

## SEC Proposes New Rule Governing Funds' Use of Derivatives



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**THE PROPOSED RULE WOULD ESTABLISH THE EXCLUSIVE MEANS THROUGH WHICH FUNDS COULD ENTER INTO CERTAIN LEVERAGED TRANSACTIONS, INCLUDING SWAPS, FUTURES, REVERSE REPURCHASE AGREEMENTS AND SHORT SALES.**

At an open meeting of the U.S. Securities and Exchange Commission (SEC or Commission) on December 11, the SEC proposed new rule 18f-4 under the Investment Company Act of 1940 (the 1940 Act), limiting the use of derivatives and other leveraged transactions by mutual funds, exchange-traded funds (ETFs) and closed-end funds (including business development companies) (collectively, the funds).<sup>1</sup>

SEC Chair Mary Jo White in her remarks supporting the proposal stated that “[t]he current regulatory framework no longer effectively achieves the statutory objectives of the

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Investment Company Act, which seeks to protect investors from the risks of excessive leverage.” She further commented that “[d]erivatives can raise risks for a fund, including risks related to leverage, so it is important to require funds to monitor and manage derivatives-related risks and to provide limits on their use.”<sup>2</sup>

The proposed rule would be the exclusive rule on which funds rely to enter into certain leveraged transactions, including swaps, futures, reverse repurchase agreements and short sales, notwithstanding the limits on the issuance of senior securities in section 18 of 1940 Act. Currently, funds rely on Commission guidance in Release 10666 from the 1970s and subsequent staff guidance to avoid implicating the section 18 limitations on senior securities.<sup>3</sup> The proposed rule would replace and rescind such Commission and staff guidance. In many ways, the proposed rule is more restrictive and less flexible than current Commission and staff guidance.

The proposed rule bifurcates senior securities transactions covered by the rule into “derivative transactions” and “financial commitment transactions” and defines such terms as follows:

- “Derivatives transaction” means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing 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 a margin or settlement payment or otherwise.
- “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).

Compliance requirements under the proposed rule would differ depending on the type of senior security transaction.

## Requirements for Derivative Transactions

- **Portfolio Limitations.** Under the proposed rule, a fund would be required to comply with one of two alternative portfolio limitations designed to limit the amount of leverage the fund may obtain through derivatives and certain other transactions:
  1. *Exposure-based limit:* a fund would have to limit its exposure to 150 percent of the fund's net assets in order to rely on this limit. Generally, a fund's "exposure" would be calculated by adding the fund's aggregate notional amount of its derivatives transactions with its obligations under financial commitment transactions (such as short sale borrowings, reverse repurchase agreements or firm commitment agreements) and other senior securities transactions.
  2. *"Valuation at Risk" or "VaR" limit:* a fund would be permitted to obtain exposure up to 300 percent of the fund's net assets if, when evaluated using a test based on VaR, the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.
  
- **Asset Segregation.** A fund would need to segregate certain assets (generally cash and cash equivalents) equal to the sum of two amounts:
  1. *Mark-to-market coverage amount:* the amount that the fund would need to pay if the fund were to exit the derivatives transaction at the time of determination.
  2. *Risk-based coverage amount:* a reasonable estimate of the potential amount that the fund would need to pay if the fund were to exit the derivatives transaction under stressed conditions.
  
- **Derivatives Risk Management Program**

In addition to the restrictions proposed in the new rule, certain funds would also be required to have a formalized derivatives risk management program. This requirement would apply to funds that (1) "engage in more than a limited amount of derivatives transactions" or (2) use "complex derivatives transactions" (as such term is defined in the proposed rule). The derivatives risk management program

would be approved by the fund's board, administered by a designated derivatives risk manager (who cannot be a portfolio manager of the fund) and contain certain elements specified by the SEC.

The fund's board would be required to review written reports prepared by the designated derivatives risk manager at least quarterly.

### **Requirements for Financial Commitment Transactions**

Under the proposed rule, if a fund engages in financial commitment transactions, the fund would be required to segregate coverage assets equal to 100 percent of its payment or delivery obligations (whether conditional or unconditional) under these transactions. A fund would also be able to maintain, as qualifying coverage assets for a financial commitment transaction fund, assets that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors. As proposed, securities lending transactions are not included under the definition of "financial commitment transaction."

Fund boards would also be required to adopt policies and procedures regarding the maintenance of coverage assets.

### **Amendments to Reporting Forms**

In May 2015, the SEC proposed two new reporting forms, Form N-PORT and Form N-CEN. These forms have not been finalized yet. The amendments to proposed Form N-PORT would require funds that are required to implement a derivatives risk management program to provide certain risk metrics relating to the fund's use of derivatives. The proposed amendments to Form N-CEN would require funds to disclose whether they relied on the new rule and to identify the portfolio limitation(s) (proposed under the new rule and described above) that the fund relied on during the reporting period.

### **Comment Period**

The comment period for the proposal will be 90 days after publication in the *Federal Register*.

### **Pepper Points**

- The proposed rule limits the assets that a fund may use to cover its senior securities transactions currently permitted under Commission and staff guidance.
- The proposed rule would add reporting and compliance responsibilities to funds, as well as increased oversight responsibilities to the boards of directors. As Commissioner Luis Aguilar suggested at the SEC's open meeting on the proposed rule, the boards may not be equipped to handle these added responsibilities.<sup>4</sup>
- The proposed rule could severely impact the manner in which certain managed futures mutual funds and leveraged ETFs operate. The proposing relief suggests that managed futures funds may be compelled to deregister from the 1940 Act and operate as private funds or as public or private commodity pools.
- If you have any questions about the SEC's proposed rule or how it affects your operations, please contact the authors of this article.

### **Endnotes**

1. Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), *available at* <http://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.
2. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting (Dec. 11, 2015), *available at* <http://www.sec.gov/news/statement/chair-white-statement-at-open-meeting.html>.
3. Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979).
4. Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, Public Statement, Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance (Dec. 11, 2015), *available at* <http://www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html>.