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SEC Proposes New Derivatives Rules for Registered Funds

[29578]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 54-15 RE: SEC PROPOSES NEW DERIVATIVES RULES FOR REGISTERED FUNDS

I. Background and General Overview

On December 11, 2015, the Securities and Exchange Commission ("SEC") issued a release ("Release") proposing exemptive Rule 18f-4 ("Proposed Rule") under the Investment Company Act of 1940 ("1940 Act") regarding the use of derivatives and certain similar instruments by mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and business development companies ("BDCs") (collectively, "funds"). [1] The Release builds upon a Concept Release issued in 2011, in which the SEC sought public comment on the current regulatory framework surrounding funds' use of derivatives. [2] The Proposed Rule would permit a fund to enter into derivatives transactions [3] and financial commitment transactions [4] notwithstanding the prohibitions and restrictions on the issuance of senior securities under Section 18 of the 1940 Act, [5] provided that the fund complies with the conditions of the Proposed Rule. If the Proposed Rule is adopted, the SEC intends to rescind Investment Company Act Release No. 10666 [6] and the staff's related no-action letters and guidance addressing derivatives transactions and financial commitment transactions. Funds would be permitted to enter into derivatives transactions and financial commitment transactions only to the extent permitted by, and consistent with the requirements of, Rule 18f-4 or Sections 18 or 61 of the 1940 Act. [7]

The Proposed Rule seeks to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act: to ensure that funds are not unduly speculative and have sufficient assets to meet payment obligations. [8] In addition, the Proposed Rule seeks to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and financial commitment transactions. [9] As the Release notes, the current regulatory framework regarding derivatives transactions is based in large part on a series of no-action letters that address specific questions relating to the application of the approach set forth in Release 10666 to certain derivatives transactions. [10] The development of this guidance on an instrument-by-instrument basis, coupled with the dramatic growth in the derivatives markets, has led to situations in which there is no specific guidance from the SEC or its staff and, as a result, different funds may be applying different segregation approaches to the same derivatives instrument. [11] Accordingly, the SEC believes that there is a need for an updated and more comprehensive approach to regulating funds' use of derivatives and financial commitment transactions.

The Proposed Rule would require a fund relying on it to:

- comply with one of two alternative portfolio limitations designed to restrict the amount of leverage the fund may obtain through derivatives transactions, financial commitment transactions, and other senior securities transactions; [12]
- manage the risks associated with the fund's derivatives and financial commitment transactions by maintaining an amount of certain assets, defined in the Proposed Rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under those transactions; [13] and
- establish a formalized derivatives risk management program if a fund engages in a more than a limited use of derivatives or uses complex derivatives.

In addition, the Proposed Rule would amend proposed Form N-PORT and proposed Form N-CEN to require reporting and disclosure of certain information regarding a fund's derivatives usage.

Comments are due within 90 days of publication of the Release in the Federal Register (to date, it has not been published).

II. Portfolio Limitations for Derivatives Transactions

To the extent that a fund elects to rely on the Proposed Rule, the fund's board of directors, including a majority of the directors who are not interested persons of the fund ("independent directors"), would be required to approve one of two alternative portfolio limitations to apply to the fund: an exposure-based portfolio limit or a risk-based portfolio limit.

Exposure-Based Portfolio Limit (150% of the fund's net assets): A fund that relies on the exposure-based portfolio limit would be required to operate so that its aggregate exposure under "senior securities transactions," [14] measured immediately after entering into any such transaction, does not exceed 150% of the fund's net assets. [15]

- Calculation of Exposure: A fund's exposure would be the sum of (i) the aggregate notional amounts of the fund's derivatives transactions, subject to certain adjustments; (ii) the aggregate obligations of the fund under its financial commitment transactions; and (iii) the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the fund pursuant to Sections 18 or 61 of the 1940 Act. [16] In determining its aggregate notional exposure for derivatives transactions, the Proposed Rule would permit a fund to net only directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity, and other material terms (an offsetting transaction may, however, have a different counterparty). [17]
- Determination of Notional Amount: For purposes of calculating a fund's exposure, the Proposed Rule generally defines the "notional amount" as the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions) or the principal amount on which payment obligations under the derivatives transaction are calculated. [18]

- Adjusted Notional Amount: The Proposed Rule would require the use of an adjusted notional amount for certain derivatives transactions, including (i) derivatives transactions that provide a return based on the leveraged performance of an underlying reference asset; [19] (ii) derivatives transactions for which the underlying reference asset is 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; [20] and (iii) "complex derivatives transactions," which are derivatives transactions for which the amount payable by either party upon settlement date, maturity or exercise is either: (a) dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction or (b) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price. [21]

Risk-Based Portfolio Limit (300% of the fund's net assets): As an alternative to the exposure-based portfolio limit, the Proposed Rule includes a risk-based portfolio limit that would permit a fund to obtain exposure of up to 300% of the fund's net assets, [22] if the fund meets a value-at-risk ("VaR") [23] test that measures whether the fund's aggregate use of derivatives reduces, rather than magnifies, potential loss from market movements.

- The VaR Test: Pursuant to the Proposed Rule, a fund's VaR test must measure two components: (i) the VaR of the fund's entire portfolio, including securities, other investments, and derivatives transactions ("full portfolio VaR"); and (ii) the VaR of the fund's portfolio of securities and other investments, excluding any derivatives transactions ("securities VaR"). [24] To satisfy the VaR test, a fund's full portfolio VaR must be less than the fund's securities VaR immediately after entering into any senior securities transaction.
- Parameters for the VaR Test: Although specific methodologies for a fund's calculation of VaR may vary, the Proposed Rule would require a fund's VaR model to (i) take into account and incorporate all significant, identifiable market risk factors associated with the fund's investments; [25] (ii) use a minimum 99% confidence interval; (iii) use a time horizon of not less than ten and not more than 20 trading days; and (iv) use a minimum of three years of historical data to estimate historical VaR. In addition, a fund would be required to apply its VaR model consistently when calculating its full portfolio VaR and securities VaR.

III. Asset Segregation Requirements

In addition to imposing the portfolio limitations described above, the Proposed Rule would require a fund to manage the risks associated with its derivatives transactions by maintaining an amount of "qualifying coverage assets" (as defined in the Proposed Rule) for each derivatives transaction, identified on its books and records and determined pursuant to policies and procedures that a fund's board of directors, including a majority of the fund's independent directors, would be required to approve. These requirements are distinct from separate asset segregation requirements applicable to financial commitment transactions, which impose a higher (i.e., notional) coverage threshold but apply a broader definition of "qualifying coverage assets," as summarized in Section III.B. below. [26] The total amount of a fund's qualifying coverage assets for derivatives transactions could not exceed the fund's net assets, [27] and qualifying coverage assets used to cover a derivatives transaction could not also be used to cover a financial commitment transaction. [28]

A.Derivatives Transactions

Coverage Amount: For each derivatives transaction, a fund would be required to maintain qualifying coverage assets (generally, cash or cash equivalents) determined at least once each business day in an amount equal to the sum of (i) the mark-to-market coverage amount and (ii) the risk-based coverage amount, as described below.

- Mark-to-Market Coverage Amount: The mark-to-market coverage amount for a particular derivatives transaction would be equal to the amount that would be payable by the fund if it were to exit the derivatives transaction at the time of determination. [29] The fund could reduce its mark-to-market coverage amount for a derivatives transaction by the value of any assets that represent variation margin or collateral to cover the fund's mark-to-market loss with respect to that particular transaction or for other transactions covered by a netting agreement. [30] The collateral posted does not have to be in the form of cash or cash equivalents for a fund to reduce its mark-to-market coverage amount.
- Risk-Based Coverage Amount: The Proposed Rule would require a fund to segregate an additional amount of qualifying coverage assets that represents a reasonable estimate of the potential amount payable by the fund if it were to exit the derivatives transaction under stressed conditions. [31] Qualifying coverage assets would have to be identified on the fund's books and records and determined at least once each business day for each derivatives transaction. The Proposed Rule would allow a fund to reduce the risk-based coverage amount for a derivatives transaction by the value of any assets that represent initial margin or collateral posted to cover the future potential amounts payable by the fund under that particular derivatives transaction or for other transactions covered by a netting agreement. [32] The collateral or margin posted does not have to be in the form of cash or cash equivalents for a fund to reduce the risk-based coverage amount.
- Netting Arrangements: If the fund has entered into a netting agreement that allows it to net its payment obligations with respect to multiple derivatives transactions, the Proposed Rule would allow the fund to calculate each of its mark-to-market coverage and risk-based coverage amounts on a net basis for all derivatives transactions covered by the netting agreement. [33]

Qualifying Coverage Assets: Under the Proposed Rule, qualifying coverage assets in respect to a derivatives transaction would be fund assets that are either:

- Cash and Cash Equivalents: A fund would generally be required to segregate cash and cash equivalents as qualifying coverage assets to cover its derivatives transactions. The Release identified certain items commonly considered cash equivalents, including "certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds." The scope of assets that are eligible as qualifying coverage assets is narrower than what is currently permitted by the SEC staff through its no-action letters. [34]
- Assets Required to be Delivered Under the Derivatives Transaction: If a fund may satisfy its obligations under a derivatives transaction by delivering a particular asset, the Proposed Rule would allow the fund to fulfill its asset segregation obligation by segregating that particular asset. [35] The SEC notes that a qualifying coverage asset for a derivatives transaction generally would not include a derivative that provides an offsetting exposure. [36]

B. Financial Commitment Transactions

The Proposed Rule would impose separate asset segregation requirements on a fund's use of financial commitment transactions (i.e., any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement, or similar agreement), which depart in significant ways from those that would apply to derivatives transactions. In particular, funds would be required to cover the full notional amount of the obligation under a financial commitment transaction, whereas coverage for derivatives transactions would be essentially mark-to-market plus an additional risk-based coverage. Financial commitment transactions may be covered, however, using a broader set of qualifying coverage assets as described below. Under the Proposed Rule, the fund's board of directors, 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 for its financial commitment transactions. [37]

Coverage Amount: Under the Proposed Rule, a fund would be required to maintain qualifying coverage assets equal to at least the amount of the "financial commitment obligation" [38] associated with each of its financial commitment transactions (i.e., the notional value of the obligation). [39] The fund's qualifying coverage assets for its financial commitment transactions would be required to be identified on the fund's books and records and determined at least once each business day. [40]

Qualifying Coverage Assets: The Proposed Rule includes the following asset categories as qualifying coverage assets in respect of a fund's financial commitment transactions:

- cash and cash equivalents;
- assets that may be delivered to fulfill a fund's obligations under a financial commitment transaction; [41] or
- assets that are convertible to cash, or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such 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 of directors. [42]

IV. Derivatives Risk Management Program

Under the Proposed Rule, a fund that engages in more than a limited amount of derivatives transactions, or that engages at all in complex derivatives transactions, would be required to adopt and implement a formalized derivatives risk management program. [43] Although the Proposed Rule sets forth various specific parameters and formal requirements, it allows the program to be customized by a fund to manage the risks posed by the particular types of derivatives used by the fund and the manner in which the derivatives relate to the fund's investment portfolio and strategy.

Application of the Derivatives Risk Management Program: The derivatives risk management program requirements would be applicable to "funds that exceed a 50% threshold of notional derivatives exposure" [44] or that enter into complex derivatives transactions. [45] Accordingly, the Proposed Rule would not require a fund to adopt a formalized derivatives risk management program if the fund's board, including a majority of independent directors, approves a particular portfolio limitation under which the fund will limit its aggregate derivatives exposure to no more than 50% of its net assets and will not engage at all in complex derivatives transactions. The requirement to adopt a risk management program applies on a fund-by-fund basis, so some funds in a complex might determine to limit their use of derivatives so as to avoid the requirement while others would be required to adopt a program.

Design of the Derivatives Risk Management Program: A fund's derivatives risk management program must be reasonably designed to assess and manage the risks associated with the fund's derivatives transactions. The derivatives risk management program would consist of the following elements:

- Derivatives Risk Manager: The Proposed Rule would require that a fund designate, and the board approve, an employee or officer of the fund or its adviser (or sub-adviser) to act as derivatives risk manager and administer its derivatives risk management program. [46]
- Assessment of the Risks of a Fund's Derivatives Transactions: A fund's derivatives risk management program would be required to assess five specific risks: leverage risk, market risk, counterparty risk, liquidity risk, and operational risk, as well as other risks that are applicable to a fund's derivatives transactions. [47] The Release indicates that such policies and procedures should be customized such that the costs, burdens, and scope of the program are appropriate to assess the derivatives risks faced by a particular fund.
- Management of the Risks of a Fund's Derivatives Transactions: The Release suggests that the derivatives risk management policies and procedures might include portfolio tracking systems, exception reporting, and other mechanisms designed to monitor derivatives risks. Funds should design these mechanisms to manage risks from derivatives transactions such that the risks are consistent with a fund's investment guidelines, portfolio limitations, disclosure, and investment strategy. [48] The Release notes that derivatives risk management could involve the evaluation of counterparties, maintenance of contingency plans, stress testing (including the use of a stressed VaR model), and communication between derivatives risk management personnel and the fund's portfolio managers or board members.
- Reasonable Segregation of Derivatives Risk Management Function: The Proposed Rule would require that a fund institute policies and procedures reasonably designed to segregate the fund's derivatives risk management functions from the fund's portfolio management. [49] The Release stresses the importance of regular communication between a fund's derivatives risk management and portfolio management personnel. [50] Although requiring segregation of functions, the Proposed Rule does not require that the derivatives risk function and portfolio management be subject to a communications "firewall." [51]
- Periodic Program Review and Update: The Proposed Rule would require a fund to review and update its derivatives risk management program at least annually. [52] The Release recommends that a fund also consider regulatory, market-wide and fund-specific developments that affect the program. [53]

Board Review and Approval: The Release indicates that a fund's board of directors would be responsible for general oversight of the program. [54] The Proposed Rule would require board approval of a fund's initial derivatives risk management program and any material changes to the program, [55] board approval of the fund's designation of the derivatives risk manager, and quarterly board review of the adequacy and effectiveness of the program. [56] The Release indicates that serious compliance issues arising under a fund's derivatives risk management program should be brought to the attention of the fund's board promptly. [57]

V. Recordkeeping

The Proposed Rule imposes requirements for a fund to maintain certain records, including those with respect to:

i. determinations made by the fund's board that the fund will comply with one of the portfolio limits under the Proposed Rule;

ii. policies and procedures approved by the fund's board regarding the fund's maintenance of qualifying coverage assets;

iii. compliance with the portfolio limitation applicable to the fund immediately after entering into a senior securities transaction, reflecting the fund's aggregate exposure, the value of the fund's net assets and, if applicable, the fund's full portfolio VaR and its securities VaR;

iv. mark-to-market and risk-based coverage amounts and the fund's financial commitment obligations, which identify the qualifying coverage assets maintained by the fund to cover these amounts;

v. qualifying coverage assets maintained by the fund to cover the aggregate amount of its mark-to-market and risk-based coverage amounts for derivatives transactions;

vi. specific qualifying coverage assets maintained by the fund to cover each financial commitment transaction; and

vii. the fund's written derivatives risk management program (if applicable), including any materials provided to the board in connection with its approval of the program, as well as any written reports provided to the board relating to the program.

The Proposed Rule would require funds to retain copies of these records for a period of five years (the first two years in an easily accessible place).

VI. Amendments to Proposed Forms N-PORT and N-CEN

The Proposed Rule also includes amendments to proposed Forms N-PORT and N-CEN [58] that would (i) require funds that must implement a formalized risk management program under the Proposed Rule to report on Form N-PORT certain portfolio- and position-level risk metrics; and (ii) require all funds engaging in derivatives transactions to identify on Form N-CEN the portfolio limitation (either the exposure-based portfolio limit or the risk-based portfolio limit) on which the fund relied during the reporting period.

VII. Existing Guidance and Compliance Dates

If the Proposed Rule is adopted, the SEC intends to rescind Release 10666 and the staff's no-action letters and other guidance addressing derivatives transaction and financial commitment transactions. Funds would only be permitted to enter into derivatives transactions and financial commitment transactions to the extent permitted by, and consistent with the requirements of, Rule 18f-4 or Sections 18 or 61 of the 1940 Act. Prior to the Proposed Rule's adoption, however, the SEC is not rescinding Release 10666 or any no-action letters issued by the staff or related guidance, on which funds may continue to rely for the time being.

A fund would be able to rely on the Proposed Rule after its effective date as soon as the fund could comply with the rule's conditions. The SEC would, in addition, expect to provide a transition period during which it would permit funds to continue to rely on Release 10666, staff no-action letters and other guidance from the staff, including with respect to derivatives transactions and financial commitment transactions entered into by a fund after the rule's effective date but before the end of the transition period. [59]

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endnotes

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933, available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf. The Release also proposes related amendments to proposed Forms N-PORT and N-CEN.

[2] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, SEC Release No. IC-29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)] ("Concept Release"), available at http://www.sec.gov/rules/concept/2011/ic-29776fr.pdf. The SEC notes that its staff has been exploring the benefits, risks, and costs associated with funds' use of derivatives, and that its staff's review of these and other matters, together with input from commenters on the Concept Release and others, have informed its consideration of the regulation of funds' use of derivatives, including in particular whether funds' current practices, based on their application of SEC and staff guidance, are consistent with the investor protection purposes and concerns underlying Section 18 of the 1940 Act. Release at 8-9.

[3] The Proposed Rule defines a "derivatives transaction" as any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise. Proposed Rule 18f-4(c)(2).

[4] The Proposed Rule defines a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement, or similar agreement. Proposed Rule 18f-4(c)(4). This definition is intended to address the types of instruments discussed in Release 10666, as well as short sales of securities. Release at 58.

[5] The SEC notes in the Release that it recognizes that "not every derivative will involve the issuance of a senior security because not every derivative imposes a future payment obligation on the fund." Release at 30. The SEC preliminarily believes that a derivative that does not impose a future payment obligation on the fund (e.g., a purchased option) would not involve a senior security transaction for purposes of Section 18. Id.

[6] Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] ("Release 10666"), available at

http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

[7] A fund could enter into other senior securities transactions outside the defined scope of "derivatives transactions" or "financial commitment transactions," such as borrowings from a bank by mutual funds or the issuance of other debt securities or preferred equity by closed-end funds or BDCs, pursuant to the requirements of Section 18 (or Section 61 in the case of BDCs) or in accordance with some other exemption, rather than the Proposed Rule.

[8] Release 10666. These concerns also are reflected in Sections 1(b)(7) and 1(b)(8) of the 1940 Act. See Release at 33.

[9] In presenting its new approach, the SEC points to the significant growth in the volume and complexity of the derivatives markets in recent decades and the increased use of derivatives transactions by certain funds. Release at 33.

[10] See Release at 19; see also Concept Release, supra note 2, at Section I, for a discussion of certain no-action letters.

[11] Release at 48-49. In the Release, the SEC takes the view that funds are segregating a broader range of liquid assets, and more funds are using mark-to-market segregation for derivatives, than was contemplated by Release 10666. Release at 36-37.

[12] As described in greater detail below, the first portfolio limitation would limit the fund's exposure to underlying reference assets and potential leverage to 150% of the fund's net assets (the "exposure-based portfolio limit"). The second portfolio limitation would permit a fund to obtain exposure of up to 300% of the fund's net assets when the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, evaluated using a value-at-risk-based (VaR) test (the "risk-based portfolio limit"). Release at 52.

[13] A fund would be required to maintain qualifying coverage assets to cover the fund's mark-to-market obligations under a derivatives transaction, as well as an additional amount designed to address potential future losses and resulting payment obligations under the derivatives transaction. Qualifying coverage assets for derivatives transactions generally would be required to consist of cash and cash equivalents. Release at 53.

[14] The Proposed Rule defines "senior securities transactions" as any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to Section 18 or 61 of the 1940 Act without regard to the exemption provided by the Proposed Rule. Proposed Rule 18f-4(c)(10).

[15] Proposed Rule 18f-4(a)(1)(i). The SEC believes the 150% limit is sufficiently flexible to permit derivatives transactions that may be entered into for hedging (or risk-mitigating) purposes or that may be used as "cover transactions." Release at 110. The SEC recognizes, however, that certain funds (including alternative strategy funds, managed futures funds, and leveraged ETFs) may need to modify their portfolios in order to comply with a 150% exposure limitation or deregister under the 1940 Act. Release at 101, 105.

[16] Proposed Rule 18f-4(c)(3).

[17] Proposed Rule 18f-4(c)(3)(i).

[18] Proposed Rule 18f-4(c)(7). The Release provides a table listing common types of

derivatives transactions, together with calculation methods funds may use to determine their notional amounts (before applying any requisite adjustments) for purposes of the Proposed Rule’s exposure-based portfolio limit. Release at 69.

[19] The notional amount for this type of derivatives transaction would be multiplied by the applicable leverage factor. Proposed Rule 18f-4(c)(7)(iii)(A).

[20] The Proposed Rule includes a “look-through” for this type of derivatives transaction that requires a fund to calculate the notional amount by reference to the fund’s pro rata portion of the notional amounts of the derivatives transactions of the underlying reference vehicle, which in turn must be calculated in a manner consistent with the requirements of the Proposed Rule. Proposed Rule 18f-4(c)(7)(iii)(B).

[21] The notional amount for this type of derivatives transaction would equal the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction at the time the fund enters into the transaction. Proposed Rule 18f-4(c)(7)(iii)(C).

[22] The SEC determined to propose an exposure limit of 300% of a fund’s net assets, notwithstanding that satisfaction of the VaR test would indicate that the fund’s use of derivatives transactions has the overall effect of reducing risk to market exposures. Although certain derivatives transactions may limit risk in normal market conditions, the SEC believes that typical correlations among different positions may break down in times of market stress, and even derivatives positions intended to mitigate risk may end up magnifying risk.

[23] “Value-at-risk” or “VaR” is defined in the Proposed Rule as “an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level.” Proposed Rule 18f-4(c)(11).

[24] The VaR test under the risk-based portfolio limit is modeled after the “relative VaR” approach used by some UCITS funds. The two tests differ in that the VaR test under the risk-based portfolio limit uses the fund’s own portfolio investments (exclusive of derivatives) as the baseline against which the full portfolio VaR (inclusive of derivatives) is compared, while the relative VaR test commonly used by UCITS uses a reference index.

[25] The Proposed Rule provides a non-exclusive list of risk factors that may be relevant, including equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk, material risks arising from the nonlinear price characteristics of options and positions with embedded optionality, and the sensitivity of the market value of the fund’s derivatives to changes in volatility or other material market factors. Although the Proposed Rule does not mandate a specific VaR calculation methodology, it does require that the fund’s chosen methodology consider all of the factors outlined above, and suggests that the methodology be assessed and updated periodically. Release at 134.

[26] The Proposed Rule provides for different categories of “qualifying coverage assets” for derivatives transactions, on the one hand, and for financial commitment transactions, on the other hand. Proposed Rule 18f-4(c)(8).

[27] Proposed Rule 18f-4(c)(8). This limitation is intended to prohibit a fund from using additional assets resulting from leveraging transactions (such as a borrowing or financial

commitment transaction) to support another layer of leverage through senior securities transactions. Release at 183-184.

[28] Release at 160, n.337.

[29] Proposed Rule 18f-4(c)(6). The SEC observes that the methodology for determining the mark-to-market coverage amount aligns with how funds typically calculate their liability under derivatives transactions for purposes of determining net asset value. Release at 159.

[30] Initial margin, however, could not reduce a fund’s mark-to-market coverage amount with respect to a derivatives transaction because it is generally not available to settle or cover the fund’s mark-to-market exposure. Instead, initial margin represents a “security guarantee to cover potential future amounts payable by the fund.” Release at 162.

[31] Proposed Rule 18f-4(c)(9); Release at 165. Even if the mark-to-market coverage amount is zero for a specific derivatives transaction, a fund would still be required to consider the risk-based coverage amount for the transaction. Release at 157, n.333. The term “stressed conditions” is not defined in the Proposed Rule and the SEC solicits comment on whether to clarify the term. Release at 175-176. The SEC indicates that a fund’s policies and procedures could, among other possible approaches, provide for stress testing or a stressed VaR model to estimate the potential amount payable by a fund to exit a derivatives transaction under various adverse scenarios. Release at 170.

[32] Proposed Rule 18f-4(c)(9)(ii). The SEC believes it is appropriate to count only initial margin (and not variation margin) toward the risk-based coverage amount because variation margin is used to satisfy the fund’s current liability and not potential future liabilities. Release at 172, n.360.

[33] Proposed Rule 18f-4(c)(6)(i), (c)(9)(i). Qualifying coverage assets could not be used to cover more than one derivatives transaction unless the transactions are subject to a netting agreement and the fund calculates its coverage amounts with respect to such transactions on a net basis. Release at 160, n.337.

[34] Release at 179. The SEC did not include as qualifying coverage assets other types of assets, such as equity securities or other debt securities, because such assets could decline in value and be insufficient to cover a fund’s obligations under its derivatives transactions. This represents a major departure from prior SEC guidance in the context of Release 10666. See Merrill Lynch Asset Management, L.P., SEC No-Act. (pub. avail. July 2, 1996), available at http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf.

[35] Proposed Rule 18f-4(c)(8)(ii).

[36] Release at 183. The Release indicates that a fund may be able to reduce the amount of qualifying coverage assets required to be segregated if it enters into two offsetting transactions that were covered by a netting agreement. Release at 182, n.374.

[37] Proposed Rule 18f-4(b)(2).

[38] The Proposed Rule defines “financial commitment obligation” as the “amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction.” Proposed Rule 18f-4(c)(5). This obligation includes, in the case where a particular asset is to be delivered, the value of that asset.

[39] Proposed Rule 18f-4(b)(1). As distinguished from the proposed market-to market and risk-based coverage requirements for derivatives transactions, a fund would be required to maintain qualifying coverage assets to cover the full amount of the fund's obligations under its financial commitment transactions.

[40] Proposed Rule 18f-4(b)(1).

[41] Proposed Rule 18f-4(c)(8)(ii).

[42] Proposed Rule 18f-4(c)(8)(iii). This category of assets, which the Release notes would be consistent with funds' current practices of segregating liquid assets under Release 10666 and its progeny, is significantly broader than the types of qualifying coverage assets that may be used to cover derivatives transactions under the Proposed Rule. For relevant examples and discussion, see the Release at 240-244.

[43] The use of financial commitment transactions or other senior securities that are not derivatives transactions does not trigger the derivatives risk management program requirement.

[44] Proposed Rule 18f-4(a)(4). The 50% notional exposure test applies only to a fund's derivatives transactions and not to financial commitment transactions or other senior securities transactions entered into pursuant to section 18 or 61 of the 1940 Act. Release at 199. The 50% notional exposure test would apply immediately after a derivatives transaction is entered into and any fund that uses derivatives would be required to monitor the notional amounts of the fund's derivatives transactions and the fund's aggregate exposure to ascertain whether a fund's exposure has exceeded 50% of net assets such that it is subject to the proposed formalized risk management program. Release at 196.

[45] See supra text surrounding note 21.

[46] The Proposed Rule would require that the derivatives risk manager be an employee or officer of the fund or its investment adviser, a provision that "would effectively bar funds from outsourcing the administration of the derivatives risk manager to third parties." Release at 224. However, the fund could designate an employee or officer of the fund's sub-adviser as the fund's derivatives risk manager, and the derivatives risk manager may serve other roles, such as acting as the fund's chief compliance officer. Release at 222. Unlike Rule 38a-1's treatment of a fund's chief compliance officer, the Proposed Rule would not require board action for the removal of the derivatives risk manager or approval of the derivatives risk manager's compensation.

[47] The Release notes that a derivatives risk management program might consider "idiosyncratic" risks applicable to specific derivatives transactions, such as an analysis of the legal validity of customized derivatives contracts or the difficulty of enforcing such contracts in the event of a counterparty's default. Release at 210-211.

[48] The Release recommends that, under the Proposed Rule, a fund should establish written guidelines describing the scope and objectives of its derivatives transactions, maintain a list of approved derivatives instruments and persons authorized to engage in derivatives transactions, and establish size controls or fund-wide limits for approved transactions. Release at 213-214.

[49] Proposed Rule 18f-4(a)(3)(i)(C). One aspect of this segregation of responsibilities is that a fund's designated derivatives risk manager is not permitted to be a portfolio

manager of the fund. Release at 222.

[50] Release at 218.

[51] Release at 217.

[52] Proposed Rule 18f-4(a)(3)(i)(D). The SEC indicates that more frequent reviews may be appropriate depending on the circumstances, and should take place frequently enough to account for changing market conditions and changing use of derivatives by the fund.

[53] Release at 220.

[54] The Release notes that the board's proposed oversight role for the derivatives risk management program would be similar to the oversight role described in the SEC's recent liquidity release relating to proposed Rule 22e-4. See Release at 227, n. 446.

[55] Proposed Rule 18f-4(a)(3)(ii). The SEC acknowledges that directors might conduct their initial review of a fund's risk management program by "reviewing summaries of the program prepared by the fund's derivatives risk manager, legal counsel, or other persons familiar with the program." Release at 226.

[56] Proposed Rule 18f-4(a)(3)(ii)(B)-(C).

[57] Release at 228.

[58] See Investment Company Reporting Modernization Release, SEC Release No. IC-31610 (May 20, 2015) [80 FR 33590 (June 12, 2015)], available at http://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf (describing proposed Form N-PORT, which would require funds to file certain monthly portfolio investment information, and proposed Form N-CEN, which would require funds to file annual reports with certain census-type information).

[59] In requesting comments on the parameters of a transition period, the SEC notes the possible use of tiered compliance dates, similar to those proposed for proposed Rule 22e-4, such as a compliance period of 18 months for larger entities and an extra 12 (or 30 total months) for smaller entities. Release at 261.