STRADLEY RONON

Client Alert

A Publication of the Stradley Ronon
Investment Management Group

WWW.STRADLEY.COM

DECEMBER 2015

Stradley Ronon Stevens & Young, LLP
Philadelphia, Pa.
2005 Market Street, Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile

Washington, D.C.
1250 Connecticut Avenue, N.W., Suite 500
Washington, DC 20036
202.822.9611 Telephone
202.822.0140 Facsimile

New York, N.Y.
100 Park Avenue, Suite 3210
New York, NY 10017
212.812.4124 Telephone
646.682.7180 Facsimile

With other offices in:
Malvern, Pa.
Harrisburg, Pa.
Wilmington, Del.
Cherry Hill, N.J.

www.stradley.com

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What You Need to Know About the SEC's New Proposal on the Use of Derivatives by Registered Investment Companies and Business Development Companies

On December 11, 2015, the Securities and Exchange Commission (the SEC) Commissioners voted three to one in favor of proposing new Rule 18f-4 that is designed to modernize the regulation of derivatives usage by open-end funds, closed-end funds, exchange-traded funds and business development companies (the Proposal).[1] The Proposal, if adopted, would replace over 30 years of SEC and staff guidance on the use of derivatives by registered funds and business development companies with new limits on funds' use of derivatives transactions. Consequently, certain funds, such as managed futures funds, would likely be forced to cease operating as registered investment companies under the Investment Company Act of 1940 (the 1940 Act).

The SEC stated that the Proposal is intended to address the investor protection concerns embodied in the 1940 Act associated with funds' use of leverage by reducing undue speculation by funds that use leverage and reducing the risk that funds will operate without adequate assets to meet their obligations. The SEC hopes that the Proposal will establish an updated and more comprehensive approach to the regulation of funds' use of derivatives and other transactions that create leverage.

The Proposal is the third in a series of SEC proposals[2] designed to address the impact of investment activities on investors and the financial markets, and the risks associated with increasingly complex portfolio composition and operations of the asset management industry.[3]

SUMMARY

The Proposal is complex and involves the establishment of new definitional terms, tests and risk oversight protocols. The Proposal has five major components.

- **Portfolio Level Limitations for Derivatives Transactions**. Funds would be required to limit the aggregate notional amount of leverage they obtain through derivatives

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933 (December 11, 2015) (the Proposing Release), *available at* http://www.sec.gov/rules/proposed/2015/ic-31933.pdf. *But see also* Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (December 11, 2015), *available at* http://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html.

[2] See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release Nos. 33-9922, IC-31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (October 15, 2015) (the Liquidity Release), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf; Investment Company Reporting Modernization, SEC Release Nos. 33-9776, 34–75002, IC–31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015) (the Reporting Modernization Release), available at https://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf.

[3] Proposing Release, *supra* note 1, at 51-52.

transactions, other financial transactions that create leverage, borrowings and other senior securities to either: (i) 150% of a fund's net assets, or (ii) 300% of a fund's net assets if derivatives reduce (hedge) the market risk of the fund.

- **Asset Segregation for Derivatives Transactions**. Any fund using derivatives transactions would be required to maintain liquid assets sufficient to cover the fund's obligations under the transactions. The amount of assets to be segregated as cover would be calculated based on the fund's current obligations, as marked-to-market daily, plus an additional "cushion" designed to address potential future losses under stressed conditions. In contrast to current SEC and staff guidance, funds would generally be permitted to use as segregated assets only cash and cash equivalents or the particular asset required to be delivered, if any.

- **Derivatives Risk Management Program**. Funds that have more than a limited amount of exposure from derivatives transactions (*i.e.*, 50% of net assets) or that enter into complex derivatives transactions would be required to establish a formal derivatives risk management program administered by a designated derivatives risk manager, which would be approved and overseen by the fund's board.

- **Requirements for Financial Commitment Transactions**. Funds that enter into reverse repurchase agreements, short sales, firm or standby commitment agreements and similar agreements (together, financial commitment transactions) would be required to maintain "qualifying coverage assets" equal in value to the full amount of a fund's conditional or unconditional obligation to pay or deliver assets under these transactions. Qualifying coverage assets would include cash, cash equivalents, assets that are convertible into cash as permitted by policies and procedures approved by the fund's board, or the particular asset required to be delivered, if any.

- **Disclosure and Recordkeeping**. Funds would be required to disclose on proposed Form N-PORT additional information and risk metrics relating to options transactions, including position-level estimation of sensitivity to underlying price movements (gamma), and position-level sensitivity to volatility (vega). Funds would also be required to report on proposed Form N-CEN whether the fund relied on Rule 18f-4 during the reporting period. Separately, funds would be required to maintain records relating to the fund's selection of either the 150% or 300% portfolio limitation for derivatives transactions, records of the fund's derivatives risk management program, if any, and any materials provided to the fund's board related to the operation of the program.

Comments on the Proposal are due within 90 days of publication of the Proposal in the Federal Register (to date, it has not yet been published). The proposed compliance date of the Proposal is described at the end of this Client Alert.

DETAILED DISCUSSION

I. Portfolio Level Limitations for Derivatives Transactions

The Proposal would require a fund that enters into derivatives transactions to comply with one of two alternative portfolio limitations: an exposure-based portfolio limit or a risk-based portfolio limit. The fund's board, including a majority of the fund's independent directors, would be required to approve which of the two alternative portfolio limitations would apply to the fund.

A. Exposure-Based Portfolio Limit

1. Overview

A fund that relies on the exposure-based portfolio limit would be required to operate so that its aggregate exposure under senior securities transactions, measured immediately after entering into any such transaction, does not exceed 150% of the value of the fund's net assets.[4] For this purpose, "senior securities transactions" include derivatives transactions, financial commitment transactions, and other transactions involving senior securities, such as borrowing from a bank and closed-end fund issuances of preferred shares.[5] The exposure-based portfolio limit is designed to

[4] Proposed Rule 18f-4(a)(1)(i).

[5] Proposed Rule 18f-4(c)(10) defines "senior securities transaction" to mean "any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to section 18 (15 U.S.C. 80a-18) or 61 (15 U.S.C. 80a-61) of the [1940] Act without regard to the exemption provided by this section." Section 18(g) of the 1940 Act generally defines "senior security" as any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends. Section 61 of the 1940 Act makes the provisions of Section 18 of the 1940 Act applicable to business development companies (BDCs) with certain alterations.

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impose an overall limit on the amount of exposure, and thus the amount of potential leverage that a fund would be able to obtain through derivatives and other senior securities transactions.[6]

The 150% exposure limitation is intended to balance the proposed rule's effects on funds and their investors, on the one hand, with concerns related to funds' ability to obtain leverage through derivatives and other senior securities transactions, on the other.[7] The SEC believes that setting the exposure limitation at 150% would allow the fund to obtain a level of indirect market exposure solely through derivatives transactions that could approximate the level of market exposure that would be possible through securities investments augmented by borrowings as permitted under Section 18 of the 1940 Act.[8]

2. ***Calculation of Exposure***

The proposed rule would define a fund's "exposure" as 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 (financial commitment obligations); and (iii) the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any senior securities transactions entered into by the fund pursuant to Section 18 of the 1940 Act without regard to the exemption provided by the proposed rule.[9]

Note that the calculation of "exposure" is different from the calculation used to determine whether a fund meets the requirements of Commodity Futures Trading Commission (CFTC) Rule 4.5. It is therefore possible for the investment adviser to a fund to be excluded from commodity pool operator status under CFTC Rule 4.5, because the aggregate net notional value of the fund's derivatives does not exceed 100% of the fund's liquidation value under that rule, yet the fund exceeds the 150% exposure limitation under Proposed Rule 18f-4.

3. ***Determination of Notional Amounts***

The proposed rule would define the "notional amount" of a derivatives transaction 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, subject to certain adjustments described below.[10] The notional amount generally serves as a measure of the underlying economic exposure of a derivative. The Proposing Release acknowledges that a test based on notional amounts could be viewed as a relatively blunt measurement, in that different derivatives transactions having the same notional amount (*e.g.*, an interest rate swap and a credit default swap) may expose a fund to very different potential risks and payment obligations.[11]

a. *Leveraged Performance*

For derivatives that provide a return based on the leveraged performance of a reference asset, the proposed rule would require the notional amount to be multiplied by the applicable leverage factor.[12] For example, the proposed rule would require a total return swap that has a notional amount of $1 million and provides a return equal to three times the performance of an equity index to be treated as having a notional amount of $3 million.[13]

b. *Look-Through*

The proposed rule provides a "look-through" for calculating the notional amount when the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives

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[6] Proposing Release, *supra* note 1, at 66.

[7] *Id*. at 97.

[8] Proposing Release, *supra* note 1, at 95.

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

[10] Proposed Rule 18f-4(c)(7).

[11] Proposing Release, *supra* note 1, at 70.

[12] Proposed Rule 18f-4(c)(7)(iii)(A).

[13] Proposing Release, *supra* note 1, at 72.

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transactions, or an index that reflects the performance of such a managed account or entity. In such cases, the proposed rule would require a fund to calculate the notional amount by reference to the fund's pro rata share of the notional amounts of the derivative transactions of such account or entity.[14]

c. *Complex Derivatives Transactions*
The proposed rule contains specific provisions for calculating the notional amount for a complex derivatives transaction. A "complex derivatives transaction" is a derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise is: (i) dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction, or (ii) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.[15] Examples of complex derivatives transactions include variance swaps and non-standard options that have a payoff that is contingent on whether the price of the underlying asset reaches some specified level prior to expiration. The notional amount of a complex derivatives transaction would be equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, that are reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction.[16]

d. *Limited Netting Provision*
The proposed rule includes a netting provision that would permit a fund, in determining its aggregate notional exposure, to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.[17] This would apply to derivatives transactions for which a fund typically would use an offsetting transaction to effectively settle all or a portion of the transaction prior to expiration or maturity, such as certain futures and forward transactions, as well as situations in which a fund seeks to reduce or eliminate its economic exposure under a derivatives transaction without terminating the transaction.[18] The netting provision permits offsetting transactions to have different counterparties.[19] The netting provision would not apply to transactions that may have offsetting risk characteristics but do not have the same underlying reference asset, maturity and other material terms or that involve different types of derivatives instruments.[20]

B. Risk-Based Portfolio Limit

1. Overview
As an alternative to the exposure-based portfolio limit, the proposed rule includes a risk-based portfolio limit that would permit a fund to enter into derivatives transactions, and obtain exposure in excess of that permitted under the exposure-based portfolio limit, if the fund complies with a value-at-risk test (VaR test).[21] The risk-based portfolio limit is designed to provide an indication of whether a fund's derivatives transactions, in aggregate, have the effect of reducing the fund's exposure to market risk.[22] A fund that elects the risk-based portfolio limit would be required to limit its aggregate "exposure" (using the same definition as the exposure-based portfolio limit) to no more than 300% of the value of the fund's net assets.[23]

[14] Proposed Rule 18f-4(c)(7)(iii)(B). The Proposing Release explains that this provision is necessary to prevent funds from avoiding the exposure limitations of the proposed rule by obtaining exposure indirectly. *See* Proposing Release, *supra* note 1, at 72-73.

[15] Proposed Rule 18f-4(c)(1). The definition carves out standard put or call options, which are technically non-linear because they have a single strike price.

[16] Proposed Rule 18f-4(c)(7)(iii)(C).

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

[18] Proposing Release, *supra* note 1, at 80.

[19] *Id.*

[20] *Id.* at 81.

[21] *See* Proposed Rule 18f-4(a)(1)(ii). *See also* Proposing Release, *supra* note 1, at 64-65.

[22] Proposing Release, *supra* note 1, at 115-16.

[23] Proposed Rule 18f-4(a)(1)(ii).

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2. VaR Test

To satisfy the VaR test, the fund's "full portfolio VaR" must be less than the fund's "securities VaR," immediately after the fund enters into any senior securities transaction.[24] "VaR" is a measure of risk and is defined 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 interval, provided that certain additional requirements described below are satisfied.[25] A fund's "securities VaR" means the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions.[26] A fund's "full portfolio VaR" means the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions.[27]

The SEC notes in the Proposing Release that VaR may be calculated using at least three different methods.[28] The proposed rule does not specify that a fund must use any particular VaR calculation method, but a fund must apply its VaR model consistently. Any VaR model used by a fund for purposes of determining the fund's securities VaR and full portfolio VaR must: (i) take into account and incorporate all significant, identifiable market risk factors associated with the fund's investments, such as equity price risk, interest rate risk and foreign currency risk, among others; (ii) calculate VaR using a 99% confidence level and a time horizon of not less than 10 nor more than 20 trading days; and (iii) include at least three years of historical market data if using a historical simulation model.[29]

The SEC selected VaR for the test because it generally enables risk to be measured in a comparable and consistent manner across diverse types of instruments that may be included in a fund's portfolio, and provides a means of integrating the market risk associated with different instruments into a single number that provides an overall indication of market risk.[30] Although VaR has been criticized because it may underestimate the risk of loss under stressed market conditions, the SEC believes that these concerns are mitigated when it is used to assess whether a fund's derivatives as a whole directionally increase or mitigate risk, rather than to precisely estimate potential losses.[31]

II. Asset Segregation for Derivatives Transactions

Proposed Rule 18f-4 would require funds to manage the risks associated with derivatives transactions by maintaining "qualifying coverage assets," identified on the books and records of the fund as specified under paragraph (a)(6)(v) of the rule, with a value equal to at least the sum of two amounts: (1) the fund's aggregate "mark-to-market coverage amounts" and (2) the "risk-based coverage amounts."[32] The sum of these amounts would generally be between the mark-to-market exposure of a derivative transaction and the full notional amount of the derivatives transaction. This proposed new segregation requirement would be a departure from the bifurcated segregation methodology applied today by many funds, which segregate assets equal in value to the current mark-to-market exposure for cash-settled derivative transactions and assets equal in value to the notional amount of physically-settled derivative transactions.

A. Qualifying Coverage Assets (for Derivatives Transactions)

Under the proposed rule, "qualifying coverage assets" that may be used to cover derivative transactions include:

(i) cash or cash equivalents; and

(ii) with respect to any derivative transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset.[33]

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[24] Proposed Rule 18f-4(a)(1)(ii).

[25] Proposed Rule 18f-4(c)(11).

[26] Proposed Rule 18f-4(c)(11)(i)(A).

[27] Proposed Rule 18f-4(c)(11)(i)(B).

[28] Proposing Release, *supra* note 1, at 135-36.

[29] Proposed Rule 18f-4(c)(11)(ii).

[30] Proposing Release, *supra* note 1, at 119-20.

[31] *Id.* at 127-29.

[32] Proposed Rule 18f-4(a)(2).

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

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Pursuant to current U.S. generally accepted accounting principles, "cash equivalent" instruments generally include short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.[34] Instruments commonly considered to be cash equivalents include certain agency securities, bank deposits, commercial paper, shares of money market funds and certain Treasury bills, but generally do not include longer-dated Treasury notes or Treasury bonds.[35] A fund must determine its qualifying coverage assets at least once each business day.[36]

Restricting qualifying coverage assets to cash and cash equivalents would also represent a departure from current SEC and staff guidance, which permits any asset, including equity securities and non-investment grade debt, to be used as a segregated asset so long as the asset is liquid and marked-to-market daily.[37] The SEC expressed concerns in the Proposing Release that an asset other than cash and cash equivalents could decline in value at the same time the fund's potential obligations under the derivatives transaction could increase, thus "increasing the possibility that such assets could be insufficient to cover the fund's obligations under derivatives transactions."[38]

In addition, qualifying coverage assets would not include another derivative instrument that provides offsetting exposure.[39] The SEC expressed concern that the counterparty to such other derivative instrument could default or fail to perform its obligation, potentially leaving the fund without the ability to satisfy its obligation.[40]

B. Mark-to-Market Coverage Amount

Under the proposed rule, the mark-to-market coverage amount means, for each derivatives transaction, at any time of determination under the rule, the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time.[41] A fund would be required to calculate the mark-to-market coverage amount at least once each business day.[42] The SEC stated in the Proposing Release that it expected that the mark-to-market coverage amount would generally be consistent with the valuation of the derivatives transaction, which, in many cases, is already being used for purposes of determining net asset value.[43]

The fund's mark-to-market coverage amount for a derivatives transaction may be reduced by the value of assets that represent *variation margin* or collateral for the amounts payable with respect to the derivative transaction.[44] Initial margin, however, may not be used to reduce the mark-to-market coverage amount as initial margin represents a security guarantee and is not used by a counterparty, absent a default by the fund, to satisfy a fund's obligation under the derivatives transaction.[45]

[34] *See* Proposing Release, *supra* note 1, at 178-79.

[35] *Id.* at 180, note 370.

[36] Proposed Rule 18f-4(a)(2).

[37] *See* Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf (providing that liquid assets, including cash, U.S. Government securities, or other appropriate high-grade debt obligations, could be used as segregated assets); *see also* Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (expanding the types of assets that could be used as segregated assets).

[38] Proposing Release, *supra* note 1, at 180.

[39] *See id.* at 182.

[40] *Id.*

[41] Proposed Rule 18f-4(c)(6).

[42] Proposed Rule 18f-4(a)(2). *See also* Proposing Release, *supra* note 1, at 158.

[43] *See id.* at 158-59.

[44] Proposed Rule 18f-4(c)(6)(ii).

[45] Proposing Release, *supra* note 1, at 162.

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C. Risk-Based Coverage Amount

Under the proposed rule, the "risk-based coverage amount" means, for each derivatives transaction, an amount, in addition to the derivative transaction's mark-to-market coverage amount, that represents, at any time of determination under the rule, "a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions."[46] The risk-based coverage amount would be determined at least once each business day in accordance with policies and procedures approved by the fund's board and must take into account, as relevant: (i) the structure, terms and characteristics of the derivatives transaction; and (ii) the underlying reference asset.[47] A fund's risk-based coverage amount for a derivatives transaction would be permitted to be reduced by the value of assets that represent *initial margin* or collateral for the potential amounts payable with respect to the derivative transaction.[48]

The SEC stated in the Proposing Release that the proposed rule is "designed to allow funds to assess and determine risk-based coverage amounts based on their specific derivatives transactions, investment strategies and associated risks," which the SEC believed was preferable to prescribing a particular amount or formula for every fund.[49] The SEC noted that a fund could use one or more financial models to determine the risk-based coverage amount and, in certain situations, the full notional amount could be the appropriate risk-based coverage amount.[50]

D. Netting Arrangements

If a fund enters into a netting arrangement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, a fund would be permitted to calculate both its mark-to-market coverage amount and risk-based coverage amount for those derivatives transactions as the net amount that would be payable, if any, with respect to all derivatives transactions covered by the netting agreement.[51]

III. Derivatives Risk Management Program

A. Adoption and Implementation of a Derivatives Risk Management Program, or Alternatively, a Portfolio Limitation on the Use of Derivatives

Any fund that engages in more than a limited amount of derivatives transactions or that uses any complex derivatives transactions would be required to adopt and implement a formalized derivatives risk management program.[52] For this purpose, a "limited amount" means that immediately after entering into any derivatives transaction, the aggregate notional exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets.[53]

A derivatives risk management program would not be required if the fund complies, and monitors its compliance, with a portfolio limitation under which the fund may not: (i) permit its aggregate exposure associated with the fund's derivatives transactions to exceed 50% of the value of the fund's net assets; or (ii) enter into any complex derivatives transactions.[54] This portfolio limitation would need to have been approved by the fund's board, including a majority of its independent directors or trustees (the Independent Board Members).[55]

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[46] Proposed Rule 18f-4(c)(9).

[47] Proposed Rule 18f-4(a)(2) and (c)(9).

[48] Proposed Rule 18f-4(c)(9)(ii).

[49] Proposing Release *supra* note 1, at 167.

[50] *Id.* 169.

[51] Proposed Rule 18f-4(c)(6)(i) and 18f-4(c)(9)(i).

[52] Proposed Rule 18f-4(a)(3) and (a)(4).

[53] *Id.* This 50% notional calculation would include exposures from derivatives transactions entered into by the fund in reliance on the proposed rule, but would not include exposures from financial commitment transactions or other senior securities transactions entered into by the fund pursuant to Section 18 or 61 of the 1940 Act. *See* Proposing Release, *supra* note 1, at 199.

[54] Proposed Rule 18f-4(a)(4).

[55] Proposed Rule 18f-4(a)(5)(i).

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B. Required Elements of a Derivatives Risk Management Program

1. Assessment of Risks

A formalized derivatives risk management program would require a fund to have written policies and procedures reasonably designed to assess the risks associated with the fund's derivatives transactions, including an evaluation of potential risks specifically enumerated in the proposed rule (*i.e.*, leverage, market, counterparty, liquidity and operational risks, as applicable) and any other risks considered relevant.[56] It would require funds to engage in a process of identifying and evaluating the potential risks posed by the specific derivatives used by the fund as well as those the fund reasonably expects to use in the future.[57]

2. Management of Risks

A formalized derivatives risk management program would require a fund to have written policies and procedures reasonably designed to manage the risks of its derivatives transactions, including by: (i) monitoring whether those risks continue to be consistent with the fund's or its adviser's investment guidelines, applicable portfolio limitations and relevant disclosure to investors; and (ii) informing persons responsible for portfolio management of the fund or the fund's board, as appropriate, regarding material risks arising from the fund's derivatives transactions.[58] The SEC in the Proposing Release suggested various tools for risk management that funds may wish to consider, including, among other things, stress testing, evaluation of counterparties, the imposition of investment size controls or limits, and the establishment of an "approved list" of derivatives.[59]

3. Segregation of Functions

A fund's derivatives risk management program would be required to reasonably segregate the functions associated with the program from the portfolio management of the fund.[60] Specifically, the employee or officer of the fund or the fund's investment adviser who is responsible for administering the fund's derivatives risk management program (the derivatives risk manager) cannot be a portfolio manager of the fund,[61] although portfolio manager(s) are expected to communicate with and provide input to the derivatives risk manager.[62]

4. Periodic Review

A fund would be required to have policies and procedures reasonably designed to periodically (but at least annually) review and update the fund's derivatives risk management program, including any models, measurement tools, or policies and procedures that are a part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time.[63]

C. Board Approval and Oversight Requirements

1. Initial Board Approval; Approval of Material Changes

The fund would be required to obtain initial approval of its derivatives risk management program, including the derivatives risk manager, as well as approval of any material change to the program, from the fund's board, including a majority of Independent Board Members.[64] In considering whether to approve the program or any material changes to it, the fund's board generally should consider the types of derivatives transactions in which the fund engages or plans to

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[56] Proposed Rule 18f-4(a)(3)(i)(A).

[57] *See* Proposing Release, *supra* note 1, at 206.

[58] Proposed Rule 18f-4(a)(3)(i)(B).

[59] For a full discussion of the SEC's suggestions, *see* Proposing Release, *supra* note 1, at 212-215.

[60] Proposed Rule 18f-4(a)(3)(i)(C).

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

[62] *See* Proposing Release, *supra* note 1, at 216-17 ("We believe that the independence of risk management from portfolio management should promote objective and independent risk assessment … [h]owever, this segregation of functions is not meant to indicate that the derivatives risk manager and portfolio management should be subject to a communications 'firewall.]").

[63] Proposed Rule 18f-4(a)(3)(i)(D).

[64] Proposed Rule 18f-4(a)(3)(ii)(A) and (D).

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engage, their particular risks, and whether the program sufficiently addresses the fund's compliance with its investment guidelines, any applicable portfolio limitation, and relevant disclosure.[65] A fund's board may also wish to consider the nature of the fund's risk exposures, best practices used by other fund complexes, and their recent experiences regarding the fund's use of derivatives.[66]

2. **Board Review of Report on Adequacy and Effectiveness of Program**
The fund's board, including a majority of the Independent Board Members, would be required to review, no less frequently than quarterly, a written report prepared by the derivatives risk manager that describes the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation.[67]

3. **Designation and Board Approval of Derivatives Risk Manager**
The fund must designate the fund's derivatives risk manager, whose designation must be approved by the fund's board, including a majority of the Independent Board Members.[68] The derivatives risk manager must be a specific person tasked with the administration of the program (it cannot simply be the fund's investment adviser or multiple employees, which is a departure from the approach taken in the SEC's recent liquidity risk management proposal), and it cannot be a portfolio manager of the fund.[69]

IV. Requirements for Financial Commitment Transactions

Financial commitment transactions, including reverse repurchase agreements, short sales, or any firm or standby commitment or similar agreement (including agreements under which a fund is obligated, conditionally or unconditionally, to make a loan to or invest in a company, such as a capital commitment to a private fund), create leverage because the fund is committing to make a future payment. Proposed Rule 18f-4 would limit the ability of funds to incur these types of obligations to circumstances where the fund has sufficient assets to cover its payment obligation.

A. Coverage Amount

Funds that enter into financial commitment transactions in reliance on Proposed Rule 18f-4 would be required to maintain "qualifying coverage assets," identified on the books and records of the fund as specified under paragraph (b)(3)(ii) of the rule, with a value equal to at least the fund's "financial commitment obligation."[70] "Financial commitment obligation" means the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction. Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation shall be the value of the asset, determined at least once each business day.[71] Such coverage amount is similar to the notional amount of a derivatives transaction. The SEC stated in the Proposing Release that requiring a fund to cover its full financial commitment obligation for financial commitment transactions, rather than the mark-to-market and risk-based coverage permitted for derivatives, is appropriate because funds are more often required to fulfill their obligation under a financial commitment transaction as compared to derivatives transactions.[72] Further, the SEC believes that the requirement to maintain qualifying coverage assets at least equal to the full amount of a fund's financial commitment obligation is consistent with current practices for funds that rely on existing SEC guidance.[73]

B. Limit on Financial Commitment Transactions

Proposed Rule 18f-4 would require that a fund's qualifying coverage assets may not exceed the fund's net assets.[74] For example, a fund with $100 in assets and no liabilities or senior securities that sells securities short, generating $10 in short sale proceeds and a $10 liability, would be permitted to count only $100 in qualifying coverage assets.[75] This requirement

[65] *See* Proposing Release, *supra* note 1, at 226.

[66] *Id.* at 226-27.

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

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

[69] *See* Proposed Rule 18f-4(a)(3)(ii)(C). *See also* Proposing Release, *supra* note 1, at 221, note 438.

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

[71] Proposed Rule 18f-4(c)(5).

[72] *See* Proposing Release, *supra* note 1, at 232.

[73] *See id.* at 233 (referencing SEC Release No. IC-10666, *supra* note 35).

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

[75] *See* Proposing Release, *supra* note 1, at 234-35.

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would serve to limit the exposure a fund could obtain through financial commitment transactions by not allowing the proceeds generated from these transactions to increase a fund's qualifying coverage assets. In addition, financial commitment transactions are included in the 150% and 300% portfolio level limitations applicable to funds that use derivatives, which would be an additional limit on the usage of financial commitment transactions for such funds.[76]

C. Qualifying Coverage Assets (for Financial Commitment Transactions)

Under the proposed rule, "qualifying coverage assets" that may be used to cover financial commitment transactions include:

(i) cash and cash equivalents;

(ii) with respect to a financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; and

(iii) assets that are convertible to cash, or that will generate cash, equal in amount to the fund's financial commitment obligation prior to the expected payment date, 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.[77]

A fund could include as qualifying coverage assets any assets pledged by the fund with respect to the financial commitment transaction, such as assets pledged in connection with a short sale or assets transferred to a counterparty in connection with a reverse repo transaction. A fund would be required to determine which assets constitute qualifying coverage assets, and that such assets have a value equal to at least the fund's aggregate financial commitment obligations, at least once each business day.[78]

The proposed rule requires funds to adopt policies and procedures, approved by the fund's board (including a majority of the Independent Board Members), that provide for the fund's maintenance of qualifying coverage assets.[79] The rule does not require a fund's policies and procedures to consider any specific factors in determining qualifying coverage assets. The Proposing Release states that the SEC believes funds are best situated to evaluate the obligations under their financial commitment transactions and therefore determine permitted qualifying coverage assets.[80] The Proposal noted, however, that funds may find it efficient to consider the factors that would be required under Proposed Rule 22e-4 with regard to classifying the liquidity the fund's portfolio assets, as explained in the Liquidity Release.[81]

V. Disclosure and Reporting

A. Recordkeeping

Proposed Rule 18f-4 would include certain recordkeeping requirements relating to the fund's selection of a portfolio limitation; its compliance with the other requirements of the proposed rule; and if the fund is required to implement a formalized derivatives risk management program, records of the program's policies and procedures, and any materials provided to the fund's board related to its operation.[82] All the records would be required to be kept for five years (the first two years in an easily accessible place).[83]

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[76] *See* Proposed Rule 18f-4(c)(3)(ii).

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

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

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

[80] Proposing Release, *supra* note 1, at 241.

[81] Proposing Release, *supra* note 1, at 241-42. In determining the liquidity of a portfolio asset, Proposed Rule 22e-4 would require a fund to consider factors such as the existence of an active trading market for the asset, the frequency of trades or quotes, average daily trading volume, price volatility and bid-ask spreads, among others. *See* Liquidity Release, *supra* note 2.

[82] *See* Proposed Rule 18f-4(a)(6).

[83] *Id.*

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First, the proposed rule would require a fund to maintain a written record of each determination made by the fund's board that the fund will comply with one of the portfolio limitations under the proposed rule, following each determination.[84]

Second, the proposed rule would require the fund to maintain a written copy of the policies and procedures approved by the board under the rule that are in effect, or at any time within the past five years were in effect.[85]

Finally, the proposed rule would require a fund to maintain records relating to the derivatives risk management program, if the fund is required to adopt and implement a derivatives risk management program.[86] Specifically, the proposed rule would require funds to maintain a written copy of the policies and procedures approved by the fund's board that are in effect, or at any time within the past five years were in effect. The proposed rule also would require funds to maintain records of any materials provided to the fund's board in connection with its approval of the derivatives risk management program, including any material changes to the program, and any written reports provided to the fund's board relating to the program, and records documenting periodic updates and reviews required conducted as part of the risk management program.

B. Amendments to Form N-PORT and Form N-CEN

The Proposal would also amend proposed Form N-PORT and Form N-CEN, which were proposed by the SEC in May 2015 (but have not yet been finalized).[87] The amendments to Form N-PORT would require a fund to disclose certain risk metrics relating to the fund's use of derivatives, specifically the delta for derivatives instruments—which is a measure of the sensitivity of an option's value to changes in the price of the referenced asset—as well as the portfolio's interest rate risk and credit spread risk. As the Proposal explains, the disclosure of delta would assist the SEC, investors, and other potential users with an important measurement of the impact on a fund or group of funds that hold options on an asset of a change in such asset's price.[88] The Proposal also requires those funds that are required to implement a formalized derivatives risk management program to report additional risk metrics such as gamma, which enables more precise position-level estimation of sensitivity to underlying price movements, and vega, which provides position-level sensitivity to volatility.[89]

In addition, the amendments to Form N-CEN would require a fund to identify whether the fund relied on Proposed Rule 18f-4 during the reporting period and the portfolio limitation relied upon by the fund for the period.[90]

VI. Compliance Dates

If Proposed Rule 18f-4 is adopted, the SEC would rescind Release 10666 and the SEC staff's no-action letters addressing derivatives and financial commitment transactions.[91] Funds then 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 Section 18 or 61 of the 1940 Act. At this time, however, funds may continue to rely to Release 10666, SEC staff no-action letters and other guidance from the SEC staff.

The Proposing Release states that the SEC would expect to provide a transition period during which the SEC would permit funds to continue to rely on Release 10666, staff no-action letters, and other guidance from SEC staff, including with respect to derivatives transactions and financial commitment transactions entered into by a fund after the proposed rule's effective date but before the end of any transition period.[92] The Proposing Release requests comments on whether a proposed compliance period of 18 months for larger entities and an extra 12 months (or 30 total months) for smaller entities would provide sufficient time for funds to transition to Proposed Rule 18f-4.[93]

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84 Proposed Rule 18f-4(a)(6)(i).

85 Proposed Rule 18f-4(a)(6)(ii).

86 Proposed Rule 18f-4(a)(6)(iii).

87 Proposing Release, *supra* note 1, at 250.

88 *Id.* at 251.

89 *Id.* at 254.

90 *Id.* at 252.

91 *Id.* at 260.

92 *Id.* at 261.

93 *Id.*

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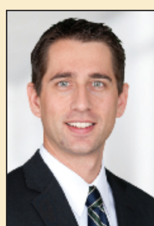
The following attorneys contributed to this client alert:

Matthew R. DiClemente

John M. Baker

Nicole Simon

Alison M. Fuller



Christopher J. Zimmerman

Joel D. Corriero

If you would like more information, contact
Matthew R. DiClemente at 215.564.8173 or mdiclemente@stradley.com,
or John M. Baker at 202.419.8413 or jbaker@stradley.com.

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