

# SEC Re-Proposes New Rule Governing Registered Funds' Use of Derivatives

January 14, 2020

## Summary

Under proposed Rule 18f-4, a “derivatives transaction” means: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument, under which a fund is or may be required to make any payment of 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 (2) any short sale borrowing. In the Proposing Release, the SEC noted that although short sale borrowings are included in the definition of a “derivative transaction,” other financial commitment transactions, i.e., reverse repurchase agreements and unfunded commitment agreements, are not included in the definition because such transactions are addressed separately under the proposed rule.

In a November 25, 2019 [release](#) (the “**Proposing Release**”), the Securities and Exchange Commission (the “**SEC**”) proposed a substantially revised version of proposed new Rule 18f-4 under the Investment Company Act of 1940, as amended (the “**Investment Company Act**”), which was originally proposed by the SEC on December 11, 2015 (the “**2015 Proposal**”). According to the Proposing Release, proposed Rule 18f-4 would impose requirements on the use of [derivatives transactions](#) and certain other transactions by registered investment companies (other than money market funds and UITs) and business development companies (“**registered funds**”), and is designed to promote the ability of registered funds to use derivatives in a broad variety of ways that serve investors, while still addressing the investor protection concerns underlying Section 18 of the Investment Company Act. The SEC’s proposals outlined in the Proposing Release included notable differences from the 2015 Proposal, including, among other things, removal of the asset segregation requirement and general notional exposure limits, introduction of a fund leverage risk limit based on a registered fund’s value at risk (“**VaR**”) relative to the VaR of a designated reference index (subject to certain exceptions), revised exceptions for registered funds that are limited derivatives users, and modified elements of the written derivatives risk management program that registered funds would be required to adopt (with limited exceptions).

In addition, the SEC proposed alternative requirements for [leveraged/inverse investment vehicles](#), which in most cases, because of their extensive use of derivatives, would be unable to meet the fund leverage risk limits under proposed Rule 18f-4. The alternative framework proposed by the SEC would exclude certain leveraged/inverse investment vehicles from the fund leverage risk limit under the proposed rule, but would impose new sales practices rules, under the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”) and the Investment Advisers Act of 1940, as amended (the “**Investment Advisers Act**”), with respect to the purchase and sale of leveraged/inverse investment vehicles for retail investor accounts. In light of these specific provisions to address leveraged/inverse investment vehicles, the SEC also proposed to amend Rule 6c-11, the new ETF exemptive rule, to permit ETFs that are leveraged/inverse investment vehicles to rely on Rule 6c-11 rather than SEC exemptive orders.

The SEC also proposed amendments to Forms N-PORT, N-LIQUID and N-CEN, which would require a registered fund to report, among other

A “leveraged/inverse investment vehicle” is defined in the Proposing Release as “a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.”

things, certain information regarding its derivatives exposure and testing of its fund leverage risk.

The SEC has requested public comments on the proposals, to be received by the SEC on or before the 60th day after publication of the Proposing Release in the *Federal Register*.

## Key Takeaways

The proposals contained in the Proposing Release are discussed in greater detail below. Some key takeaways of the proposal include:

- Revised fund leverage risk limits for derivatives transactions based on daily testing of a registered fund’s relative VaR, replacing the 2015 Proposal’s asset segregation requirements and general notional exposure limits.
- Apparent loosening of the 2015 Proposal’s extensive board oversight responsibilities with respect to a registered fund’s derivatives risk management program.
- Alternative regulatory framework proposed for leveraged/inverse investment vehicles, including new sales practice requirements for broker-dealers and registered investment advisers.
- In recent remarks relating to the Proposing Release, Democratic Commissioners Jackson and Lee expressed concerns regarding the proposed reduction in the board’s involvement in a registered fund’s use of derivatives, while Republican Commissioners Peirce and Roisman were generally critical of the proposed alternative regulatory framework for leveraged/inverse investment vehicles. As Commissioners from both parties expressed concerns regarding different elements of the proposed new rule, significant modifications may need to be made to the final version of the rule before it can be approved by a majority.

## Background

Section 18 of the Investment Company Act is a protective measure designed to limit the leverage a registered fund can incur through the issuance of “senior securities,” which broadly include instruments that evidence indebtedness. In a 1979 release (“**Release 10666**”),<sup>1</sup> and in no-action letters and comment letters issued since then, the SEC and its staff provided guidance on the application of Section 18 limits to reverse

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

repurchase agreements, firm and standby commitment agreements, various derivative instruments and short sale transactions. 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 liquid assets sufficient to cover its risk of loss under those transactions.

As noted in the Proposing Release, the SEC continues to believe that Section 18 serves the Investment Company Act's fundamental purpose of protecting investors against the potential adverse effects of excessive leverage, which could unduly increase the speculative nature of a registered fund's common shares, and increase the risk that a registered fund may be operating without sufficient assets or reserves to meet its obligations. However, the SEC also expressed its concern, as it did at the time of the 2015 Proposal, that current market practices among registered funds with respect to the use of derivatives may not adequately address the undue speculation and asset sufficiency concerns underlying Section 18. For example, the Proposing Release noted that for cash-settled derivatives, registered funds commonly segregate their mark-to-market liability, as opposed to the notional amount of their potential obligation, which may not reflect the full investment exposure of such positions. In addition, the SEC noted that different interpretations of SEC staff guidance in this area have led to varying practices among registered funds regarding the amounts and types of assets segregated for the same types of transactions. In the SEC's view, disparate market practices may create unfair disadvantages for certain registered funds, and may make it more difficult for a registered fund and SEC staff to evaluate the fund's compliance with Section 18.

To address these concerns, the SEC initially issued the 2015 Proposal, which took a more rigid approach to limiting derivatives use by imposing restrictive asset segregation requirements and limits on a registered fund's notional exposure to derivative transactions and other Section 18 senior securities. Commenters were largely critical of the 2015 Proposal and noted in particular that such requirements could limit the ability of registered funds to use derivatives for non-speculative purposes that benefit investors, such as risk mitigation.<sup>2</sup> In response, the SEC's current proposal replaces the prescriptive approach of the 2015 Proposal with a more flexible approach that recognizes the valuable role that derivatives can play in helping a registered fund to manage risks and achieve its investment objectives efficiently.

As in the 2015 Proposal, the SEC proposed to rescind prior guidance provided in Release 10666 regarding the application of Section 18 to reverse repurchase agreement transactions and firm and standby

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<sup>2</sup> Commissioner Hester M. Peirce and Commissioner Elad L. Roisman, "Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices" (November 26, 2019), <https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices>.

commitment transactions. Consistent with its approach in other areas of the securities laws, including within the Division of Investment Management, the SEC staff is also reviewing previously issued no-action letters to determine whether any such no-action letters should be withdrawn in the event that proposed Rule 18f-4 is adopted.

## Proposed Rule 18f-4 Requirements

Proposed Rule 18f-4 would generally permit registered funds (including business development companies, but not money market funds or UITs) to enter into derivatives transactions, notwithstanding the restrictions under Section 18 of the Investment Company Act, subject to certain conditions as described below.

### Adoption of Derivatives Risk Management Program

A registered fund would be required to adopt a written derivatives risk management program reasonably designed to manage a registered fund's derivatives risks while, as recently seen in other SEC rulemakings, allowing principles-based tailoring to the registered fund's particular risks. The proposed rule would require one or more officers of a registered fund's adviser to administer the derivatives risk management program as the fund's derivatives risk manager. According to the Proposing Release, this requirement is intended to centralize the fund's derivatives risk management function and promote accountability, while allowing the flexibility for a group or committee of officers to serve as a fund's derivatives risk manager, as opposed to a single officer as was required under the 2015 Proposal. The derivatives risk management program must also be designed to reasonably segregate the registered fund's derivatives risk management function from its portfolio management, based on the view that such segregation promotes objective and independent risk assessment, and serves as a check and balance on the fund's portfolio management function. Commenters generally supported a similar segregation requirement in the 2015 Proposal but urged the SEC to permit portfolio managers to provide some input into a fund's derivatives risk management function. In the Proposing Release, the SEC recognized the value of such input and noted that the proposed rule would not require strict communications barriers between the derivatives risk management and portfolio management functions, and would permit a group or committee serving as a registered fund's derivatives risk manager to include the fund's portfolio managers. However, a single portfolio manager for a registered fund would not be permitted to serve as the fund's derivatives risk manager, and if a group or committee serves as the fund's derivatives risk manager, the fund's portfolio managers would not be permitted to be a majority of such group or committee.

The proposed rule would also require a registered fund's derivatives risk management program to include the following elements:

- Identification and assessment of the registered fund's derivatives risks, including leverage risk, market risk, counterparty risk, liquidity

risk, operational risk, legal risk and any other risks that are deemed material by the registered fund's derivatives risk manager (or investment adviser, in the case of a limited derivatives user that is exempt from the requirement to appoint a derivatives risk manager),

- Establishment, maintenance and enforcement of risk guidelines that provide for quantitative or otherwise measurable criteria, metrics or thresholds, and that specify the levels that the registered fund does not normally expect to exceed and the measures to be taken if exceeded,
- Stress testing to be conducted at least weekly to evaluate potential losses to a registered fund's portfolio due to "extreme but plausible market changes" or changes in market risk factors that would significantly adversely affect the fund's portfolio, taking into account correlations of market risk factors, and resulting payments to derivatives counterparties,
- Daily backtesting of the VaR calculation model used by the registered fund to conduct the fund leverage risk limit tests,
- Internal reporting to persons responsible for a registered fund's portfolio management under circumstances that must be specified in the fund's derivatives risk management program, including the results of stress tests conducted under the program and breaches of the risk guidelines established under the program,
- Escalation of material risks arising from a registered fund's derivatives transactions in a timely manner to persons responsible for a registered fund's portfolio management and, if the derivatives risk manager deems it appropriate, to the board of directors, and
- Periodic review of the derivatives risk management program at least annually by a registered fund's derivatives risk manager to evaluate the program's effectiveness and to reflect changes in risk over time, including a review of the VaR calculation model (and its backtesting), and any designated reference index, used by the registered fund to conduct the fund leverage risk limit tests.

## Fund Leverage Risk Limits

### *Use of VaR*

As described in the Proposing Release, proposed Rule 18f-4 would replace the 2015 Proposal's asset segregation requirement and general notional exposure limits with a fund leverage risk limit based on a registered fund's **VaR**. The SEC eliminated the 2015 Proposal's asset segregation requirement because, in the SEC's view, such requirement would be more restrictive and less risk-sensitive than the newly proposed VaR tests as a means to limit fund leverage risk, and may limit a registered fund's ability to enter into derivative transactions that do not raise the concerns underlying Section 18. Similarly, the SEC noted that requiring a notional exposure limit would be a relatively blunt tool that would not differentiate between derivatives transactions that may have the same notional amount but different underlying reference assets with varying levels of risk. Therefore,

For purposes of proposed Rule 18f-4, VaR means 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.

the re-proposed version of Rule 18f-4 introduced a new VaR test (as described below), which the SEC viewed as a more effective means to analyze whether a registered fund uses derivatives for leverage, as opposed to other purposes that do not raise the concerns underlying Section 18.

Like the VaR test alternative that was originally proposed in the 2015 Proposal, the re-proposed Rule 18f-4 would require that any VaR model used by a registered fund to test its compliance with the rule's fund leverage risk limit (as described below) take into account all significant, identifiable market risk factors associated with the fund's investments, including (as relevant):

- equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
- material risks arising from 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 proposed rule would also require such VaR model to use a 99% confidence level and a time horizon of 20 days, which is similar to requirements under the 2015 Proposal (except that the 2015 Proposal would have required a time horizon range of 10 to 20 trading days). In addition, the proposed rule would require such VaR model to be based on at least 3 years of historical market data, which unlike the 2015 Proposal, would apply to all types of VaR models, not just those that use historical simulation. The SEC believed this change to be appropriate because, in the SEC's view, all VaR calculation methods rely on historical data.

#### ***Default Test: Relative VaR***

Under the proposed rule, registered funds that use derivative transactions would be required to comply with a relative VaR test whereby the VaR of the registered fund's portfolio may not exceed 150% of the VaR of a designated reference index, i.e., an unleveraged index selected by the registered fund's derivatives risk manager that reflects the markets or asset classes in which the registered fund invests. The designated reference index is intended to represent a baseline VaR that would approximate the VaR of a registered fund's unleveraged portfolio. By comparing the fund's VaR to the baseline VaR of the designated reference index, the VaR test was designed to limit the extent to which the fund increased its leverage risk through the use of derivatives.

The SEC modified this test from the original relative risk test that appeared as an element of the alternate notional exposure limit in the 2015 Proposal, under which a registered fund's full portfolio VaR would have been required to be less than its "securities VaR," i.e., the VaR of the fund's portfolio excluding derivatives transactions, in order to benefit from a higher notional exposure limit. The SEC noted that a relative risk test based on a fund's securities VaR may not provide an appropriate comparison of risk because some funds that use derivatives extensively may hold primarily cash and

cash equivalents, apart from its derivatives. The SEC noted that in such cases, the fund's securities VaR would be very low because it would be based on the cash and cash equivalents, and would not provide a relevant baseline level of risk associated with the fund's investment strategy.

### ***Alternative Test: Absolute VaR***

If the derivatives risk manager is unable to identify an appropriate designated reference index, the registered fund would be required to comply with an absolute VaR test whereby the VaR of the registered fund's portfolio could not exceed 15% of the value of its net assets.

### ***Implementation***

The SEC recognized the concerns regarding operational complexities raised under the 2015 Proposal, which required testing of the applicable limits immediately after a registered fund entered into a senior securities transaction. To address these concerns, the SEC modified the current proposal to require testing of the applicable VaR test at least once each business day. In the event that a registered fund does not meet the required fund leverage risk limit, the proposed rule would require the fund to come into compliance within three business days, and if the fund is not in compliance within three business days, then the derivatives risk manager must comply with certain board reporting requirements and must review the fund's derivatives risk management program to make updates to the program as necessary. In addition, the fund would not be permitted to enter into any derivatives transactions (other than derivatives designed to reduce the fund's VaR) until the fund had complied with the applicable VaR test for three consecutive business days.

### **Board Oversight and Reporting**

Notably, the proposed rule eliminated the 2015 Proposal's extensive requirements for board approval and oversight of a registered fund's use of derivative transactions and derivatives risk management program. Instead, the current proposal would require a registered fund's board to approve the designation of the fund's derivatives risk manager, and the derivatives risk manager would be required to provide a written report, at least annually, to the board regarding the implementation and effectiveness of the fund's derivatives risk management program. The derivatives risk manager would be required to include in such report a representation that the derivatives risk management program was reasonably designed to manage the fund's derivatives risks and complies with the requirements of the rule. Such representation may be based on the derivative risk manager's reasonable belief after due inquiry, which basis must be included in the written report to the board, along with such information as may be reasonably necessary to evaluate the program. The SEC proposed such representation because it believes that a fund's derivatives risk manager is in the best position to make such determination, as opposed to the fund's board, and that management of a fund's derivatives risks is primarily the responsibility of the fund and the fund's adviser, with board oversight.

Commissioners Robert J. Jackson Jr. and Allison Herren Lee commented on this change from the 2015 Proposal, stating that they were “unpersuaded that hiring the risk manager is enough board-level engagement on the risks presented by derivatives use.”<sup>3</sup> The Commissioners requested commenters to help the SEC understand the appropriate role of the board with respect to derivatives use, noting that insufficient board involvement in this area could hinder development of expertise among directors needed “to provide meaningful oversight and ensure sound risk management for investors.”<sup>4</sup>

The proposed rule would also require the derivatives risk manager to provide written reports to the board, at a frequency determined by the board, regarding any breaches of the risk guidelines set forth in the derivatives risk management program, and results of the stress testing and backtesting conducted under the program.

### Exception for Limited Derivatives Users

The proposed rule provides exceptions from the VaR-based limit on fund leverage risk and the required elements of the derivatives risk management program for a registered fund that uses derivatives in a limited manner, if the registered fund:

- Adopts and implements policies and procedures reasonably designed to manage the registered fund’s derivatives risks, and
- Either: (a) limits its notional derivatives exposure (including the value of assets sold short) to 10% of its net assets, or (b) uses derivative transactions solely to hedge certain currency risks.

### Recordkeeping

Proposed Rule 18f-4 would require a registered fund to maintain certain records that are designed to provide SEC staff, the registered fund’s board and its compliance staff the ability to evaluate compliance with the proposed rule. Specifically, the proposed rule would require a registered fund to maintain:

- The written policies and procedures of its derivatives risk management program, along with results of the stress testing and backtesting required under the proposed rule, and records documenting any internal reporting, escalation of material risks and periodic reviews of the program, as required under the proposed rule.

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<sup>3</sup> Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee, “Statement on Proposed Rules on Funds’ Use of Derivatives” (November 26, 2019), <https://www.sec.gov/news/public-statement/jackson-lee-statement-proposed-rules-funds-derivatives>.

<sup>4</sup> *Id.*



- Copies of materials provided to the fund's board of directors in connection with approval of the derivatives risk manager and other reports required to be made to the board under the proposed rule.
- Determinations or actions taken by the fund under the proposed rule's fund leverage risk limit requirements.
- The written policies and procedures required for limited derivatives users under the proposed rule.

These records would be required to be kept for not less than five years, with the first two years in an easily accessible place.

### Reverse Repurchase Agreements and Unfunded Commitments

Proposed Rule 18f-4 would permit a registered fund to enter into reverse repurchase agreements and similar transactions provided that the registered fund treats the transaction as a borrowing and meets the asset coverage requirements under Section 18 of the Investment Company Act. Proposed Rule 18f-4 would also permit a registered fund to enter into unfunded commitment agreements (e.g., agreements to make a loan to a company or to invest in the equity of a company in the future) subject to certain conditions, including the registered fund's reasonable belief that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements.

### Alternative Framework for Leveraged/Inverse Investment Vehicles

In the Proposing Release, the SEC proposed alternative requirements for leveraged/inverse investment vehicles, which currently are primarily structured as ETFs, and generally use derivatives extensively to pursue their investment strategies. The SEC expressed concerns with retail investors' investment in such vehicles, which are generally intended as short-term trading tools and can result in large and unexpected losses for longer term investors (noting in particular FINRA sanctions against broker-dealers for unsuitable sales of leveraged/inverse ETFs). However, the SEC also noted that investors who are sophisticated enough to be able to evaluate the risks of such investments may want to be able to use such investments for short-term investment needs. The SEC therefore designed the proposed alternative regulatory framework to address investor protection concerns, while still preserving the availability of leveraged/inverse investment vehicles as an investment choice for certain retail investors.

Specifically, proposed Rule 18f-4 would provide for an exception to the VaR-based limit on fund leverage risk for a leveraged/inverse investment vehicle that:

- Discloses in its prospectus that it is not subject to such limit on fund leverage risk, and

- Does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse return) of its underlying index.

As a counterweight to this exception, the Proposing Release proposed sales practice rules with respect to transactions in leveraged/inverse investment vehicles, which were designed to ensure that retail investors making investments in such vehicles were capable of evaluating the risks of such investment. Proposed Rule 15l-2 under the Exchange Act and proposed Rule 211(h)-1 under the Investment Advisers Act would permit a broker-dealer or investment adviser to buy and sell leveraged/inverse investment vehicles for the account of a client that is a natural person only if the broker-dealer or investment adviser had approved the account for such investments, based on its due diligence on the client's financial situation, investment objectives, and knowledge and experience in financial matters as they relate to the client's ability to evaluate the risks of such investments. The proposed account approval and due diligence requirements in the Proposing Release are modeled after similar FINRA rules governing customer accounts for options trading. The SEC noted that such approach may allow for efficiencies and reduced compliance costs for broker-dealers who already have policies and procedures in place to address the FINRA rules, however such efficiencies would not benefit investment advisers that are not also broker-dealers.

Notably, the proposed rules do not provide any bright-line tests for broker-dealers and investment advisers to follow in approving or disapproving a client's account for transactions in leveraged/inverse investment vehicles. Instead, the proposed rules would provide that broker-dealers and investment advisers may approve a client's account for such transactions if the broker-dealer or investment adviser has a "reasonable basis for believing that the customer 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." In a separate statement, Commissioners Peirce and Roisman criticized the Proposing Release for its lack of guidance on this point and the difficulties that this may present for broker-dealers and investment advisers attempting to meet the due diligence and approval requirement under the proposed rules. Expressing their concerns regarding the proposed rules' requirement to obtain certain enumerated due diligence items on the client's income, wealth and investment experience, the Commissioners stated: "By providing so little information about the result we are aiming to achieve, we worry that such a requirement will either become a meaningless check-the-box exercise or a regulatory deterrent for brokers and advisers to offer these ETFs on their menus at all."<sup>5</sup> Commissioners Peirce and Roisman were generally critical of the alternative framework for leveraged/inverse investment vehicles, which in

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<sup>5</sup> *Supra*, note 2.

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their view, would micro-manage broker-dealers in ways that seem unnecessary and insufficient to meet regulatory objectives, and would impose “blunt, over-paternalistic” investor protection measures that would restrict investors’ access to certain leverage/inverse investment vehicles (i.e., leverage/inverse investment vehicles that may seek to exceed the performance of an underlying index by more than 300%).<sup>6</sup> In contrast, separate remarks by Commissioners Jackson and Lee questioned whether the approach in the Proposing Release went far enough to protect investors from the risks presented by leveraged/inverse investment vehicles, which in their view “are rarely appropriate for retail use.”<sup>7</sup> It is interesting to note the contrast in public comments that have been made by the Commissioners regarding the proposed regulatory framework for leveraged/inverse investment vehicles, which may indicate that there are still significant differences to be worked out before the final rules are adopted. In connection with the alternative framework proposed for leverage/inverse investment vehicles, proposed amendments to Rule 6c-11 would remove the provision that currently excludes ETFs that are leveraged/inverse investment vehicles from relying on the rule.

## Reporting Requirements

Proposed amendments to Forms N-PORT, N-LIQUID and N-CEN would require a registered fund to provide information regarding: (1) its exposure to derivatives, (2) its VaR (and if applicable, its designated reference index) and backtesting results, (3) VaR test breaches (to be reported to the SEC in a nonpublic current report) and (4) certain identifying information regarding the registered fund (e.g., whether it is a limited derivatives user that is excepted from certain requirements under proposed Rule 18f-4, or whether it is a leveraged/inverse investment vehicle).

## Transition Period

The SEC proposed a one-year transition period from the date of publication of any final rule in the *Federal Register* to provide time for affected registered funds, broker-dealers and investment advisers to prepare for compliance with the final rules.

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<sup>6</sup> *Id.*

<sup>7</sup> *Supra*, note 3.

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