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Summary of the SEC's Re-Proposal on the Use of Derivatives by Registered Funds and BDCs

On November 25, 2019, the Securities and Exchange Commission (the "SEC") approved by seriatim action of the Commissioners without a meeting the release of proposed rule amendments to govern the use of derivatives and certain other transactions by registered investment companies and business development companies (the "Proposal").¹ The Proposal supersedes an earlier proposal from December 2015 (the "2015 Proposal").² Given the timing of the re-proposal, it appears that the SEC intends to adopt the rule in 2020.

The centerpiece of the Proposal is proposed Rule 18f-4 under the Investment Company Act of 1940 (the "1940 Act"), which would set forth the conditions under which open-end funds (including ETFs but excluding money market funds), closed-end funds and business development companies ("BDCs") could enter into derivatives transactions. The Proposal also includes new rules under the Securities Exchange Act of 1934 (the "Exchange Act") and Investment Advisers Act of 1940 (the "Advisers Act") that would govern sales practices of broker-dealers and investment advisers, respectively, for leveraged/inverse funds. Registered funds and BDCs would also be subject to enhanced board reporting as well as new reporting requirements related to their use of derivatives.

This alert provides our initial observations as well as a summary of the major features of the Proposal, which include: (i) a new derivatives risk management program requirement; (ii) a new proposed limit on fund leverage risk; (iii) exceptions for limited derivatives users; (iv) special rules for leveraged/inverse funds; (v) requirements relating to reverse repurchase agreements and unfunded commitments; (vi) board oversight and reporting requirements; (vii) amendments to fund reporting and disclosure requirements; and (viii) the proposed rule's comment period and compliance date. Please let our team know if you have any questions about proposed Rule 18f-4 or this alert.

I. Derivatives Risk Management Program

As proposed, Rule 18f-4 would generally require a fund that enters into derivatives transactions (which, for purposes of the rule, would include short sale borrowings) to adopt and implement a written derivatives risk management program, 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. Derivatives risk is defined as the risk associated with a fund's derivatives transactions or use of derivatives transactions, including leverage, market, counterparty, liquidity, operational, and legal risks, but could include additional risks deemed material. A derivatives risk manager meeting the requirements of Rule 18f-4, as discussed further below, would administer the program.

The program requirement is designed to result in a program with elements that are tailored to the particular types of derivatives that the fund uses and their related risks,

as well as how those derivatives impact the fund’s investment portfolio and strategy. The program must include the following elements:

- *derivatives risk identification and assessment*, which must take into account the fund’s derivatives transactions and other investments;
- *risk guidelines* that provide for quantitative or other measurable criteria, metrics of thresholds of a fund’s derivatives risks, including specifying the levels that the fund is not normally expected to exceed, and measures to be taken if such levels are exceeded;
- *stress testing* to evaluate potential losses to the fund’s portfolio under stressed conditions, to be conducted no less frequently than weekly;
- *backtesting* the results of the value at risk (“VaR”) calculation model by the fund each business day;
- *internal reporting*, which must identify the circumstances under which portfolio management will be informed of the operation of the program, including exceeding the risk guidelines or the results of the stress testing;
- *escalation of material risks* in a timely manner by the derivatives risk manager to inform portfolio management and the board, as appropriate, of material risks arising from derivatives transaction, including exceeding the risk guidelines or the results of the stress testing; and
- *periodic review* conducted by the derivatives risk manager at least annually to evaluate the program’s effectiveness and to reflect changes in risk over time, which must include a review of the VaR calculation model and any designated reference index to evaluate whether it remains appropriate.

The designation of a fund’s derivatives risk manager must be approved by the fund’s board, as discussed further below under

“Board Oversight and Reporting.” Such person must have relevant experience regarding the management of derivatives risk, and could be either an individual officer or group of officers of the fund’s investment adviser; provided, that if an individual officer serves as the derivatives risk manager, such officer may not be a portfolio manager of the fund, or if a group of officers serve as the derivatives risk manager, such group may not have a majority composed of portfolio managers of the fund.

II. Proposed Limit on Fund Leverage Risk

As proposed, Rule 18f-4 would generally require a fund that engages in derivatives transactions (other than a fund that qualifies as a “limited derivatives user,” discussed further below) to comply with an outer limit on fund leverage risk based on VaR, which is an estimate of potential losses on an instrument or portfolio over a given time horizon and at a specified confidence level.³ This VaR-based limit on fund leverage risk would replace the current regime of asset segregation for purposes of limiting leverage-related risks in registered funds.⁴

As proposed, a fund portfolio’s VaR would not be permitted to exceed 150% of the VaR of a designated reference index for that fund, as selected by the fund’s derivatives risk manager (the “Relative VaR Test”).⁵ A fund would be required to comply with the Relative VaR Test unless a designated reference index is unavailable. If a fund’s derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund, then the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund’s net assets (the “Absolute VaR Test”).⁶

Designated Reference Index Requirements—For purposes of the Relative VaR Test, a fund’s designated reference index must be unleveraged and reflect the markets or asset classes in which the fund invests.⁷ The index must not be administered by an organization that is an affiliated person of the fund, its

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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. Additionally, the designated reference index must either be an “appropriate broad-based securities market index” or an “additional index” as defined in Item 27 of Form N-1A. The designated reference index could be a blended index, so long as it meets the foregoing requirements.

Rule 18f-4 as proposed would require that (1) the fund’s derivatives risk manager select the designated reference index and periodically review it; (2) the fund disclose the designated reference index in its annual report, together with a presentation of the fund’s performance relative to the designated reference index; and (3) the fund’s board receive a written report providing the derivatives risk manager’s basis for selecting the designated reference index.

VaR Model Requirements—Any VaR model that a fund uses for purposes of either the Relative VaR Test or the Absolute VaR Test must take into account and incorporate all significant, identifiable market risk factors associated with a fund’s investments. The proposed rule includes the following non-exhaustive list of market risk factors that a fund must account for in its VaR model, if applicable: (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.

VaR Calculations—The proposed rule would require that a fund’s VaR model use a 99% confidence level and a time horizon of 20 trading days (which may be calculated on a rolling, overlapping basis or on a non-overlapping basis), and all VaR calculations must be based on at least three years of historical data, rather than historical simulation. Unlike the 2015 Proposal, the proposed rule would not require a fund to apply its VaR models 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. It would, however, require that VaR calculations comply with the same proposed VaR definition and specified model requirements.

Compliance Testing and Remediation—Proposed Rule 18f-4 would require that a fund test for compliance under the Relative VaR Test or Absolute VaR test, as applicable, at a consistent time at least once each business day, either in the mornings before market open or in the evenings after market close.⁸ If a fund determines that it is not in compliance with its applicable VaR test, proposed Rule 18f-4 would require the fund to come back into compliance promptly and within no more than three business days after such determination. If a fund is not in compliance within three business days, then (1) the derivatives

risk manager must report to the fund’s board and explain how and by when (i.e., the number of 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 those 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 has satisfied the board reporting requirement and program analysis and update requirements. A fund would not be forced to exit positions at the end of the three day period, as the SEC noted that such a requirement could harm investors by forcing the fund to realize trading losses that could be avoided under a more flexible approach.

III. Exceptions for Limited Derivatives Users

A fund would be considered a “limited derivatives user” and thus not be required to adopt a derivatives risk management program meeting the requirements set forth above or comply with the limit on fund leverage risk if the fund adopts and implements policies and procedures reasonably designed to manage the fund’s derivative risk and the fund either (i) limits its derivatives exposure to 10% of its net assets or (ii) used derivatives solely to hedge certain currency risks. Derivatives exposure is defined as the sum of the notional amounts of the fund’s derivatives instruments and, in the case of short sale borrowing, the value of the assets sold short, subject to certain adjustments for interest rate derivatives and options. Such a fund would still be required to adopt and implement policies and procedures reasonably designed to manage the fund’s derivatives risks.

IV. Special Rules for Leveraged/Inverse Funds

Alternative Leverage Limit—A fund meeting the definition of a “leveraged/inverse fund” under proposed Rule 18f-4 would not be required to comply with the proposed VaR-based leverage risk limit so long as it discloses in its prospectus that it is not subject to the limit on fund leverage risk in Rule 18f-4(c)(2). Instead, the fund would be required to limit the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index.⁹ Note, however, that leveraged/inverse funds would still be required to satisfy all of the other conditions of proposed Rule 18f-4, including the conditions requiring a derivatives risk management program, board oversight and reporting, and recordkeeping.

Definition—The definition of leveraged/inverse funds for purposes of proposed Rule 18f-4 is included in proposed Rule 151-2 under the Exchange Act and proposed Rule 211(h)-1 under the Advisers Act (collectively referred to as the “sales

practice rules”). These rules would define a “leveraged/inverse investment vehicle” as a 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.¹⁰

The SEC’s rationale for proposing an alternative limit for leveraged/inverse funds is that most existing leveraged/inverse funds provide leveraged or inverse market exposure exceeding 150% of the return or inverse return of the relevant index. As a result, these funds would fail the Relative VaR test and would not be eligible to use the Absolute VaR test. Hence, absent an alternative limit, sponsors of certain existing leveraged/inverse funds would not be able to offer such funds in their current form.

Sales Practice Rules—In conjunction with proposed Rule 18f-4, the SEC is also proposing new sales practices rules for broker-dealers and investment advisers. These sales practice rules would require broker-dealers and investment advisers to engage in due diligence before accepting or placing an order for a customer or client that is a natural person (or the legal representative of a natural person¹¹) (a “retail investor”) to trade a leveraged/inverse investment vehicle, or approving a retail investor’s account for such trading. The required due diligence would involve ascertaining certain essential facts about a customer or client who is a retail investor before accepting or placing, respectively, the customer’s or client’s order to buy or sell shares of a leveraged/inverse investment vehicle, or approving the customer’s or client’s account to engage in those transactions.¹² The Proposing Release notes that the sales practice rules are designed to help ensure that investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating their characteristics and the unique risks they present.

Broker-dealers and investment advisers would be required to maintain written records of investor information obtained under the sales practice rules’ due diligence requirements, the firm’s written approval of the retail investor’s account for buying and selling shares of leveraged/inverse investment vehicles, and the firm’s policies and procedures adopted under the proposed rules that were in place when the firm approved or disapproved the account. These records would need to be retained for a period of at least six years (the first two in an easily accessible place) after the date of the closing of the investor’s account.

Amendment to Rule 6c-11—The Proposal would amend Rule 6c-11 under the 1940 Act (the “ETF Rule”), which permits certain types of ETFs to operate without first obtaining exemptive relief, to remove the condition that prevents leveraged/inverse ETFs from relying on the ETF Rule. The amendment permitting ETFs to rely on the ETF Rule would be effective one year following publication of the final rules in the Federal Register. In addition, the SEC also proposes to rescind the exemptive orders previously issued to leveraged/inverse ETFs on the same

effective date. Following this effective date, existing leveraged/inverse ETFs would be required to rely upon the ETF Rule instead of their existing exemptive orders. New sponsors of leveraged/inverse ETFs would be permitted to launch and operate leverage/inverse ETFs upon the effective date of the amendment to Rule 6c-11.

V. Reverse Repurchase Agreements and Unfunded Commitments

As proposed, Rule 18f-4 would also address reverse repurchase agreements (“reverse repos”) and similar financing transactions and unfunded commitment agreements. Under proposed Rule 18f-4, a fund may engage in reverse repos or similar financing transactions if the fund combines the aggregate amount of indebtedness associated with the reverse repo or similar financing transaction when calculating the asset coverage ratio under the 1940 Act.

The SEC noted that a fund that engages in securities lending and reinvests cash collateral in highly liquid, short-term investments would generally not be considered a “similar financing transaction” under the Proposed Rule because the fund would be limited in its ability to use securities lending transactions to increase leverage in its portfolio. As a result, proposed Rule 18f-4 would not treat a fund’s obligation to return securities lending collateral as a financing transaction similar to a reverse repo. In contrast, the investment of securities lending collateral in securities other than cash or cash equivalents would be a similar financing transaction under the Proposal. In addition, the Proposing Release notes that a fund’s obligation with respect to a “tender offer bond” financing may be similar to a reverse repo in some circumstances.

Proposed Rule 18f-4 would permit a fund to enter into unfunded commitment agreements if the fund reasonably believed, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, and documents the basis for its reasonable belief. Unfunded commitment agreements include contracts that are not derivatives transactions, 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.¹³ Such commitments would not be included in or subject to the asset coverage requirements under Sections 18(a), 18(c), 18(f)(1) or Section 61 of the 1940 Act.

VI. Board Oversight and Reporting

Proposed Rule 18f-4 includes a number of requirements for fund boards. First, it would require a fund’s board to approve the designation of the fund’s derivatives risk manager meeting the requirements of the rule, as described above under “Derivatives Risk Management Program.” In designating the derivatives risk manager, the board must take into account the manager’s

relevant experience regarding the management of derivatives risk. Second, the rule would require the derivatives risk manager to provide regular written reports to the board regarding the program's implementation and effectiveness, and describing any exceeding of the fund's guidelines, and the results of any stress testing. The reports on the effectiveness of the program must be provided at least annually, and provide a representation from the derivatives risk manager that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program, as well as the basis for that representation. The reports on the fund's guidelines and stress tests must be provided to the board at a frequency determined by the board. Finally, the board is also responsible for overseeing the fund's compliance with Rule 18f-4. The SEC stated in the Proposing Release that the requirements of proposed Rule 18f-4 regarding board oversight and reporting are designed to further facilitate the board's oversight of the fund's derivatives risk management.

VII. Amendments to Fund Reporting and Disclosure Requirements

All funds relying on Rule 18f-4, other than BDCs, would be required to report information about their derivatives exposure and VaR on Form N-PORT. The required information would include the fund's derivatives exposure from derivatives instruments and short sales, the fund's median daily and highest daily VaR during the reporting period, and the number of exceptions identified during the reporting period arising from backtesting the fund's VaR calculation model. Information on Form N-PORT for the third month of each quarter would be made publicly available, 60 days after the end of the quarter.

Funds that are subject to a VaR test would also have to make current reports on Form N-LIQUID, which would be retitled Form N-RN. A fund that determines that it is out of compliance with the VaR test and has not come back into compliance within three business days after the determination would provide information regarding its VaR test breaches on Form N-RN. All funds and BDCs that are subject to a VaR test would have a Form N-RN filing obligation, whether or not they are currently required to file Form N-LIQUID. Form N-RN filings generally will not be made public.

Funds other than BDCs would also have to disclose publicly on Form N-CEN whether they relied on Rule 18f-4 and its exceptions, and whether they entered into reverse repurchase agreements or unfunded commitment agreements.

VIII. Comment Period and Compliance Date

Comments on the Proposal are due within 60 days of publication of the Proposal in the Federal Register (the Proposal has not yet been published).

The Proposal contemplates a one year transition period following the effective date of the final rule for registered funds and BDCs to come into compliance with the requirements of Rule 18f-4. After this transition period, the SEC would rescind Release 10666 and the SEC staff's no-action letters addressing derivatives and possibly other no-action letters and guidance. At this time, registered funds and BDCs may continue to rely on Release 10666, SEC staff no-action letters and other derivatives-related guidance from the SEC staff.

¹ 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, Release No. 34-87607; IA-5413; IC-33704 (Nov. 25, 2019), available at <https://www.sec.gov/rules/proposed/2019/34-87607.pdf> ("Proposing Release"). See also 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 (Nov. 26, 2019), available at <https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices>; Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee, Statement on Proposed Rules on Funds' Use of Derivatives (Nov. 26, 2019), available at <https://www.sec.gov/news/public-statement/jackson-lee-statement-proposed-rules-funds-derivatives>.

² Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (December 11, 2015), available at <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.

³ As explained by the SEC, "VaR will not provide, and is not intended to provide, an estimate of an instrument of portfolio's maximum loss amount. For example, if a fund's VaR calculated at a 99% confidence level is \$100, this means that the fund's model estimates that 99% of the time, the fund would not be expected to lose more than \$100. However, 1% of the time, the fund would be expected to lose more than \$100, and VaR does not estimate the extent of this loss." Proposing Release at 91.

⁴ The elimination of an asset segregation requirement from Rule 18f-4 in favor of proposed VaR-based tests is a significant departure from the 2015 Proposal and from current practice.

⁵ Unlike the 2015 Proposal, which proposed a Relative VaR test that would compare the fund's VaR to the fund's "securities VaR," the Proposal would compare the fund's VaR to the VaR of the fund's designated reference index. The SEC noted that this change was made in consideration of the reality that some funds that use derivatives extensively hold primarily cash, cash equivalents and derivatives, and a securities VaR based on cash and cash equivalents would be very low and would not provide a reference level of risk associated with the fund's strategy.

⁶ Based on internal analysis of the universe of existing funds that would be subject to the proposed VaR-based limit on fund leverage risk, the SEC staff identified only six that would fail the proposed Relative VaR Test and, of those, only one that would also fail the Absolute VaR Test. Proposing Release at 276.

⁷ For example, a fund would not be permitted to use an index that tracks 200% of the performance of the S&P 500.

⁸ This is a departure from the VaR calculation requirements in the 2015 Proposal, which would have required VaR to be calculated immediately after entering into any senior securities transactions.

⁹ More specifically, Rule 18f-4(c)(4)(iii) would provide that the fund must not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index. This limitation reflects the highest leverage level currently permitted by exemptive orders issued to existing leveraged/inverse ETFs.

¹⁰ This definition is substantively identical to the provision in new rule 6c-11 under the 1940 Act excluding leveraged/inverse ETFs from the scope of that rule, except that the sales practice rules are also proposed to apply to exchange-listed commodity- or currency-based trusts or funds that follow a similar leveraged or inverse strategy to leverage/inverse ETFs.

¹¹ According to the Proposing Release, the SEC interprets “legal representative” of a natural person to mean non-professional legal representatives of a natural person, which would exclude institutions

and certain professional fiduciaries, but include certain legal entities such as trusts that represent the assets of a natural person. The Proposing Release provides that this interpretation is designed to provide the protections of the sales practices rules where non-professional persons are acting on behalf of natural persons, but where such professional persons are not regulated financial services industry professionals retained by natural persons to exercise independent professional judgment.

¹² The Proposing Release provides that these essential facts, at a minimum, should include the retail investor’s: (i) investment objectives and time horizon; (ii) employment status; (iii) estimated annual income from all sources; (iv) estimated net worth; (v) estimated liquid net worth; (vi) percentage of the retail investor’s liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and (vii) investment experience and knowledge regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.

¹³ An unfunded commitment would include, for example, capital commitments to a private fund that requires investors to fund capital contributions upon the request of the private fund.