Client Update

SEC Proposes New Limits on Registered Funds' and BDCs' Use of Derivatives

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On December 11, 2015, the Securities and Exchange Commission (the "SEC") proposed a new rule 18f-4 (the "Proposed Rule")[1] under the Investment Company Act of 1940 (the "ICA") relating to the use of derivatives, reverse repurchase agreements and other leverage-producing transactions by registered investment companies and business development companies ("BDCs" and, collectively, "Funds"). The Proposed Rule, if adopted, would provide an exemption permitting Funds (including exchange-traded funds ("ETFs") and closed-end funds) to enter into derivatives and financial commitment transactions notwithstanding the restrictions on the issuance of "senior securities" under section 18 of the ICA.

If adopted, the Proposed Rule and related amendments would supersede existing SEC guidance on which funds have historically relied to engage in such transactions and would impose significant new portfolio exposure limits, asset segregation requirements and additional compliance obligations on Funds that engage in such transactions. Of particular importance, the Proposed Rule would impose additional oversight responsibilities on Funds' boards of directors and require certain Funds to adopt a derivatives risk management program and appoint a derivatives risk manager.

The Proposed Rule, if adopted, will obviously have a significant impact on Funds. It may also have an impact on private funds to the extent they seek capital commitments from Funds.

Comments on the Proposed Rule are due March 28, 2016.

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1 The text of the Proposed Rule is available at: https://www.federalregister.gov/articles/2015/12/28/2015-31704/use-of-derivatives-by-registered-investment-companies-and-business-development-companies

BACKGROUND

Sections 18 (in the case of registered investment companies) and 61 (in the case of BDCs) of the ICA[2] restrict the ability of a Fund to issue senior securities. Section 18 was designed to simplify the capital structure of Funds, as well as to limit the ability of Funds to engage in excessive borrowing, which could "increase unduly the speculative character" of their common stock.[3] Subsequently, Funds began using derivatives and other transactions to achieve leverage for their investment portfolios.

In 1979, the SEC issued Investment Company Act Release No. 10666 ("Release 10666")[4] clarifying that the SEC would treat reverse repurchase agreements[5] and certain other trading strategies that imposed payment obligations on Funds as "evidence of indebtedness," but would permit a Fund to engage in such transactions if it segregates sufficient liquid assets to cover its risk of loss under the transactions. In the decades that followed, the SEC staff has expanded this approach to various derivatives and other transactions through a series of no-action letters and other SEC staff guidance. Thus, under current guidance, a Fund is not subject to any statutory limit on the level of its derivatives and financial commitment transactions, provided it complies with the asset segregation requirements.

In recent years, the SEC has become increasingly concerned about the regulatory uncertainty surrounding Funds' use of derivatives, as well as the increased use of derivatives by Funds. Among other things, the SEC notes in the release proposing the rule that varying industry practices have developed over time as to the appropriate amount and type of assets to be segregated to "cover" various types of derivatives, so that similar transactions are treated differently despite posing similar risks.

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2 For convenience, this client memorandum refers only to section 18. Section 61 modifies the requirements of section 18 for BDCs.

3 See section 1(b)(7) of the ICA.

4 SEC, "Securities Trading Practices of Registered Investment Companies," Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 27, 1979).

5 The SEC uses the term "reverse repurchase agreement" in the Proposed Rule and in Release 10666 to refer to transactions in which a fund transfers possession of a security to another party and agrees to repurchase the security (at a premium) at a future date. Such a transaction is commonly referred to in the industry as a "repurchase agreement."

In 2011, the SEC published a concept release[6] seeking public comment on the effectiveness of the current regulatory framework. The comments that the SEC received in response to that concept release, as well as additional work undertaken by the SEC staff (including the SEC's Division of Economic and Risk Analysis), led to the publication of the Proposed Rule.

The Proposed Rule contains three key provisions:

- It would limit the extent to which a Fund could invest in derivatives (portfolio exposure limits).
- It would require a Fund to maintain certain assets to meet its financial obligations under derivatives and certain other types of transactions (asset segregation).
- It would require certain Funds to establish a derivatives risk management program and appoint a derivatives risk management officer.

The Proposed Rule would also impose various recordkeeping and reporting requirements on Funds, as well as additional oversight responsibilities for Fund boards.

KEY TERMS

The Proposed Rule uses certain key terms that are central to its portfolio exposure limits and asset segregation requirements:

Derivatives Transaction (or Derivative):[7] Any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which the Fund is or may be required to make any payment or delivery during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise. Note that this does not include a derivatives instrument that does not impose a future payment obligation on a fund, such as a purchased option.

Complex Derivatives Transaction: Any Derivatives Transaction for which the amount payable by either party is dependent on the value of a reference asset at

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6 SEC, "Use of Derivatives by Investment Companies under the Investment Company Act of 1940," Investment Company Act Release No. 29776 (Aug. 31, 2011).

7 For convenience, this client memorandum refers to "Derivatives" in certain instances, rather than "Derivatives Transactions."

multiple points in time or is a non-linear function of the value of the reference asset, other than due to optionality arising from a single strike price.

Financial Commitment Transaction: Any reverse repurchase agreement, short sale borrowing, 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).

Financial Commitment Obligation: The amount of cash or other assets that the Fund is conditionally or unconditionally obligated to pay or deliver under a Financial Commitment Transaction.

Senior Securities Transactions: Any Derivatives Transaction, Financial Commitment Transaction or any transaction involving a senior security entered into under section 18 of the ICA.

Exposure: The sum of (1) the aggregate notional amount of the Fund's Derivatives Transactions (taking into account the netting of certain offsetting transactions, including across counterparties, provided the transactions involve the same type of instrument and have the same underlying reference asset, maturity and other material terms);[8] (2) the aggregate Financial Commitment Obligations of the Fund; and (3) the aggregate indebtedness (or preferred stock involuntary liquidation preference) with respect to any other Senior Securities Transactions entered into by the Fund.

VaR (Value at Risk): 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 level.

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8 This limited netting provision is designed to apply to Derivatives Transactions that a Fund typically would settle (in whole or in part) with an offsetting transaction prior to expiration or maturity, such as certain futures and forward transactions, and would also apply where a Fund seeks to reduce or eliminate its economic exposure under a transaction without terminating it (such as where a Fund would need to pay an early termination fee or would realize gain or loss for tax purposes earlier than if it entered into an offsetting transaction).

ALTERNATIVE PORTFOLIO EXPOSURE LIMITS

The Proposed Rule would allow a Fund to enter into a Derivatives Transaction if it complies with one of the following limits on its Exposure to Senior Securities Transactions.

- A Fund could not enter into a Derivatives Transaction unless, after giving effect to that transaction, its Exposure does not exceed 150% of the Fund's net asset value ("NAV") (the "exposure-based portfolio limit").
- A Fund could have an Exposure that exceeds 150% of its NAV if (1) it maintains a "full portfolio VaR" (the VaR of the Fund's entire portfolio, including securities, Derivatives and other investments) that is less than the Fund's "securities VaR" (the VaR of the Fund's portfolio, excluding Derivatives) and (2) the Fund's aggregate Exposure does not exceed 300% of the Fund's NAV (the "risk-based portfolio limit"). The full portfolio VaR and securities VaR would both need to be calculated using a 99% confidence interval, a time horizon of at least 10 and no more than 20 trading days and, for any Fund using a historical simulation to estimate VaR, a minimum of three years of historical market data.

The decision as to which Exposure limitation to comply with would have to be approved by the Fund's board.

Measuring Exposure

The Proposed Rule would require a Fund to measure its Exposure each time it enters into a Senior Securities Transaction. However, the Exposure limitation is not a maintenance test; a Fund would not be required to terminate or otherwise unwind a Derivative or other Senior Securities Transaction solely because its Exposure subsequently increased beyond the relevant Exposure limits.

The Proposed Rule prescribes different methods for calculating the Exposure arising from three categories of Derivatives Transactions:

- For any Derivatives Transaction that provides a return based on the leveraged performance of a reference asset, the notional amount would be multiplied by the applicable 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, or an index that reflects the performance of such a managed account or entity, the notional amount would be determined by

reference to the Fund's pro rata share of the notional amounts of the underlying reference vehicle's Derivatives Transactions; and

- For any "Complex Derivatives Transaction," the notional amount would be equal to the aggregate notional amount of non-complex Derivatives Transactions that the Fund reasonably estimates would offset substantially all of the market risk of the Complex Derivatives Transaction.

ASSET SEGREGATION REQUIREMENTS

The Proposed Rule would impose two asset segregation requirements—one for a Fund's Derivatives Transactions and the other for the Fund's Financial Commitment Transactions. These requirements are designed to assure that a Fund has sufficient assets to meet its obligations under these types of transactions.

Asset Segregation for Derivatives

A Fund that enters into a Derivatives Transaction in reliance on the exemption in the Proposed Rule would be required to maintain "qualifying coverage assets" (as defined below) with a value equal to at least the sum of the Fund's (1) aggregate "mark-to-market coverage amounts" and (2) "risk-based coverage amounts" under all of its Derivatives.

The "mark-to-market coverage amount" for each Derivatives Transaction is the amount that would be payable by the Fund if it were to exit the transaction at the time of determination.[9] The "risk-based coverage amount" for each Derivatives Transaction is a reasonable estimate of the potential amount payable by the Fund if it were to exit the transaction under stressed conditions (*i.e.*, the Fund's potential future exposure under the transaction).[10]

Both of these coverage amounts may be calculated as the net amount that would be payable, if any, with respect to the Derivatives Transactions covered by a netting agreement. In addition, the mark-to-market coverage amount may be reduced by any variation margin posted for the Derivatives Transaction (or netting set thereof), while the risk-based coverage amount for a Derivatives

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9 A transaction that has appreciated in value to the Fund would receive a mark-to-market coverage amount of zero.

10 The risk-based coverage amount would need to be determined in accordance with board-approved policies and procedures which take into account, as relevant, the structure, terms and characteristics of the Derivatives Transaction and the underlying reference asset.

Transaction may be reduced by any initial margin posted for such Derivatives Transaction (but not by any initial margin posted for other Derivatives Transactions).

Asset Segregation for Financial Commitments

A Fund that enters into Financial Commitment Transactions in reliance on the exemption in the Proposed Rule would be required to maintain "qualifying coverage assets" with a value at least equal to the Fund's aggregate Financial Commitment Obligations.

Qualifying Coverage Assets

For Derivatives, "qualifying coverage assets" includes cash and cash equivalents and, for any physically settled Derivatives, the asset that the Fund may use to satisfy its obligations under such transaction. The Fund would be required to identify such assets on its books and records and determine the amount of qualifying coverage assets that it is required to maintain at least once each business day.

For Financial Commitment Transactions, "qualifying coverage assets" includes, in addition to cash and cash equivalents and any asset that may be used to satisfy the Fund's obligations under such a transaction, any asset that is convertible to cash or will generate cash equal to the Financial Commitment Obligation prior to the date on which payment is expected to be required, or that has been pledged with respect to the Financial Commitment Obligation and can be expected to satisfy such obligation.

In both cases, the Proposed Rule provides that the amount of a Fund's qualifying coverage assets must not exceed its NAV. This condition would prevent a Fund from using assets acquired through borrowing or other leverage transactions to increase its available qualifying coverage assets. In addition, the qualifying coverage assets could not be used to cover both a Derivatives Transaction and a Financial Commitment Transaction.

DERIVATIVES RISK MANAGEMENT PROGRAM

A Fund would be required to adopt and implement a formalized derivatives risk management program ("RMP") if it engages in (1) Derivatives[11] with an

[11] The threshold for implementing the RMP is triggered by the notional exposure of the Fund's Derivatives only, not the exposure to a Fund's Financial Commitment Transactions or other Senior Securities Transactions.

aggregate Exposure greater than 50% of the Fund's NAV (the "50% Exposure Limit") or (2) Complex Derivatives Transactions.

Under the Proposed Rule, such a Fund would be required to adopt and implement written policies and procedures reasonably designed to:

- Assess the risks associated with its Derivatives (both for Derivatives it currently uses, as well as Derivatives it reasonably expects to use in the future), including potential leverage, market, counterparty, liquidity and operational risks and any other relevant risks (including idiosyncratic risks, such as legal risks, posed by the specific types of Derivatives).
- Manage the risks associated with its Derivatives, including by (1) monitoring whether its use of Derivatives is consistent with its investment guidelines or those of its investment adviser (if any), the relevant portfolio limitation and relevant disclosure to investors; and (2) informing internal portfolio management personnel or the Fund's board regarding material risks arising from its Derivatives; and
- Periodically (but at least annually) review and update the RMP, including any models (*e.g.*, any VaR calculation models), measurement tools or policies and procedures that are part of, or used in, the RMP to evaluate their effectiveness and reflect changes in risks over time.

The Fund would be required to designate an employee or officer of the Fund or its investment adviser responsible for administering the RMP (the "Derivatives Risk Manager"). The Derivatives Risk Manager must be approved by the Fund's board (as described below) and may not be a portfolio manager of the Fund. The policies and procedures would have to be designed to reasonably separate the functions associated with the RMP from the Fund's portfolio management. This requirement is designed to promote objective and independent risk assessment to complement and serve as a check on portfolio management (without requiring total segregation or a communications firewall between these functions). The SEC also notes that ensuring that the compensation of risk management personnel is not tied to the Fund's performance may be an important tool for ensuring such independence.

BOARD APPROVAL AND OVERSIGHT RESPONSIBILITIES

The Proposed Rule would impose a number of new responsibilities on Fund boards, particularly on the boards of those Funds that are required to adopt a RMP. A Fund's board would be required to:

- Approve the Fund's chosen portfolio limitation (*i.e.*, the exposure-based portfolio limit or the risk-based portfolio limit);
- Approve policies and procedures reasonably designed to provide for the Fund's maintenance of qualifying coverage assets; and
- Either (1) approve the Fund's compliance with the 50% Exposure Limit (if the Fund is not required to implement a RMP) or (2) comply with the following requirements (if the Fund is required to implement a RMP):
  - Provide initial approval of the RMP and approval of any material changes to the RMP;
  - Review, on at least a quarterly basis, a written report prepared by the Derivatives Risk Manager that describes the adequacy of the RMP and the effectiveness of its implementation; and
  - Approve the designation of a Derivatives Risk Manager.

With respect to the board approval requirements for Funds that are required to implement a RMP, the SEC notes that many Fund boards, as part of their general oversight function, already oversee the Fund's risk management processes (which may include a formalized risk management program), such that requiring board approval of a Fund's RMP and Derivatives Risk Manager "would likely have the effect of enhancing practices that are in place at many funds today."

In considering whether to approve a Fund's RMP or any material changes to it, a Fund's board generally would be expected to consider the types of Derivatives in which the Fund engages or plans to engage, their particular risks and whether the RMP sufficiently addresses the Fund's compliance with its investment guidelines, any applicable portfolio limitation and relevant disclosure. Boards would be expected to periodically consider the adequacy of a Fund's RMP in light of past experience (both by the Fund in particular and with market derivatives use in general) and recent compliance experiences, best practices used by other Fund complexes and consultations with other experts on derivatives risk management by similar funds.

Directors would be permitted to satisfy their obligation to provide initial approval of the RMP by reviewing summaries of the RMP prepared by the Fund's Derivatives Risk Manager, legal counsel, or other persons familiar with the RMP.

RECORDKEEPING AND REPORTING REQUIREMENTS

The Proposed Rule would impose detailed recordkeeping requirements on a Fund that engages in Derivatives Transactions or Financial Commitment Transactions, as well as certain additional requirements for Funds that are required to implement a RMP. These recordkeeping requirements are designed to demonstrate compliance with the Proposed Rule.

The Proposed Rule would also amend certain previously proposed reporting rules to require Registered Funds to report certain additional information concerning Derivatives Transactions on proposed Form N-PORT (requiring certain Funds to report their monthly portfolio holdings to the SEC) and Form N-CEN (requiring Funds to annually report certain census information to the SEC).

- For Funds that are required to adopt a RMP, the Proposed Rule would amend proposed Form N-PORT to require such Funds to report the gamma and vega[12] for options and warrants (including options on a derivative, such as swaptions). Information reported on Form N-PORT for the third month of a Fund's fiscal quarter would be made publicly available 60 days after the end of such month.
- The Proposed Rule would amend Proposed Form N-CEN to require a Fund that engages in Derivatives Transactions to identify the portfolio limitation with which the Fund has elected to comply.

IMPACT OF THE PROPOSED RULE

The SEC appears to have designed the Proposed Rule with a view toward avoiding the need for most Funds to restructure their portfolios or change their portfolio management techniques. A study of a sample of Funds prepared by the SEC's Division of Economic and Risk Analysis ("DERA") concluded that substantially all of the Funds reviewed had aggregate Exposures below the 150% threshold (and that none of the sampled BDCs reported any Derivatives Transactions). In addition, only one of the non-alternative strategy ETFs had an aggregate Exposure above the 150% threshold.

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12 The terms "gamma" and "vega" refer to risk metrics used for providing a position-level estimate of the sensitivity of an option or warrant (or portfolio thereof) to underlying price movements (for gamma) and to the volatility of the underlying asset (for vega). Gamma is the rate of change in an option's delta with respect to changes in the underlying price (where delta measures the rate of change of the option's value with respect to changes in the underlying asset's price). All long options have positive gamma and all short options have negative gamma. Vega is typically expressed as the amount of money per underlying share that the option's value will gain or lose as volatility rises or falls by 1%. All options (both calls and puts) will gain value (*i.e.*, increase vega) with rising volatility.

However, the SEC acknowledges that a number of alternative strategy funds (in particular, leveraged ETFs) in the sample had aggregate Exposures that exceeded the 150% portfolio limitation and that these types of funds may be unable to scale down their Exposures while maintaining their investment objectives or providing a product that has sufficient investor demand, and may thus be forced to deregister and liquidate or merge into other funds. The SEC believes these funds represent a very small percentage of fund assets under management ("AUM") (approximately 3% of all fund assets) and "would not be significant to the industry as a whole." With respect to the subset of funds that may be unable to operate in their current form under the Proposed Rule, the SEC suggests that fund sponsors that are unable to operate such a fund under the proposed exposure limits may choose to offer the fund as a private fund or (public or private) commodity pool, which are not subject to such limits.

Similarly, the SEC appears to believe that the universe of Funds that would be required to have an RMP might be limited. The DERA report concluded that approximately 10% of the open-end funds and 9% of the closed-end funds in its sample would be required to adopt a RMP. However, it noted that the alternative strategy funds are far more likely to be subject to this requirement than traditional funds. This requirement could impose significant burdens on Funds and Fund boards, including the time and resources expended in appointing a Derivatives Risk Manager.

The Proposed Rule, if adopted, could affect Funds' appetite to invest in private funds. As noted above, an unfunded commitment by a Fund to invest in a private fund would be treated as a Financial Commitment Transaction and the Fund would have to segregate qualifying assets in an amount equal to the unfunded commitment. Depending on the composition of the Fund's portfolio, this could have an impact on its flexibility to pursue its investment objectives. The SEC has requested comment on whether such unfunded commitments should be excluded from the "Financial Commitment Transaction" definition.

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Please feel free to contact us with any questions.