

SEC Re-Proposes Exemptive Rule Relating to the Use of Derivatives by Registered Funds

On Nov. 25, 2019 the Securities and Exchange Commission (SEC) voted to propose a new rule, under the Investment Company Act of 1940 (the “1940 Act”), designed to modernize the way the SEC regulates the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs) and closed-end funds, as well as business development companies (collectively, “Registered Funds”). SEC Chairman Jay Clayton indicated that the intent of the proposed rule was to provide an updated and more comprehensive approach to the regulation of funds’ derivatives use, in recognition of “the extensive changes that have taken place in our capital markets and the fund industry over the past several decades, including the importance of derivatives in effective portfolio management.”

The 1940 Act limits the ability of Registered Funds to obtain leverage, or, the economic equivalent of leverage, resulting from engaging in transactions that involve potential future payment obligations. More specifically, derivatives, such as forwards, futures, swaps and written options, can create future payment obligations, and hence leverage. The proposed rule would permit Registered Funds to use derivatives, provided that they comply with certain conditions designed to protect investors. These conditions include adopting a derivatives risk management program and complying with a limit on the amount of leverage-related risk that the fund may obtain, based on value-at-risk.

Proposed new rule 18f-4, an exemptive rule under the 1940 Act, would permit Registered Funds to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under section 18 of the 1940 Act. The SEC also proposed new sales practice rule 15l-2 under the Securities Exchange Act of 1934 and rule 211(h)-1 under the Investment Advisers Act of 1940, designed to address specific considerations raised by certain leveraged or inverse funds and exchange-listed commodity or currency pools. In connection with these proposed new rules, the SEC also proposed to amend rule 6c-11 under the 1940 Act to allow certain leveraged or inverse ETFs to operate without obtaining an exemptive order. Finally, the SEC proposed new reporting requirements and amendments to certain disclosure forms.

Related Capabilities

- Investment Management
- Investment Funds
- Securities & Financial Services Litigation & Enforcement

Registered Funds that use derivatives in a limited way would be subject to a streamlined set of rules. Registered Funds that seek to provide leveraged or inverse exposure to an underlying index, including leveraged ETFs, would not be subject to the proposed limit on fund leverage risk but instead would be subject to alternative requirements under the proposed rule. These funds would have to limit the investment results they seek to three (3) times of the return (or the inverse of the return) of their underlying index (i.e., 300%). Finally, the proposed rule would also permit Registered Funds to enter into reverse repurchase agreements and similar financing transactions, as well as “unfunded commitments” to make certain loans or investments, subject to conditions tailored to these transactions.

In proposing the rule the SEC acknowledged that Registered Funds often use derivatives to gain exposure to certain asset classes more efficiently and to mitigate risks, but they note that in certain cases derivatives can heighten risks to investors and markets. The SEC acknowledges that the current regime for regulating derivatives usage by Registered Funds is an outdated patchwork of requirements and exemptions. It is noteworthy that most of the existing guidance reflects interpretive positions of the SEC staff, not the Commission. The SEC hopes that by standardizing the framework for Registered Funds’ derivatives risk management, that, investors, Registered Funds and other market participants will benefit and that the proposed rule will allow Registered Funds more flexibility to use derivatives for non-speculative purposes.

Under the new sales practice rules, a broker, dealer, or investment adviser that is registered with the SEC would have to exercise due diligence in approving a retail customer or client’s account to buy or sell shares of these funds, as well as shares of exchange-listed commodity or currency pools that have similar investment strategies. These proposed new rules are aimed at ensuring that retail investors in these products are limited to those who are sophisticated enough to evaluate their unique risks.

Proposed Rule 18f-4 Under the Investment Company Act

SEC staff guidance and industry practice has developed on an instrument-by-instrument basis while at the same time the derivatives markets have grown and become more complex over past decades. The SEC acknowledges that these dynamics have resulted in situations where different Registered Funds treat the same type of derivative instrument differently, based on their own interpretation of SEC staff guidance. The SEC also notes that where there is no specific guidance, or where the application of existing guidance is unclear or applied inconsistently, Registered Funds may take approaches that do not address the purposes and concerns underlying section 18 of the 1940 Act.

Proposed rule 18f-4 imposes a uniform set of conditions and provides certain exemptions from the 1940 Act. The conditions include the following:

- *Derivatives Risk Management Program.* The proposed rule would generally require a Registered Fund to implement a written derivatives risk management program (“DRP”). The DRP would institute a standardized risk management framework for Registered Funds, while requiring principles-based tailoring based on each

Registered Fund's particular risks. The DRP would be required to include risk guidelines as well as stress testing, back-testing, internal reporting and escalation, and DRP review elements. Each Registered Fund's board would be required to approve a derivatives risk manager to administer the DRP. The derivatives risk manager would have to report to the board on the DRP's implementation and effectiveness to facilitate the board's oversight of the Registered Fund's derivatives risk management.

- *Limit on Fund Leverage Risk.* A Registered Fund relying on the proposed rule would generally have to comply with a value-at-risk, or "VaR" based limit on leverage risk. This limit would be based on a relative VaR test that compares the Registered Fund's VaR to the VaR of a "designated reference index." The Registered Fund's VaR could not exceed 150% of the VaR of the designated reference index. If the derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of its net assets.
- *Exception for Limited Users of Derivatives.* The proposed rule would provide an exception from the DRP requirement and the VaR-based limit on fund leverage provided that the Registered Fund either: (i) limits its derivatives exposure to 10% of its net assets, or (ii) uses derivatives only to hedge certain currency risks.
- *Alternative Conditions for Certain Leveraged or Inverse Funds.* The proposed rule includes a set of alternative conditions for certain leveraged or inverse funds ("Leverage Funds"). A Leveraged Fund would be excepted from the proposed limit on fund leverage risk, provided that, it: (i) limits the investment results it seeks to 300% of (or three (3) times) the return (or inverse of the return) of the underlying index, (ii) discloses in its prospectus that it is not subject to the proposed limit on fund leverage risk, and (iii) is a Registered Fund to which the new proposed sales practices rules would apply, prohibiting a retail investor from trading through a broker-dealer or investment adviser unless the broker-dealer or investment adviser were to approve the investor's account for such trading, upon due diligence.
- *Reverse Repurchase Agreements and Unfunded Commitment Agreements.* The proposed rule would also permit a Registered Fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions.

Proposed Sales Practice Rules and Amendments to Rule 6c-11

The proposed sales practice rules would establish the due diligence and approval requirements for broker-dealers and SEC-registered investment advisers with respect to trades in shares of certain leveraged investment vehicles.

Under the proposed rules, a firm would have to exercise due diligence in determining whether to approve a retail customer to buy or sell leveraged investment vehicles. A broker-dealer or investment adviser could only approve the account if it had a reasonable basis to believe that the customer or client is capable of evaluating the risks associated with these products.

The proposed amendments to 1940 Act rule 6c-11 would permit certain leveraged or inverse ETFs to rely on rule 6c-11. The SEC proposed to rescind the exemptive orders previously issued to the sponsors of leveraged or inverse ETFs in connection with any

adoption of the proposed amendments.

Reporting Requirements

The proposal would require a Registered Fund to report confidentially to the SEC on a current basis on Form N-LIQUID (renamed “Form N-RN”) when the Registered Fund is out of compliance with the VaR-based limit on leverage risk for more than three consecutive business days. The proposal also would amend Forms N-PORT and N-CEN to require Registered Funds that are currently required to file these forms to provide certain information regarding derivatives exposure and, as applicable, information regarding the Registered Fund’s VaR, which would be publicly available.

Review of Relevant Staff Guidance

The SEC has proposed to rescind the General Statement of Policy, widely known as Release 10666, issued in 1979, which provides SEC guidance on how funds may use certain derivatives and derivatives-like transactions in light of the section 18 restrictions. In addition, staff in the SEC Division of Investment Management is reviewing its no-action letters and other guidance addressing Registered Funds’ use of derivatives and other transactions covered by proposed rule 18f-4. This guidance, viewed as the progeny of Release 10666, is the subject of a bibliography, which serves as an aid to Registered Funds and their counsel, and includes relevant authority and precedent relating to Registered Funds’ use of “senior securities.” The Division of Investment Management will seek to determine which letters and staff guidance, or portions thereof, should be withdrawn in connection with any adoption of the proposal. The current bibliography can be found [here](#).

Timeline

The proposal will be published on SEC.gov and in the Federal Register. The public comment period will remain open for 60 days after publication in the Federal Register. Registered Funds are encouraged to submit additional feedback on proposed rule 18f-4 in light of their current risk management practices, while broker-dealers and investment advisers are encouraged to submit additional feedback on the proposed sales practice rules.