manager of the fund.
10. *Role of the board*: Fund boards, including a majority of the Independent Directors, would be responsible for approving certain parameters pursuant to which the fund would operate under the Proposed Rule, including the applicable exposure limit, and, if applicable, boards would be responsible for approving and overseeing a fund's derivatives risk management program. As suggested by Commissioner Aguilar in his public statement regarding the Proposed Rule, the additional responsibilities that fund boards would take on under the Proposed Rule "will require more time, resources, and, of course, expertise."[34]

Detailed discussion of the Proposed Rule

Portfolio limitations for derivatives transactions

One of the most sweeping changes to the regulation of funds' use of derivatives would be the new aggregate exposure limits on a fund's derivatives transactions, financial commitment transactions and other senior securities transactions. The Proposed Rule contains two alternative portfolio limitations – an exposure-based portfolio limit and a risk-based portfolio limit. A fund's board of directors, including a majority of the Independent Directors, would be required to approve the particular portfolio limitation under which the fund would operate pursuant to the Proposed Rule[35].

As further discussed below, measurement of compliance with the exposure limits under the Proposed Rule would occur at the time the fund entered into a "senior securities transaction." Senior securities transaction is defined in the Proposed Rule to mean "any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund, pursuant to [Section 18 or 61 of the 1940 Act] without regard to the exemption provided by [the Proposed Rule]."[36] The SEC states that a fund would not be required to terminate or otherwise unwind a senior securities transaction solely because the fund's exposure subsequently increased beyond the exposure limits included in either of the portfolio limitations[37]. The SEC notes that if a fund's exposure, as defined in the Proposed Rule, exceeded the applicable exposure limit, the fund would not be permitted to enter into additional derivatives transactions unless the fund would be in compliance with the applicable exposure limitation immediately after entering into such transaction[38]. As a result, a fund may need to limit its derivatives transactions or close out existing derivatives positions in order to retain flexibility to enter into risk mitigating derivatives[39].

Exposure-based portfolio limit. The portfolio limitation that would apply to funds that engage in derivatives transactions for reasons other than, or in addition to, limiting a portfolio's risk would be a pure exposure-based portfolio limit. Under this limit, immediately after entering into any senior securities transaction, the aggregate "exposure" of the fund to senior securities transactions, including derivatives transactions, financial commitment transactions and outstanding borrowings that are senior securities, cannot exceed 150 per cent of the value of the fund's net assets[40]. The SEC states that the exposure limitation of 150 per cent, as proposed, would allow funds to use derivatives transactions that could approximate the level of market exposure that would be possible through securities investments augmented by borrowings as permitted under Section 18[41]. The SEC states that it has proposed an exposure limitation at a level (*i.e.*, 150 per cent of the value of a fund's net assets) that would "appropriately" constrain funds that use derivatives to obtain highly leveraged exposures[42]. Nonetheless, the SEC requests comment on whether the exposure limit should be higher or lower, for example 200 per cent or 100 per cent[43]. Comment is also requested on whether there are types of funds for which a higher or lower limit would be appropriate[44].

Risk-based portfolio limit. As an alternative to the exposure-based portfolio limit, the Proposed Rule includes a risk-based portfolio limit that would permit a fund to enter into derivatives transactions if the fund complied with a risk-based limit. Under this limit, immediately after a fund entered into a senior securities transaction, the fund's full portfolio "value-at-risk" or "VaR" would have to be less than the fund's securities VaR and the aggregate exposure of the fund could not exceed 300 per cent of the value of the fund's net assets[45]. In other words, a fund would be able to use the risk-based portfolio limit if its derivatives use reduced rather than magnified market risk[46]. As used in the Proposing Release, "market risk" refers to "the risk of financial loss resulting from movements in market prices, and includes both *general* market risk, which refers to the risk associated with movements in the markets as a whole, and *specific* market risk, which refers to the risk associated with movements in the price of a particular asset."[47] The SEC notes that a

fund that holds only cash, cash equivalents and derivatives (*e.g.*, certain alternative strategy funds and leveraged ETFs) would not be able to satisfy the VaR test because the fund's securities VaR would reflect the VaR of the cash and cash equivalents, and thus would be very low[48].

The Proposed Rule defines "value-at-risk" or "VaR" to mean an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in US dollars, over a specified time horizon and at a given confidence interval[49]. A fund must apply its VaR model consistently when calculating the fund's securities VaR and the fund's full portfolio VaR[50], which are defined as follows:

- "Securities VaR" means the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions[51].
- "Full portfolio VaR" means the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions[52].

The SEC states that its definition of "VaR" is broad enough to encompass most methods of calculating VaR[53]. A fund's VaR model must, however:

1. Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable:
   - equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
   - material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and
   - the sensitivity of the market value of the fund's investments to changes in volatility.
2. Use a 99 per cent confidence level and a time horizon of not less than 10 and not more than 20 trading days.
3. If using historical simulation, include at least three years of historical market data[54].

The SEC states that the "VaR test is designed to serve as a means of limiting a fund's ability to leverage its assets in a manner that would implicate the undue speculation concern in [Section 1(b)(7) of the 1940 Act], but [the VaR test] is not intended as a substitute for other measures that a fund may consider in connection with its derivatives risk management."[55] A consequence of the Proposed Rule's VaR test is that "even if a fund uses VaR for internal risk-management purposes and applies different time horizons to different types of instruments for such purposes, the fund nevertheless would need to select a single holding period for purposes of the VaR test."[56] The SEC recognizes that VaR has limitations as a risk management tool, including "that it does not adequately reflect 'tail risks' (*i.e.*, the size of losses that may occur on the trading days during which the greatest losses occur) . . . [and] . . . may underestimate the risk of loss under stressed market conditions."[57]

Meaning of "exposure" under the Proposed Rule. The Proposed Rule defines "exposure" to mean the sum of the following amounts, as determined immediately after a fund enters into any senior securities transaction:

- the aggregate notional amounts of the fund's derivatives transactions, subject to certain netting provisions;
- the aggregate financial commitment obligations of the fund; and
- the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any senior securities transaction entered into by the fund pursuant to Section 18 or 61 of the 1940 Act without regard to the exemption provided by the Proposed Rule[58].

The SEC recognizes that the notional amount is not a risk measure, and that two funds can have the same aggregate notional exposures but very different risk characteristics. Nonetheless, it considers the use of notional amount measure to be a "more effective and administrable means of limiting potential leverage from derivatives" than other leverage measures that might not be usable for certain funds or strategies[59]. As a consequence, even the notional amount of a derivative used for hedging will be added to the aggregate limit.

Meaning of "notional amount" under the Proposed Rule. The Proposed Rule defines "notional amount," with respect to most derivatives transactions, to mean:

- the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions)[60]; or
- the principal amount on which payment obligations under the derivatives transaction are calculated[61].

The SEC states that the Proposed Rule's definition of notional amount generally would allow a fund to use the calculation methods in the following table to determine the notional amounts of the particular derivatives transactions (before applying any adjustments under the Proposed Rule) for purposes of calculating a fund's exposure under the Proposed Rule[62] (Table I).

For the three types of derivatives transactions described below, however, the Proposed Rule defines "notional amount" in a different manner.

Table I General calculation methods for determining the notional amounts of derivatives transactions

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
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

Leveraged transactions. For any derivatives transaction that provides a return based on the leveraged performance of a reference asset, the notional amount must be multiplied by the leverage factor of the derivatives transaction[63]. The SEC provides the following example: "the [Proposed Rule] would require a total return swap that has a notional amount of $1 million and provides a return equal to three times the performance of an equity index to be treated as having a notional amount of $3 million."[64]

The SEC notes that most of the funds that would be affected by this provision are ETFs operating pursuant to exemptive orders granted by the SEC that provide relief from certain provisions of the 1940 Act other than Section 18[65]. Although the Proposed Rule would apply to leveraged ETFs and inverse ETFs in this manner, the SEC asks for comment on whether it would be more appropriate to consider these ETFs' use of derivatives transactions in the exemptive application context, based on an ETF's particular facts and circumstances, rather than in the context of the Proposed Rule[66]. Alternatively, the SEC asks for comment as to whether a higher exposure limit would be appropriate for leveraged ETFs (or other funds) that seek to replicate the leveraged or inverse performance of an index[67].

Look-through for certain derivatives transactions. The notional amount of any derivatives transaction where the reference asset is: (a) a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or (b) an index that reflects the performance of such a managed account or entity, must be determined by reference to the fund's pro rata share of the notional amounts of the account or entity's derivatives transactions, which in turn must be calculated in a manner consistent with the requirements of the Proposed Rule[68]. The SEC notes that this provision "would apply to transactions such as swaps on pooled investment vehicles that are formed or operated primarily for the purpose of investing in or trading derivatives transactions, which could include hedge funds, managed futures funds and leveraged ETFs, in order to prevent a fund from entering into a leveraged swap on the performance of shares or other interests issued by such vehicles and thereby indirectly obtain leverage in excess of what the [Proposed Rule] would permit a fund to obtain directly."[69]

As an example of the interaction of the look-through notional amount calculation with the leverage factor notional amount calculation, the SEC explains that if a fund entered into a swap on the performance of a trading entity that in turn entered into a swap that provided a return based on the leveraged performance of an equity index, the notional amount of the equity index would need to be multiplied by the applicable leverage factor, consistent with the method set out in the Proposed Rule, for purposes of calculating the fund's pro rata share of the notional amounts of the trading entity's derivatives transactions in accordance with the Proposed Rule[70].

Complex derivatives transactions. For any "complex derivatives transaction," the Proposed Rule provides that the notional amount would be an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction[71]. The Proposed Rule defines "complex derivatives transaction" to mean any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise:

- is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction (*i.e.*, a path dependent derivative)[72]; or
- is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price[73].

An example of a path dependent derivatives transaction that would be considered "complex" is a barrier option, which has "a payoff that is contingent on whether the price

of the underlying asset reaches some specified level prior to expiration."[74] Another example is an Asian option, which has "a payoff that depends on the average value of the underlying asset from inception until expiration."[75]

An example of a non-linear derivatives transaction that would be considered "complex" is a variance swap, which is "an instrument that allows investors to profit from the difference between the current implied volatility and future realized volatility of an asset [providing for a payoff that] is a function of the difference between current implied variance and future realized variance of the asset."[76]

The SEC states that it is unnecessary to treat standard put and call options as complex derivatives transactions. The method for determining the notional amount for these derivatives serves as an appropriate measure of a fund's exposure for purposes of the Proposed Rule, according to the SEC, "because it generally would result in a notional amount that reflects the market value of an equivalent position in the underlying reference asset for the derivatives transaction."[77]

Asset coverage requirements for derivatives transactions

A fund that enters into derivatives transactions in reliance on the Proposed Rule would be required to maintain an amount of "qualifying coverage assets" designed to enable the fund to meet its obligations arising from such derivatives transactions[78]. The SEC states that "this requirement is designed to address the asset sufficiency concern reflected in [Section 1(b)(8) of the 1940 Act],"[79] as well as the "undue speculation concern reflected in [Section 1(b)(7) of the 1940 Act] to the extent that funds limit their derivatives usage in order to comply with the asset segregation requirements."[80] A fund's board, including a majority of the Independent Directors, must approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets[81].

While the Proposed Rule would require funds to segregate a mark-to-market coverage amount plus a cushion, or risk-based coverage amount, for *all* derivatives transactions, under current market practice funds typically segregate their mark-to-market obligations under derivatives transactions that are contractually required to cash settle and the full notional amount[82] of their derivatives transactions that are contractually required to physically settle, with no required additional cushion. Moreover, the proposed definition of "qualifying coverage assets" would substantially narrow the types of liquid assets that currently may be segregated in accordance with the Merrill Lynch Letter. In support of these proposed changes, the SEC states that funds' current "use of the mark-to-market segregation approach with respect to various types of derivatives, plus the segregation of any liquid asset, enables funds to obtain leverage to a greater extent than was contemplated in Release 10666."[83]

Coverage amount for derivatives transactions. Under the Proposed Rule, a fund would be required to manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets, identified on the books and records of the fund in accordance with the Proposed Rule and determined at least once each business day, with a value equal to at least the sum of the fund's aggregate "mark-to-market coverage amounts" and "risk-based coverage amounts."[84]

Mark-to-market coverage amount. "Mark-to-market coverage amount" means, for each derivatives transaction, at any time of determination, the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time; provided that:

- the fund's mark-to-market coverage amount for derivatives transactions entered into pursuant to a netting agreement, which allows the fund to net its payment obligations with respect to multiple derivatives transactions, may be calculated as the net amount

that would be payable by the fund, if any, for all derivatives transactions covered by such agreement; and

- the fund's mark-to-market coverage amount for a derivatives transaction may be reduced by the value of assets that represent *variation* margin or collateral for the amounts payable with respect to the derivatives transaction[85].

For purposes of this definition, a fund could not reduce its mark-to-market coverage amount by the value of its assets that represent *initial* margin or collateral with respect to a derivatives transaction. The SEC states that it omitted initial margin or collateral for this purpose because initial margin amounts would not be expected to be available to satisfy the fund's variation margin requirements under a derivatives contract absent a default by the fund, and thus the fund would need additional assets to cover these mark-to-market payments[86]. Initial margin or collateral may, however, be used to reduce a fund's risk-based coverage amount, as discussed below.

Risk-based coverage amount. "Risk-based coverage amount" means an amount in addition to the derivatives transaction's mark-to-market coverage amount that represents, at any time of determination, a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. This amount would be determined for each derivatives transaction in accordance with policies and procedures (which must take into account the structure, terms and characteristics of the derivatives transaction and the underlying reference asset) approved by the fund's board of directors, including a majority of the Independent Directors, as provided in the Proposed Rule; provided that:

- the risk-based coverage amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, in accordance with the terms of the netting agreement; and
- the fund's risk-based coverage amount for a derivatives transaction may be reduced by the value of assets that represent initial margin or collateral for the "potential amounts payable by the fund if the fund were to exit the derivatives transaction under stressed conditions."[87]

Qualifying coverage assets for derivatives transactions. The Proposed Rule's definition of qualifying coverage assets would eliminate the current market practice of funds segregating any liquid securities in addition to cash to cover their obligations under derivatives contracts. The Proposed Rule defines "qualifying coverage assets" for derivatives transactions to mean:

- cash and cash equivalents[88]; and
- with respect to any derivatives transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; provided that (i) the total amount of a fund's qualifying coverage assets may not exceed the fund's net assets, and (ii) assets of the fund maintained as qualifying coverage assets may not be used to cover both a derivatives transaction and a financial commitment transaction[89].

Under the Proposed Rule, in contrast with existing Staff guidance, the "particular asset" that could be a qualifying coverage asset would not include a derivative that provides offsetting exposure[90]. Also, the qualifying coverage amount would be determined asset by asset, rather than on a fund's entire portfolio[91].

Limit of total fund assets available to use as qualifying coverage assets. The Proposed Rule would limit the total amount of fund assets available for use as qualifying coverage assets to the fund's net assets[92] in order to, among other things, limit the amount of leverage a fund could obtain through derivatives transactions[93].

Limited netting provisions that differ for the exposure limits and asset coverage requirements for derivatives transactions

Under the Proposed Rule, the ability to net derivatives positions for purposes of applying the exposure limits differs from the ability to net derivatives positions for purposes of determining the amount required for asset coverage.

Ability to net derivatives transactions for purposes of the exposure-based and risk-based portfolio limits. For purposes of applying its exposure limits, the Proposed Rule would allow a fund to net any directly offsetting derivatives transactions that are the *same* type of instrument and have the *same* underlying reference asset, maturity and other material terms, regardless of whether the counterparty is the same[94]. The SEC indicates that such derivatives transactions that are directly offsetting, though they may involve different counterparties, "are an appropriate means to eliminate or reduce market exposure under derivatives transactions" for purposes of the Proposed Rule's exposure limits[95].

The Proposed Rule would not permit funds to offset or "net" positions in the same instrument with the same reference asset, however, if they had different maturities. This means, for example, that long and short exposures to futures contracts traded on the same exchange with the same reference asset would both be required to be counted as exposure if the corresponding long and short futures contracts did not have the same expiration date. The SEC provides the following example: "[a] March 2016 copper futures contract . . . would not directly offset a short position with respect to copper options or April 2016 copper futures."[96]

The SEC notes that it considered whether to reflect the different ways in which funds might use derivatives by excluding from the exposure limit calculation any exposure associated with derivatives transactions that may arguably be used to hedge or cover other transactions[97]. The SEC states, however, that it would be difficult for its Staff and fund compliance personnel to confirm compliance with an exposure standard that would permit a fund to reduce its exposure for purposes of the Proposed Rule for particular derivatives transactions that may be entered into for hedging (or risk-mitigating) purposes, or that may be "cover transactions."[98] The SEC cites an example of a private fund, which was not registered under the 1940 Act, to support its proposition that there are challenges in assessing whether ostensibly hedged positions will perform as intended under future market conditions[99]. The SEC states that the private fund's "exposure on its long and short natural gas positions in August 2006 could have been viewed as balanced or hedged at the time it made the investments, in that the [private] fund reportedly had a net exposure that was much less substantial than the [private] fund's substantial long and short gross exposures."[100] Subsequent losses on certain positions that were not offset by other gains resulted in substantial margin calls on the private fund that it was unable to meet with its available cash[101]. The SEC does not provide a similar example involving a RIC or BDC.

Ability to net derivatives transactions for purposes of asset coverage. Unlike the exposure limits, netting is only permitted for purposes of calculating the mark-to-market coverage amount and the risk-based coverage amount if a fund has entered into a netting agreement with a counterparty that allows the fund to net its payment obligations with respect to multiple derivatives transactions[102]. Limiting the ability to net to where a netting agreement is in place would depart from current market practice. The SEC states that this narrowing aspect of the Proposed Rule is designed to cause the mark-to-market coverage amount to more accurately reflect the fund's current net amounts payable with respect to the derivatives transactions covered by a netting agreement because, absent such a netting agreement, a fund "could be required to tender the full amount payable under all of its derivatives transactions."[103] The risk-based coverage amount may also be determined on a net basis for derivatives transactions that are covered by such a netting agreement[104].

Derivatives risk management program

The Proposed Rule would require each fund that engages in more than a limited amount of derivatives transactions (*i.e.*, aggregate "exposure" exceeds 50 per cent of the value of the fund's net assets)[105], or that uses "complex derivatives transactions," to have a formalized set of policies and procedures reasonably designed to assess and manage the risks associated with its particular use of derivatives[106]. The SEC states that all complex derivatives transactions should be assessed and managed through a formalized risk management program due to their potential for highly asymmetric and unpredictable outcomes[107].

While the SEC acknowledges that many funds already have risk management programs in place, including investment restrictions and disclosures relating to the risks of derivatives, the proposed derivatives risk management program requirement is intended to enhance these existing policies by formalizing the rules for funds that rely on the Proposed Rule[108]. Funds that make only a limited use of derivatives and do not use complex derivatives transactions would not be required to adopt such a formalized program, and could continue to employ their general risk management procedures, provided that they regularly monitor derivatives use to ensure that a formalized program does not become necessary[109].

Required elements of the program. The Proposed Rule would require the formalized risk management program to have policies and procedures reasonably designed to:

1. assess and evaluate the potential risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity and operational risks, as applicable, and any other risks considered relevant;
2. manage the risks associated with the fund's derivatives transactions, including:
   - monitoring whether the fund's use of derivatives transactions is consistent with any investment guidelines established by the fund or the fund's investment adviser, the relevant portfolio limitation applicable to the fund under the Proposed Rule, and relevant disclosure to investors; and
   - informing persons responsible for portfolio management of the fund or the fund's board of directors, as appropriate, of material risks arising from the fund's derivatives transactions.
3. reasonably segregate the functions associated with the program from the portfolio management of the fund; and
4. review and update the program at least annually, including any models (including a review of any VaR calculation models used by the fund during the period covered by the review), measurement tools, or policies and procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time[110].

Program administration and oversight. The day-to-day implementation of the fund's risk management program's policies and procedures would be handled by the derivatives risk manager, subject to the oversight of the fund's board[111]. The board, including a majority of the Independent Directors, would approve the risk manager's designation and the initial risk management program (as well as any material changes to it)[112]. In determining whether to approve the proposed program or any material changes to it, the Proposing Release suggests that the board consider the nature of the fund's derivatives risk exposures and the adequacy of the program to manage those risks in light of recent experiences[113]. The board may consult other experts familiar with derivatives risk, consider best practices used by other funds, and review summaries prepared by the risk manager, legal counsel, or other persons familiar with the program and the relevant derivatives risks in making such a determination[114]. The board would also receive and

review quarterly (or more frequent) written reports from the risk manager that describe the adequacy of the fund's program and the effectiveness of its implementation[115].

While the fund's board, including a majority of the Independent Directors, must approve the risk manager's designation, they need not approve his compensation and he need not be removable from his role only by the board[116].

Requirements for financial commitment transactions

The Proposed Rule includes separate asset segregation and qualifying coverage assets requirements for a "financial commitment transaction," defined by the Proposed Rule 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 private fund's general partner)."[117]

Coverage amount for financial commitment transactions. Under the Proposed Rule, a fund may enter into financial commitment transactions, provided that the fund maintains qualifying coverage assets, identified on the books and records of the fund and determined at least once each business day, with a value equal to at least the fund's aggregate financial commitment obligations[118]. The Proposed Rule defines "financial commitment obligation" to mean "the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction. Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation shall be the value of the asset, determined at least once each business day."[119]

A fund's board, including a majority of the Independent Directors, must approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets for financial commitment transactions[120].

Qualifying coverage assets for financial commitment transactions. The Proposed Rule defines "qualifying coverage assets" to mean the following assets of the fund with respect to financial commitment transactions:

- cash and cash equivalents;
- 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; and
- 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 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 of directors, including a majority of the Independent Directors; provided that (i) the total amount of a fund's qualifying coverage assets may not exceed the fund's net assets, and (ii) assets of the fund maintained as qualifying coverage assets may not be used to cover both a derivatives transaction and a financial commitment transaction[121].

This proposed definition differs from and is somewhat more expansive than the proposed definition of "qualifying coverage assets" for derivatives transactions, which does not include as qualifying coverage assets those assets that are convertible to cash (*e.g.*, liquid assets) or that will generate cash.

As with derivatives transactions, the Proposed Rule would limit the total amount of fund assets available for use as qualifying coverage assets for financial commitment transactions to the fund's net assets[122] in order to, among other things, limit the amount of leverage a fund could obtain through financial commitment transactions[123]. The

Proposing Release included, by way of an example, a fund that has $100 in assets and no liabilities or senior securities but borrows a security in connection with a short sale[124]. If the short sale is "in-the-money" $10, the Proposing Release notes that the fund would have $110 in total assets[125]. The purpose of the limit according to the Proposing Release is to limit the ability of the fund to use the $110 as qualifying coverage assets by requiring the fund to reduce the amount of otherwise available qualifying coverage assets by the amount of the liability from the short sale (*i.e.*, $10 in this example)[126].

Amendments to proposed forms

In the Investment Company Reporting Modernization Release issued in May 2015, the SEC proposed two new reporting forms for registered investment companies, Form N-PORT and Form N-CEN[127]. The Proposing Release includes proposed amendments to these forms.

Amendments to proposed Form N-PORT. Form N-PORT, as initially proposed, would require funds to disclose certain risk metrics, including the portfolio's interest rate risk[128], credit spread risk[129], and delta, which is a measure of the sensitivity of an option's value to changes in the price of the reference asset[130]. As now proposed, Form N-PORT would require certain funds to report additional risk metrics: vega, which provides position-level sensitivity to volatility, and gamma, which enables more precise position-level estimation of sensitivity to underlying price movements[131]. This added requirement would be limited to those funds required by the Proposed Rule to implement a formalized derivatives risk management program[132]. The Proposing Release states that while the SEC recognizes that collecting and reporting these metrics may be burdensome for the affected funds, it believes that many of the funds that would be required to do so already calculate these metrics for internal risk monitoring purposes, and therefore adding the reporting requirement on Form N-PORT would pose only a limited additional cost[133].

Amendments to proposed Form N-CEN. Proposed Form N-CEN would require funds to provide annual census-type information regarding the fund's reliance on certain rules under the 1940 Act[134]. As now proposed, Item 31 of Form N-CEN would require funds to identify which of the two alternative portfolio exposure limitations under the Proposed Rule they relied on during the relevant period[135].

Recordkeeping requirements

The Proposed Rule would also include recordkeeping requirements relating to a fund's compliance with its provisions, including with respect to a fund's selection of a portfolio exposure limitation and its risk management program's policies and procedures, if applicable[136]. Records would have to be kept for five years, the first two years in an easily accessible place[137].

With respect to a fund's selection of a portfolio exposure limitation, the Proposed Rule would require a fund to retain a record of its initial determination, as well as any subsequent changes[138]. The Proposed Rule also would require a fund to retain records of the policies and procedures for maintaining qualifying coverage assets in connection with the asset coverage requirement[139]. These written records must include the mark-to-market and risk-based coverage amounts for each derivatives transaction entered into by the fund and identify the qualifying coverage assets maintained by the fund with respect to the fund's aggregate mark-to-market and risk-based coverage amounts for derivatives transactions, with the amount of each financial commitment obligation associated with each financial commitment transaction entered into by the fund and the qualifying coverage assets maintained by the fund with respect to each financial commitment obligation noted for financial commitment transactions[140].

Additionally, for funds whose use of derivatives triggers the requirement for a formalized risk management program, the Proposed Rule would impose an obligation to maintain records of the policies and procedures approved by the board, along with any changes

thereto, written reports provided to the board and the periodic updates and reviews as required[141].

Effect on existing SEC and staff guidance

The SEC is not currently rescinding Release 10666 or any no-action letters issued by the Staff, and the SEC states in the Proposing Release that funds may continue to rely on Release 10666, Staff no-action letters, and other guidance from the Staff[142]. The SEC states that if it adopts the Proposed Rule, it would rescind Release 10666 and the Staff's no-action letters addressing derivatives and financial commitment transactions[143]. Following this action, funds would only be permitted to enter into derivatives transactions and financial commitment transactions to the extent permitted by, and consistent with the requirements of, the Proposed Rule (as adopted) or Section 18, and for BDCs, Section 61 of the 1940 Act[144].

Transition period

If the Proposed Rule is adopted, the SEC expects to provide a transition period during which funds would be permitted to continue to rely on Release 10666, Staff no-action letters, and other Staff guidance, including with respect to derivatives transactions and financial commitment transactions entered into by a fund after the Proposed Rule's effective date but before the end of any transition period[145]. The SEC requests comment, however, on whether a transition period would be appropriate and, if so, the appropriate amount of time to provide before rescinding Release 10666 and the Staff no-action letters[146].

Notes

1. *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at: www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf (the "Proposing Release").

2. The Proposed Rule would apply to most RICs, including open-end funds (*i.e.*, mutual funds), closed-end funds, exchange-traded funds ("ETFs") and exchange-traded managed funds. The Proposed Rule would not apply to unit investment trusts ("UITs"), including ETFs structured as UITs, because UITs are not subject to Section 18 of the 1940 Act. *See id.* at 80898 n.139.

3. BDCs are subject to the prohibitions and asset coverage requirements of Section 18, as modified by Section 61 of the Investment Company Act of 1940 (the " 1940 Act").

4. *See* Proposing Release at 80884. The SEC states that if a fund's use of derivatives that impose a future payment obligation on the fund were not viewed as involving senior securities subject to appropriate limitations under Section 18 of the 1940 Act, the concerns underlying Section 18, including the undue speculation concern expressed in Section 1(b)(7) of the 1940 Act, would be frustrated. *Id.* at 80891. Section 1(b)(7) declares that "the national public interest and the interest of investors are adversely affected when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities." The SEC also states that a fund's use of derivatives that impose a future payment obligation on the fund implicates the asset sufficiency concern expressed in Section 1(b)(8) of the 1940 Act. *Id.* Section 1(b)(8) declares that "the national public interest and the interest of investors are adversely affected when investment companies operate without adequate assets or reserves."

5. *See Securities Trading Practices of Registered Investment Companies*, Release No. IC-10666 (Apr. 19, 1979) ("Release 10666"). There are more than 30 Staff no-action letters addressing derivatives and financial commitment transactions, including Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "Merrill Lynch Letter") (permitting a fund to cover its obligations with cash or any liquid securities regardless of type) and Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) (providing for alternative forms of asset "cover" positions for funds that sell securities short, purchase and sell futures contracts, purchase and

sell options on specific securities, stock indexes, or interest rate futures contracts, and purchase and sell forward contracts on currencies).

6. Proposing Release at 80912, 80961. The SEC notes that these funds could be offered as a private fund or a public or private commodity pool. *Id.*

7. *See* Commissioner Michael S. Piwowar, *Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies* (Dec. 11, 2015), available at: www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html ("Piwowar Statement").

8. Specifically, Commissioner Piwowar does not support the exposure limitations and formalized risk management program requirements in the Proposed Rule because (i) "the proposed asset segregation requirements should function as a leverage limit on funds and ensure that funds have the ability to meet their obligations arising from derivatives [and] absent data indicating that a separate specified leverage limit is warranted there is no justification for imposing any additional requirements or burdens on funds," and (ii) the timing of the proposal is not appropriate "given other recently proposed or adopted rules that address derivatives or funds' use of derivatives," which "will either have a direct impact on the risks of derivatives positions held by funds, or will provide us with data that could be used to better understand how we should regulate this market." Piwowar Statement. The other SEC initiatives referenced by Commissioner Piwowar are included in the following proposals: *Investment Company Reporting Modernization*, Release No. IC-31610 (May 20, 2015), available at: www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf (the "Investment Company Reporting Modernization Release"); *Revisions of Guidelines to Form N-1A, Release No. IC-18612 (Mar. 12, 1992); Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, Release No. IC-31835 (Sept. 22, 2015), available at: www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf. According to Commissioner Piwowar, the SEC should first complete the Title VII rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act and study the rules' effectiveness before proposing comprehensive new requirements governing funds' use of derivatives. Piwowar Statement.

9. *See* Proposing Release at 80953-54.

10. *Id.* at 80899.

11. Proposed Rule 18f-4(c)(2).

12. Proposing Release at 80899.

13. Proposed Rule 18f-4(c)(4). The SEC states that funds often refer to agreements under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company as "unfunded commitments." Proposing Release at 80900.

14. Proposing Release at 80900 n.147.

15. *Id.* at 80900. The SEC also notes that the Staff has expressed the view that "a mutual fund should not have on loan at any given time securities representing more than one-third of its total asset value." *See id.* and n.149 (citing The Brinson Funds, SEC No-Action Letter (Nov. 25, 1997)).

16. *See* Proposed Rule 18f-4(a)(5)(i).

17. *See* Proposing Release at 80952.

18. The SEC notes that these funds could be offered as a private fund or a public or private commodity pool. *Id.* at 80912, 80961. Operating as a private fund or private commodity pool would require a fund to limit its investors to those that at least meet the "accredited investor" standard in the rules under the Securities Act of 1933 (the " 1933 Act"). RICs, which are often dually registered under the 1933 Act and the 1940 Act, and public commodity pools, which are registered under the 1933 Act but are not subject to the investor protection provisions of the 1940 Act, can be sold to retail and institutional investors. The SEC also notes that the Staff has observed that certain of the funds that may not be able to comply with the 150 per cent exposure limitation "often do not make significant investments in securities and the securities

investments they do make generally do not meaningfully contribute to their returns." *Id.* at 80912.

19. As further explained below, the Proposed Rule requires more complex calculations of the notional amount a fund is exposed to for the following derivatives transactions: (A) derivatives transactions that provide a return based on the leveraged performance of a reference asset, (B) derivatives transactions for which the 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 managed account or entity, and (C) "complex derivatives transactions" as defined under the Proposed Rule. *See* Proposed Rule 18f-4(c)(7)(iii).

20. The Proposed Rule would include aggregate indebtedness (and, with respect to any closed-end fund or BDC, the involuntary liquidation preference of preferred stock) with respect to any senior securities transaction entered into by the fund pursuant to Section 18 or 61 as part of the fund's "exposure" to senior securities transactions. Proposed Rule 18f-4(c)(3)(iii). The term "senior security" when used in Section 18 does not include any "promissory note or other evidence of indebtedness where such a loan is for temporary purposes only and in an amount not exceeding five percent of the value of the total assets of the [fund] at the time the loan is made." *See* Section 18(g) of the 1940 Act.

21. Proposed Rule 18f-4(c)(6).

22. Proposed Rule 18f-4(c)(9).

23. *See* Proposing Release at 80967 ("In addition, the proposed asset segregation requirements may benefit investors by eliminating the existing practice by some funds (under existing [Staff] guidance) to segregate for certain derivatives transactions (*e.g.*, derivatives that permit physical settlement), the notional amount. . . . The [Proposed Rule] would benefit investors by requiring funds to evaluate their obligations under a derivatives transaction – including by considering future potential payment obligations represented by the derivative's risk-based coverage amount – rather than segregating assets equal to either a derivative's notional value or a mark-to-market liability based solely on the type of derivative involved, as under the current approach.").

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

25. Proposing Release at 80906.

26. Proposed Rule 18f-4(c)(6)(i); Proposed Rule 18f-4(c)(9)(i).

27. Proposing Release at 80927.

28. Proposed Rule 18f-4(b)(1) and (c)(5). Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation would be the value of the asset, determined at least once each business day. Proposed Rule 18f-4(c)(5).

29. *See* Merrill Lynch Letter.

30. Proposed Rule 18f-4(a)(4).

31. The Proposed Rule defines "complex derivatives transaction" to mean any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise is (i) dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction (*i.e.*, a path dependent derivative), or (ii) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price. *See* Proposed Rule 18f-4(c)(1).

32. Proposed Rule 18f-4(a)(4)(ii).

33. Proposing Release at 80943.

34. *See* Commissioner Luis A. Aguilar, *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#_ednref33

35. Proposed Rule 18f-4(a)(5)(i).

36. Proposed Rule 18f-4(c)(10).

37. Proposing Release at 80924.

38. *Id.* at 80924, 80961-62.

39. *Id.* at 80925. As an example involving the exposure-based portfolio limit, the SEC explains that if a fund's exposure was initially 140 per cent but subsequently increased to 160 per cent solely due to losses in the value of the fund's securities portfolio, the fund would not be required to unwind its senior securities transactions in order to bring its exposure below 150 per cent. If the fund entered into any new senior securities transaction, however, then immediately after entering into such transaction, the fund would be required to be in compliance with the 150 per cent exposure limit. *Id.* at 80925 n.320.

40. Proposed Rule 18f-4(a)(1)(i). Temporary borrowings are not senior securities for purposes of Section 18. *See supra* n.20.

41. Proposing Release at 80910. Section 18 requires 300 per cent asset coverage for borrowings or indebtedness incurred by RICs. The SEC recognizes that this reasoning for the 150 per cent exposure limit is not consistent with the 200 per cent asset coverage requirement for BDCs in Section 61, and seeks comment on whether the Proposed Rule should provide BDCs with greater exposure limits in recognition of the greater latitude that BDCs have to issue senior securities under Section 61. *Id.* at 80913.

42. *Id.* at 80910.

43. *Id.* at 80912.

44. *Id.* at 80913.

45. Proposed Rule 18f-4(a)(1)(ii).

46. Proposing Release at 80916.

47. *Id.* at 80916 n.249.

48. *Id.* at 80911 n.223; *id.* at 80924 n.314 and accompanying text. In such a case, the SEC states that "the fund's derivatives, in aggregate, generally would add to, rather than reduce, the fund's exposure to market risk and thus generally would not result in a full portfolio VaR that is lower than the fund's securities VaR, as required under the [risk-based portfolio limit]." *Id.*

49. Proposed Rule 18f-4(c)(11).

50. Proposed Rule 18f-4(c)(11)(i)(C).

51. Proposed Rule 18f-4(c)(11)(i)(A). Although the Proposed Rule uses the term "securities VaR," the SEC states that some instruments that a fund could hold, and that would need to be included in the fund's securities VaR, may not be "securities" for all purposes under the federal securities laws. As an example, the SEC notes that a fund's securities VaR would include: (i) any direct holdings of non-US currencies, and (ii) derivative instruments that do not entail a future payment obligation for a fund (and thus are not "derivatives transactions" as defined in the Proposed Rule), such as most purchased options. *See* Proposing Release at 80916 n.253.

52. Proposed Rule 18f-4(c)(11)(i)(B).

53. Proposing Release at 80920.

54. Proposed Rule 18f-4(c)(11)(ii).

55. Proposing Release at 80919.

56. *Id.* at 80922.

57. *Id.* at 80918.

58. Proposed Rule 18f-4(c)(3). *See supra* n.20.

59. Proposing Release at 80903.

60. Proposed Rule 18f-4(c)(7)(i).

61. Proposed Rule 18f-4(c)(7)(ii).

62. Proposing Release at 80902.

63. Proposed Rule 18f-4(c)(7)(iii)(A).

64. Proposing Release at 80903.

65. *Id*. at 80912. The SEC states in the Proposing Release that these ETF applicants did not seek, and their orders do not provide, any exemption from the requirements of Section 18, noting that the Proposed Rule would prohibit leveraged ETFs from obtaining exposure in excess of the Proposed Rule's exposure limits. *Id*. at 80912 n.226.

66. *Id*. at 80913.

67. *Id*.

68. Proposed Rule 18f-4(c)(7)(iii)(B); Proposing Release at 80904.

69. Proposing Release at 80904.

70. *Id*. at 80904 n.174.

71. Proposed Rule 18f-4(c)(7)(iii)(C).

72. Proposed Rule 18f-4(c)(1)(i).

73. Proposed Rule 18f-4(c)(1)(ii).

74. Proposing Release at 80904.

75. *Id*.

76. *Id*. at 80905. "Because variance is the square of volatility, the payment obligations under a variance swap are non-linear." *Id*.

77. *Id*.

78. *Id*. at 80925.

79. *Id*. at 80891, 80925.

80. *Id*. at 80925.

81. Proposed Rule 18f-4(a)(5)(ii).

82. The SEC notes that the "notional amount of a derivatives transaction does not necessarily equal, and often will exceed, the amount of cash or other assets that a fund ultimately would likely be required to pay or deliver under the derivatives transaction." Proposing Release at 80899.

83. *Id*. at 80893.

84. Proposed Rule 18f-4(a)(2).

85. Proposed Rule 18f-4(c)(6).

86. Proposing Release at 80928.

87. Proposed Rule 18f-4(c)(9).

88. Examples of items cited by the SEC as commonly considered to be cash equivalents include certain Treasury bills, agency securities, bank deposits, commercial paper and shares of money market funds. Proposing Release at 80932.

89. Proposed Rule 18f-4(c)(8).

90. Proposing Release at 80933.

91. *Id.* at 80932.

92. Proposed Rule 18f-4(c)(8).

93. Proposing Release at 80934, 80957.

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

95. Proposing Release at 80906.

96. *Id.*

97. *Id.* at 80909.

98. *Id.* As recognized by the SEC in the Proposing Release, the Proposed Rule differs from the exposure limits that apply to UCITS funds (*i.e.*, Undertakings for Collective Investments in Transferable Securities, which are public funds sold in Europe). UCITS funds generally are subject to an exposure limit of 100 per cent of net assets, but are not required to include exposure relating to certain hedging transactions. If the Proposed Rule is adopted in its current form, advisers to UCITS funds and to U.S. registered funds will thus be left with two divergent calculations to perform.

99. *Id.* at 80896-97.

100. *Id.* at 80896.

101. *Id.*

102. Proposed Rule 18f-4(c)(6)(i) and (c)(9)(i). A fund that has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions may include the net amount that would be payable by the fund, if any, with respect to all derivatives transactions covered by the netting agreement when calculating the mark-to-market coverage amount. Proposed Rule 18f-4(c)(6)(i). In addition, a fund's mark-to-market coverage amount for a derivatives transaction may be reduced by the value of assets that represent variation margin or collateral to cover the fund's mark-to-market loss on a transaction, but not initial margin or collateral. *See* Proposed Rule 18f-4(c)(6)(ii).

103. Proposing Release at 80927.

104. Proposed Rule 18f-4(c)(9)(i). In contrast to determining the mark-to-market coverage amount, a fund's risk-based coverage amount may be reduced by the value of assets that represent initial margin or collateral in connection with such derivatives transactions. *See* Proposed Rule 18f-4(c)(9)(ii).

105. Proposing Release at 80936. The 50 per cent exposure condition would include exposure from derivatives transactions entered into in reliance on the Proposed Rule, but would not include exposure from financial commitment transactions or other senior securities transactions entered into pursuant to Section 18 or 61 of the 1940 Act. *See id.* at 80937.

106. Proposed Rule 18f-4(a)(3) and (a)(4). *See* Proposing Release at 80935; *see also* Proposing Release at 80938-39 (explaining that the program should be tailored to the fund's particular use of derivatives, with funds using significant amounts of derivatives and complex derivatives having more in-depth programs than those using a more minimal amount).

107. Proposing Release at 80938.

108. *Id.* at 80935.

109. Proposed Rule 18f-4(a)(3). Proposing Release at 80935; *see also* Proposing Release at 80936-37. Under the Proposed Rule, any fund that engaged in even a single derivatives transaction would be required to segregate qualifying coverage assets at least once each business day and track exposure to ensure that the fund's derivatives transactions did not exceed 50 per cent of the fund's net assets and that the fund did not enter into any complex derivatives transactions without having established such a program. Therefore, any fund engaging in derivatives transactions in any capacity

would be required to have a derivatives monitoring and management program, even if the Proposed Rule's formalized program requirement did not apply.

110. Proposed Rule 18f-4(a)(3)(i). This review would be required at least annually, but more often if the fund's use of derivatives necessitates a more frequent review. In addition, the risk management program would need to be reviewed whenever the fund changed its approach to derivatives transactions, or if market conditions surrounding derivatives were to result in a rapid or significant increase in related risks. Proposing Release at 80943.

111. Proposing Release at 80944.

112. Proposed Rule 18f-4(a)(3)(ii).

113. Proposing Release at 80944.

114. *Id.* at 80944-45.

115. Proposed Rule 18f-4(a)(3)(ii)(B); Proposing Release at 80945.

116. Proposing Release at 80943-44. In these respects, the appointment of a designated risk manager would be different from that of a chief compliance officer. *See* Rule 38a-1(a)(4).

117. Proposed Rule 18f-4(c)(4).

118. Proposed Rule 18f-4(b)(1).

119. Proposed Rule 18f-4(c)(5).

120. Proposed Rule 18f-4(b)(2).

121. Proposed Rule 18f-4(c)(8).

122. *Id.*

123. Proposing Release at 80946-47, 80957.

124. *Id.* at 80946-47.

125. *Id.*

126. *Id.*

127. *See* Investment Company Reporting Modernization Release.

128. *See* Item B.3.a of proposed Form N-PORT.

129. *See* Item B.3.b of proposed Form N-PORT.

130. *See* Item C.11.c.iii.1 of proposed Form N-PORT.

131. *See* Item C.11.c.viii of proposed Form N-PORT. Funds would be required to provide the gamma and vega for options and warrants, including options on a derivative, such as swaptions. Proposing Release at 80952.

132. Proposing Release at 80952; *see supra* n.106 and accompanying text.

133. Proposing Release at 80952, 80991-92.

134. *See* Investment Company Reporting Modernization Release; Item 31 of proposed Form N-CEN.

135. Proposing Release at 80952; Items 31(k) and 31(l) of proposed Form N-CEN.

136. Proposed Rule 18f-4(a)(6).

137. *Id.* These records must show that the fund was in compliance with its selected portfolio exposure limitation immediately after entering into any senior securities transaction and include the fund's aggregate exposure, value of the fund's net assets and, if applicable, full portfolio VaR and securities VaR. Proposing Release at 80950.

138. Proposed Rule 18f-4(a)(6)(i).

139. Proposed Rule 18f-4(a)(6)(ii).

140. Proposed Rule 18f-4(a)(6)(v) and (b)(3)(ii).

141. Proposed Rule 18f-4(a)(6)(iii). These records would need to be maintained for at least five years after the end of the fiscal year in which the documents were put into effect or provided, as applicable, the first two years in an easily accessible place. Proposing Release at 80950.

142. Proposing Release at 80953.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.* The SEC asks whether a compliance period of 18 months for larger entities and 30 months for smaller entities would be appropriate, and whether longer transition periods should be provided for certain types of funds.

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