SULLIVAN & CROMWELL LLP

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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 Registered Investment Companies and Business Development Companies to Comply with Portfolio Limitations on Their Use of Derivatives, Establish Stricter Asset Coverage Requirements, and Require Funds That Utilize Derivatives to Establish a Derivatives Risk Management Program; Rule Would Mandate Board Oversight and Require Various Board Approvals

SUMMARY

On December 11, 2015, the Securities and Exchange Commission, by a vote of three to one, proposed new rule 18f-4 under the Investment Company Act of 1940. The proposed rule would provide registered investment companies and business development companies that comply with certain requirements with an exemption that would permit them to enter into derivatives transactions and financial commitment transactions (as those terms are defined in the proposed rule) notwithstanding the Investment Company Act's prohibitions and restrictions on the issuance of senior securities.[1] Compared to existing SEC and SEC staff guidance on which funds have historically relied to engage in such transactions, which would be superseded and rescinded, the new rule would impose significant new restrictions and requirements. In particular, a fund seeking to rely on the new rule would be required to:

- comply with one of two alternative portfolio limitations designed to impose a limit on the total amount of leverage the fund can obtain through derivatives and financial commitment transactions;

- maintain an amount of "qualifying coverage assets" (which must generally be cash or cash equivalents) with respect to each derivative or financial commitment transaction designed to enable it to meet its obligations under such transaction;
- if the fund engages in derivatives transactions with a combined notional value of at least 50% of a fund's net assets, or transacts in complex derivatives, establish a formalized derivatives risk management program;
- obtain various board approvals, including of the fund's choice of portfolio limitation, its asset coverage policies and procedures, and its derivatives risk management program, and conduct periodic board reviews of various aspects of the fund's compliance with the proposed rule; and
- comply with new recordkeeping, disclosure and reporting requirements related to a fund's use of derivatives.

The SEC acknowledged in the proposing release that certain alternative strategy funds, particularly so-called leveraged ETFs, could not continue operating as registered funds under the proposed rule's restrictions, and stated that such funds may wish to consider de-registering under the Investment Company Act, with the funds' sponsors offering such strategies via private funds or other vehicles not subject to statutory limitations on the use of leverage.

The SEC also proposed amendments to proposed Forms N-PORT and N-CEN that would require registered investment companies to report additional information regarding their derivatives and financial commitment transactions.

The SEC has requested comments regarding the proposed rule and the proposed amendments to Form N-PORT and N-CEN generally and on numerous specific matters discussed in the release. Comments must be submitted no later than 90 days following the release's publication in the Federal Register.

BACKGROUND

Section 18 of the Investment Company Act of 1940, as amended (the "ICA"), places significant restrictions on the ability of registered investment companies to issue "senior securities." The provision was intended to protect fund investors from the risks of excessive leverage, which, at the time the ICA was enacted, could typically only be achieved by issuing debt securities or obtaining bank loans. In the decades since then, with the advent of derivatives, reverse repurchase agreements and other transactions through which funds are effectively able to achieve leverage, the SEC has broadly interpreted section 18's restrictions against "senior securities" as being implicated by such transactions. 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 such 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.[2] The asset coverage requirement was intended to "assure the availability of adequate funds to meet the [fund's] obligations" from such activities and 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."[3] This concept has been further developed and expanded to cover new types of derivatives and other leverage-producing instruments, and other ways to "cover" funds' potential obligations, in a series of over 30 no-action letters and SEC releases over the past few decades.

Responding to the dramatic growth in the volume and complexity of the derivatives markets, 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, and in 2011 published a concept release which discussed and requested comments on various related issues.[4] In remarks delivered at an SEC meeting last week to discuss the proposed rule, Chair Mary Jo White stated that she had concluded from the SEC's review that existing SEC guidance no longer effectively protects investors from the risks of excessive leverage.[5] In particular, Chair White noted the ability of funds under existing guidance to obtain high levels of exposure through the practice of "mark-to-market segregation," whereby a fund segregates liquid assets only in an amount equal to the current liability, if any, of a derivatives transaction – leaving the fund exposed to potential future losses from the transaction. Proposed rule 18f-4 would supersede the existing guidance concerning funds' use of derivatives and financial commitment transactions (including Release 10666), which would be rescinded if the proposed rule is adopted.

The proposing release notes that, in December 2014, the Financial Stability Oversight Council ("FSOC") issued a notice requesting comments on aspects of the investment management industry, including potential risks related to leverage, and that although the proposed rule is independent of FSOC, the SEC considered comments responding to the FSOC notice in proposing the rule.

The proposed rule is the latest in a series of recent SEC rulemakings aimed at addressing the perceived risks to investors resulting from increasingly complex portfolio composition and operations in the asset management industry.[6] SEC Commissioner Michael S. Piwowar, who dissented from the SEC's decision to issue the rule proposal, noted his support for the proposed asset coverage requirements, discussed below, but disapproved of the proposed portfolio limitations, which he considered unnecessary and unduly burdensome given the effective limitations on leverage imposed by the proposed asset coverage requirements.[7]

PORTFOLIO LIMITATIONS FOR DERIVATIVES TRANSACTIONS

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.[8] "Derivatives transaction" would be defined as "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."[9] This definition would not encompass types of derivatives (such as purchased call options) that do not impose a payment obligation on the fund beyond its investment.[10]

Funds seeking to utilize the exemption and engage in derivatives transactions would be required to comply with one of two alternative portfolio limitation rules – an "exposure-based portfolio limit," or a "risk-based portfolio limit" – both of which are designed to address concerns of excessive leverage and undue speculation by imposing an overall limit on the amount of exposure to underlying reference assets, and thus potential leverage, that a fund would be able to achieve through the use of derivatives and similar transactions, while also providing funds flexibility to use derivatives for a variety of purposes.

1. Exposure-Based Portfolio Limit

Under the exposure-based portfolio limit, a fund would be required to operate such that its overall exposure to (i) derivatives transactions, (ii) financial commitment transactions (as defined below under "Financial Commitment Transactions") and (iii) other transactions involving senior securities entered into other than in reliance on rule 18f-4, does not exceed 150% of its net assets, measured immediately after entering into any such transaction (collectively, "senior securities transactions").[11] The fund's "exposure" for purposes of this limit would be calculated as the sum of (i) the aggregate notional amounts[12] of the fund's derivatives transactions (subject to certain exceptions described below), (ii) the aggregate obligations of the fund under its financial commitment transactions, and (iii) the fund's aggregate indebtedness with respect to any other senior securities transactions.[13]

For three categories of derivatives transaction, the proposed rule prescribes alternative methods for calculating the transaction's exposure:

- for derivatives that provide a return based on the leveraged performance of an underlying reference asset, the rule would require the notional amount to be multiplied by the applicable leverage factor;[14]
- for derivatives transactions for which the underlying reference asset in a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the rule includes a "look-through" provision, requiring the fund to calculate the notional amount of such transaction by reference to its pro rata portion of the notional amounts of derivatives transactions of the underlying reference vehicle;[15] and
- for certain "complex derivatives transactions," (*i.e.*, derivatives providing for payments that are dependent on the value of a reference asset at multiple points in time,[16] or on a non-linear function of the value of the reference asset, other than due to optionality arising from a single strike price[17]), the notional amount would be equal to the aggregate notional amount of other, non-complex derivatives transactions which, taken together, would in the fund's reasonable estimation offset substantially all of the market risk of the complex derivatives transaction at the time it was entered into.[18]

In determining aggregate notional exposure, a fund would be permitted to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. Such transactions need not be with the same counterparty.

The proposing release discusses at length research undertaken by the SEC's Division of Economic and Risk Analysis ("DERA"), published in an accompanying white paper (the "DERA White Paper"), and surveys the effects the proposed rule may have on a range of Funds.[19] The SEC notes that 99% of mutual funds sampled in its survey have exposure to derivatives transactions below the proposed 150% threshold, but also acknowledges that the proposed rule will have particularly significant effects on alternative strategy funds that employ leverage as part of their investment strategy. In particular, certain leveraged ETFs which seek to return a multiple of market performance on a daily basis "may find it impractical to reduce their exposures below the proposed limit of 150%," and the SEC states that such funds may wish to consider deregistering under the ICA.[20]

2. Risk-Based Portfolio Limit

As an alternative to the exposure-based portfolio limit, under the proposed rule, funds seeking to utilize rule 18f-4 could choose to comply with a risk-based portfolio limit. The risk-based portfolio limit would allow a fund to obtain exposure of up to 300% of its net assets, provided it satisfies a value-at-risk test (the "VaR test") designed to measure whether the fund's derivatives transactions, in aggregate, have the effect of reducing the fund's exposure to market risk.[21] The risk-based portfolio limit option is designed to accommodate funds which engage in extensive derivatives transactions primarily for the purpose of hedging (*i.e.*, limiting their exposure to market risks).

Value at risk is defined for purposes of the proposed rule as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in US dollars, over a specified time horizon and at a given confidence level."[22] To satisfy the VaR test, a fund's "full portfolio VaR" (defined as the VaR of its entire portfolio, including all holdings) must be less than the fund's "securities VaR" (defined as the VaR of all holdings other than derivatives transactions) immediately after the fund enters into any derivatives transaction or other senior securities transaction.[23] Under the proposed rule, a fund would have flexibility to select a VaR model (including historical, Monte Carlo or parametric models) and to determine the parameters for the test, provided that compliant VaR tests must:[24]

- take into account all significant, identifiable market risk factors associated with a fund's investments, including but not limited to equity price risk, interest rate risk, credit spread risk, foreign currency risk, commodity price risk and market sensitivity;
- utilize a minimum 99% confidence interval;
- utilize a time horizon of at least 10 and not more than 20 trading days;
- utilize a minimum of three years of historical data to estimate historical VaR; and
- be implemented consistently when calculating its securities VaR and full portfolio VaR.

3. Implementation and Operation of Portfolio Limitations

When a fund elects to engage in derivatives transactions pursuant to the exemption in the proposed rule, the fund's board of directors, including a majority of independent directors, would be required to approve the fund's choice as to which of the two alternative portfolio limit rules will apply to the fund.[25] Compliance with the applicable limitation would be measured immediately after entering into any derivatives transaction or other senior securities transaction. Thus, a fund would not be required to terminate or unwind a transaction that was permitted under the portfolio limitation when entered into solely because the fund's exposure increased after the fund entered into such transaction.

ASSET COVERAGE REQUIREMENTS

In addition to compliance with one of the two alternative portfolio limitations, funds that choose to engage in derivatives transactions in reliance on the exemption in the proposed rule must also comply with specified asset coverage requirements. While the portfolio limitations are designed to limit the amount of leverage a fund may achieve, the asset coverage requirements are intended to ensure that funds have sufficient assets to meet their payment obligations under such transactions. The proposed rule requires a fund to maintain a certain amount of "qualifying coverage assets" for each derivatives transaction, determined pursuant to policies and procedures approved by the fund's board, including a majority of independent directors.[26] Funds would be required to determine, and identify on their books and records, the qualifying coverage assets for their derivatives transactions at least once each business day. With certain exceptions, only cash and cash equivalents[27] would be considered qualifying coverage assets for derivatives transactions.[28]

Under the proposed rule, the amount of qualifying coverage assets for any derivatives transaction would be equal to (i) the amount that would be payable by the fund if it were to exit the transaction at the time of determination (the "mark-to-market coverage amount") and (ii) a reasonable estimate of the potential amount payable by the fund if the fund were to exit the transaction under stressed conditions (the "risk-based coverage amount").[29] The addition of the risk-based component is intended to address the risk that the mark-to-market coverage amount may be significantly less than the fund's ultimate payment obligations under a transaction.[30]

The proposed rule would require a fund to calculate its risk-based coverage amounts in accordance with policies and procedures approved by the fund's board, which must take into account the structure, terms and characteristics of each derivatives transaction and the underlying reference asset.[31] A fund would also be free to take into account additional considerations, such as (i) the fund's ability to terminate the trade or otherwise exit the position under stressed conditions, and (ii) if the fund's policies and procedures under its derivatives risk management program (discussed below) include stress testing, the results of such stress testing. Alternatively, the proposing release notes that a fund's policies and procedures could provide for the use of a stressed VaR model to estimate the risk-based coverage amount of certain types of derivatives transactions.

In calculating the mark-to-market and risk-based coverage amounts, the proposed rule would only allow a fund to net derivatives positions if the fund is party to a netting agreement that provides for the netting of its payment obligations under such transactions.[32] Moreover, a fund may subtract from the mark-to-market coverage amount the amount of any variation margin it has posted to cover its mark-to-market losses on derivatives transactions, and may subtract from the risk-based coverage amount the amount of any initial margin to cover the fund's future potential payment obligations.[33] In this way, the rule credits funds for assets that have, practically speaking, already been segregated.

Finally, the total amount of a fund's qualifying coverage assets (including any such assets being maintained with respect to financial commitment transactions, as described below) may not exceed the fund's net assets.[34]

DERIVATIVES RISK MANAGEMENT PROGRAM

Funds that engage in derivatives transactions with an aggregate notional exposure greater than 50% of the value of the fund's net assets, or that use complex derivatives transactions (as defined above), would be required to adopt and implement a formalized derivatives risk management program (referred to herein as a "DRMP").[35] Under the proposed rule, a DRMP must include policies and procedures reasonably designed to:[36]

- assess the risks associated with the fund's derivatives transactions, including by evaluating potential leverage, market, counterparty, liquidity and operational risks, as applicable, in addition to any other factors considered relevant;
- manage the risks of the fund's derivatives transactions, including by (i) monitoring whether the fund's use of derivatives is consistent with the fund's investment guidelines, the applicable portfolio limitation under the rule and relevant disclosure to investors and (ii) informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions;
- reasonably segregate the functions associated with the DRMP from the portfolio management of the fund; and
- periodically, but at least annually, review and update the DRMP, in accordance with procedures adopted for this purpose, which must include a review of any models, measurement tools, or policies and procedures used in the DRMP, and may include any additional considerations the fund considers appropriate in light of the fund's circumstances.

The DRMP must be administered by a designated derivatives risk manager, who may not be a portfolio manager of the fund, and whose designation must be approved by the fund's board, including a majority of independent directors.[37] The proposing release notes that among funds sampled by DERA for purposes of the DERA White Paper, about 6% of mutual funds, and about 52% of alternative strategy funds, had aggregate notional exposure in excess of the 50% threshold.[38]

The fund's board of directors (including a majority of independent directors) would be required to approve the adoption of the DRMP and any material changes to the DRMP. The board would also be required to review a written report from the derivatives risk manager on at least a quarterly basis reviewing the adequacy of the DRMP and the effectiveness of its implementation.[39] The proposing release emphasizes the role of a fund's independent directors in overseeing the DRMP.[40] However, the proposing release notes, consistent with the general scheme of board oversight of staff day-to-day management of compliance, that directors may satisfy their obligations with respect to initial approval of the DRMP by reviewing summaries of the DRMP prepared by the fund's derivatives risk manager, legal counsel or other persons familiar with the DRMP.

FINANCIAL COMMITMENT TRANSACTIONS

In addition to the use of derivatives transactions, the proposed rule would also address funds' use of "financial commitment transactions," defined as any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement or other similar agreement.[41] Consistent with the current regulatory treatment of such transactions under the principles of Investment Company Act Release 10666,[42] funds that enter into financial commitment transactions in reliance on the proposed rule would be required to maintain qualifying coverage assets equal in value to the full amount that the fund is conditionally[43] or unconditionally obligated to pay under each of the financial commitment transactions (the fund's "financial commitment obligation"). The amount of qualifying coverage assets with respect to financial commitment transactions would be required to be determined and identified on the fund's books and records at least once each business day.

The types of qualifying coverage assets would be broader with respect to financial commitment transactions than derivatives transactions. In addition to cash and cash equivalents, and, in the case of a financial commitment transaction that may be settled by delivering a particular asset, that particular asset, funds would also be permitted to satisfy the coverage requirement using assets that are convertible to cash or that will generate cash in an amount equal to the financial commitment obligation prior to the expected date of the fund's payment obligation, or 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.

Under the proposed rule, a fund's board, including a majority of independent directors, would be required to approve policies and procedures "reasonably designed to provide for the fund's maintenance of qualifying coverage assets" with respect to financial commitment transactions.[44] As described above with regard to derivatives transactions, the total amount of a fund's qualifying coverage assets (including any such assets being maintained with respect to derivatives transactions) would not be permitted to exceed the fund's net assets.[45]

RECORDKEEPING, DISCLOSURE AND REPORTING REQUIREMENTS

The proposed rule includes certain recordkeeping requirements related to the fund's compliance with the proposed rule. Funds must maintain, for at least five years, written records of board determinations with respect to the fund's selection of portfolio limitation, copies of the policies and procedures required under the rule, copies of any materials provided to the board relating to the DRMP, records documenting the periodic reviews and updates required under the rule and written records demonstrating compliance with the applicable portfolio limitation and asset coverage requirements with respect to each senior securities transaction entered into by the fund.[46]

Moreover, the proposing release includes amendments to proposed Form N-PORT and proposed Form N-CEN that would require additional disclosure and reporting regarding registered investment company use of derivatives and associated risk calculations. Proposed Form N-PORT would be amended to require any registered investment company that is required under proposed rule 18f-4 to implement a DRMP to disclose on its schedule of portfolio investments the "gamma" and "vega" for options and warrants.[47] Proposed Form N-CEN would be amended to require that any registered investment company that engages in derivatives transactions in reliance on proposed rule 18f-4 disclose which of the two alternative portfolio limitations the fund has elected to comply with.

RESPONSIBILITIES OF FUND DIRECTORS UNDER THE PROPOSED RULE

As described above, the proposed rule would add significant new responsibilities for fund directors, who would be required to approve, oversee and review various aspects of a fund's compliance with the rule. To the extent a fund elects to engage in derivatives transactions in reliance on the proposed rule, the fund's board, including a majority of independent directors, would be required to:

- approve the fund's choice of which of the two alternative portfolio limit rules will apply to the fund;
- approve policies and procedures for determining the proper amount of qualifying coverage assets for each derivatives transaction, including the fund's procedures for calculating the risk-based coverage amounts;
- monitor the fund's derivatives transactions, and, if the notional amount of those transactions exceeds 50% of the fund's net assets or the fund engages in any complex derivatives transactions, approve the fund's adoption of a DRMP, appoint a derivatives risk manager to oversee the program, review written reports produced by the derivatives risk manager on at least a quarterly basis, and engage in a thorough periodic review and update of the program on at least an annual basis, including a review of any models, measurement tools or policies and procedures used in the program; and
- with respect to financial commitment transactions, approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, including specific guidance regarding the fund's use of non-cash or cash-equivalent assets as coverage for such transactions.

To the extent a fund does not intend to use derivatives transactions in excess of the 50% aggregate exposure threshold or engage in complex derivatives transactions, the fund would not be required to establish a formalized DRMP provided that the fund's board of directors determines that the fund will comply, and monitor its compliance with, a portfolio limitation under which the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its net asset value and does not use complex derivatives transactions.

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ENDNOTES

[1] *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 "proposing release").

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

[3] *See* proposing release at 17–18 (quoting Release 10666, at discussion of "Segregated Account").

[4] "Use of Derivatives by Investment Companies under the Investment Company Act of 1940" (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.

[5] *See* Public Statement of Mary Jo White (December 11, 2015), *available at* http://www.sec.gov/news/statement/chair-white-statement-at-open-meeting.html.

[6] *See generally* "SEC Proposes Rules to Modify Reporting Regime for Registered Investment Companies and Investment Advisers" Sullivan & Cromwell LLP (May 26, 2015), *available at* https://www.sullcrom.com/sec-proposes-rules-to-modify-reporting-regime-for-registered-investment-companies-and-investment-advisers, "SEC Issues Liquidity Risk Management and "Swing Pricing" Proposal for Open-End Investment Funds" Sullivan & Cromwell LLP (October 2, 2015), *available at* https://www.sullcrom.com/sec-issues-liquidity-risk-management-and-swing-pricing-proposal-for-open-end-investment-funds.

[7] *See* Michael Piwowar, "Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies" (December 11, 2015) *available at* http://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html.

[8] The proposed rule would not apply to unit investment trusts ("UITs"), including ETFs structured as UITs, because UITs are not subject to the restrictions of section 18 of the ICA.

[9] Proposed rule 18f-4(c)(2). The SEC considered using a more conceptual definition of derivatives transaction but declined to do so due to concerns that such a definition might inadvertently be overbroad or include instruments not expected to implicate section 18 concerns.

[10] The release notes that although such types of derivatives provide the "economic equivalent" of leverage because they expose the fund to gains or losses in excess of the amount of the fund's investment, unlike other types of derivatives that impose a conditional or unconditional future payment obligation, they do not result in the kind of "indebtedness leverage" that section 18 is designed to limit. The release notes that the staff "preliminarily believe[s] that a derivative that does not impose a future payment obligation on the fund would not involve a senior security transaction for purposes of section 18." *See* proposing release at 30.

[11] *See* proposed rule 18f-4(a)(1)(i). The SEC proposed the 150% limit after considering a 50% limit, which would more closely track the leverage now available to funds through bank borrowing under section 18, and 100%, which approximates the exposure possible through Release 10666. *See* proposing release at 93. However, the SEC proposed a higher 150% limit, out of deference to industry commenters who noted that derivatives may be used by funds for a wide variety of purposes not resulting in additional leverage and thus not implicating investor protection concerns under the ICA. Moreover, the SEC acknowledged that its definition of notional amount "could be viewed as a relatively blunt measurement" insofar as certain derivatives transactions may feature a large notional value but not add leverage to the fund commensurate with that notional amount. *Id.* at 70. The 150% limit, which allows funds exposure in excess of their net assets, was proposed partly in recognition of the various ways that a fund might use derivatives transactions.

(*continued . . .*)

ENDNOTES (CONTINUED)

[12] The "notional amount" of a derivatives transaction would generally be defined under the rule as the market value of any equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transaction are calculated. A chart illustrating sample calculations of notional amount for a variety of derivatives transactions is set forth in the proposing release at 69.

[13] *See* proposed rule 18f-4(c)(7).

[14] For example, the proposing release states that a total return swap with a notional amount of $1 million that provides a return equal to three times the performance of an equity index would be treated as having a notional amount, for purposes of the exposure-based limit, of $3 million. Proposing release at 72.

[15] *See* proposing release at 73.

[16] The proposing release notes that this exception is designed to capture derivatives whose payouts are "path dependent," *i.e.*, dependent on the path taken by the value of the underlying asset during the term of the transaction.

[17] As an example of a complex derivative with a non-linear payout, the proposing release refers to a "variance swap," *i.e.*, an instrument that allows investors to profit from the difference between the current implied variance and future realized variance of an asset.

[18] *See* proposing release at 74.

[19] *See* Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang and William Yost, "Use of Derivatives By Registered Investment Companies," DERA White Paper (December 2015), *available at* http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

[20] *See* proposing release at 102, 105. The proposing release also notes (at 104) that while the moratorium on consideration of exemptive requests relating to ETFs that would make extensive use of derivatives announced in March 2010 was no longer in effect, the staff "continues not to support new exemptive relief for leveraged ETFs."

[21] Proposed rule 18f-4(a)(1)(ii).

[22] *See* proposing release at 119.

[23] *See* proposing release at 118. *See also* the example at 124: "Suppose that a fund has a net asset value of $100 million and holds a portfolio of non-U.S. debt securities, and that the fund calculates the VaR of such securities, using a VaR model that meets the requirements of the proposed rule, to be $3 million. Suppose further that the fund wishes to hedge some of its credit risk by purchasing [a credit default swap], adjust its duration by entering into interest rate swaps, and enter into currency forwards both to obtain exposure to certain foreign currencies and to hedge some of its exposure to euro and yen currency risk. If the VaR of its full portfolio (*i.e.*, its securities investments plus its derivatives transactions) immediately after entering into these derivatives transactions is less than $3 million, the fund would comply with the risk-based portfolio limit's VaR test."

[24] Proposed rule 18f-4(c)(11)(ii)(A-C).

[25] *See* proposing release at 149, proposed rule 18f-4(a)(5)(i).

[26] *See* proposing release at 156.

[27] The proposed rule adopts the GAAP definition of cash equivalents to cover "short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates" and enumerates examples of proper cash equivalents, including Treasury bills,

(*continued . . .*)

agency securities, bank deposits, commercial paper and shares of money market mutual funds. *See* proposing release at 179.

28 With respect to a derivatives transaction under which the fund may satisfy its obligations by delivering a particular asset, such asset would be a qualifying coverage asset.

29 *See* proposing release at 166, proposed rule 18f-4(a)(2) and 18f-4(c)(6)–(8).

30 The SEC decided not to propose a rule requiring funds to segregate the entire notional amount of their derivatives transactions, arguing that such a rule, in some cases, would "require funds to hold more liquid assets than may be necessary to address the investor protection purposes and concerns underlying section 18," as the notional amount often exceeds a fund's ultimate liability in such transactions. *See* proposing release at 168.

31 *See* proposing release at 169-170, proposed rule 18f-4(c)(9).

32 Proposed rule 18f-4(c)(6)(i).

33 Proposed rule 18f-4(c)(6)(ii); 18f-4(c)(9)(ii).

34 *See* proposing release at 183, proposed rule 18f-4(c)(8). This restriction is intended to prevent funds from using the proceeds of financial commitment transactions or other borrowings as coverage assets to support an additional layer of senior securities transactions.

35 The proposing release notes that although a fund that does not exceed the 50% threshold or employ complex derivatives is not required to implement a formal derivatives risk management program, if such fund enters into even a single derivatives transaction, (i) it must monitor such transactions to ensure that it does not exceed the 50% threshold or enter into any complex derivatives transaction and (ii) if it engages in a derivatives transaction in reliance on the proposed rule, it must comply with one of the two portfolio limitations and the asset coverage requirements of the rule.

36 *See* proposing release at 191, proposed rule 18f-4(a)(3).

37 *See* proposing release at 221, proposed rule 18f-4(a)(3)(ii)(C). The proposing release explicitly acknowledges that the derivatives risk manager may also serve as a chief compliance officer or chief risk officer. However, unlike a chief compliance officer, the proposed rule would not require that derivatives risk manager be removable only by the board or that a fund's board approve compensation arrangements. *See also* at 222-223.

38 *See* proposing release at 98-99, DERA White Paper *supra*, n.17 at 74.

39 *See* proposing release at 228.

40 *See* proposing release at 226.

41 Proposed rule 18f-4(c)(4).

42 *See supra*, n.2.

43 The proposed rule does not distinguish between conditions that are entirely within the control of the fund and those that are outside the control of the fund.

44 Proposed rule 18f-4(b)(2).

45 Proposed rule 18f-4(c)(8).

46 Proposed rule 18f-4(a)(6); 18f-4(b)(3).

47 "Gamma" measures the sensitivity of delta in response to price changes in an underlying instrument. "Vega" measures the amount that an option contract's price changes in relation to a one percent change in the volatility of an underlying asset. *See* proposing release at 255.

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