

SEC Proposes New Rule Governing the Use of Derivatives by Registered Investment Companies

December 11, 2015

This morning, the Securities and Exchange Commission proposed new measures to govern the use of derivatives by registered investment companies and business development companies (“registered funds”). The summary of these measures below is based on the fact sheet issued by the SEC and available on the SEC’s website [here](#). We will prepare a more detailed summary based on the full proposal, which is available [here](#). Comments on the proposal are due 90 days after its publication in the *Federal Register*.

The proposal would impose restrictions on a registered fund that engages in derivatives transactions. The proposed restrictions would fall into two main categories:

1. Portfolio Limitations. A registered fund would need to comply with one of two alternative portfolio limitations:

- **Exposure-based limit.** The fund’s exposure would be limited to 150% of the registered fund’s net assets, where “exposure” is generally calculated as the aggregate notional amount of the fund’s derivatives transactions, plus its obligations under financial commitment transactions (which include, for example, reverse repurchase agreements, short sale borrowings, and firm and standby commitment agreements) and aggregated indebtedness under senior securities transactions. In calculating exposure, a registered fund may 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.
- **Risk-based limit.** The fund’s exposure (calculated as above) would be limited to 300% of the registered fund’s net assets, but only if its derivatives transactions, in the aggregate, reduce the total VaR of the fund’s portfolio (*i.e.*, the VaR with derivatives must be less than VaR without derivatives).

2. Asset Segregation. A registered fund would need to segregate certain qualifying assets equal to the sum of:

- **Mark-to-market coverage amount.** The amount the fund would need to pay to close out its derivatives at the time of the determination (adjusted for netting under a netting agreement and reduced by variation margin posted by the fund); and
- **Risk-based coverage amount.** A reasonable estimate of the potential amount the fund would pay if the fund exited the derivatives under stressed conditions.

Qualifying assets for purposes of this requirement would generally include cash and cash equivalents.

Financial Commitment Transactions. In addition, a registered fund that engages in financial commitment transactions (such as unfunded commitments) would need to segregate assets equal to 100% of its payment or delivery obligations under these transactions, whether conditional or unconditional.

Formalized Derivatives Risk-Management Program. A registered fund whose derivatives use is not limited under a portfolio limitation to an aggregate exposure of 50% or less of the value of its net assets or

that uses “complex derivatives” (as defined in the proposed rules) must enact a formalized derivatives risk-management program that contains specified components. The program would need to be approved by the fund’s board and be administered by a board-approved derivatives risk manager.

Additional Reporting. The SEC also proposed amendments to two reporting forms, Forms N-PORT and N-CEN, which were proposed by the SEC in May 2015 (but have not yet been finalized). These amendments would require registered funds to provide: information about their derivatives risk management program; additional risk metrics related to derivatives use; and disclosure about which of the portfolio limitations under the proposed rule (as described above) the fund is relying upon.

- ▶ [See a copy of Davis Polk’s September 2, 2011 Client Newsflash on the SEC’s previous concept release on the use of derivatives by registered investment companies.](#)

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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