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

November 27, 2019

In a November 25, 2019 release (the "**Proposing Release**"), the Securities and Exchange Commission (the "**SEC**") proposed a substantially revised version of proposed new Rule 18f-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), which was originally proposed by the SEC on December 11, 2015 (the "**2015 Proposal**"). According to the Proposing Release, proposed Rule 18f-4 would impose requirements on the use of derivatives and certain other transactions by registered investment companies (other than money market funds and UITs) and business development companies ("**registered funds**"), and is designed to promote the ability of registered funds to use derivatives in a broad variety of ways that serve investors, while still addressing the investor protection concerns underlying Section 18 of the Investment Company Act. The SEC's proposals outlined in the Proposing Release included notable differences from the 2015 Proposal, including, among other things, removal of the asset segregation requirement and general notional exposure limits, introduction of a fund leverage risk limit based on a registered fund's value at risk ("**VaR**") relative to the VaR of a designated reference index (subject to certain exceptions), revised exceptions for registered funds that are limited derivatives users, and modified elements of the written derivatives risk management program that registered funds would be required to adopt (with limited exceptions).

In addition, the SEC proposed alternative requirements for a "**leveraged/inverse investment vehicle**," which is defined in the Proposing Release as "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time." The alternative framework proposed by the SEC includes an exception for certain leveraged/inverse investment vehicles from the fund leverage risk limit under proposed Rule 18f-4, as well as newly proposed sales practices rules under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and the Investment Advisers Act of 1940, as amended (the "**Investment Advisers Act**"), with respect to the purchase and sale of leveraged/inverse investment vehicles for retail investor accounts. In light of these specific provisions to address leveraged/inverse investment vehicles, the SEC also proposed to amend Rule 6c-11 to permit ETFs that are leveraged/inverse investment vehicles to rely on Rule 6c-11 rather than SEC exemptive orders.

As in the 2015 Proposal, the SEC proposed to rescind prior guidance provided in Release 10666[1] regarding the application of Section 18 to the use of derivatives and financial commitment transactions by registered funds. Consistent with its approach in other areas of the securities laws, including within the Division of Investment Management, the SEC staff is also reviewing previously issued no-action letters to determine whether any such no-action letters should be withdrawn in the event that proposed Rule 18f-4 is adopted.

[1] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25, 128 (Apr. 27, 1979).

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Outlined below is a summary of some of the main provisions of the proposals contained in the Proposing Release:

- *Primary Requirements for Derivatives Transactions*. Proposed Rule 18f-4 would generally permit registered funds (including business development companies, but not money market funds or UITs) to enter into derivatives transactions, notwithstanding the restrictions under Section 18 of the Investment Company Act, subject to certain conditions including:
  - *Derivatives Risk Management Program*: Adoption and implementation of a written derivatives risk management program reasonably designed to manage a registered fund's derivatives risks while, as recently seen in other SEC rulemakings, allowing principles-based tailoring to the registered fund's particular risks. The derivatives risk management program must also be designed to reasonably segregate the registered fund's derivatives risk management function from its portfolio management, and must include the following elements:
    - Identification and assessment of the registered fund's derivatives risks,
    - Risk guidelines that provide for quantitative or other measurable criteria, metrics or thresholds that the registered fund does not normally expect to exceed, and measures to be taken if exceeded,
    - Stress testing to be conducted at least weekly,
    - Daily backtesting of the VaR calculation model used by the registered fund to conduct the fund leverage risk limit tests,
    - Internal reporting and escalation of material risks to the registered fund's portfolio management function and board of directors, as appropriate, and
    - Periodic review of the derivatives risk management program at least annually by the registered fund's derivatives risk manager.
  - *Limit on Fund Leverage Risk*: Compliance with a relative VaR test whereby the VaR of the registered fund's portfolio may not exceed 150% of the VaR of a designated reference index, i.e., an unleveraged index selected by the registered fund's derivatives risk manager that reflects the markets or asset classes in which the registered fund invests.
    - If the derivatives risk manager is unable to identify an appropriate designated reference index, the registered fund must comply with an absolute VaR test whereby the VaR of the registered fund's portfolio may not exceed 15% of the value of its net assets.
  - *Board Oversight and Reporting*:
    - Board approval of the derivatives risk manager,
    - Written reports to the board regarding the implementation of the derivatives risk management program and its effectiveness at least annually by the derivatives risk manager, and
    - Regular written reports to the board, at a frequency determined by the board, by the derivatives risk manager regarding any breaches of the risk guidelines set forth in the derivatives risk management program, and results of the stress testing and backtesting conducted under the program.
  - *Exception for Limited Derivatives Users*: Exceptions from the VaR-based limit on fund leverage risk and the required elements of the derivatives risk management program for a registered fund that:

- Adopts and implements policies and procedures reasonably designed to manage the registered fund's derivatives risks, and
- Either: (a) limits its notional derivatives exposure (including the value of assets sold short) to 10% of its net assets, or (b) uses derivative transactions solely to hedge certain currency risks.

o *Alternative Requirements for Certain Leveraged/Inverse Investment Vehicles*: Exception from the VaR-based limit on fund leverage risk for a leveraged/inverse investment vehicle that:

- Discloses in its prospectus that it is not subject to such limit on fund leverage risk, and
- Does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse return) of the underlying index.

o *Recordkeeping*: Retention of certain records required under proposed Rule 18f-4 that are designed to provide SEC staff, the registered fund's board and its compliance staff the ability to evaluate compliance with the proposed rule.

- *Reverse Repurchase Agreements and Unfunded Commitments*. Proposed Rule 18f-4 would permit a registered fund to enter into reverse repurchase agreements and similar transactions provided the registered fund treats the transaction as a borrowing and meets the asset coverage requirements under Section 18 of the Investment Company Act. Proposed Rule 18f-4 would also permit a registered fund to enter into unfunded commitment agreements (e.g., agreements to make a loan to a company or to invest in the equity of a company in the future) subject to certain conditions, including the registered fund's reasonable belief that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements.
- *Sales Practices for Leveraged and Inverse Funds*. Proposed Rule 15l-2 under the Exchange Act and proposed Rule 211(h)-1 under the Investment Advisers Act would permit a broker-dealer or investment adviser to buy and sell leveraged/inverse investment vehicles for the account of a client that is a natural person only if the broker-dealer or investment adviser has approved the account for such investments, based on its due diligence on the client's financial situation, investment objectives, and knowledge and experience in financial matters as they relate to the client's ability to evaluate the risks of such investments.
- *Amendment to New ETF Rule*. Proposed amendments to Rule 6c-11 would remove the provision that currently excludes ETFs that are leveraged/inverse investment vehicles from relying on the rule.
- *Reporting Requirements*. Proposed amendments to Forms N-PORT, N-LIQUID and N-CEN would require a registered fund to provide information regarding: (1) its exposure to derivatives, (2) its VaR (and if applicable, its designated reference index) and backtesting results, (3) VaR test breaches (to be reported to the SEC in a non-public current report) and (4) certain identifying information regarding the registered fund (e.g., whether it is a limited derivatives user that is excepted from certain requirements under proposed Rule 18f-4, or whether it is a leveraged/inverse investment vehicle).
- *Transition Period*. The SEC proposed a one-year transition period from the date of publication of any final rule in the *Federal Register* to provide time for affected registered funds, broker-dealers and investment advisers to prepare for compliance with the final rules.

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The SEC has requested public comments on the proposals, to be received by the SEC on or before the 60th day after publication of the Proposing Release in the *Federal Register*.

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