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Use of Derivatives by Registered Investment Companies and Business Development Companies

SEC Proposes Significant Modifications to Existing Regulatory Framework for Derivatives — New Rule Would Require Certain Funds and BDCs to Comply with a VaR-Based Fund Leverage Risk Limit and to Establish a Derivatives Risk Management Program; Broker-Dealers and Investment Advisers Would be Subject to New Sales Practices Rules for Leveraged/Inverse Investment Vehicles

SUMMARY

On November 25, 2019, the Securities and Exchange Commission, by a unanimous vote, re-proposed rule 18f-4 under the Investment Company Act of 1940 (the "proposed rule"), and proposed new rule 15*l*-2 under the Securities Exchange Act of 1934 and new rule 211(h)-1 under the Investment Advisers Act of 1940 (the "proposed sales practices rules"), as well as certain related form amendments.[1] The SEC notes that these proposals are designed to promote the ability of funds to continue to use derivatives in a broad variety of ways that serve investors, while providing an updated and more comprehensive approach to the regulation of funds' derivatives use. The SEC has requested comments regarding the proposed rule, sales practices rules, and form amendments generally and on numerous specific matters discussed in the proposing release. Comments must be submitted no later than 60 days following the publication of the proposing release in the Federal Register.

Notable items in the proposing release include the following:

The proposed rule would provide registered investment companies and business development companies that comply with certain requirements an exemption that would permit them to enter into derivatives

transactions (as defined in the proposed rule), notwithstanding the restrictions on the issuance of senior securities under the Investment Company Act of 1940, as amended (the "ICA"). If the proposed rule is approved, much existing SEC and SEC staff guidance on which funds have historically relied to engage in such transactions would be superseded and rescinded or withdrawn.[2] A fund seeking to rely on the proposed rule, subject to certain exceptions, would be required to:

- comply with an outer limit on fund leverage risk by satisfying a relative value at risk ("VaR") test that compares the fund's VaR to the VaR of a designated reference index for that fund or, in the event that the fund's derivatives risk manager cannot identify an appropriate reference index, comply with an absolute VaR test;
- establish a written derivatives risk management program (a "DRMP") to be administered by a board-approved derivatives risk manager, subject to board oversight; and
- comply with new recordkeeping, disclosure and reporting requirements related to the fund's use of derivatives.

The proposed rule would allow a leveraged/inverse fund to engage in derivatives transactions without complying with the fund leverage risk limit, so long as the fund makes certain disclosures in its prospectus, and does not seek or obtain, directly or indirectly, a return in excess of 300% of the return, or inverse of the return, its underlying index. The proposed sales practices rules would require broker-dealers to conduct due diligence before approving a retail customer's account to buy or sell shares of leveraged/inverse investment vehicles or accepting the customer's order for such transactions, and would require investment advisers to conduct due diligence before placing an order for the account of a retail advisory client to buy or sell shares of leveraged/inverse investment vehicles.

The proposed rule would additionally permit certain limited derivatives users to engage in derivatives transactions without complying with the fund leverage risk limit or establishing a DRMP. This exception would be available only for funds that limit their derivatives exposure to 10% of their net assets, or use derivatives transactions only for the purpose of hedging certain currency risks. A fund relying on this exception would be required to adopt and implement policies and procedures reasonably designed to manage its derivatives risks.

Recognizing that reverse repurchase agreements and similar financing transactions, as well as unfunded commitment transactions, have characteristics that distinguish them from derivatives transactions, the proposed rule would address funds' engagement in these transactions separately from funds' use of derivatives. The proposed rule would permit funds to enter into reverse repurchase agreements and similar financing transactions so long as they meet the applicable asset coverage requirements under the ICA. In addition, the proposed rule would permit funds to enter into unfunded commitment agreements if the fund reasonably believes that its assets will allow the fund to meet its obligations under these agreements.

The proposed rule would also impose substantially less onerous obligations on fund boards of directors than the SEC's initial proposal of rule 18f-4 in 2015 (the "2015 proposal"). The proposed rule would require

a fund board to approve the appointment of a derivatives risk manager for the fund and to review certain reports. However, unlike the 2015 proposal, it would not require boards to, among other things: approve the DRMP or any material changes thereto; approve policies and procedures for determining the proper amount of qualifying coverage assets for each derivatives transaction; or undertake a thorough annual review and update of the DRMP. The SEC also proposed amendments to Forms N-PORT, N-LIQUID (which the SEC proposes to re-name Form N-RN) and N-CEN that would require registered investment companies to report additional information regarding their derivatives transactions, and addressed reporting requirements applicable to BDCs.

BACKGROUND

Section 18 of the ICA places significant restrictions on the ability of registered investment companies to issue "senior securities." Section 18 was intended to protect fund investors from the risks of excessive leverage and inadequate assets and reserves, and to prevent abuses of purchasers of senior securities.[3] At the time the ICA was enacted, excessive leverage could typically be achieved only by issuing debt securities or preferred stock or by obtaining bank loans. In the decades since 1940, with the advent of derivatives of many kinds, reverse repurchase agreements and other transactions through which funds are effectively able to achieve leverage, the SEC has broadly interpreted section 18's restrictions on issuances of "senior securities" as applicable to derivatives that involve future payment obligations, as well as reverse repurchase agreements, commitment agreements and other transactions.[4] Recognizing that limited use of such transactions for certain purposes could benefit fund investors, in 1979 the SEC issued a general statement of policy in Investment Company Act Release No. 10666 ("Release 10666") providing that funds engaging in certain transactions (reverse repurchase agreements, firm commitment agreements and standby commitment agreements) would not be considered to be in violation of section 18 provided they segregated liquid assets in an amount sufficient to "cover" their potential obligations, thereby limiting the risk of loss from such transactions.[5] The asset coverage requirement was intended to "assure the availability of adequate funds to meet the [fund's] obligations" from such activities and to serve as "a practical limit on the amount of leverage which [a registered] investment company can undertake and on the potential increase in the speculative character of its outstanding common stock."[6] The concepts in Release 10666 were subsequently developed and expanded to cover various types of derivatives and other leverage-producing instruments, and to provide other ways to "cover" funds' potential obligations, in a series of over 30 no-action letters and other SEC staff guidance. Section 61 of the ICA subjects BDCs to the limitations in section 18 to the same extent as registered closed-end funds, with a reduced asset coverage requirement for senior securities representing indebtedness.

Responding to the dramatic growth in the volume and complexity of the derivatives markets and the use of derivatives by funds, in 2010 the SEC announced that it had initiated a review of the use of derivatives by funds and the adequacy of the existing regulatory framework. In 2011, the SEC published a concept release that discussed and requested comments on various related issues.[7] In 2015, the SEC released the 2015

proposal, which would have allowed funds to enter into derivatives transactions subject to certain conditions, including (i) compliance with one of two alternate portfolio limitations intended to limit the amount of leverage that a fund may obtain through derivatives transactions, (ii) asset segregation for derivatives transactions, (iii) adoption of a derivatives risk management program for funds that engage in more than limited derivatives transactions, and (iv) reporting requirements regarding a fund's derivatives usage.[8]

The SEC received over 200 comments on the 2015 proposal,[9] many of which were critical of the proposal.[10] The SEC subsequently engaged with fund complexes and investor groups and developed the more recent proposals. In the proposing release, the SEC highlights the need for an updated regulatory framework that addresses the unique risks of the use of derivatives by funds, including the undue speculation and asset sufficiency concerns underlying section 18 of the ICA and the risk that derivatives usage can result in substantial losses, while respecting "the valuable role derivatives can play in helping funds to achieve their objectives efficiently or manage their investment risks."[11]

LIMIT ON FUND LEVERAGE RISK

Proposed rule 18f-4 would permit mutual funds, exchange-traded funds ("ETFs"), closed-end funds and companies that have elected to be treated as business development companies (each of which is referred to herein as a "fund") to engage in "derivatives transactions" by providing a limited exemption from section 18 and section 61 of the ICA.[12] "Derivatives transaction" would be defined as "(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 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; and (2) any short sale borrowing."[13] This definition would not encompass types of derivatives (such as purchased call options) that do not impose a future payment obligation on the fund beyond the amount of its investment.[14]

Funds seeking to utilize the exemption and engage in derivatives transactions, with the exception of funds that utilize derivatives to a limited extent (as discussed under "Limited Derivatives Users" below), would be required to comply with an outer limit on fund leverage risk based on a value at risk, or VaR, test. Value at risk is defined as "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".[15] Funds would be required to comply with a relative VaR test that compares the VaR of the fund to that of an unleveraged "designated reference index", and in the event that the fund's derivatives risk manager cannot identify an applicable designated reference index, the fund would instead be required to comply with an "absolute VaR test".[16]

The proposed rule imposes numerous parameters on any VaR model used for determining a fund's compliance with the relative or absolute VaR tests set forth below, effectively disallowing the use of bespoke VaR models. The VaR model must:

- take into account and incorporate all significant, identifiable market risk factors associated with the fund's investments, including (as applicable) (a) equity price risk, interest rate risk, credit spread risk, foreign currency and commodity price risk; (b) material risks arising from the nonlinear price characteristics of the fund's investments (including options and positions with embedded optionality); and (c) the sensitivity of the market value of the fund's investments to changes in volatility;
- use a 99% confidence level and a time horizon of 20 trading days;
- be based on at least three years of historical market data.[17]

Notwithstanding these parameters, a fund's derivatives risk manager would be free to choose among the historical simulation, Monte Carlo simulation or parametric VaR models.[18] Additionally, a fund would not be required to apply the same VaR model in the same way when calculating the VaR of its portfolio and of its designated reference index.[19]

1. Relative VaR Test

The relative VaR test is designed to limit the extent to which a fund can increase its market risk by leveraging its portfolio through the use of derivatives, without restricting the fund's ability to use derivatives for purposes other than leverage. To satisfy the relative VaR test, the VaR of a fund's entire portfolio could not exceed 150% of the VaR of its designated reference index.[20] The fund's derivatives risk manager would be responsible for selecting a designated reference index, which is defined as an unleveraged index that:

- reflects the markets or asset classes in which the fund invests;
- is not administered by an affiliated person of the fund, its investment adviser, or its principal underwriter, and is not created at the request of the fund or its investment adviser, unless the reference index is "widely recognized and used"; and
- is an "appropriate broad-based securities market index" or "additional index" as defined in the instruction to Item 27 in Form N-1A.[21]

The proposed rule would afford derivatives risk managers flexibility to select an appropriate reference index subject to the above parameters. The proposing release states that a risk manager could select a designated reference index that is a blended index if appropriate. For instance, a balanced fund could determine that a blended index of an equity index and a fixed income index is an appropriate designated reference index.[22]

2. Absolute VaR Test

Funds wishing to utilize the exemption but unable to identify an appropriate designated reference index would instead be required to comply with the absolute VaR test, under which the VaR of the fund's portfolio may not exceed 15% of the value of the fund's net assets.[23] The 15% limit represents the SEC's attempt to

subject funds complying with the absolute VaR test to a roughly comparable restriction to funds complying with the relative VaR test.[24]

3. Implementation of VaR Testing

The proposed rule would require a fund to determine its compliance with the applicable VaR test a minimum of once a business day. In the event that a fund determines that it is not in compliance with the applicable VaR test, the proposed rule would require that it return to compliance within three business days. If the fund fails to come into compliance within three business days, the proposed rule would mandate the following remediation process:

- the derivatives risk manager must report on the fund's non-compliance to the fund's board, and must specify how, and within how many business days, the derivatives risk manager reasonably expects the fund to come into compliance;
- the derivatives risk manager must analyze the circumstances that gave rise to non-compliance for more than three business days, and update the derivatives risk management program as necessary to reflect such circumstances;
- the fund may not enter into derivatives transactions (except for transactions intended to reduce the fund's VaR) until the fund has been in compliance with the relevant VaR test for three business days and has satisfied the immediately preceding two requirements. The fund is not required to exit its existing derivatives transactions while it remains non-compliant with the applicable VaR test.[25]

DERIVATIVES RISK MANAGEMENT PROGRAM

1. Elements of the Derivatives Risk Management Program

Funds that engage in derivatives transactions in reliance on the proposed rule, with the exception of funds that utilize derivatives to a limited extent (as discussed under "Limited Derivatives Users" below), would be required to adopt and implement a formalized derivatives risk management program, or DRMP, which must include "policies and procedures that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund."[26] Under the proposed rule, a DRMP would be required to provide for:

- identification and assessment of the fund's derivatives risks (including leverage, market, counterparty, liquidity, operational, legal and any other material risks);
- establishment and enforcement of investment, risk management, or related guidelines that set forth quantitative (or otherwise measureable) criteria, metrics or thresholds of the fund's derivatives risks. The guidelines must indicate levels of the given criterion, metric or threshold that the fund does not typically expect to exceed, along with measures to be taken if a designated level is exceeded;
- stress testing to evaluate potential losses in response to extreme but plausible market changes or changes in market risk factors (to the extent the latter would have a significant adverse effect on the fund's portfolio), taking into account correlations of market risk factors and resulting payments to derivatives counterparties. The frequency of such stress testing must take into account the fund's strategy and investments and current market conditions, and must be conducted at least weekly;

- backtesting of the fund's VaR calculation model each business day, comparing the fund's gain or loss with the corresponding VaR calculation for that day, estimated over a one trading day time horizon, and identifying as an exception any instance in which the fund experiences a loss beyond that estimated by the corresponding VaR calculation;
- internal reporting and escalation:
    - the DRMP must set forth the circumstances under which portfolio managers will be informed regarding the operation of the DRMP, including violations of the investment, risk management or related guidelines, and the results of the stress tests; and
    - the derivatives risk manager must inform portfolio managers in a timely fashion, and the fund's board as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified by the fund's violation of the investment, risk management or related guidelines, and the results of the stress tests.
- review of the DRMP by the derivatives risk manager at least annually to evaluate its effectiveness and reflect changes in risks, including a review of the VaR calculation model and the appropriateness of any designated reference index.[27]

The proposed rule would require the DRMP to be administered by one or more officers of the fund designated as derivatives risk managers, whose designation must be approved by the fund's board (including a majority of the independent directors), taking into account each manager's relevant experience.[28] The derivatives risk manager (if the position is filled by only one officer) may not be a portfolio manager of the fund, or if multiple officers serve as derivatives risk manager, a majority of such officers may not be portfolio managers of the fund.[29] Additionally, the proposed rule would require a fund to "reasonably segregate" the DRMP from its portfolio management.[30] The SEC states in the proposing release that there are a number of ways that a fund might achieve this goal, including independent reporting chains, oversight arrangements or separate monitoring systems.[31] The SEC states that the requirement of reasonable segregation would not require funds to implement strict protocols regarding communications between specific personnel (such as a "firewall") and that it expects that a fund's derivatives risk management team would work with the portfolio management team.[32]

2. Board of Directors Approval and Reporting

The proposed rule would not require approval of the adoption of the DRMP by the fund's board or board approval of subsequent material changes to the DRMP. The derivatives risk manager would be required to provide the board with a written report, on or before the implementation of the DRMP and at least annually thereafter, on the DRMP's implementation and effectiveness. The report would be required to include a representation (based on the derivatives risk manager's reasonable belief after due inquiry) that the DRMP is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the DRMP, as well as the basis for such representation and such information as is reasonably necessary for the board to evaluate the adequacy of the DRMP and the effectiveness of its implementation. The report would also be required to include the derivatives risk manager's basis for the selection of any designated reference index (or in the absence thereof, an explanation of why an appropriate index was not identified).[33]

The proposed rule would also obligate a fund's derivatives risk manager to provide the board (at a frequency determined by the board) with a written report analyzing any circumstances under which the metrics in the fund's risk guidelines were exceeded, as well as the results of the fund's stress tests and backtesting. This report would also be required to include such information as is reasonably necessary for the board to evaluate the fund's response to the circumstances under which any metrics in the fund's risk guidelines were exceeded, as well as the stress testing and backtesting results.[34]

The proposed board approval and reporting requirements represent a significant relaxation of those included in the version of rule 18f-4 proposed in 2015. The earlier version of the proposed rule would have required a fund's board to monitor the fund's derivatives transactions to determine whether the adoption of a DRMP would be mandated by the proposed rule, approve the DRMP as well as any material changes thereto, appoint a derivatives risk manager, review written reports prepared by the derivatives risk manager on at least a quarterly basis, and undertake a thorough review and update of the DRMP on at least an annual basis, including a review of any models or policies used in the program.[35] The 2015 proposal would have additionally required a fund's board to approve the fund's choice of portfolio limit rules, and to approve policies for determining the proper amount of qualifying coverage assets for each derivatives transaction.[36] A number of commenters on the 2015 proposal stressed that a fund board's role is one of oversight rather than management, and objected to various elements of the proposal that were viewed as requiring excessive board involvement in management or operational matters.[37] The SEC states in the proposing release that "[t]he proposed rule's requirements regarding board oversight and reporting are designed to further facilitate the board's oversight of the fund's derivatives risk management" and notes that a fund's board would also be responsible for overseeing the fund's compliance with the proposed rule.[38]

Commenting on the fund board's role, the SEC stated:

> Board oversight should not be a passive activity. Consistent with that view, we believe that directors should understand the program and the derivatives risk it is designed to manage as well as participate in determining who should administer the program. They also should ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation. The board should view oversight as an iterative process. Therefore, the board should inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including as those risks may emerge over time. To facilitate the board's oversight, the proposed rule, as discussed below, would require the fund's derivatives risk manager to provide reports to the board.[39]

LIMITED DERIVATIVES USERS

The proposed rule allows certain "limited derivatives users" to engage in derivatives transactions without complying with the fund leverage risk limit or adopting a DRMP.[40] A fund would be able to qualify as a limited derivatives user if:

- the fund's derivatives exposure (defined to mean the sum of notional amounts of the fund's derivatives instruments and, for short sale borrowings, the value of any asset sold) does not exceed 10% of the fund's net assets;[41] or
- the fund engages in derivatives transactions for the sole purpose of hedging currency risks associated with specific foreign-currency-denominated equity or fixed-income investments in the fund's portfolio. The notional amount of the currency derivatives held by the fund cannot exceed the value of the instruments denominated in the foreign currency by more than a negligible amount.[42]

While a fund relying on the exception for limited derivatives users would not be required to adopt a formal DRMP, it would be required to adopt policies and procedures reasonably designed to manage its derivatives risk.[43] The proposing release notes that a fund would need to tailor its risk management policies and procedures to the extent and nature of its derivatives use. For instance, a fund that only occasionally uses derivatives for a limited purpose could institute limited policies and procedures, while a fund utilizing complex derivatives in an amount approaching 10% of its net assets would need more extensive policies and procedures.[44]

The proposing release notes that this exception would allow the majority of mutual funds, ETFs, registered closed-end funds and variable annuity separate accounts registered as management investment companies to maintain their present level of derivatives exposure.[45] The proposing release further notes that the SEC staff believes that most business development companies ("BDCs") either "would not use derivatives or would rely on the exception for limited derivatives users."[46]

ALTERNATIVE REQUIREMENTS FOR LEVERAGED/INVERSE FUNDS

1. Limits on Engagement in Derivatives Transactions

The proposed rule and proposed sales practices rules set forth alternative requirements for funds that are leveraged/inverse investment vehicles (as defined in the proposed sales practices rules) seeking to engage in derivatives transactions in reliance on the proposed rule's exemption from section 18. A leveraged/inverse investment vehicle is proposed to be defined as "a registered investment company (or any 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."[47] In the proposing release, the SEC reviews various issues relating to leveraged/inverse investment vehicles, noting that its Office of Investor Education and Advocacy and the Financial Industry Regulatory Authority ("FINRA") have issued alerts, commencing over ten years ago, "to highlight issues investors should consider when investing in leveraged/inverse funds."[48] The SEC further states that the special provisions of the proposed rule and the proposed sales practices rules "are designed to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are

capable of evaluating the risks these products present" and "also would limit the amount of leverage that leveraged/inverse funds subject to rule 18f-4 can obtain to their current levels."[49]

The proposed rule would allow a fund to engage in derivatives transactions in reliance on the proposed rule without complying with the limit on fund leverage risk, provided that the fund:

- meets the definition of a "leveraged/inverse investment vehicle";
- discloses in its prospectus that it is not subject to the fund leverage risk limit; and
- does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return, or inverse of the return, of its underlying index.[50]

A fund that satisfies the above conditions would be subject to all other conditions in the proposed rule, including the requirement for the adoption and implementation of a DRMP, board approval of a derivatives risk manager and recordkeeping.[51]

2. Sales Practices Rules

The proposed sales practices rules would require broker-dealers to satisfy the following requirements before accepting retail investor orders for or approving retail investor accounts to engage in transactions in leveraged/inverse investment vehicles, and would require investment advisers to satisfy the same requirements before placing an order for the account of a retail advisory client to buy or sell shares of leveraged/inverse investment vehicles:

- engage in due diligence to ascertain certain key facts about the retail investor;
- adopt policies and procedures reasonably designed to effectuate compliance with the proposed sales practices rules.[52]

For this purpose, a retail investor is any natural person, without regard to net worth, or his or her legal representative, consistent with the approach recently taken in Regulation Best Interest. The proposed sales practices rules would require a broker-dealer or investment adviser, at a minimum, to seek to obtain information about the retail investor's investment objectives, employment status, estimated annual income, estimated net worth, estimated liquid net worth (and the percentage thereof that the investor plans to invest in leveraged/inverse investment vehicles), and investment experience and knowledge concerning leveraged/inverse investment vehicles and other financial instruments.[53] Following on this inquiry, a firm may proceed to approve or place a retail investor's account or order (as applicable) only if it has a reasonable basis to believe that the investor is capable of evaluating the risks associated with leveraged/inverse investment vehicles.[54]

The SEC states in the proposing release that "[t]he approval and due diligence requirements under the proposed rules are modeled after current FINRA options account approval requirements for broker-dealers."[55] In an "Economics Note" issued with the proposing release, the SEC's Division of Economic and

Risk Analysis found that the likelihood of experiencing losses from a long-term investment in a leveraged ETF increases with leverage, similar to holding an option.[56]

3. Proposed Amendment to Rule 6c-11

The SEC also proposes to amend rule 6c-11, which the SEC adopted on September 26, 2019. Rule 6c-11 allows ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the SEC, but includes a provision excluding leveraged/inverse ETFs from the scope of ETFs permitted to rely on that rule.[57] The proposed amendment to rule 6c-11 would remove the provision disallowing leveraged/inverse ETFs from relying on rule 6c-11, effective one year after the publication of the final amendments in the Federal Register. The SEC additionally proposes to rescind the exemptive orders that it had previously issued to leveraged/inverse ETFs. The proposing release states that only two fund complexes currently rely upon the exemptive orders for leveraged/inverse ETFs.[58]

REVERSE REPURCHASE AGREEMENTS AND UNFUNDED COMMITMENT AGREEMENTS

Pursuant to sections 18 and 61 of the ICA, funds may engage in certain transactions involving senior securities for the primary purpose of obtaining financing. The proposing release notes that reverse repurchase agreements are economically equivalent to secured borrowings and, therefore, more closely resemble bank borrowings with a known repayment obligation rather than the more-uncertain payment obligations of many derivatives.[59] For this reason, the proposed rule would treat reverse repurchase agreements, and similar financing transactions that have the effect of allowing a fund to obtain additional cash for investment purposes or to finance fund assets, like a bank borrowing or other borrowing, and not like a derivatives transaction, for the purposes of section 18. As such, proposed rule 18f-4(d) would allow funds to enter into reverse repurchase agreements or similar financing transactions, subject to the relevant asset coverage requirements of section 18 or section 61, as applicable.[60]

The proposing release provides additional guidance on two types of transactions that may be structurally or economically similar to a reverse repurchase agreement and thus may be deemed "similar financing transactions" for purposes of the proposed rule. With respect to securities lending arrangements, which are structurally similar to reverse repurchase agreements because in both cases a fund transfers a portfolio security to a counterparty in exchange for cash or other assets, the proposing release notes that a fund's obligation to return securities lending collateral would not be viewed as a "similar financing transaction" for purposes of the proposed rule so long as "the obligation relates to an agreement under which a fund engages in securities lending, the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests cash collateral solely in cash or cash equivalents."[61] However, if a fund engaged in securities lending were to invest the cash collateral in securities other than cash or cash equivalents, the transaction would be a "similar financing transaction,"

because the transaction may result in leveraging of the fund's portfolio.[62] The proposing release also provides guidance with respect to "tender option bond" ("TOB") financing.[63]

The proposed rule would also establish a new set of requirements for unfunded commitment agreements, which the proposed rule would define as "a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."[64] In the proposing release, the SEC acknowledges that unfunded commitment agreements have characteristics that distinguish them from derivatives transactions, including that they do not have a leveraging effect on a fund's portfolio.[65] Based on those characteristics, the SEC takes the position that unfunded commitment agreements should not be subject to the same restrictions as derivatives transactions, as they generally do not raise the undue speculation concerns associated with derivatives transactions. However, the SEC finds that unfunded commitment agreements could raise asset sufficiency concerns.[66] As such, the proposed rule would allow a fund to enter into an unfunded commitment agreement, notwithstanding the requirements of sections 18 and 61 of the ICA, if the fund reasonably believes, at the time of its entry into the agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.[67]

In forming a reasonable belief, the fund must take into account its reasonable expectations with respect to other obligations (including senior securities or redemptions), but may not take into account (i) cash that may become available from the sale or disposition of any investment at a price deviating significantly from the market value of such investment, or (ii) cash from issuance of additional equity.[68] In the event that a fund proceeds to enter into an unfunded commitment agreement, it must document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its payment obligations thereunder, and maintain a record of this documentation for not less than five years following the date that the fund entered into the agreement.[69]

The proposed rule's treatment of reverse repurchase agreements and unfunded commitment agreements is substantially less restrictive than the 2015 proposal, which would have categorized reverse repurchase agreements and unfunded commitment agreements as "financial commitment transactions", and required funds entering into such transactions in reliance on the proposed rule to maintain qualifying coverage assets equal or greater in value than the fund's aggregate financial commitment obligations.[70]

RECORDKEEPING, DISCLOSURE AND REPORTING REQUIREMENTS

The proposed rule includes certain recordkeeping requirements related to a fund's compliance with the proposed rule. A fund would be required to maintain, for at least five years, a copy of the fund's DRMP (or, in the case of a fund that is a limited derivatives user, a copy of the policies and procedures reasonably designed to manage the fund's derivatives risks), results of stress tests and backtesting, results of any

internal reporting or escalation of material risks pursuant to the DRMP, records of the periodic reviews of the DRMP, copies of any materials provided to the fund's board in connection with its designation of the derivatives risk manager, any written reports provided to the board in connection with the DRMP, and copies of the fund's determination of the VaR of its portfolio, VaR of its designated reference index (if applicable), VaR ratio, or any updates to any VaR calculation models used by the fund.[71]

Moreover, the proposing release includes proposed amendments to Forms N-PORT, N-LIQUID (which is proposed to be re-titled Form N-RN), and N-CEN that would require additional disclosure and reporting regarding registered investment company use of derivatives and associated risk calculations. The SEC proposes to amend Form N-PORT to require a fund to report its derivatives exposure as of the end of the reporting period, and to require a fund that is subject to the VaR-based fund leverage risk limit to report its highest daily VaR during the reporting period and its corresponding date, its median daily VaR for such period, and the number of exceptions during the reporting period that arose from backtesting the fund's VaR model.[72] Form N-RN would be amended to require a fund to provide certain information regarding its VaR or the value of its net assets (and if applicable, the VaR of its designated reference index) during any period in which the fund is out of compliance with its VaR limit for more than three business days.[73] Form N-CEN would be amended to require a fund to identify whether it relied on proposed rule 18f-4 during the reporting period.[74]

STATEMENTS OF COMMISSIONERS ON THE PROPOSALS

On November 26, 2019, Commissioners Robert Jackson Jr. and Allison Lee issued a joint statement broadly supporting the proposed rules, but expressed their view that even under the proposed new regime, leverage still "presents serious risks, magnifying losses for investors in times of turbulence."[75] Commissioners Jackson and Lee questioned whether the sales practices rules offer sufficient protection against risks presented by leveraged/inverse funds. They also expressed their concern about the fact that, in contrast with the 2015 proposal, a fund's board would not be required to approve the fund's DRMP under the proposed rule, and they urged the SEC to "consider further measures to ensure that funds' VaR models are reliable and not subject to opportunistic gaming".[76]

On the same day, Commissioners Hester Peirce and Elad Roisman released a joint statement lauding the proposal as a "much needed modernization" that offers funds more flexibility than the 2015 proposal. However, they expressed concern that the proposal may be "overly prescriptive or expansive" as presently constituted. They expressed the views that the proposed 300% cap on leveraged/inverse fund returns relative to an underlying index is an "overly-paternalistic approach to investor protection", and that the existing regulatory regimes governing the conduct of broker-dealers and investment advisers, including Regulation Best Interest, obviate the need for the sales practices rules. They additionally remarked that the

proposing release provides insufficient guidance on how broker-dealers and investment advisers are to assess retail investors' answers to the mandated diligence questions in the sales practices rules.[77]

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ENDNOTES

[1] *See* "Use of Derivatives by Registered Investment Companies and Business Development Companies, Securities Act Release No. IC-33704" (November 25, 2019) (the "proposing release"), *available at* https://www.sec.gov/rules/proposed/2019/34-87607.pdf. The initial proposal was released in 2015. *See* "Use of Derivatives by Registered Investment Companies and Business Development Companies, Securities Act Release No. IC-31933" (December 11, 2015), *available at* http://www.sec.gov/rules/proposed/2015/ic-31933.pdf (the "2015 proposing release"). *See also* Sullivan & Cromwell LLP Memorandum, Use of Derivatives by Registered Investment Companies and Business Development Companies (December 18, 2015), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Use_of_Derivatives_by_Registered_Investment_Companies.pdf.

[2] The SEC proposes that Release 10666 be rescinded, and states that the staff in the Division of Investment Management is reviewing certain of the Division's no-action letters and other guidance concerning derivatives transactions and other transactions covered by the proposed rule to determine which no-action letters or other guidance documents should be withdrawn. Proposing release at 36.

[3] *See* proposing release at 17-19.

[4] Section 18(g) of the ICA defines "senior security" in part as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness" and the SEC states in the proposing release (at 22) that "where a fund has entered into a derivatives transaction and has . . . a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18." (footnote omitted).

[5] *See* "Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666" (April 18, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

[6] *See* 2015 proposing release at 17–18 (quoting Release No. 10666, at discussion of "Segregated Account").

[7] "Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. IC-29776" (August 31, 2011), *available at* https://www.sec.gov/rules/concept/2011/ic-29776.pdf. *See also* "Concept Release on Use of Derivatives by Funds" Sullivan & Cromwell LLP (September 15, 2011), *available at* https://www.sullcrom.com/Concept-Release-on-Use-of-Derivatives-by-Funds.

[8] *See generally* the 2015 proposing release. The 2015 proposal also would have imposed different requirements upon "financial commitment transactions", including that a fund's obligations under such transactions could not exceed the fund's net asset value. *See* proposing release at 229.

[9] Proposing release at 12.

[10] Public Statement, 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) (the "Peirce-Roisman Statement").

[11] *See* proposing release at 28–29.

[12] The proposed rule would not apply to money market funds, which typically do not engage in derivatives transactions or unit investment trusts ("UITs"), including ETFs structured as UITs, because UITs are not subject to the restrictions of section 18 of the ICA. *Id.* at 36–37.

[13] Proposed rule 18f-4(a). The 2015 proposal utilized a near-identical definition. *See* proposing release at 39. The proposing release states that the SEC considered using a more conceptual definition of "derivatives transaction" as an instrument or contract whose value is based upon some other asset or metric, but concluded that the relatively comprehensive list of derivatives within the definition, along with the inclusion in the definition of "any similar instrument", would suffice to

include types of derivatives developed in the future within the scope of the definition. Proposing release at 40, n.83.

[14] The proposing release notes that such types of derivatives instruments would not constitute "senior securities" under section 18 of the ICA, as "senior security" is defined in part as "any . . . similar obligation or instrument constituting a security and evidencing indebtedness," and that the SEC has previously stated that for purposes of section 18, "evidence of indebtedness" would include "all contractual obligations to pay in the future for consideration presently received." Proposing release at 40.

[15] Proposed rule 18f-4(a).

[16] *See* proposed rule 18f-4(c)(1). While VaR is not itself a measure of leverage, the SEC notes that it is a widely-used industry metric that allows risk to be measured in a comparable and consistent manner across the diverse instruments in a portfolio, in a manner reflecting the risk characteristics of those investments. In addition, comparison of a fund's VaR to an unleveraged reference index can shed light on whether the fund is using derivatives transactions to leverage its portfolio or for other purposes. The proposing release provides the example of fixed-income funds, which often utilize derivatives transactions for reasons unrelated to leverage, such as lessening the risks associated with their investments in bonds, or achieving specified risk targets. Proposing release at 92-93.

[17] Proposed rule 18f-4(a).

[18] Proposing release at 118–119.

[19] *Id.* at 123.

[20] Proposed rule 18f-4(a).

[21] *Id.*

[22] Proposing release at 100–101.

[23] Proposed rule 18f-4(a). The proposing release notes that multi-strategy funds, in particular, may be unable to pinpoint a single index (even a blended index) that would be an appropriate reference index. *See* proposing release at 114.

[24] The proposing release notes that Division of Economic and Risk Analysis staff calculated the mean VaR of the S&P 500 since inception as approximately 10.4%. The SEC expresses the view in the proposing release that "[s]etting the level of loss in the proposed absolute VaR test at 15% of a fund's net assets would therefore provide approximately comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the S&P 500 as their designated reference index during periods where the S&P 500's VaR is approximately equal to the historical mean." Proposing release at 115.

[25] Proposed rule 18f-4(c)(2).

[26] Proposed rule 18f-4(c)(1).

[27] *Id.*

[28] Proposed rule 18f-4(c)(5)(i).

[29] Proposed rule 18f-4(a).

[30] Proposed rule 18f-4(c)(1).

[31] Proposing release at 50.

[32] Proposing release at 50–51.

[33] Proposed rule 18f-4(c)(1)(v).

[34] Proposed rule 18f-4(c)(5)(iii).

ENDNOTES (CONTINUED)

[35] *See* 2015 proposing release at 228.

[36] *See id.* at 149.

[37] *See, e.g.*, Comment Letter of Mutual Fund Directors Forum (Mar. 28, 2016), at 2 ("we are concerned that the Commission's description of the board's role goes beyond a board's oversight responsibilities and, instead, forces the board to become involved in risk management"); Comment Letter of the Independent Directors Council (Mar. 28, 2016), at 2 ("we believe that the proposed should be revised in a manner that appropriately acknowledges and reflects the board's oversight role"); and Comment Letter of the American Bar Association Business Law Section Federal Regulation of Securities Committee (Apr. 8, 2016), at 3 ("We are concerned that the tasks the proposed rule allocates to a Fund's board of directors . . . would require the Board to go beyond its traditional oversight role and move closer to the role of an investment manager.").

[38] Proposing release at 80–81.

[39] *Id.*

[40] Proposed rule 18f-4(c)(3).

[41] When calculating derivatives exposure, a fund may convert the notional amount of interest rate derivatives to ten-year bond equivalents, and may delta adjust the notional amounts of options contract. Proposed rule 18f-4a.

[42] Proposed rule 18f-4(c)(3).

[43] *Id.* The proposing release notes that even if a fund's use of derivatives does not introduce leverage risks, it could introduce other risks, such as counterparty risk or the risk that a fund may be required to sell its investments to meet margin calls. Proposing release at 168.

[44] *See* proposing release at 168–169.

[45] The proposing release notes that of the funds required to file Form N-PORT as of September 2019, 78% of funds have adjusted notional amounts of derivatives exposure (after adjusting interest rate derivatives as permitted under the proposed rule) below 10% of their net asset value. *See* proposing release at 152.

[46] Proposing release at 111.

[47] Proposed rules 240.15*l*-2(d) and 211(h)-1.

[48] Proposing release at 179. SEC staff and FINRA jointly issued an alert in August 2009, following FINRA's June 2009 alert which raises concerns regarding retail investors holding leveraged/inverse ETFs over periods of time exceeding one day. SEC Investor Alert and Bulletins, *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors* (Aug. 1, 2009), *available at* https://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.

[49] Proposing release at 181.

[50] Proposed rule 18f-4(c)(4).

[51] Proposing release at 201.

[52] Proposed rule 240-15*l*-1.

[53] Proposed rule 240-15*l*-2.

[54] Proposed rule 240.15*l*-1.

[55] Proposing release at 183.

[56] *See* Division of Economic and Risk Analysis, Economics Note: The Distribution of Leveraged ETF Returns (Nov. 2019), *available at* https://www.sec.gov/files/DERA_LETF_Economics_Note_Nov2019.pdf.

ENDNOTES (CONTINUED)

[57] *See* rule 6c-11(a)-(c). *See also* Sullivan & Cromwell LLP Memorandum, SEC Adopts New ETF Rule and Related Form Amendments and Issues Exemptive Order (October 7, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-SEC-Adopts-New-ETF-Rule-and-Issues-Exemptive-Order.pdf.

[58] Proposing release at 205, n.357. The SEC has maintained a moratorium on granting fund sponsors exemptive relief to launch leveraged/inverse ETFs. Proposing release at 295.

[59] Proposing release at 224-225. The proposing release notes that in a reverse repurchase agreement, a fund transfers a security to a counterparty in exchange for a payment equaling a percentage of the value of the security, and that at a future date, the fund repurchases the transferred security for consideration equaling the proceeds of the initial sale transaction plus interest. *Id.* at 224.

[60] Section 18, in the case of registered funds, and section 61, in the case of BDCs, sets forth the required amount of asset coverage for a fund's or BDC's senior securities, and provides for certain consequences for a fund or BDC that does not satisfy the asset coverage requirements applicable to it. Proposing release at 224. When calculating its asset coverage ratio, a fund must combine "the aggregate amount of indebtedness associated with the reverse repurchase agreement or similar financing transaction with the aggregate amount of any other senior securities representing indebtedness." Proposed rule 18f-4(d).

[61] *See* proposing release at 226–227.

[62] *Id.* at 227.

[63] *Id.* at 227–228.

[64] Proposed rule 18f-4(a).

[65] Proposing release at 229–232.

[66] *Id.* at 232–233.

[67] Proposed rule 18f-4(e)(1).

[68] *Id.*

[69] Proposed rule 18f-4(e)(2).

[70] *See* proposing release at 229, n.409.

[71] Proposed rule 18f-4(c)(6).

[72] *See* proposed Item B.9 of Form N-PORT and proposed Item B.10 of Form N-PORT; *see generally* proposing release at 208–212.

[73] *See* proposed Form N-RN; *see generally* proposing release at 213-219.

[74] *See* proposed Item C.7 of form N-CEN.

[75] Public Statement, Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee, Statement on Proposed Rules on Funds' Use of Derivatives (November 26, 2019). The Commissioners emphasized their concern that "insufficient board involvement" in the adoption of the DRMP can "prevent development of the director-level proficiency needed to provide meaningful oversight and ensure sound risk management for investors".

[76] *See id.*

[77] *See* Peirce-Roisman statement.

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