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The Securities and Exchange Commission Re-Proposes Rule Regulating the Use of Derivatives by Registered Investment Companies

On November 25, 2019, the U.S. Securities and Exchange Commission (the *"Commission"*) re-proposed Rule 18f-4 (*"Proposed Rule 18f-4"* or the *"Proposed Rule"*), a new exemptive rule designed to provide a more comprehensive approach to the regulation of funds' use of derivatives and certain other transactions.[1] In addition, the Commission proposed new rules applicable to brokers and investment advisers relating to sales practices in connection with the sale of shares of certain "leveraged/inverse investment vehicles."

The Commission recognized in the Proposing Release that funds' use of derivatives has grown in both volume and complexity over time, and funds using such derivatives must consider the requirements under the Investment Company Act of 1940 (the *"1940 Act"*), particularly Section 18 of the 1940 Act. Section 18 of the 1940 Act is designed to limit the leverage a fund can obtain or incur through the issuance of senior securities. More specifically, Section 18 of the 1940 Act imposes various limits on the capital structure of funds, including, in part, by restricting the ability of funds to issue "senior securities", generally defined to include any bond, debenture, note, or similar obligation or instrument constituting a security that evidences indebtedness and any class of stock that has priority over any other class as to the distribution of assets or payments of dividends.[2] The Commission has historically viewed derivative transactions that create future payment obligations either during the life of the instrument or at maturity or early termination to involve an "evidence of indebtedness" that is a senior security for purposes of Section 18. As noted in the Proposing Release, Section 18 was intended generally to address concerns of excessive borrowing and issuance of excessive amounts of senior securities by funds which may increase unduly the speculative character of a fund's junior securities; funds operating without adequate assets and reserves; and potential abuse of the purchasers of senior securities.[3] The Commission and its staff have long recognized that certain securities practices and derivatives may raise the concerns underlying Section 18 and have issued guidance addressing specific derivatives and other portfolio/operating practices under Section 18 throughout the years.[4]

The prior guidance, however, did not comprehensively address the broad range of derivatives used by funds today and as a result, the Commission noted that inconsistent industry practices have developed which may result in an unlevel competitive landscape and difficulties for the staff to evaluate a fund's compliance with Section 18.[5] The Commission originally proposed Rule 18f-4 under the 1940 Act in 2015 to address these concerns and after reviewing a multitude of comment letters and subsequent meetings with fund and investment groups, the Commission re-proposed a revised Rule 18f-4 to provide a more updated and comprehensive approach to the regulation of funds' use of derivatives transactions and certain other transactions. Proposed Rule 18f-4 would permit the funds to enter into these transactions, notwithstanding the restrictions of Section 18 of the 1940 Act, *provided* the funds comply with the conditions of the rule. The rule is only a proposal at this time, and whether it will be ultimately adopted or whether the proposed conditions will be changed has yet to be determined. The following is a summary of the conditions of the Proposed Rule.

What Are the Basic Requirements of Proposed Rule 18f-4?

Proposed Rule 18f-4 will permit a fund to enter into "derivatives transactions"[6] notwithstanding the requirements of Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the 1940 Act, and derivatives transactions entered into by the fund in compliance with the Proposed Rule will not be considered for purposes of computing "asset coverage"(as defined in Section 18(h) of the 1940 Act), provided the fund satisfies conditions (subject to certain exceptions) that generally will require:

- the adoption and implementation of a derivatives risk management program;
- limits on fund leverage risk;
- additional board oversight and reporting; and
- additional recordkeeping requirements.

What Funds Are Covered by the Proposed Rule?

The Proposed Rule would apply to registered open-end funds (including exchange-traded funds (*"ETFs"*)), registered closed-end funds and business development companies (*"BDCs"*), including separate series thereof. The Proposed Rule would not apply to registered money market funds and unit investment trusts.

What Are the Components of the Derivatives Risk Management Program?

Subject to certain exceptions, each fund relying on the Proposed Rule would have to adopt a written derivatives risk management program (the *"Program*"), which includes 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. The Program must include the following elements, each of which is described in further detail below:

- risk identification and assessment;
- risk guidelines;
- stress testing;
- backtesting;
- internal reporting and escalation; and
- periodic review of the Program.

Who Will Administer the Program?

The fund adviser's officer or officers must serve as the derivatives risk manager, and such manager must have the relevant experience regarding derivatives risk management. The fund's board of directors, including a majority of disinterested directors, must approve the derivatives risk manager, taking into account the manager's relevant experience regarding derivatives risk management.[7] The manager also must have direct communication with the fund's board of directors. The Proposed Rule would not permit a third party to serve as the fund's derivatives risk manager, but the manager could obtain assistance from third parties in administering the program. Further, if only a single officer serves as the derivatives risk manager, such position may not be filled by a portfolio manager. In addition, a majority of the officers who comprise the derivatives risk manager position may not be portfolio managers. The Proposed Rule requires the fund to reasonably segregate the functions of the Program from fund portfolio management "to promote objective and independent identification, assessment and management of the risks associated with derivatives use."[8]

What Should be Included in the Risk Identification and Assessment Component of the Program?

A fund would be required to identify and assess its "derivatives risks" in order to manage those risks. The Proposed Rule generally defines the derivatives risks to be identified and managed to include leverage, market, counterparty, liquidity, operational, legal and other risks the derivatives risk manager (or if a Limited Derivatives User as described below, the investment adviser) deems material. The Commission noted in its Proposing Release that a fund would take into account the fund's other investments as well as its derivatives transactions in identifying and assessing its derivatives risks as an appropriate assessment of these risks generally would involve assessing how a fund's derivatives may interact with the fund's other investments or whether the fund's derivatives have the effect of helping the fund manage risks.[9] By assessing the fund's derivatives use holistically, the Commission believed a fund will be better positioned to implement a Program that does not over- or understate the risks its derivatives use may pose.[10]

What Risk Guidelines Are Required in the Program?

The Proposed Rule would require a fund's Program to provide for the "establishment, maintenance and enforcement of investment, risk management or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivative risks."[11] These guidelines would be required to "specify levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed, and the measures to be taken if they are exceeded."[12] The Proposed Rule does not impose specific risk limits for these guidelines. The intent of the guidelines is to address the derivatives risks the fund would routinely monitor and help identify when to respond to changes in those risks.[13]

What Stress Testing is Required in the Program?

The Program must include stress testing to "evaluate potential losses to a fund's portfolio in response to extreme but plausible market changes or changes in significant market risk factors that would have a significant adverse effect on the fund's portfolio…."[14] The stress tests would have to take into account correlations of market risk factors and resulting payments to derivatives counterparties. The Proposed Rule would permit a fund to determine the frequency of stress tests, provided that they are conducted at least weekly. In establishing the frequency, a fund must take into account the fund's strategy and investments and current market conditions.[15]

What Backtesting is Required in the Program?

As described in further detail below, a fund will be required to meet an outer limit on fund leverage risk based on value-at-risk or “VaR” of the entire portfolio of the fund. The Program would have to provide for backtesting of the VaR calculation model that the fund uses under the Proposed Rule. Under the backtesting requirement, the fund would have to compare its actual gain or loss for that business day with the VaR the fund had calculated for that day. The VaR would be estimated over a one-trading day time horizon. The backtesting would be conducting using a 99% confidence level and over a one-day time horizon.[16] The backtesting should also identify as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation’s estimated loss. The backtesting requirement is designed to require a fund to monitor the effectiveness of its VaR model and assist a fund in confirming the continuing appropriateness of the model and related assumptions and identifying when adjustments should be made.[17]

What Are the Internal Reporting Requirements of the Program?

In recognizing that communications between risk management and portfolio management help to provide portfolio managers with insight in executing the fund’s strategy and mitigating or addressing derivatives risks, the Program is required to identify the circumstances under which a fund must communicate with its portfolio management about the operation of the Program, including exceedances of the guidelines and results of stress tests. The derivatives risk manager must also inform, in a timely manner, persons responsible for the fund’s portfolio management and the fund’s board of directors as the manager determines appropriate, of material risks arising from the fund’s derivatives transactions, including any material risks identified by the fund’s guideline exceedances or stress testing.[18]

How Often Must the Program be Reviewed?

The derivatives risk manager must review the Program at least annually to evaluate its effectiveness and reflect changes to the fund’s derivatives risk over time, including the VaR model used to limit fund leverage risk and the designated reference index as described below. The review of the overall program should include each of its elements outlined above.[19]

Are There Additional Responsibilities for the Board of Directors and Board Reporting under the Proposed Rule?

Yes. Under the Proposed Rule, the board will:

- approve the fund’s derivatives risk manager taking into account the manager’s relevant experience with the management of derivatives risks; and
- oversee the fund’s derivatives risk management.[20]

To help with the board’s oversight, the derivatives risk manager must provide annual and other periodic reports to the board. More specifically, the derivatives risk manager must provide a written report on or before the implementation of the Program and at least annually thereafter. The derivatives risk manager must represent in the report that the Program is reasonably designed to manage the fund’s derivatives risks and incorporates the required elements of the Program. The reports also must include the basis for the representation (which may be based on his or her reasonable belief after due inquiry); information as may be reasonably necessary to evaluate the adequacy of the fund’s Program and for reports following the initial implementation, the effectiveness of its implementation; and the basis for the selection of the designated reference index or, if applicable, why a designated reference index could not be identified. In addition to the annual report, the derivatives risk manager must provide written reports to the fund’s board at a frequency determined by the board that analyze any exceedances of the fund’s risk guidelines, the results of the fund’s stress tests and backtesting and information as may be reasonably necessary for the board to evaluate the fund’s response to the foregoing.[21]

Are There Limits Imposed on the Fund’s Leverage Risk under the Proposed Rule?

Yes. The Proposed Rule would require a fund relying on the rule when engaging in derivatives transactions to comply with a limit on fund leverage risk based on its VaR. The VaR is described as an estimate of an instrument or portfolio’s potential losses over a given time horizon and at a specified confidence level.[22] The fund would be required to calculate the VaR of its portfolio and compare it to the VaR of a “designated reference index,” and if the derivatives risk manager cannot identify an appropriate designated reference index, the fund must comply with an absolute VaR test. For funds with a designated reference index, the fund’s VaR must not exceed 150% of the VaR of the fund’s designated reference index (i.e., the “relative VaR test”). The Proposing Release notes that the 150% limit is intended to effectively limit a fund’s leverage risk related to derivatives transactions similar to the manner a registered open- or closed-end fund’s ability to borrow from a bank (or issue other senior securities representing indebtedness for registered closed-end funds) is limited by Section 18 of the 1940 Act.[23] If a derivatives risk manager is unable to identify an appropriate designated reference index, the fund must comply with the proposed absolute VaR test in which case the VaR of the fund’s portfolio must not exceed 15% of the value of the fund’s net assets.[24]

What Are the Characteristics of a Designated Reference Index?

The designated reference index must: (1) be unleveraged, (2) be selected by the derivatives risk manager, (3) reflect the markets or asset classes in which the fund invests,[25] (4) not be administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter or created at the request of the fund or its investment adviser, unless the index is widely recognized and used, and (5) be an "appropriate broad-based securities market index" or an "additional index" as defined in instruction 27 of Form N-1A.[26] The designated reference index may be a blended index; however, none of the indexes that composed the blended index may be administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.[27] To help address the concern that a derivatives risk manager will select a derivatives reference index composed of more volatile securities to allow a fund to obtain more leverage risk under the relative VaR test, the Proposed Rule also requires the derivatives risk manager to select and periodically review the index; disclose the designated reference index, relative to its performance in its annual report; and provide a written report to the board of directors providing the basis for selecting the respective designated reference index.[28]

What VaR Model Can be Used for the Relative or Absolute VaR Test?

The Proposed Rule requires that any VaR model used by a fund for purposes of the relative or absolute VaR test take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments. The Proposed Rule includes a non-exhaustive list of common market risk factors that a fund must account for in its VaR model, if applicable. These market risks factors include: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility.[29] The VaR model must have a 99% confidence level, a horizon of 20 trading days and be based on at least three years of historical market data. It would be the responsibility of the derivatives risk manager to choose the appropriate VaR model.[30]

How Often Must the Fund Test for Compliance with the VaR Test?

Under the Proposed Rule, a fund must determine its compliance with the applicable VaR test at least once each business day.[31]

What Happens When a Fund Is Not in Compliance with Its VaR Test?

The Proposed Rule addresses steps that must be taken when a fund fails to comply with its VaR test. If a fund is not in compliance, the fund must come back into compliance promptly and within no more than three business days after such determination.[32] If the fund is still not in compliance within three business days, then (1) the derivatives risk manager must report to the fund's board of directors and explain how and by when (*i.e.,* the number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance; (2) the derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances; and (3) the fund may not enter into derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days and satisfied the board reporting requirement and program analysis and update requirements.[33] See also reporting of breaches in "Will There Be Additional Fund Reporting Requirements?" below.

Are There Exceptions to the Risk Management Program and VaR-Based Limits?

Yes. Funds that limit their derivatives exposure to 10% of their net assets or that use derivatives transactions solely to hedge certain currency risks are excluded from the proposed risk management program requirement and VaR-based limits (hereafter, *"Limited Derivatives Users"*). The Limited Derivatives Users, however, must adopt policies and procedures that are reasonably designed to manage their derivatives risks in recognition of the Commission's view that even a limited use of derivatives involves risks that should be managed.

How Is Derivatives Exposure Calculated for the 10% Limit?

Proposed Rule 18f-4(a) generally defines derivatives exposure as the sum of the notional amounts of the fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short. The Proposing Release notes the definition is designed to provide a measure of the market exposure associated with a fund's derivatives transactions entered into in reliance on the Proposed Rule.[34] The Proposed Rule, however, includes two adjustments to calculating derivatives exposure that are designed to address certain limitations associated with measures of market exposure that use derivatives' notional amounts without adjustments and to provide for more tailored notional amounts that better reflect the exposure that a derivative creates to the underlying reference asset. In this regard, the Proposed Rule permits a fund to convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of option contracts.[35]

How Is the Currency Hedging Exception Determined?

A fund also could rely on the Limited Derivatives Users exception if the fund only uses currency derivatives to hedge currency risks associated with specific foreign-currency-denominated equity or fixed-income investments in the fund's portfolio and the notional amounts of the currency derivatives the fund holds could not exceed the value of the instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount.[36] The Proposing Release noted that the currency hedging exception reflected the Commission's view that using currency derivatives solely to hedge currency risk does not raise the policy concerns underlying Section 18.

Does the Proposed Rule Require a Specific Asset Segregation Test?

No. Although the Commission and staff had historically taken the position that a fund may appropriately manage the risks Section 18 was designed to address if a fund covers it obligations with respect to various transactions by maintaining segregated accounts, the Commission noted in the Proposing Release that the Proposed Rule does not include a specific asset segregation requirement because, among other things, the Commission did not believe that it was necessary in light of the Proposed Rule's requirements, the proposed portfolio-wide stress testing requirement which specifically takes into account a fund's payments to derivatives counterparties that could result from losses in stressed conditions, and the belief that a separate asset requirement may be less effective.[37]

What Is the Alternative Approach Applicable to Certain Leveraged/Inverse Funds under Proposed Rule 18f-4?

The Proposed Rule provides an alternative approach for certain funds that provide leveraged or inverse exposure to an underlying index generally on a daily basis. Registered investment companies (hereafter, the *"leveraged/inverse funds"*) that fall within the definition of a "leveraged/inverse investment vehicle" as defined in proposed Rule 15*l*-2 under the Securities Exchange Act of 1934 (the *"Exchange Act"*) and proposed Rule 211(h)-1 under the Investment Advisers Act of 1940 (the *"Advisers Act"*) (collectively, the *"sales practices rules"*)[38] would qualify for the alternative approach under Proposed Rule 18f-4. In the Proposing Release, the Commission explained that leveraged/inverse funds, generally structured as ETFs, "seek to amplify the returns of an underlying index by a specified multiple or to profit from a decline in the value of their underlying index over a predetermined period of time using financial derivatives."[39] The Commission recognized that the leveraged/inverse funds use derivatives extensively and generally would not be able to comply with the VaR tests of the Proposed Rule. Although the Commission considered the unique risks these funds may present to longer term investors, the Commission also noted that investors capable of evaluating these funds' characteristics and unique risks may want to use them to meet specific short-term or other investment goals. To preserve investment choices for these investors, the Commission proposed the sales practices rules to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating the general characteristics and unique risks of these products and alternative provisions under Proposed Rule 18f-4.[40]

Under the Proposed Rule, the leveraged/inverse fund would not have to comply with the VaR leverage risk limit *provided* the fund meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules, limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index and discloses in its prospectus that it is not subject to the Proposed Rule's limit on fund leverage risk. Other than the VaR tests, a leveraged/inverse fund would have to satisfy the other conditions in the Proposed Rule.[41]

What Are the Proposed Sales Practices Rules Applicable to Leveraged/Inverse Investment Vehicles?

As noted, to help ensure that leveraged/inverse investment vehicles are limited to those who can evaluate such products' characteristics and risks, the proposed sales practices rules would require broker-dealers and investment advisers to exercise due diligence on retail investors before approving their accounts to invest in leveraged/inverse investment vehicles.[42] Under the proposed sales practices rules, a firm must (1) approve in writing the retail investor's account[43] for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement;[44] and (2) adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rules. To grant its approval, the firm must have a reasonable basis for believing that the retail investor has such knowledge and experience in financial matters to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles. The firm must maintain a written record of the investor information that it obtained pursuant to the due diligence requirements, the written approval, and the versions of the firm's policies and procedures that it adopted under the proposed rules that were in place when the firm approved or disapproved the account. The records must be retained for six years (the first two years in an easily accessible place) after the date of the closing of the investor's account.

Will There Be Additional Fund Reporting Requirements?

Yes. To help with its oversight, the Commission is proposing amendments to the reporting requirements for funds relying on Proposed Rule 18f-4, including amendments to Forms N-PORT, N-LIQUID (to be retitled Form N-RN), and N-CEN. The proposed amendments to Form N-PORT require a fund to report, among other things, its derivatives exposure as of the end of the reporting period and information related to the proposed VaR tests.[45] The foregoing information would be publicly available for the third month of each fund's quarter. A fund also would be required to report information about its VaR test breaches on Form N-RN if a fund has not come back into compliance within three business days after the determination that the fund is out of compliance with its VaR test. A fund would be required to file this information within one business day following the third business day after the fund has determined it is out of compliance with its relative VaR test or absolute VaR test, as applicable. The fund must file another Form N-RN when the fund is back in compliance.[46] The funds subject to the new VaR test breach reporting would include registered open-end funds as well as registered closed-end funds and BDCs. The Commission proposed to make the reports on Form N-RN non-public. In addition, under the amendments to Form N-CEN, a fund would be required to identify, among other things, whether it relied on the Proposed Rule during the reporting period or on any exceptions from the requirements of the Proposed Rule and whether it has entered into any reverse repurchase agreements or similar financing transactions or unfunded commitment agreements. [47]

How Are Reverse Repurchase Agreements and Similar Financing Arrangements Addressed in the Proposed Rule?

In the Proposing Release, the Commission recognized that reverse repurchase agreements[48] and similar financing transactions essentially allow a fund to obtain additional cash that the fund can use for investments or finance fund assets similar to a bank borrowing under Section 18. As a result, the Proposed Rule permits a fund to engage in reverse repurchase agreements and other similar financing transactions provided it complies with the relevant asset coverage requirements of Section 18 and combines 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 when calculating the asset coverage ratio.[49] The Proposing Release further noted that the reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under the Limited Derivatives Users provisions. If the fund does not qualify as a Limited Derivatives User due to its other investment activity, however, "any portfolio leveraging effect of reverse repurchase agreements or similar financial transactions would be included and restricted through the proposed VaR-based limit on fund leverage risk. This is because the proposed VaR tests estimate a fund's risk of loss taking into account all of its investments, including the proceeds or reverse repurchase agreements and similar investments the fund purchased with those proceeds."[50]

With respect to securities lending, the Proposing Release noted that funds typically reinvest cash collateral in highly liquid, short-term investments and under such circumstances have limited ability to increase leverage. Accordingly, the Proposed Rule would not treat a fund's obligation to return the securities lending collateral as a financial transaction similar to a reverse repurchase agreement if the obligation relates to an agreement under which a fund engages in securities lending, the fund does not use the non-cash collateral received to leverage the fund's portfolio, and the fund invests the cash collateral solely in cash and cash equivalents. If the fund, however, invested the cash collateral in securities other than cash and cash equivalents, the Commission noted that it would consider such activity to be a "similar financing transaction" and therefore should be included in calculating the fund's asset coverage ratio.[51]

How is Tender Option Bond ("*TOB*") Financing Treated under the Proposed Rule?

The Commission noted in the Proposing Release that a fund's obligation with respect to TOB financing may be similar to a reverse repurchase agreement under some circumstances. TOB financings may be economically similar to reverse repurchase agreements as a fund employing a TOB trust in effect has used the underlying bond as collateral to secure a borrowing similar to a fund's use of a security to secure a reverse repurchase agreement. The Commission advised that whether a TOB is similar to a financing transaction depends on the facts and circumstances. Accordingly, to the extent a fund concludes that there are economic similarities between a TOB financing and a reverse repurchase agreement, the fund should treat the obligations with respect to TOB financings as a similar financing transaction under the Proposed Rule.[52]

How Are Unfunded Commitment Agreements Treated under the Proposed Rule?

The Commission recognized in the Proposing Release that unfunded commitment agreements generally do not raise undue speculation concerns but could raise asset sufficiency concerns. An unfunded commitment agreement is generally defined to mean "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."[53] The Proposed Rule would permit a fund to enter into unfunded commitment agreements if it *reasonably believes,* at the time it enters into such an 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. To form this reasonable belief, a fund (1) must take into account its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions), and (2) may not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments or from issuing additional equity.[54] As an illustration, a fund could consider its strategy, its assets' liquidity, its borrowing capacity under existing committed lines of credit and the contractual provisions of its unfunded commitment agreements in forming its reasonable belief. Unfunded commitment agreements entered into in compliance with the Proposed Rule will not be considered for purposes of computing asset coverage (as defined in Section 18(h) of the 1940 Act). A fund must document the basis for its reasonable belief and maintain a record of this documentation for a period of not less than five years (the first two years in an easily accessible place) following the date that the fund entered into the agreement.[55]

Are There Additional Recordkeeping Requirements under the Proposed Rule?

Yes. The Proposed Rule imposes certain recordkeeping requirements including, among other things, certain records documenting the derivatives risk management program, various materials provided to the board, materials related to its VaR requirements and certain policies and procedures.

What Happens to Existing Guidance Addressing Derivatives?

The Commission proposed to rescind Release 10666, and the staff is reviewing relevant no-action letters and other guidance to determine which should be withdrawn in connection with the adoption of the proposal. The Commission proposed a one-year transition period for funds to prepare to come into compliance with the new rule; a one-year compliance period for the sales practices rules; and a one-year delay to the effective date of the amendments to Rule 6c-11 permitting leveraged/inverse ETFs to rely on the rule and the rescission of existing exemptive orders permitting leveraged/inverse ETFs.

Conclusion

The Commission proposed the new Proposed Rule to provide a comprehensive approach to regulating funds' use of derivatives and address the disparate practices that have developed under the existing guidance. While the foregoing summarizes the provisions of the Proposed Rule, the requirements of any final rule, if adopted, have yet to be determined. Comments on the Proposed Rule are due on or before March 24, 2020.

For More Information

If you would like further information concerning the matters discussed in this article, please contact Felice Foundos or the Chapman attorney with whom you regularly work.

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1 See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Rel. No. 33704 (November 25, 2019) (the *"Proposing Release"*).

2 Generally, Section 18(f)(1) prohibits open-end investment companies from issuing senior securities except that they may borrow from a bank if they maintain 300% asset coverage. Closed-end funds, in relevant part, are not limited to bank-indebtedness and may issue any senior securities that represent indebtedness subject to 300% asset coverage immediately following the issuance and other restrictions. Closed-end funds also may issue senior securities that are stock, subject to 200% asset coverage and other restrictions. In addition, closed-end funds may, among other things, issue notes in consideration of loans (or extension or renewal thereof) made by banks or other persons that are privately arranged and not intended to be publicly distributed (subject to the asset coverage requirement) or for certain temporary loans that do not exceed 5% of a fund's total assets. See Sections 18(a) and 18(g).

3 See Proposing Release at 18.

4 *See, e.g.,* Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 (April 27, 1979) (*"Release 10666"*). See also a list of the staff's interpretative guidance relating to investment company use of derivatives, "Registered Investment Company Use of Senior Securities – Select Bibliography," at www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

5 See Proposing Release at 11.

6 Proposed Rule 18f-4(a) defines a derivatives transaction as "(1) [a]ny swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (*"derivatives 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) [a]ny short sale borrowing."

7 See Proposed Rule 18f-4(c)(5).

8 See Proposing Release at 49.

9 See Proposing Release at 55.

10 See Proposing Release at 55.

11 See Proposed Rule 18f-4(c)(1)(ii).

12 See Proposed Rule 18f-4(c)(1)(ii) and Proposing Release at 59.

13 See Proposing Release at 59.

14 See Proposed Rule 18f-4(c)(1)(iii).

15 See Proposing Release at 64-67 and Proposed Rule 18f-4(c)(1)(iii).

16 See Proposing Release at 69-70.

17 See Proposing Release at 69-72 and Proposed Rule 18f-4(c)(1)(iv).

18 See Proposing Release at 72-75 and Proposed Rule 18f-4(c)(1)(v).

19 See Proposing Release at 77-78 and Proposed Rule 18f-4(c)(1)(vi).

20 The board would also be responsible for overseeing a fund's compliance with the Proposed Rule as part of its oversight of compliance pursuant to Rule 38a-1 of the 1940 Act. See Proposing Release at 80-81.

21 See Proposing Release at 84-87 and Proposed Rule 18f-4(c)(5).

22 See Proposing Release at 91. The Commission recognized that the VaR is not a leverage measure but can be used to compare it to an unleveraged index to determine whether the fund's use of derivatives is magnifying its potential for losses and significant payment obligations of fund assets to derivatives counterparties. If the VaR exceeds the designated reference index, the difference may be attributed to leverage risk. See Proposing Release at 91-131.

23 See Proposing Release at 109.

24 See Proposed Rule 18f-4(c)(2).

25 The requirement that the index include markets or asset classes in which the fund invests is intended to help ensure that the differences between the fund's VaR and the index's VaR are likely the result of leverage rather than other factors such as differences in securities holdings. See Proposing Release at 99-100

26 The Proposing Release explained that if a fund is complying with the relative VaR test, an open-end fund would have to disclose the designated reference index in the fund's annual report as its "appropriate broad-based securities index" or an "additional index" that Form N-1A describes in the context of annual report performance presentation requirements. Similarly, if complying with the relative VaR test, a registered closed-end fund or business development fund would have to disclose its designated reference index in the annual report, together with a presentation of the fund's performance relative to the designated reference index. New funds are not required to include this disclosure in their annual report. See Proposed Rule 18f-4(c)(2)(iv) and Proposing Release at 101-102.

27 See Proposing Release at footnote 190.

28 See Proposing Release at 103-104.

29 See Proposed Rule 18f-4(a).

30 The Proposing Release noted that the Proposed Rule would not require a fund to apply its VaR model consistently (*i.e.,* the same VaR model applied in the same way) when calculating the VaR of its portfolio and the VaR of its designated reference index as requiring consistency may prevent funds from using less-costly approaches. See Proposing Release at 123-124.

31 See Proposed Rule 18f-4(c)(2)(ii).

32 See Proposed Rule 18f-4(c)(2)(ii).

33 See Proposed Rule 18f-4(c)(2)(iii)(A), (B) and (C).

34 See Proposing Release at 149.

35 The Proposing Release notes that delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. The Commission explained that a fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta. See Proposing Release at footnote 276.

36 See Proposed Rule 18f-4(c)(3)(ii).

37 See Proposing Release at 173-174.

38 A leveraged/inverse investment vehicle in the proposed sales practices rules is defined to mean "a registered investment company (including any separate series thereof), or a 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." See Proposed Rule 15*l*-2(d) and Proposed Rule 211(h)-1(d).

39 See Proposing Release at 177.

40 In 2019, the Commission adopted Rule 6c-11 permitting ETFs to operate without first obtaining an exemptive order provided the ETFs meet certain conditions. As adopted, Rule 6c-11 excluded leveraged/inverse ETFs from relying on the rule. With the Proposed Rule and proposed sales practices rules, the Commission is proposing to amend Rule 6c-11 to remove the exclusion of leveraged/inverse ETFs and rescind exemptive orders the Commission previously issued to leveraged/inverse ETFs. See Proposing Release at 204-205.

41 See Proposed Rule 18f-4(c)(4).

42 More specifically, Rule 15*l*-2 under the Exchange Act generally would require a broker-dealer (or any associated person of the broker-dealer) to exercise due diligence to ascertain certain essential facts about a customer who is a retail investor before accepting the customer's order to buy or sell shares of a leveraged/inverse investment vehicle, or approving the customer's account to engage in those transactions. Proposed Rule 211(h)-1 under the Advisers Act similarly would require an investment adviser (or supervised person of the investment adviser) to exercise due diligence to ascertain such essential facts relative to a client who is a retail investor before placing an order for that client's account to buy or sell shares of a leveraged/inverse investment vehicle or approving the client account to engage in those transactions. Under either rule, the firm could approve the retail investor's account to buy or sell shares of leveraged/inverse investment vehicles only if the firm had a reasonable basis to believe that the investor is reasonably expected to be capable of evaluating the risks associated with these products. Although the rules would apply to existing accounts before the rules' compliance date, the sales practices rules would not apply to a position in a leveraged/inverse investment vehicle established before the rules' compliance date. See Proposing Release at 181-182.

43 The scope of the sales practices rules is limited to natural persons or the legal representative of a natural person. See Proposing Release at 189.

44 The due diligence requirements provide that a firm must exercise due diligence to ascertain certain essential facts relative to the retail investor, his or her financial situation, and investment objectives. At a minimum, such information about the retail investor would include his or her: investment objectives; employment status; estimated annual income from all sources; estimated net worth; estimated liquid net worth; percentage of the retail investor's liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and investment experience and knowledge regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities and other financial instruments. See Proposing Release at 187-188.

45 More specifically, for a fund subject to the VaR-based limits, the fund would be required to report their highest daily VaR during the reporting period and its corresponding date and the median daily VaR for the monthly reporting period. A fund subject to the relative VaR test would also provide the fund's designated reference index, index identifier, the fund's highest daily VaR ratio (i.e., the value of the fund's portfolio VaR divided by the VaR of the designated reference index) during the reporting period and its corresponding date and the fund's median daily VaR ratio for the reporting period. A fund would also have to report the number of exceptions the fund identified during the reporting period as a result of its backtesting the fund's VaR calculation model. This information would be made public for the third month of each fund's quarter. See Proposing Release 210-212 and proposed Items B.9 and B.10 of Form N-PORT.

46 See Proposing Release 213–215.

47 See Proposing Release 220-221. The Commission also noted that BDCs do not file reports on Form N-CEN or Form N-PORT, but the Commission proposed to require that BDCs provide in their annual reports on Form 10-K the new information proposed for registered funds on Form N-CEN and the new information regarding derivatives exposure and VaR required of funds on Form N-PORT. See Proposing Release 221-222.

48 When a fund enters into a reverse repurchase agreement, the fund transfers a security to another party in return for a percentage of the value of the security. The fund will repurchase the security on an agreed-upon future date by paying an amount equal to the proceeds of the initial sale transaction plus interest. See Proposing Release at 223-224.

49 See Proposed Rule 18f-4(d).

50 See Proposing Release at 225.

51 See Proposing Release at 226-227.

52 See Proposing Release at 227.

53 See Proposed Rule 18f-4(a). The Proposed Rule further provides that an agreement that meets the rule's definition of a derivatives transaction is not an unfunded commitment.

54 The Proposed Rule, however, would not preclude a fund from considering the issuance of debt to support a reasonable belief that a fund could meet an unfunded commitment. See Proposing Release at 234 and Proposed Rule 18f-4(e).

55 See Proposed Rule 18f-4(e)(2).

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