CLIENT ALERT

The SEC Re-Proposes Derivatives Rule for Registered Investment Companies and BDCs

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AUTHORS

P. Georgia Bullitt | Benjamin J. Haskin | Margery K. Neale | P. Jay Spinola

On November 25, 2019, the Securities and Exchange Commission ("SEC") re-proposed Rule 18f-4 (the "Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act"), which would regulate the use of derivatives and other transactions involving leverage by mutual funds (other than money market funds), exchange-traded funds ("ETFs"), registered closed-end funds and business development companies ("BDCs") (together, "funds").[1] The Rule represents a significant change from the long-standing approach currently relied on by funds to enter into derivatives and other leveraged transactions not structured as borrowings, which is founded on "segregation" by funds of liquid assets sufficient to "cover" their obligations under the instruments (or entry by funds into certain offsetting transactions). The Rule reflects feedback received by the SEC from the industry on a 2015 rule proposal regarding the use of derivatives and other leveraged transactions by funds (the "2015 Proposal")[2] and the view of the SEC that the current asset segregation framework "may not address investor protection concerns that underlie [Investment Company Act] Section 18's limitations on funds' issuance of senior securities."[3]

1 *See* Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Rel. No. 34-87607; IC-33704 (Nov. 25, 2019), *available* here (the "Proposing Release"). The Rule would not apply to unit investment trusts.

2 *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015).

3 Proposing Release at 11.

Executive Summary of Proposed Rules

The Rule, as well as related proposed reporting requirements for funds, and proposed sales practices rules for broker-dealers and registered investment advisers regarding Leveraged/Inverse Investment Vehicles (defined below)[4] (together, the "Proposed Rules") include the following key features:

- **VaR Based Limits on Fund Leverage** – The Rule would provide an "exemption" for funds entering into derivative transactions from the prohibitions of Section 18 of the Investment Company Act (or, with respect to BDCs, Section 61 of the Investment Company Act) if a fund complies with a designated Value-at-Risk ("VaR")-based test and implements a comprehensive risk management program.[5] Generally, funds entering into derivatives (unless excepted by the Rule) would be required to ensure each business day that the VaR of the fund's portfolio does not exceed 150% of the VaR of a designated reference index. If a fund's risk manager were 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 the fund's full portfolio would not be allowed to exceed 15% of the value of the fund's net assets. The Rule would except from the VaR limit requirements Limited Derivatives Users as well as Leveraged/Inverse Funds (each as described below).

- **Limited Derivatives User Exception –** A fund that either limits its "derivatives exposure"[6] to 10% of its net assets or uses derivatives transactions solely to hedge certain currency risks (a "Limited Derivatives User") would not be required to comply with the VaR-based limits or to test for compliance with those limits. In addition, it would not be required to adopt a formalized derivatives risk management program ("Program") or appoint a derivatives risk manager (a "Risk Manager"). A Limited Derivatives User would, however, still be required to adopt and implement policies and procedures that are reasonably designed to manage the fund's derivatives risks.

- **Derivatives Risk Management Program** – Funds that engage in derivatives transactions (other than Limited Derivatives Users) would be required to adopt a Program. As part of the Program, the fund would be required to appoint a Risk Manager, who would be required to be approved by, and to have a reporting line to, the fund's board of directors or board of trustees (the "Fund Board"). A fund's Program would be required to include a

[4] The sales practices rules are proposed under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the Investment Advisers Act of 1940, as amended (the "Advisers Act") and are applicable to broker-dealers and registered investment advisers accepting orders from retail customers and clients for Leveraged/Inverse Investment Products, which include leveraged and inverse ETFs ("Leveraged/Inverse ETFs") and other leveraged and inverse funds, as described below.

[5] The Rule would define "VaR" or "Value-at-Risk" as "an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level . . . ." *See* proposed Rule 18f-4(a).

[6] "Derivatives exposure" is defined as "the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short."

number of features, including risk guidelines, stress testing, back testing, internal reporting and escalation, and Program review elements.

- **Role of the Fund Board** – The Fund Board would be responsible for actively overseeing a fund's compliance with the Rule. Responsibilities would include approval of the designation of a Risk Manager, evaluation of regular reports regarding the effectiveness of the Program, and oversight of compliance by the fund with the Program, including oversight of the investment adviser's remediation of exceedances of VaR-based limits.

- **Additional Reporting Items** – Form N-PORT would be amended to require funds to publicly report derivatives exposure and detailed information regarding VaR levels and compliance with VaR-based limits. Any fund that is subject to a VaR-based limit also would be required to report breaches of the applicable VaR-based limits to the SEC on Form N-LIQUID (which would be retitled as Form N-RN) unless the breaches were remediated within three business days. Form N-CEN would be amended to require a fund to identify in this non-public SEC filing whether the fund relied on the Rule during the reporting period and whether it relied on any of the exceptions from certain of the Rule's requirements, along with other related information.

- **Reverse Repurchase Agreements** – Reverse repurchase agreements and similar financing transactions, including securities lending transactions that are viewed as increasing leverage for a fund,[7] would be treated as borrowings and would be subject to the asset coverage tests of Investment Company Act Section 18 and, for BDCs, Investment Company Act Section 61. Unlike the treatment of other borrowings by open-end funds under Investment Company Act Section 18(f), however, open-end funds would not be limited to entering into these transactions only with banks.

- **Treatment of Unfunded Commitment Agreements** – Unfunded commitment agreements (*i.e.*, a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the private fund's general partner) would not be treated as derivatives transactions under the Rule. Instead, under the Rule, a fund would be permitted to enter into unfunded commitment agreements if it reasonably believed, at the time it entered into any such agreement, that it would have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case, as they came due. In establishing its reasonable belief regarding the sufficiency of the Fund's assets to meet future obligations with respect to unfunded commitment agreements, a fund would be required to consider obligations and not count as available to satisfy such obligations: (i) any proceeds of

[7] According to the Proposing Release, securities lending transactions should not be viewed as a "similar financing transaction" so long as the fund that lent out its securities reinvests cash collateral received in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, or, if the fund receives non-cash collateral, the fund does not sell or otherwise use the non-cash collateral to leverage itself. *See* Proposing Release at 224-226.

investment liquidations at prices that significantly differ from the market value of the investments; or (ii) funding to be obtained by issuing additional equity.

- **Elimination of Asset Segregation and Rescission of SEC Release 10666** – The SEC proposes to rescind its prior guidance regarding entry by funds into specified types of leveraged transactions that may involve the issuance of a "senior security" in reliance on asset segregation, as set forth in its 1979 SEC General Statement of Policy,[8] and to ask the SEC staff to review and consider rescinding related no-action letters. In contrast to the 2015 Proposal, the Rule would not treat asset segregation as a means to avoid issuance of a "senior security" by a fund entering into a derivatives transaction.

- **Leveraged/Inverse Funds and Leveraged/Inverse Investment Vehicles** – Leveraged and inverse investment companies, including ETFs ("Leveraged/Inverse Funds"), would be excluded from the VaR-based limits, provided that the applicable fund: (i) discloses in its prospectus that it is not subject to the limits; and (ii) does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of its relevant underlying index. In addition, broker-dealers taking orders to buy or sell Leveraged/Inverse Funds or listed commodity- or currency-based trusts or funds[9] that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple ("Leveraged/Inverse Investment Vehicles") for retail customers would become subject to proposed new Exchange Act Rule 15l-2, and registered investment advisers taking orders to buy or sell such instruments for retail clients would become subject to proposed new Advisers Act Rule 211(h)-1 (together, the "Sales Practices Rules"). The Sales Practices Rules would require these intermediaries to approve a retail customer's or retail client's account for investment in a Leveraged/Inverse Investment Vehicle, subject to a determination, following due diligence, that the customer or client has knowledge and experience sufficient to evaluate the risks associated with the instrument. Subject to compliance with the 300% index return limit and application of the Sales Practices Rules, new Leveraged/Inverse ETFs would become eligible to rely on recently adopted Rule 6c-11 under the Investment Company Act.[10]

8 Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] ("SEC Release 10666").

9 To be a Leveraged/Inverse Investment Vehicle, a fund, other than a Leveraged/Inverse Fund, must be: "a trust or other person: (1) issuing securities in an offering registered under the Securities Act of 1933 and which class of securities is listed for trading on a national securities exchange; (2) the assets of which consist primarily of derivative instruments that reference commodities or currencies, or interests in the foregoing; and (3) that provides in its registration statement under the Securities Act of 1933 that a class of its securities are purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets." *See* proposed Exchange Act Rule 15l-2(d) and proposed Advisers Act Rule 211(h)-1(d).

10 Proposing Release at 35. *See generally* Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019) ("ETF Rule Adopting Release") [84 FR 57162 (Oct. 24, 2019)], *available* here. *See also* Willkie Client Alert, Oct. 29, 2019, *available* here.

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The Proposed Rules

1. Definition of "Derivatives Transaction"

The Rule would define 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 margin or settlement payment or otherwise; and

- Any short sale borrowing.

Unlike the SEC's 2015 Proposal, the definition of derivatives transaction in the Rule would include short sale borrowings. The Proposing Release explains the characterization of a "short sale" as a derivative as follows: "[t]he value of a short position is . . . derived from the price of another asset, *i.e.*, the asset sold short," and "a short sale of a security provides the same economic exposure as a derivatives instrument, like a future or swap, that provides short exposure to the same security."[11] The Proposing Release notes that firm and standby commitment agreements would also be "derivatives transactions" because they fall within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the Investment Company Act."[12]

The Proposing Release characterizes derivatives transactions as "senior securities" and suggests that compliance with the Rule would be required to exempt the funds entering into such transactions from the requirements of Section 18 and Section 61 of the Investment Company Act. The types of derivatives transactions that are described as implicating the "senior security" definition are those "that create future payment obligations."[13] By contrast, prior SEC guidance was less conclusive regarding the status of derivatives and other leveraged transactions, as "senior securities" and, notwithstanding that the SEC concluded these types of transactions incorporated "evidences of indebtedness,"[14] it was

[11] *See* Proposing Release at 42.

[12] *See id.* at 20 and 42. The Proposing Release refers to prior guidance on "standby commitment agreement" as "a delayed delivery agreement in which the investment company contractually binds itself to accept delivery of a Ginnie Mae with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated date." The Proposing Release describes a firm commitment agreement as having the same economic characteristics as a forward contract.

[13] *Id.* at 22 ("As was the case for trading practices that Release 10666 describes, where the fund has entered into a derivatives transaction and has such a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18.").

[14] *See* SEC Release 10666 at 25128.

not clear that entry into these transactions would implicate the statutory provision of Section 18 or Section 61 of the Investment Company Act.

2. Portfolio Limits for Derivatives Transactions

Limits on Fund Leverage Risk

A fund that engages in derivatives transactions and is not within an exception would be required to comply with a relative VaR test, under which the fund must compare the VaR of the fund's portfolio to the VaR of an appropriate "designated reference index" selected by the fund's Risk Manager (the "Relative VaR Test"). If the Risk Manager is unable to identify an appropriate designated reference index, the fund must, in the alternative, comply with an absolute VaR test (the "Absolute VaR Test") under which the fund must compare the VaR of the fund's portfolio to its net assets and ensure that the VaR of the portfolio does not exceed 15% of net assets. The tests must be calculated daily and be applied to the fund's entire portfolio.[15] Notably, the two tests differ significantly from the two alternative tests in the 2015 Proposal.[16]

In the Proposing Release, the SEC acknowledges existing risk literature critiques of VaR,[17] but indicates that it selected VaR-based limits in part because VaR calculation tools are "widely available" and already used by fund managers, including those managing UCITS funds.[18] The SEC also notes that other components of the Program could mitigate any shortcomings of reliance on VaR as a measurement tool.[19] The SEC requests comment on whether aspects of the proposed VaR approach should be modified (*e.g.*, to align with the relative VaR threshold of 200% applicable to funds

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15 The Proposing Release does not provide guidance on how a fund should comply with the requirement to select a designated benchmark index (or the VaR-based limits) where the fund is a multi-manager fund and multiple independent investment advisers manage separate sleeves of the fund pursuant to different strategies.

16 Under the 2015 Proposal, a fund that engaged in derivatives transactions for reasons other than, or in addition to, limiting portfolio risk, would have been required to ensure, immediately after entering into any derivatives or other senior securities transaction, that the fund's aggregate "exposure" to senior securities transactions, including derivatives, did not exceed 150% of the value of the fund's net assets. Funds that entered into derivatives solely to limit portfolio risk would have been required, immediately after entering into a senior securities transaction, to ensure that the fund's VaR would be less than the fund's securities' VaR and that the aggregate exposure of the fund did not exceed 300% of the value of the fund's net assets.

17 *See* Proposing Release at 93-94 (describing common critiques of VaR to include: (i) the fact that it does not reflect the size of losses that may occur during trading days on which the greatest losses occur; and (ii) the fact that VaR calculations may underestimate the risk of loss under stressed market conditions).

18 *Id.* at 256. *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, CESR/10-788 (July 28, 2010), *available* here.

19 Proposing Release at 94-95 (". . . the proposed rule would require a fund to establish risk guidelines and to stress test its portfolio as part of its risk management program in part because of concerns that VaR as a risk management tool may not adequately reflect tail risks. . . A fund that adopts a derivatives risk management program under the proposed rule would have to consider these risks as part of its derivatives risk management program.").

under the European regulation)[20] or replaced with a different approach.[21] The Proposing Release notes that the SEC expects that firms that manage both funds and UCITS "would likely experience efficiencies in implementing the proposed VaR test" in light of the similarities between the tests.[22]

As discussed below, subject to compliance with specified conditions, Limited Derivatives Users and Leveraged/Inverse Funds would not be subject to the VaR-based limits.

Relative VaR Test – Summary

A fund would satisfy the proposed Relative VaR Test if the VaR of the fund's entire portfolio does not exceed 150% of the VaR of its designated reference index. A "designated reference index" would be defined as an "unleveraged index" that reflects the markets or asset classes in which the fund invests. Registered closed-end funds and BDCs, which are permitted to issue senior securities in the form of both debt and preferred stock under Section 18 and Section 61 of the Investment Company Act, as applicable, would be subject to the same "unleveraged index" requirement as open-end funds, which are not permitted to issue senior securities under Section 18 (other than bank borrowings).[23] Although the term "unleveraged index" is not defined in the Rule, the Proposing Release uses as an example of a "leveraged index" (and, as a result, ineligible to be a "designated reference index") "an index that tracks 200% of the performance of the S&P 500."[24] It is not clear, however, whether an "unleveraged index" could also include an index consisting of leveraged instruments, such as futures or credit default swaps.

A fund's designated reference index could not be administered by an organization that is an affiliated person of the fund, its investment adviser or its principal underwriter, or be created at the request of the fund or its investment adviser, unless, in each case, the index is widely recognized and used.[25] The designated reference index must also qualify as an "appropriate broad-based securities market index" or an "additional index" as those terms are defined in Item 27 of Form

20 *Id.* at 279 n.519.

21 *See id.* at 96.

22 *Id.* at 116 and 279 n.519.

23 The Proposing Release acknowledges that closed-end funds and BDCs are not currently required to disclose a benchmark index for comparing the fund's performance but suggests that a closed-end fund might include such benchmark in its Management's Discussion of Fund Performance and a BDC could include the index in its required line graph disclosure included in Form 10-K. *See id.* at 102-103.

24 *Id.* at 101 ("For example, an equity fund might select as its designated reference index an index that tracks a basket of large-cap U.S. listed equity securities such as the S&P 500. But the fund could not select an index that is leveraged, such as an index that tracks 200% of the performance of the S&P 500.").

25 In the case of a fund that uses a blended index, the Rule would require that none of the indexes that comprise the blended index be administered by an organization that is an affiliated person of the fund, its investment adviser or its principal underwriter, or created at the request of the fund or its investment adviser, unless in each case the index is widely recognized and used. *See id.* at 99 n.190.

N-1A (including blended indexes).[26] For funds, such as open-end funds, that are required to show performance in comparison to a benchmark, the Rule does not require that the selected benchmark be used as the designated reference index.[27]

A fund would be required to disclose its designated reference index in its annual report, together with its performance benchmark.[28] A fund's Risk Manager would be required to assess the continuing appropriateness of the fund's designated reference index at least annually.

Absolute VaR Test - Summary

If a fund's Risk Manager were not able to identify an appropriate designated reference index, the fund would be required to comply with the Absolute VaR Test. Under the Absolute VaR Test, a fund must ensure that the VaR of the fund's entire portfolio not exceed 15% of the value of the fund's net assets.

Model and Parameters for All VaR Testing

The Rule would require that the VaR-based limits be calculated using a VaR model having a 99% confidence level and a time horizon of 20 trading days and be based on at least three years of historical market data.[29] The Rule would also

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26 These terms are used in the Management's Discussion of Fund Performance required by Item 27(a) (7) of Form N-1A. This item requires a fund, in its registration statement, to "[p]rovide a line graph comparing the initial and subsequent account values at the end of each of the most recently completed 10 fiscal years of the fund (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. Assume a $10,000 initial investment at the beginning of the first fiscal year in an appropriate broad-based securities market index for the same period." For purposes of that instruction, the term "appropriate broad-based securities market index" means an index that is administered by an organization that is not an affiliated person of the fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used. The instruction in Form N-1A regarding an "additional index" describes other possible indexes that may be used for comparative purposes as part of the Management's Discussion of Fund Performance as follows: "A Fund is encouraged to compare its performance not only to the required broad-based index, but also to other more narrowly based indexes that reflect the market sectors in which the Fund invests. A Fund also may compare its performance to an additional broad-based index, or to a non-securities index (*e.g.*, the Consumer Price Index), so long as the comparison is not misleading."

27 For a discussion of the requirement that an open-end fund show performance in comparison to a benchmark index, *see* Item 27(b)(7)(ii) of Form N-1A. In the Proposing Release, the SEC seeks comment on whether funds anticipate that they would use their benchmark index as a designated reference index under the Rule. *See* Proposing Release at 453.

28 A fund would not be required to disclose its designated reference index in its annual report if the fund is a "New Fund" as defined in Form N-1A (or would be a "New Fund" if it were filing on Form N-1A) at the time the fund files the annual report. *See* proposed Rule 18f-4(c)(2)(iv).

29 A fund could use either an overlapping (*i.e.*, rolling) or non-overlapping approach to determining the relevant 20-trading day periods. *See* Proposing Release at 121.

require that the VaR model incorporate all significant, identifiable market risk factors associated with the fund's investments, including the following:

- 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 the 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.

The Proposing Release suggests that a fund could use a different VaR model when calculating the VaR of the fund's portfolio from that used to calculate the VaR of the designated reference index so long as both models satisfy the Rule's basic requirements. The Proposing Release notes: ". . . under the proposed approach, in many cases a fund could calculate the VaR of a designated reference index based on the index levels over time without having to obtain access to more-detailed information about the index constituents," which may be more cost-effective.[30] A fund would also be able to obtain the VaR for its designated reference index from a third-party vendor.

Testing and Remediation

Under the Rule, a fund would be required to analyze its compliance with the applicable VaR test at least once each business day. The Rule would not require that funds perform this calculation at a particular time, but the Proposing Release indicates that the applicable time for calculation should be the same each day.[31]

If a fund were to determine that it is not in compliance with the VaR test it has selected, the fund must come back into compliance promptly and within no more than three business days after such determination. In the event that a fund is not in compliance with the applicable VaR test within three business days, then:

- the fund's Risk Manager would be required to report the non-compliance to the Fund Board and explain how and by when (*i.e*., number of business days) the Risk Manager reasonably expects the fund to come back into compliance;
- the Risk Manager would be required to analyze the circumstances that caused the fund to be out of compliance for more than three business days and to update any Program elements as appropriate to address those circumstances; and

[30] *Id.* at 124.

[31] *Id.* at 127. This requirement reflects a change from the 2015 Proposal, which had required a fund to test for compliance each time the fund entered into a transaction.

- the fund would not be permitted to enter into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days (and the requirements in clauses (i) and (ii) have been satisfied).[32]

The Rule would not require a fund that did not come back into compliance within three business days to exit its derivatives transactions or make other portfolio adjustments but, as noted above, the fund would not be allowed to enter into a new derivatives transaction (other than a risk-reducing transaction) after an exceedance until the fund has been in compliance with its VaR limit for three consecutive business days. Because VaR could change significantly during volatile markets, this aspect of the Rule could materially restrict the ability of a fund to meet its investment guidelines, particularly if the fund depends upon derivatives to obtain certain types of market exposure, such as a fund seeking exposure to emerging markets where exposure may only be obtained through derivatives.

A fund that is not able to come back into compliance with its applicable VaR test within three business days would also be required to file a report with the SEC (on a non-public basis) on Form N-LIQUID (as proposed to be amended and renamed Form N-RN) the first business day after the three-day remediation period and again after the fund is back in compliance.

3. Asset Segregation

In contrast to the 2015 Proposal, which would have required a fund relying on the framework proposed at that time, to maintain an amount of "qualifying coverage assets" as part of its compliance with Section 18 and Section 61 of the Investment Company Act, the Rule does not include an asset segregation requirement for funds entering into derivatives. According to the Proposing Release, the Rule's Program requirement is intended to address the same concerns underlying the 2015 Proposal's asset segregation provisions.[33] According to the Proposing Release, the Rule "is designed to provide a framework that [the SEC] believe[s] funds can apply to a broad variety of fund types and derivatives uses without [the SEC] having to specify the operational details that an asset segregation requirement would entail."[34] Upon adoption of the Rule, the SEC intends to rescind SEC Release 10666, which provides the original basis for an asset segregation approach to address senior security concerns in connection with leveraged transactions entered into by funds.[35]

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32 Proposed Rule 18f-4(c)(2)(iii)(A)-(C).

33 *See id.* at 173.

34 *Id.* at 175.

35 *See id.* at 243.

4. Derivatives Risk Management Program

The Rule would require all funds that engage in derivatives transactions,[36] other than funds qualifying as Limited Derivatives Users,[37] to implement a written Program. The Program would be required to include policies and procedures tailored to each fund's specific derivatives risks,[38] including leverage, market, counterparty, liquidity, operational and legal risks, and other risks that the fund's Risk Manager deems material.[39] The Program would also be required to be customized to the fund's investment objectives and risk profile, taking into consideration the way the fund uses derivatives and whether that use increases or reduces portfolio risk, as well as the types of derivatives that a fund uses and the specific risks they pose.

There is no express requirement in the Rule that the Fund Board approve a fund's Program.[40] Nonetheless, since a fund would be required to adopt its Program under the Rule, it appears that Fund Board approval would be required to effectuate such adoption.

Program Administration

A fund's investment adviser and/or its sub-advisers would be required to appoint as Risk Manager an officer or officers who have experience regarding risk management of derivatives, provided that if a single individual is appointed, the Risk Manager may not be a portfolio manager and if a committee is appointed, it may not include as a majority of its members portfolio management personnel. Unlike Rule 22e-4 under the Investment Company Act, which contemplates that the investment adviser may be appointed as the liquidity risk manager to oversee the liquidity risk management program, the Rule would require that the Risk Manager be either a single individual or a committee. Under the Rule, a Risk Manager may delegate to third party vendors functions relating to the administration of a fund's Program, such as responsibility for calculating the VaR of the fund's designated reference index, but third party vendors (other than personnel of sub-advisers) would not be permitted to act as the Risk Manager for a fund. The Risk Manager would be required to be

[36] Although Leveraged/Inverse Funds would be exempt from compliance with the VaR-based limits (subject to compliance with specified conditions), these funds would be required to implement a written Program and to appoint a Risk Manager.

[37] Proposed Rule 18f-4(c)(6)(i)(D) would require a fund that is a Limited Derivatives User to maintain a written record of its policies and procedures that are reasonably designed to manage its derivatives risk. These records would be intended to help "[the SEC] staff to understand what policies and procedures that a limited derivatives user has adopted and implemented to address the risks associated with its use of derivatives." Proposing Release at 240-241.

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

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

[40] The absence of an express requirement of Fund Board approval of a Program is different from the approach reflected in Rule 22e-4 under the Investment Company Act (liquidity risk management programs) and Rule 38a-1 under the Investment Company Act (compliance procedures and practices).

approved by the Fund Board (including a majority of its independent directors) and to have a direct reporting line to the Fund Board.[41]

The Risk Manager would be responsible for:

(i) selection of a designated reference index for the Relative VaR Test;

(ii) recommendation of compliance with the Absolute VaR Test when the Risk Manager is unable to identify an appropriate designated reference index;

(iii) administering and maintaining the Program;

(iv) selecting the appropriate VaR model to be used in connection with the Relative VaR Test, the Absolute VaR Test and any other VaR-based test used under the Program;

(v) providing a written report annually to the Fund Board regarding the basis for the designated reference index or, if applicable, an explanation of why the Risk Manager was unable to identify a designated reference index;

(vi) periodically, and at least annually, reporting to the Fund Board regarding the material risks arising from the fund's derivatives transactions (including those identified by the fund's exceedances of criteria, metrics and thresholds developed under the risk guidelines related to a fund's derivatives risk and included in the Program), as well as on the implementation and effectiveness of the Program and the results of the fund's stress testing and back testing;

(vii) at least annually, providing a representation to the Fund Board that the Program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the Program; and

(viii) establishing stress testing requirements for the Program, including establishing extreme but plausible market conditions to use for the corresponding shock level.

In addition, when a fund is not in compliance with its applicable VaR-based limit, the Risk Manager would be required to:

(i) within three business days of such exceedance, explain to the Fund Board how and by when the Risk Manager reasonably expects the fund will come back into compliance;

(ii) develop a specific course of action for the fund to come back into compliance; and

[41] Proposed Rule 18f-4(c)(1), (2) and (5).

(iii) analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any Program elements to address these circumstances.

All functions performed by the Risk Manager would be required to be reasonably segregated from the fund's portfolio management functions.[42] Neither the Proposing Release nor the Rule addresses how the risk management oversight by a Risk Manager should be allocated between the primary investment adviser and any sub-adviser, although the Rule would allow a fund's investment adviser to delegate the function to a sub-adviser.

<u>Program Elements</u>

Each Program would be required to include the following elements:

- *Risk identification and assessment* of a fund's derivatives risks, taking into account the fund's derivatives transactions and other investments.[43] Derivatives risks that must be identified and managed include leverage, market, counterparty, liquidity, operational and legal risks, as well as any other risks the Risk Manager deems material to the fund.[44]

- *Risk guidelines,* to be developed by the Risk Manager and the fund's risk management team, that provide appropriate quantitative and measurable criteria, metrics, or thresholds that a fund should not exceed and provide for measures that the fund would be required to take in case it exceeds these thresholds.[45]

- *Weekly or more frequent stress testing* of derivatives risks to evaluate potential losses to a fund's portfolio under stressed conditions.[46] This is intended to complement the proposed VaR-based limits[47] and serve as an additional risk management tool to evaluate potential losses to the fund's portfolio as a result of extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio.[48] The stress testing would be required to take account of liquidity, volatility, yield curve shifts,

[42] The Proposing Release states that portfolio managers may be conflicted when addressing risk management issues because their compensation may be based in part on the fund's returns. The Proposing Release clarifies, however, that this requirement is not meant to impose a communications "firewall" between the Risk Manager and portfolio management and acknowledges the importance of open communication between the Risk Manager and portfolio management. *See* Proposing Release at 50.

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

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

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

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

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

[48] Proposing Release at 65.

sector movements or changes in the price of the underlying reference security or asset, as well as payments to counterparties.[49]

- *Daily back testing* of the fund's VaR calculation model that the fund would be using at a 99% confidence level and over a one-day time horizon.[50] To monitor and assess the effectiveness of the VaR model it applies, a fund would be required to back test the results of its Relative VaR Test or Absolute VaR Test each business day to compare its actual gain or loss for that business day with the VaR the fund had calculated for that day.[51] This requirement was not included in the 2015 Proposal.

- *Internal reporting and escalation* of material risks arising from the fund's derivatives transactions to the fund's portfolio management team and the Fund Board.[52] The Risk Manager would be required to inform, in a timely manner, portfolio management and the Fund Board of material risks and would be expected to communicate directly to the Fund Board, if appropriate. The written Program would need to identify the "material risks" and other circumstances under which the Risk Manager would need to communicate with portfolio management and the Fund Board.[53]

- *Periodic review of the Program*, at least annually, to evaluate the Program's effectiveness and to reflect changes in risk over time.[54] The Rule would require the Risk Manager to review the Program overall, including each of the specific Program elements and the VaR test used by the fund.[55] The periodic review would include an assessment of the VaR calculation model and the designated reference index, to evaluate whether the Program remains appropriate or whether the selected VaR test or any designated reference index would need to be updated. Such reviews would be required to be undertaken at least annually.

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49 *Id*.

50 Proposed Rule 18f-4(c)(1)(iv).

51 *Id*.

52 Proposed Rule 18f-4(c)(1)(v).

53 Proposed Rule 18f-4(c)(1)(v)(A). The Proposing Release notes that a fund's Program may provide that the Risk Manager update portfolio management on a regular and frequent basis, or require automated updates to portfolio management of exceedances or stress tests. *See* Proposing Release at 73-74.

54 Proposed Rule 18f-4(c)(1)(vi).

55 *See* proposed Rule 18f-4(c)(2).

5. Role of the Fund Board

The Fund Board would be responsible for overseeing the Program, including by appointing the Risk Manager and by receiving periodic reports. While the Rule does not change the scope or nature of a Fund Board's duties, the Proposing Release comments on the role of Fund Board oversight:

> "Board oversight should not be a passive activity. Consistent with that view, [the SEC] believe[s] that directors should understand the program and the derivatives risk it is designed to manage as well as participate in determining who should administer the program. They should also ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation. . . *[T]he board should inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including as those risks may change over time.* To facilitate the board's oversight, the proposed rule. . . would require the fund's derivatives risk manager to provide reports to the board.[56]
>
> *A fund's board would also be responsible for overseeing a fund's compliance with proposed rule 18f-4.* Rule 38a-1 under the Investment Company Act requires a fund's board, including a majority of its independent directors, to approve policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers. Rule 38a-1 provides for oversight of compliance by the fund's adviser and other service providers through which the fund conducts its activities. Rule 38a-1 would encompass a fund's compliance obligations with respect to proposed rule 18f-4." (Emphasis added).[57]

<u>Fund Board Approval of the Risk Manager</u>

The Fund Board (including a majority of its independent directors) would be required to approve the designation of the Risk Manager, taking into consideration the individual's relevant experience regarding management of derivatives risk.[58] The person selected to serve as Risk Manager would be required to have "relevant experience regarding derivatives risk management" to ensure that the Risk Manager is "well-positioned to manage" the "potential complex and unique risks that derivatives can pose to funds."[59]

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[56] Proposing Release at 80.

[57] *Id. See also* Rule 38a-1(a)(2) and Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204, 68 FR 74714 (Dec. 24, 2003).

[58] The requirement for approval of the Risk Manager by the Fund Board is consistent with the requirement under Rule 22e-4 that the Fund Board approve an open-end fund's administrator of its liquidity risk management program, as well as the requirement for Fund Board approval of the chief compliance officer under Rule 38a-1. *See* Investment Company Act Rule 22e-4(b)(2)(ii) and Rule 38a-1(a)(4)(i), respectively.

[59] Proposed Release at 49.

<u>Fund Board Reporting</u>

The Risk Manager would be required to provide to the Fund Board or a committee of directors designated by the Fund Board, on or before the implementation of the Program and at least annually thereafter, a written report that includes a representation that the Program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the Program, as well as the basis for the representation.[60] The representation must be based on the Risk Manager's reasonable analysis after due inquiry, including receipt of input from a fund's portfolio management. Following the initial implementation of the Program, the Risk Manager's report must address the effectiveness of the Program. The Risk Manager must also include in the report to the Fund Board: (i) an explanation of the basis for selecting the designated reference index, or (ii) an explanation as to why a designated reference index was not appropriate.

The Risk Manager would also be required to provide to the Fund Board, at a frequency to be determined by the Fund Board, a separate, written report analyzing exceedances of the fund's risk guidelines and the results of the fund's stress tests and back testing.[61] The purpose of the risk guidelines and stress testing requirements under the Program is to address derivatives risks specific to the fund and require routine monitoring. The back testing requirement is intended to ensure that a fund monitors and assesses the effectiveness of the VaR model applied by the fund. The Proposing Release notes that providing regular reports that include this analysis would be necessary for the Fund Board to perform its oversight function.[62]

6. Limited Derivatives Users

The Rule excepts from the proposed Program requirement and VaR-based limits funds that qualify as Limited Derivatives Users.[63] To rely on the exception, a fund would be required to fall within one of the following two categories:

- the fund's "derivatives exposure" does not exceed 10% of its net assets; or
- the fund limits its use of derivatives transactions to currency derivatives for hedging purposes.[64]

For purposes of the first exception, "derivatives exposure" is defined as the sum of a fund's derivatives instruments, measured on the basis of their notional value and, in the case of short sale borrowings, the value of the asset sold short. In calculating the notional amount of interest rate derivatives, a fund would be allowed to convert the value of the

60 Proposed Rule 18f-4(c)(5)(ii).

61 Proposed Rule 18f-4(c)(5)(iii); *see also* proposed Rule 18f-4(c)(1)(ii)–(iv).

62 *See* Proposing Release at 87.

63 Proposed Rule 18f-4(c)(3).

64 *Id.*

derivative to the value of an equivalent 10-year bond. The Proposing Release does not explain how such a conversion would be carried out.[65] A fund would also be permitted to delta adjust the notional amounts of options contracts for purposes of this exception.[66] The Rule does not prescribe the frequency with which a fund must calculate its derivatives exposure to evaluate its continued eligibility for the exception.

Under the second exception, a fund would qualify as a Limited Derivatives User if its derivatives use is limited to instruments that hedge foreign currency risk associated with specific equity or fixed-income instruments in the fund's portfolio. The notional amount of the currency derivatives may not exceed the value of the equity or fixed-income instruments "by more than a negligible amount," which term is not defined.[67] The Proposing Release notes that such currency hedges do not raise policy concerns underlying Section 18 as they "are not intended to leverage the fund's portfolio" and would "mitigate potential losses."[68]

A fund relying on this exception would be required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risk.

7. Reverse Repurchase Transactions and Similar Transactions

The Rule would exclude reverse repurchase transactions[69] and "similar financing transactions" from the definition of "derivatives transaction," but, in a significant departure from current practice, would treat them as "senior securities" for purposes of Section 18 and Section 61 of the Investment Company Act, similar to bank borrowings.[70] As a result, a

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65 For a discussion of how such conversion might be conducted and why it would be recommended, *see* Comment Letter of Amundi Smith Breeden Asset Management to the 2015 Proposal, *available at https://www.sec.gov/comments/s7-24-15/s72415-70.pdf*.

66 *See* Proposing Release at n.276 ("Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta.").

67 Proposed Rule 18f-4(c)(3)(ii). In request for comment 162 in the Proposing Release, the SEC asks: "Should we provide further guidance on what a negligible amount would be? For example, should we provide guidance or provide in rule 18f-4 that exceedances of 1% or 2%, for example, would be negligible?"

68 Proposing Release at 165.

69 A reverse repurchase transaction is defined in the Proposing Release as a transaction under which "a fund transfers a security to another party in return for a percentage of the value of the security [and then on] an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest." *Id.* at 224.

70 The Proposing Release notes that reverse repurchase transactions "have the economic effects of a secured borrowing, and thus more closely resemble bank borrowings." *See id.* at 225. As the Proposing Release explains, although SEC Release 10666 concludes that reverse repurchase agreements, as well as firm commitment agreements and standby commitment agreements fall within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the Investment Company Act," SEC Release 10666 relies on the use of "segregated accounts" to "cover" obligations under these transactions and to "limit the investment company's risk of loss." Proposing Release at 20 n.35 and accompanying text and citing 2015 Proposing Release, at nn. 45-47 and accompanying text (discussing SEC Release 10666's discussion of segregated accounts).

registered open-end fund entering into such transactions would be subject to the 300% asset coverage ratio required by Section 18(f)(1); a registered closed-end fund entering into such transactions would be subject to the 300% asset coverage ratio required by Section 18(a); and a BDC would be subject to an asset coverage ratio of 200% or 150%, as provided by Section 18(a) and Section 61 of the Investment Company Act, respectively.[71] A fund would be required to combine the aggregate amount of indebtedness associated with any reverse repurchase agreement or similar financing transaction with the aggregate amount of any other senior securities representing indebtedness (other than derivatives transactions and unfunded commitment agreements that comply with the Rule) when calculating the asset coverage ratio.[72]

The Proposing Release indicates that securities lending arrangements could be deemed to be "similar financing transactions" and, therefore, senior securities, if they are used to leverage a fund's portfolio.[73] The Proposing Release states that a securities lending arrangement would not be viewed as a transaction that is similar to a reverse repurchase agreement, if the fund receives cash collateral and invests such cash collateral solely in "highly liquid, short-term investments, such as money market funds or other cash or cash equivalents" or receives non-cash collateral which it does not sell or otherwise use to leverage the fund's portfolio.[74]

The Proposing Release states that the treatment of any other particular instrument as a "similar financing transaction" will depend upon the particular facts and circumstances.[75] The Proposing Release references "to be announced" dollar rolls, "when issued" transactions and tender option bonds as examples of transactions that may, under some circumstances, constitute financing transactions similar to a reverse repurchase transaction.[76] The Proposing Release notes that a fund would be expected to treat a transaction that the fund determines, based on the particular facts and circumstances, to be

[71] *See* Section 61(a)(1) of the Investment Company Act. BDCs, like registered closed-end funds also may issue a senior security that is a stock (*e.g.*, preferred stock), subject to limitations in Section 18 and Section 61. *See* Sections 18(a)(2) and 61(a)(1) of the Investment Company Act. In 2018, Congress passed the Small Business Credit Availability Act, which, among other things, modified the statutory asset coverage requirements applicable to BDCs (permitting BDCs that meet certain specified conditions to elect to decrease their effective asset coverage requirement from 200% to 150%). *See* section 802 of the Small Business Credit Availability Act, Pub. L. No. 115-141, 132 Stat. 348 (2018).

[72] Proposing Release at 225–226.

[73] *See id.* at 226.

[74] *See id.* at 226-227 ("Currently, funds that engage in securities lending typically reinvest cash collateral in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, and funds generally do not sell or otherwise use non-cash collateral to leverage the fund's portfolio. We believe a fund that engages in securities lending under these circumstances is limited in its ability to use securities lending transactions to increase leverage in its portfolio.").

[75] *See id.* at 227.

[76] *See id.* at 227-228.

similar to a reverse repurchase agreement, in accordance with the requirements applicable to reverse repurchase transactions.[77]

8. Unfunded Commitment Agreements

The Rule defines “unfunded commitment agreement” as “a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund’s general partner.”[78] Unfunded commitment agreements would not include firm and standby commitments, but, like derivatives and reverse repurchase agreements, would be treated as “senior securities” for purposes of Section 18 (or Section 61, in regard to BDCs) of the Investment Company Act, and thus, permissible only in accordance with an exception.[79] Under the proposed exception provided under the Rule, a fund would be permitted to enter into unfunded commitments (*e.g.*, such as by making a capital commitment to a private fund), only if the fund reasonably believes, at the time it enters into any such unfunded commitment, that it would have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due. A fund engaging in unfunded commitment agreements would be required to maintain records documenting the basis for concluding its assets would be sufficient to meet its obligations with respect to all unfunded commitment agreements.[80] In establishing its reasonable belief regarding the sufficiency of the fund’s assets to meet the fund’s obligations with respect to an unfunded commitment agreement, a fund would be required to consider other obligations, including those relating to senior securities and redemptions, and not count as available to satisfy such obligations: (i) any proceeds of investment liquidations at prices that significantly differ from the market value of the investments, or (ii) funding to be obtained by issuing additional equity.

9. Fund Reporting and Disclosure Requirements

The SEC is proposing to amend reporting requirements for registered funds that would rely on the Rule. As a result of the changes, registered closed-end funds and BDCs and open-end funds, other than Limited Derivatives Users and Leveraged/Inverse Funds that are excepted from the VaR-based limits, would be required to file Form N-LIQUID (renamed Form N-RN) to report exceedances of the VaR-based limits. The SEC is also proposing amendments to Forms N-CEN and N-PORT for registered funds (but not BDCs) to require information regarding a fund’s derivatives risk. The Proposing Release notes that the SEC had considered requiring BDCs to provide equivalent information in their annual reports but decided that such reporting was unnecessary because BDCs are not significant users of derivatives.

[77] *Id*.

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

[79] *See* Proposing Release at 230-231.

[80] Proposed Rule 18f-4(e)(2).

Proposed Amendments to Form N-PORT

The Proposed Rules would amend Form N-PORT to include a new reporting item relating to a fund's "derivatives exposure" (measured on a notional basis, although a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts) as of the end of the reporting period. Under the proposal, a fund that is not a Limited Derivatives User would also be required to report the following information on Form N-PORT relating to the proposed VaR-based limits:

- the fund's highest daily VaR during the reporting period and its corresponding date;
- the fund's median daily VaR for the monthly reporting period;
- for funds subject to the Relative VaR Test during the reporting period, the name of the fund's designated reference index and the index identifier;
- for funds subject to the Relative VaR Test during the reporting period, the fund's highest daily VaR ratio (*i.e.*, the value of the fund's portfolio VaR divided by the VaR of the designated reference index) during the reporting period and its corresponding date; and
- for funds subject to the Relative VaR Test during the reporting period, the fund's median daily VaR ratio for the reporting period.

A fund that is subject to the proposed VaR tests also would be required to report the number of exceptions the fund identified during the reporting period as a result of back testing the fund's VaR calculation model. This information and information regarding a fund's derivatives exposure as of the end of the applicable reporting period would be made publicly available on a delayed basis on the same basis as all other information filed on Form N-Port.[81]

[81] All registered management investment companies, other than registered money market funds and small business investment companies, are (or will be) required to electronically file with the SEC, on a quarterly basis, monthly portfolio investment information on Form N-PORT, as of the end of each month. As of April 30, 2019, larger fund groups (defined as having $1 billion or more in net assets) began submitting reports on Form N-PORT for the period ended March 31, 2019. Smaller fund groups (defined as having less than $1 billion in net assets) will begin submitting reports on Form N-PORT by April 30, 2020. Only information reported for the third month of each fund's fiscal quarter on Form N-PORT is publicly available (60 days after the end of the fiscal quarter). *See* Proposing Release at 207 n.360.

Proposed Amendments to Form N-LIQUID

Closed-end funds and BDCs, in addition to open-end funds, that are subject to the VaR-based limits under the Rule would be required to file Form N-LIQUID, which would be retitled Form N-RN.[82] Under the Proposed Rules, a fund subject to the VaR-based limits that falls out of compliance with its VaR-based test without coming back into compliance within three business days thereafter, would be required to file a report on Form N-RN providing specified information regarding the breach. The form amendments would not change the obligations of open-end funds in respect to reporting breaches arising from Investment Company Act Rule 22e-4 or subject registered closed-end funds or BDCs to Investment Company Act Rule 22e-4.[83]

For funds that are subject to the Relative VaR Test, the fund would be required to report:

- the dates on which the fund portfolio's VaR exceeded 150% of the VaR of its designated reference index;
- the VaR of its portfolio for each of these days;
- the VaR of its designated reference index for each of these days;
- the name of the designated reference index; and
- the index identifier.

For funds that are subject to the Absolute VaR Test, the fund would be required to report:

- the dates on which the fund portfolio's VaR exceeded 15% of the value of its net assets;
- the VaR of its portfolio for each of these days; and
- the value of the fund's net assets for each of these days.

A fund would have to report this information within one business day following the third business day after the fund has determined that its portfolio VaR exceeds 150% of its designated reference index VaR or 15% of the value of its net

[82] Currently, only open-end funds that are not regulated as money market funds under Rule 2a-7 under the Investment Company Act are required to file current reports on Form N-LIQUID, under Section 30(b) of the Investment Company Act and Rule 30b1-10 thereunder. The Proposed Rules, including proposed amendments to Form N-LIQUID and Rule 30b1-10 and the Rule, would add new VaR-related items to Form N-LIQUID, and would extend the requirement to file current reports with respect to these new items to any fund (including registered open-end funds, registered closed-end funds, and BDCs) that relies on the Rule and that is subject to the Rule's limit on leverage risk. *See id.* at 207 n.360.

[83] *Id.* at 216 n.384 (describing proposed amendments to the instructions to Form N-LIQUID (to be renamed Form N-RN)).

assets, as applicable. In addition, the fund would be required to file a report on Form N-RN when it comes back in compliance with the Relative VaR Test or Absolute VaR Test, as applicable.

Proposed Amendments to Form N-CEN[84]

Form N-CEN would be amended to require a fund (other than a BDC) to identify whether it relied on the Rule during the reporting period and whether it qualified for an exception from the VaR-based limits as a Limited Derivatives User or Leveraged/Inverse Fund. A fund would also be required to identify whether it entered into reverse repurchase agreements or similar financing transactions or unfunded commitment agreements during the reporting period.

Proposed Amendment to Form N-2

Form N-2 would be amended to provide that funds relying on the Rule would not be required to include their derivatives transactions and unfunded commitment agreements in the senior securities table on Form N-2.[85]

10. Recordkeeping

The Rule would include recordkeeping requirements relating to a fund's compliance with the Rule, which would be required to be retained for five years.

Funds subject to the Program requirements, including Leveraged/Inverse Funds, would be required to retain:

- a written record of the fund's policies and procedures designed to manage the fund's derivatives risks; and
- a record of each periodic review of the Program and copies of materials and reports regarding the Program or material derivatives risks provided to the Fund Board.

Funds subject to the VaR-based limits would be required to retain:

- results of the fund's stress tests, results of VaR back testing and records documenting internal reporting and escalations of material risks; and

[84] All registered investment companies, including money market funds but excluding face amount certificate companies, are currently required to file annual reports on Form N-CEN. Form N-CEN requires these funds to report census-type information including reports on whether a fund relied upon certain enumerated rules under the Investment Company Act during the reporting period. BDCs do not file reports on Form N-CEN. *See id.* at 207 n.360.

[85] Instruction 2. to sub-item "3. *Senior Securities*" of "Item 4. Financial Highlights" would be amended in Form N-2, which is referenced in §§239.14 and 274.11a-1. *See id.* at 433-434.

- the fund's daily determinations of the VaR of its portfolio, the VaR of the fund's designated reference index, the fund's VaR ratio, and any updates to the fund's VaR calculation models and the basis for material changes.

A Limited Derivatives User would be required to maintain a record of its written policies and procedures designed to manage the fund's derivatives risks.

Leveraged and Inverse Funds

The Rule excludes Leveraged/Inverse Funds from the obligation to comply with the Relative VaR Test or the Absolute VaR Test, provided that: (i) the fund discloses in its prospectus that it is not subject to the VaR limits provided by the Rule; and (ii) the fund does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index, consistent with the existing exemptive orders for Leveraged/Inverse ETFs. The Proposing Release notes that subjecting Leveraged/Inverse Funds to the VaR-based tests would "preclude sponsors from offering the funds in their current form," which could disadvantage certain investors.[86]

To "preserv[e] choice for these investors," the SEC proposes complementary sales practices rules for offers and sales of shares of Leveraged/Inverse Investment Vehicles to retail investors. The Sales Practices Rules would require broker-dealers and registered investment advisers to establish an approval process for retail customer or client accounts prior to taking an order from a retail customer or client to buy or sell an interest in a Leveraged/Inverse Investment Vehicle. Approval for a retail customer or client account would be required to be based on enhanced due diligence on the retail customer or client and may not be granted unless the broker-dealer or registered investment adviser "has a reasonable basis for believing that the [retail customer or client] has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling [Leveraged/Inverse Investment Vehicles]."[87] The definition of retail customer and retail client would expand the category beyond that covered in Regulation Best Interest and Rule 204-5 under the Advisers Act (*i.e.*, natural persons and their nonprofessional, legal representatives who use a recommendation primarily for personal, family or household purposes) to include natural persons investing or trading as part of a business.[88]

[86] Proposing Release at 181 (suggesting that Leveraged/Inverse ETFs may be useful to investors who are capable of evaluating their characteristics and unique risks to meet specified short-term or other investment goals).

[87] Proposed Rule 15l-2(b)(1) and proposed Rule 211(h)-1(b)(1).

[88] *See* Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019) *available* here, and Willkie Client Alert regarding Regulation Best Interest, June 28, 2019m *available* here. *See also* Form CRS Relationship Summary; Amendments to Form ADV, Exchange Act Release No. 86032 (Jun. 5, 2018) *available* here, and Willkie Client Alert regarding Form CRS and Advisers Act Rule 204-5, July 3, 2019 *available* here. The best interest standard of Regulation Best Interest applies in respect to "retail customers." Exchange Act Rule 15l-1 defines "retail customer" as: "a natural person, or the legal representative of such natural person, who: (i) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) Uses the recommendation

The Proposing Release recommends that broker-dealers and registered investment advisers consider establishing multiple levels of account approvals, with different approval levels for retail investors depending on the leverage multiple embedded in the particular instrument. Broker-dealers and registered investment advisers subject to the Sales Practices Rules would be required to adopt and implement written policies and procedures addressing compliance. The Sales Practices Rules were modeled on rules of the Financial Industry Regulatory Authority, Inc. ("FINRA") applicable to options trading carried out by retail as well as institutional customers.[89]

Broker-dealers and registered investment advisers subject to the Sales Practices Rules would be required to maintain a written record of the information obtained in order to approve retail customer and client accounts and a copy of the related policies and procedures. The records would be required to be maintained for not less than six years (the first two years in an easily accessible place) after the date of the closing of the investor's account. The Sales Practices Rules would not apply to positions in Leveraged/Inverse Investment Vehicles established by retail customers or clients before the compliance date for the Sales Practices Rules to facilitate liquidation or close out of positions by retail investors.

The SEC also proposes to amend Rule 6c-11 under the Investment Company Act to permit the operation of Leveraged/Inverse ETFs without receipt of an SEC exemptive order.[90] This is consistent with statements of the SEC in connection with the adoption of Rule 6c-11 that it would consider exemptive treatment for Leveraged/Inverse ETFs in the context of a broader derivatives rule proposal.[91] The SEC now proposes to allow funds to rely on Rule 6c-11 to operate as Leveraged/Inverse ETFs upon adoption and implementation of the Rule and the Sales Practices Rules.

<u>Transition Periods</u>

The SEC proposes to rescind SEC Release 10666 in connection with the adoption of the Rule. The Proposing Release also states that the SEC staff is reviewing its no-action letters and other guidance addressing derivatives transactions and

primarily for personal, family, or household purposes." Form CRS must be delivered by registered investment advisers to any "retail investor," as defined in Advisers Act Rule 204-5 as: "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes."

89 *See* FINRA Rule 2360 (b)(16) and (17).

90 *See* ETF Rule Adopting Release at 17. As adopted, Rule 6c-11 of the Investment Company Act does not provide relief for Leveraged/Inverse ETFs, defined in Rule 6c-11 as any ETF "that seeks, directly or indirectly, to provide investment returns over a predetermined period of time that: (i) correspond to the performance of a market index by a specified multiple; or (ii) have an inverse relationship to the performance of a market index (including by an inverse multiple)."

91 *Id*. at 30 ("Leveraged/inverse ETFs' use of derivatives also raises issues under section 18 of the Act, which limits a fund's ability to obtain leverage. The Commission has been evaluating these section 18 issues as part of a broader consideration of derivatives use by registered funds and business development companies ('BDCs'). We therefore proposed to exclude leveraged/inverse ETFs from the scope of rule 6c-11 so that the Commission could consider these concerns in a comprehensive manner with other funds that use leverage.")

other transactions covered by the Rule to determine which letters and other staff guidance, or portions thereof, should be withdrawn in connection with any adoption of the Rule.[92]

If adopted, the Rule would have a one-year transition period to provide time for funds to prepare to come into compliance. The SEC similarly proposes a one-year compliance period for the Sales Practices Rules and a one-year delay to the effective date of the amendments to Rule 6c-11 for leveraged/inverse ETFs. Each transition period would run from the date of the publication of any final rule in the *Federal Register*.

Request for Comment

The SEC is soliciting comment on the Proposed Rules and the specific issues discussed in the Proposing Release. The SEC has asked for comment on over 260 separate questions relating to all aspects of the Proposed Rules. The deadline for submitting comments is 60 days from the date of publication of the Proposed Rules in the *Federal Register*.

Conclusion

The Rule represents a significant change of approach from the regulatory framework in place today governing funds' use of derivatives and other types of leveraged transactions that are not structured as borrowings. Historically, the SEC and its staff have taken a principles-based approach to regulating the use of these instruments by funds. Funds have addressed potential senior security concerns regarding exposure and leverage by segregating liquid assets sufficient to "cover" their obligations under the particular instruments or by entering into certain offsetting transactions. The Rule seeks to replace the historical approach with a uniform set of limits on leverage and a variety of compliance conditions imposed on the use of derivatives and similar transactions as well as enhanced reporting, irrespective of whether a transaction is for risk management, asset class exposure or enhanced return. Implementation of the Rule together with the other Proposed Rules may be expected to impose substantial compliance and other costs on funds, including funds eligible to rely on the exception for Limited Derivatives Users. Even those funds would be required to maintain and implement policies and procedures regarding their use of derivatives. Fund managers should review the Rule carefully in light of their current portfolio management practices both to assess costs of compliance and to assess whether the Rule, if adopted, would cause a fund to alter its investment objectives or strategies.

[92] *See* Proposing Release at 243.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

P. Georgia Bullitt	**Benjamin J. Haskin**	**Margery K. Neale**	**P. Jay Spinola**
212 728 8250	202 303 1124	212 728 8297	212 728 8970
gbullitt@willkie.com	bhaskin@willkie.com	mneale@willkie.com	jspinola@willkie.com