SEC Proposes New Limits on Registered Funds' Derivatives Use

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Summary

On December 11, 2015, the U.S. Securities and Exchange Commission proposed Rule 18f-4, which would impose new exposure limits, asset segregation requirements, and compliance obligations on registered investment companies and business development companies ("registered funds") that enter into **derivatives transactions** or **financial commitment transactions**. The proposal also would amend previously proposed regulatory reporting forms, Forms N-PORT and N-CEN, to require additional reporting by registered funds about their derivatives activities and financial commitment transactions.

The proposal represents an important shift in the SEC's approach to regulating the use of derivatives and other transactions that give rise to leverage under Section 18 of the Investment Company Act of 1940 (the "Investment Company Act"). The proposal, if adopted, would not only formalize requirements for asset coverage that are, in some respects, the same as, but in many important respects different than, those applicable under Section 18 and current SEC guidance, but would also impose limits on notional exposure of a registered fund arising from derivatives transactions, financial commitment transactions, and other Section 18 senior securities. Taken together, the asset segregation requirement and exposure limits—at a minimum—would require a registered fund that engages in derivatives transactions or financial commitment transactions to evaluate its use of these instruments and would require registered funds that make extensive use of them to modify their current strategies. In addition, the proposal contemplates more board involvement in setting policies and limits regarding a registered fund's use of derivatives transactions.

Comments on the proposal are due March 28, 2016.

Background

Section 18 of the Investment Company Act limits the ability of a registered fund to issue "senior securities," which broadly include instruments that evidence indebtedness of a fund. In 1979, in Release 10666,[1] the SEC provided guidance on the application of the Section 18 limitations on senior

[1] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25,128 (Apr. 27, 1979).

Derivatives transaction means any swap, security-based swap, futures contract, forward contract, option, any combination of the forgoing, or any similar instrument ("derivatives instrument") under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise. This definition is designed to include those derivatives transactions that involve the issuance of a senior security under Section 18 of the Investment Company Act. Transactions that do not give rise to future payment obligations are meant to be outside the scope of this definition.

Financial commitment transaction means 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). This definition is designed to include both funded and unfunded commitments of a registered fund.

securities to repurchase agreements and firm and standby commitment agreements. Since Release 10666, the SEC staff has supplemented this guidance with no-action letters and comments to fund registration statements. Under the current guidance, a registered fund generally may engage in derivatives transactions and financial commitment transactions without being subject to a limit on the level of those transactions, but only if the fund segregates assets sufficient to cover its risk of loss under those transactions. In part due to the ad hoc nature of the guidance provided by the SEC staff following Release 10666, practices vary among registered funds regarding the amounts segregated for different types of transactions. In addition, different types of transactions receive different treatment despite having similar risks of loss. For example, registered funds commonly segregate the full notional amount of a physically settled derivatives transaction but segregate only the mark-to-market value for a cash-settled derivatives transaction. In addition, the types of assets that funds segregate to cover their derivatives and financial commitment transactions range from cash and cash equivalents to equity securities and non-investment grade debt.

In 2011, the SEC issued a concept release that sought public comment on the effectiveness of the existing regulatory framework under the Investment Company Act governing the use of derivatives by registered funds and the benefits, risks, and costs associated with funds' use of derivatives. The current proposal is a follow-up to the concept release.

The proposal notes the significant increase in the volume of derivatives trading of registered funds in the 36 years since Release 10666 and states the SEC's concern that market practice appears to allow greater leverage than intended by Release 10666. The proposal reflects these concerns through the proposed requirements for notional exposure limits on a registered fund's derivatives transactions, financial commitment transactions, and other Section 18 senior securities and the separate asset segregation requirements that apply to the fund's derivatives transactions and financial commitment transactions. If the proposal is adopted, the SEC intends to rescind Release 10666 and the SEC staff's no-action letters addressing derivatives transactions and financial commitment transactions.

Portfolio Exposure Limits

The proposal would require a registered fund that engages in derivatives transactions to meet one of two alternative portfolio limits, based either on the level of a fund's total derivatives exposure or on the level of risk arising from its use of derivatives. The board of directors of a registered fund, including a majority of the independent directors, would need to approve the portfolio limit upon which the fund will rely.

Measuring Exposure

Both alternatives place a threshold on a fund's **exposure**, which is a measure of the fund's aggregate notional exposure to **senior securities transactions**, defined to include derivatives transactions, financial

Notional amount of a derivatives transaction means for any derivatives transaction (subject to the adjustments below):

- 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 positons), or
- the principal amount on which payment obligations under the derivatives transaction are calculated.

Adjustments:

- For any derivatives transaction that provides a return based on the leveraged performance of a reference asset, the notional amount is to be multiplied by the leverage factor.
- For any derivatives transaction 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 a managed account or entity, the notional amount is to be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity.
- For any complex derivatives transaction, the notional amount is 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. A **complex derivatives transaction** is a derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (ii) is a nonlinear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.

commitment transactions, and any other indebtedness under senior securities transactions within the meaning of Section 18 of the Investment Company Act.

Specifically, a registered fund's exposure is the sum of the following amounts, determined immediately after the fund enters into any senior securities transaction:

- The aggregate **notional amount** (as defined in the sidebar) of the fund's derivatives transactions, provided that a fund may net any directly offsetting derivative transactions that are the same type of instrument and have the same underlying reference asset, maturity, and other material terms;

Financial commitment obligation means 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 is the value of the asset, determined at least once each business day.

- The aggregate **financial commitment obligations** of the fund (as defined in the box above); and
- The aggregate indebtedness with respect to any senior securities transactions entered into by the fund pursuant to Section 18 of the Investment Company Act.

The Limits

Alternative One: Exposure-Based Portfolio Limit

A registered fund would be permitted to enter into derivatives transactions, so long as its aggregate exposure is limited to 150% of the value of the fund's net assets.

Alternative Two: Risk-Based Portfolio Limit

A registered fund would be permitted to enter into derivatives transactions so long as:

- its full portfolio VaR is less than its securities VaR, and
- the aggregate exposure of the fund does not exceed 300% of the value of the fund's net assets.

In either case, whether a fund is in compliance with the applicable limit is calculated immediately after it enters into a senior securities transaction; a fund would not be required to unwind a transaction solely because its exposure subsequently increased beyond the applicable exposure limit due to changes in market values.

Calculating VaR. For purposes of the second alternative, the fund's VaR (or "value at risk") is defined to mean an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence interval. The fund's **full**

Mark-to-market coverage amount means, for each derivatives transaction, the amount that would be payable by the fund if the fund were to exit the derivatives transaction at that time. This amount may be calculated as the net amount that would be payable under a netting agreement, with respect to the derivatives transactions covered by the netting agreement. In addition, the amount may be reduced by the value of assets that represent variation margin or collateral posted for the derivatives transaction.

Risk-based coverage amount means, for each derivatives transaction, an amount, in addition to the derivative transaction's 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. This amount must be determined in accordance with policies and procedures which take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset and which are approved by the fund's board of directors. This amount may be calculated as the net amount that would be payable under a netting agreement, with respect to the derivatives transactions covered by the netting agreement. In addition, the amount may be reduced by the value of assets that represent initial margin or collateral posted for the derivatives transaction.

portfolio VaR is the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions. The fund's **securities VaR** is the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions.

The proposal would require both the full portfolio VaR and the securities VaR to be calculated based upon a 99% confidence level and a time horizon of not less than 10, but not more than 20, trading days. Any VaR model used for these calculations would need to take into account all significant, identifiable market risk factors associated with a fund's investments, including (as relevant):

- equity price risk, interest rate risk, credit spread risk, foreign currency 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 investment to changes in volatility.

If a historical simulation is used for these calculations, it must include at least three years of historical market data.

Asset Segregation

The proposal includes asset segregation requirements that apply to a registered fund's derivatives transactions and separately to its financial commitment transactions.

Segregation Requirement

In addition to meeting one of the two alternative portfolio limits described above, a fund that engages in derivatives transactions must maintain **qualifying coverage assets** (described in the chart below) with a value equal to at least the sum of the fund's aggregate **mark-to-market coverage amounts** and **risk-based coverage amounts** under its derivatives transactions, and must identify such assets on its books and records at least once each business day. These amounts (described in the sidebar) are designed to include a fund's current and future potential exposure under those transactions.

A fund that engages in financial commitment transactions must separately maintain qualifying coverage assets with a value at least equal to the fund's aggregate financial commitment obligations (defined in the box on page 3), determined at least once each business day. Thus, a fund would need to segregate the full amount payable under its financial commitment transactions, including both funded and unfunded financial commitment transactions.

Under the proposal, the amount of a fund's qualifying coverage assets cannot exceed its net assets. Thus, assets acquired by a fund through borrowing or other leverage transactions could not be used to increase its available qualifying coverage assets for purposes of the asset segregation requirement. The proposed rule also specifically provides that assets of the fund maintained as qualifying coverage assets cannot be used to cover both a derivatives transaction and a financial commitment transaction.

Qualifying Coverage Assets

The chart below describes the types of assets that are eligible as qualifying coverage assets for the asset segregation requirements for derivatives transactions and financial commitment transactions.

Type of Transaction		Qualifying Coverage Asset		
		Cash and Cash Equivalents*	**Underlying Asset to be Delivered by Fund**	**Asset That Converts to or Generates Cash****
Derivatives transaction	Cash settled	**X**		
	Physically settled	**X**	**X**	
Financial commitment transaction		**X**	**X**	**X**

* **Cash and Cash Equivalents** are commonly considered to include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.

** **Assets convertible to or expected to generate cash** include "highly liquid" assets that could be easily converted to cash and fixed-income securities that mature prior to the date of the financial commitment transaction. A registered fund's board must adopt policies and procedures regarding the determination of which assets meet this definition.

Derivatives Risk Management Program

The proposal would require any registered fund that engages in derivatives transactions and does not comply with the portfolio limitation described below, or that engages in complex derivatives transactions (defined in the sidebar on page 3), to have a formalized derivatives risk management program.

Portfolio Limitation

A fund would not need to put in place a formalized derivatives risk management program if the fund complies, and monitors its compliance, with a portfolio limitation under which:

- immediately after entering into any derivatives transaction the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets; and
- the fund does not enter into complex derivatives transactions.

Elements of the Derivatives Risk Management Program

A registered fund that is subject to this requirement would need to implement a written derivatives risk management program that is reasonably designed to assess and manage the risks associated with the fund's derivatives transactions. The program would need to include policies and procedures designed to address specific aspects of the fund's use of derivatives transactions, described below. The fund would need to designate an employee or officer of the fund or the fund's investment adviser—but who may not be a portfolio manager of the fund—to be responsible for administering these written policies and procedures.

In addition, the proposal would require board oversight of the program, which is described in the following section.

Written Policies and Procedures

A registered fund would need to adopt and implement written policies and procedures that address the following requirements:

- **Assessment of risks** associated with the registered fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity and operational risks, as well as any other risks considered relevant. This assessment must include any idiosyncratic risks, such as legal risks, posed by the specific types of derivatives used by the fund.
- **Management of risks** associated with the fund's use of derivatives. This should include 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 (as described above) upon which the fund is relying, and relevant disclosures to investors. It should also include informing persons responsible for portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions.
- **Segregation of functions** associated with the derivatives risk management program from the portfolio management of the fund. This requirement is based on the view that maintaining separate risk management and portfolio management functions promotes objective and independent risk assessment and serves as a complement and cross-check to portfolio management. The proposal suggests that ensuring the compensation of risk management oversight personnel is not tied to the performance of the fund may be one tool to facilitate this segregation.
- **Periodic review and update** of the risk management program. A review must be undertaken at least annually and must include a review of any models (including any VaR calculation model), measurement tools, or policies and procedures that are part of, or that are used in, the derivatives risk management program, to evaluate their effectiveness and reflect changes in risk over time.

Board Approval and Oversight

The proposal includes extensive requirements for board approval and oversight of a registered fund's use of derivatives transactions, with additional requirements for boards of funds that must have a derivatives risk management program. While registered fund boards may already undertake some of these tasks, the proposal would at a minimum necessitate an evaluation of board responsibilities to ensure full compliance with these requirements.

Under the proposal, a registered fund's board of directors (including a majority of the independent directors) would need to:

- Approve the particular portfolio limit (the exposure-based limit or risk-based limit) with which the fund will comply;
- Approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets as required under the rule; ***and***
- If relevant, approve the portfolio limitations necessary for a fund to be exempt from the derivatives risk management program requirement; ***or***
- If the fund is subject to the derivatives risk management program requirement:
    - Provide initial approval of the fund's derivatives risk management program and any approval of any material changes to the program;
    - Approve the designation (but not the compensation or removal) of the employee or officer of the fund or the fund's investment adviser who is responsible for administering the fund's derivatives risk management program (as described above); ***and***
    - Review, no less frequently than quarterly, a written report prepared by the person responsible for the program and that describes the adequacy of the program and the effectiveness of its implementation.

The board (including a majority of independent directors) of a registered fund that engages in financial commitment transactions would need to approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets as required for those transactions.

Recordkeeping Requirements

The proposal would require a registered fund to maintain in an easily accessible place a written copy of the board-approved policies and procedures required under the rule, including current policies and procedures and any policies and procedures that were in effect within the

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past five years. A fund would need to maintain a written record reflecting, among other things, the coverage amount for each derivatives transaction and the qualifying coverage assets maintained by the fund with respect to its derivatives transactions, as well as the amount of each financial commitment obligation and the associated qualifying coverage assets. These records must be kept for not less than five years, although only two years' worth must be kept in an easily accessible place.

Reporting Requirements

The proposal would amend previously proposed reporting rules (that have not yet been finalized) to require registered funds to report certain additional information relating to their derivatives transactions and treatment under the proposed rules.

- **Form N-PORT** would require, for any registered fund required to report on the form and that is subject to the derivatives risk management program requirement, to report the gamma and vega for options and warrants, including options on a derivative, such as swaptions.
- **Form N-CEN** would require a registered fund that engages in derivatives transactions to identify the portfolio limitation (exposure-based or risk-based) with which it complies.

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