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Analysis of the SEC's Proposal to Update the Regulation of Funds' Use of Derivatives

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The US Securities and Exchange Commission (SEC) on November 25, 2019, unanimously approved for publication a rule proposal (Proposal) related to the use of derivatives and certain other transactions by registered investment companies (that is, open-end funds other than money market funds; closed-end funds; and exchange-traded funds) and business development companies (collectively, funds).[1] The Proposal includes:

- New Rule 18f-4 under the Investment Company Act of 1940 (1940 Act), which would provide an exemption from the applicable restrictions on issuing "senior securities" under Sections 18 and 61 of the 1940 Act, allowing funds to enter certain transactions that create leverage, subject to certain conditions (Proposed Rule);
- New rules relating to leveraged/inverse funds and vehicles, including new sales practices rules under the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act) and a related amendment to Rule 6c-11 under the 1940 Act; and
- Amendments to fund recordkeeping requirements and reporting forms.

The Proposal would rescind Release 10666[2] and the related "asset segregation" requirements articulated in that release, and the SEC Staff also might withdraw related no-action letters and other guidance. If the Proposal were adopted, a fund would need to comply with the conditions set forth in the Proposed Rule in order to engage in the applicable transactions or otherwise comply with Section 18 of the 1940 Act. Comments on the Proposal were due on March 24, 2020, and, if adopted as proposed, the Proposal would provide a one-year transition or compliance period for all aspects of the Proposal.

While many in the industry might welcome a potential new approach to the SEC's regulation of registered funds' use of the relevant transactions under Section 18, and while the SEC has been considering such approaches for many years,[3] the Proposal raises numerous questions and issues. This article reviews the elements of the Proposal and discusses the authors' views on key questions and issues that funds currently using derivatives and other relevant transactions would need to address if the Proposal is adopted as proposed.

Proposed Rule—Conditions to Enter into Derivatives Transactions

Under the Proposed Rule, a fund (other than a fund eligible for the limited derivatives user exception or the alternative conditions for leveraged/inverse funds, discussed below) would be permitted to enter into derivatives transactions, if three conditions are satisfied: (1) the fund adopts and

implements a derivatives risk management program (Program); (2) the fund is in compliance with a limit on fund leverage risk based on the fund's value at risk (VaR); and (3) the fund is in compliance with requirements relating to the fund's derivatives risk manager and board reporting requirements. Such a fund would not consider such derivatives transactions for purposes of computing asset coverage, as defined in Section 18(h) of the 1940 Act.

A derivatives transaction would be defined to mean: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (derivatives instrument) under which a 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 margin or settlement payment or otherwise; and (2) any short sale borrowing.

Derivatives Risk Management Program

The Program would be required to include policies and procedures "reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the Program from the portfolio management of the fund." The Program would need to include the following elements:

- The identification and assessment of the fund's derivatives risks, including leverage, market, counterparty, liquidity, operational, legal, and other risks.
- The establishment, maintenance, and enforcement of investment, risk management, or related guidelines for derivatives risks (guidelines). The guidelines would have to specify measures to be taken if the fund exceeds designated criteria, metrics, or thresholds that the fund does not normally expect to exceed (guideline exceedances).
- At least weekly stress testing to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that could have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties.
- Daily backtesting of the results of the fund's VaR calculation model, as discussed below.
- Internal reporting on the operation of the Program and escalation of material risks to portfolio management and the fund's board, including on guideline exceedances and material risks and the results of stress testing.
- At least annual derivatives risk manager review of the Program to evaluate the Program's effectiveness and to reflect changes in the fund's derivatives risks over time.

Limit on Fund Leverage Risk

The fund would be required to comply with the relative VaR test if a "designated reference index" can be identified. Under this test, the fund's VaR could not exceed 150 percent of the VaR of an unleveraged "designated reference index." If the derivatives risk manager, discussed below, cannot identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy, the fund would be required to comply with the absolute VaR test, meaning the fund's VaR could not exceed 15 percent of the value of the fund's net assets.

VaR would be defined as an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, taking into account all significant, identifiable market risk factors associated with a fund's investments, using a confidence level of 99 percent and a time horizon of 20 trading days, and being based on three years of historical data.

A fund would be required to determine its compliance with the applicable VaR test at least once each business day. If a fund were to determine that it was not in compliance and did not come back

into compliance within no more than three business days, (1) the derivatives risk manager would have to report this occurrence to the fund's board, (2) the derivatives risk manager would have to analyze the circumstances and update any Program elements necessary to address the circumstances causing the non-compliance, and (3) the fund would not be permitted to enter into additional derivatives transactions unless such transactions are designed to reduce the fund's VaR until the fund has been back in compliance with its VaR test for three consecutive business days (and (1) and (2) are satisfied). The fund also would be subject to SEC reporting obligations on new Form N-RN in such circumstances.

A "designated reference index" would be defined as an unleveraged index that: (1) is selected by the derivatives risk manager and reflects the markets or asset classes in which the fund invests; (2) is not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used; and (3) is an "appropriate broad-based securities market index" or an "additional index," as defined in the instructions to Item 27 of SEC Form N-1A. The Proposed Rule would permit a fund to use a blended index for purposes of the relative VaR test as long as each component index complies with (2) above. A fund complying with the relative VaR test also would be required to disclose its designated reference index for performance comparison purposes in its annual report.

Derivatives Risk Manager, Board Approval, and Board Reporting

The derivatives risk manager would have to be an officer or officers of the fund's investment adviser (which could include a sub-adviser) and responsible for administering the Program and related policies and procedures. The derivatives risk manager could not be a portfolio manager of the fund if the role is filled by a single individual or could not be comprised of a majority of portfolio managers, if the role is filled by multiple individuals, and its member(s) would have to have relevant experience regarding the management of derivatives risk.

The designation of the fund's derivatives risk manager would be required to be approved by the fund's board, including by a majority of board members who are not interested persons of the fund (independent board members), taking into account the derivatives risk manager's relevant experience.

The derivatives risk manager would be required to provide the fund's board a written report upon implementation and annually thereafter, representing that the Program is reasonably designed to manage the fund's derivatives risks and incorporates the required elements. The report would have to include the basis for the representation, information necessary to evaluate the adequacy of the Program and the effectiveness of its implementation, and the basis for the selection of the relevant index or an explanation of why the derivatives risk manager was unable to identify a designated reference index appropriate for the fund. The derivatives risk manager also would be required to provide a periodic written report on the manager's analysis of risk guideline exceedances, and on the results of stress testing and backtesting under the Program; the report would have to include information necessary to evaluate the fund's response to exceedances and the results of stress testing.

Limited Derivatives User Exception

A fund would not be required to adopt a Program, comply with the limit on fund leverage risk, appoint a derivatives risk manager, comply with the board reporting requirements, or consider such derivatives transactions for purposes of computing asset coverage, if the fund:

- Adopts and implements policies and procedures "reasonably designed to manage the fund's derivatives risks;" and
- Either (i) limits its derivatives exposure to 10 percent of its net assets, *or* (ii) uses derivatives

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transactions solely to hedge certain currency risks and the notional amounts of such derivatives do not exceed the value of the hedged instruments by more than a negligible amount.

"Derivatives exposure" would mean the sum of the notional amounts of a fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short, adjusted to convert the notional amount of interest rate derivatives to 10-year bond equivalents and/or to delta adjust the notional amounts of options contracts.

Alternative Conditions for Leveraged/Inverse Funds and Related Sales Practices Rules

A fund that is a "leveraged/inverse investment vehicle"[4] would not be required to comply with the limit on fund leverage risk or to consider such derivatives transactions for purposes of computing asset coverage. Instead, a leveraged/inverse fund would be required to: (1) disclose in its prospectus that it is not subject to the limit on fund leverage risk, and (2) not seek or obtain, directly or indirectly, investment results exceeding 300 percent of the return (or inverse return) of the underlying index.

In addition, under the proposed sales practices rules, before a broker-dealer or investment adviser (collectively, firm)[5] could accept an order from or place an order for a customer or client who is a natural person (or the legal representative of a natural person—together, a retail investor) involving shares of a leveraged/inverse investment vehicle, the firm would have to (1) approve the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement, (2) adopt and implement certain policies and procedures, and (3) make and maintain certain records. The due diligence requires a firm to "seek to obtain, at a minimum, certain information" regarding a retail investor's financial situation, investment objective and experience, and to "have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles" and "specifically to approve or disapprove" the retail investor's account to engage in such transactions based on all relevant facts and circumstances.

In addition, proposed amendments to Rule 6c-11 would permit leveraged/inverse funds to operate as exchange-traded funds (ETFs), without obtaining a related exemptive order from the SEC. In connection with this proposal, the SEC also would rescind the exemptive orders previously issued to the sponsors of such leveraged/inverse ETFs.

Conditions to Enter into Reverse Repurchase Agreements and Similar Financing Transactions

A fund would be permitted to enter into reverse repurchase agreements and similar financing transactions "that have the effect of allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets" if the fund: (1) complies with the asset coverage requirements under Section 18 of the 1940 Act; and (2) combines the aggregate amount of indebtedness associated with such transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.

The term "similar financing transactions" is not defined in the Proposing Release. However, the Proposing Release states that the SEC would not view an obligation to return securities lending collateral as a similar financing transaction "so long as the obligation relates to an agreement under which a fund engages in securities lending, the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests cash collateral solely in cash or cash equivalents." In addition, the Proposing

Release states that whether a tender option bond (TOB) financing qualifies as a similar financing transaction would depend on the facts and circumstances and whether a fund concludes that "there are economic similarities between a TOB financing and a reverse repurchase agreement."

Conditions to Enter into Unfunded Commitment Agreements

A fund would be permitted to enter into an unfunded commitment agreement if the fund reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due. Such transactions would not be considered for purposes of computing asset coverage.

Amendments to Fund Recordkeeping and Reporting Form Requirements

The Proposed Rule would require funds to maintain a written record of: (1) the policies and procedures required under the Program or required for limited derivatives users; (2) the results of stress testing and backtesting; (3) any internal reporting or escalation of material risks, (4) the annual reviews of the Program; (5) copies of materials provided to the fund's board in connection with the requirements above; and (6) any determination or action under the limit on fund leverage risk, as applicable.

The Proposal would expand and retitle Form N-LIQUID as Form N-RN and require all funds subject to the limit on fund leverage risk to report on Form N-RN when the VaR of the fund exceeded its VaR-based limit for three business days, and also when the fund is back in compliance with the VaR-based limit. The Proposal would require funds, other than business development companies (BDCs), to report on Form N-PORT regarding the fund's derivatives exposure as of the end of the reporting period, certain VaR and VaR-based limit information, and the number of backtesting exceptions identified during the period. The Proposal would require funds (other than BDCs) to indicate on Form N-CEN whether the fund has relied on the Proposed Rule and whether it relied on any of the exceptions from various requirements under the Proposed Rule.

Potential Costs and Compliance Burdens under the Proposed Rule

The Program and certain other requirements under the Proposed Rule would create detailed and numerous new obligations for funds that enter into more than a limited amount of derivatives transactions. These obligations include, for example, implementing and maintaining ongoing monitoring for guideline exceedances, weekly or more frequent stress testing, daily backtesting, appointment of a derivatives risk manager, and specified reporting. In addition, the requirements on fund board members that are contemplated by the SEC's statements in the Proposing Release and the reporting requirements under the Proposed Rule would increase board members' *de facto* involvement in the oversight of funds' derivatives use compared to current practice.

The Proposing Release states that the SEC believes that the policy benefits of requiring users of derivatives transactions to have a formalized Program with specified elements supports exempting these transactions from Section 18, given the volume and complexity of the derivatives markets and the increased use of derivatives by certain funds and their related risks. However, it appears possible that some funds, particularly those in smaller fund complexes or fund complexes of asset managers that do not already have sophisticated derivatives risk management programs in place, would need to increase the financial and human capital resources dedicated to derivatives risk management in order to comply with the requirements under the Proposed Rule. Accordingly, it could be difficult for some asset managers and funds to comply with the obligations on derivatives users under the Proposed Rule.

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Some funds might determine that the potential costs and compliance burdens under the Proposed Rule outweigh the benefits the fund could achieve through the use of derivatives transactions under the Proposed Rule. Accordingly, the Proposed Rule might create a *de facto* barrier to the use of derivatives transactions in more than a *de minimis* amount for these funds. These funds might need to change and reduce the ways they use derivatives transactions to implement their investment objectives and strategies and to manage risk, which could reduce the efficiency of these fund activities and be detrimental to fund returns and investors.

Also, if a fund were to adopt a Program and comply with the other conditions of the Proposed Rule, certain aspects of the Proposed Rule would expose funds to the risk that the SEC Examinations Staff would question or second-guess quantitative and other risk determinations made by the fund and derivatives risk manager under the Proposed Rule. For example, the SEC Examinations Staff could question whether a fund's guidelines and responses to guideline exceedances, stress testing interval and processes, backtesting parameters and processes, and determinations in establishing the applicable VaR test were appropriate. It is not certain whether the SEC Examination Program would be able to provide clear, consistent and coordinated comments and guidance regarding the implementation of the requirements under the Proposed Rule across different SEC Examination teams and fund complexes.

The Role of the Board

As discussed above, a fund's board would be required to approve the designation of the derivatives risk manager. Moreover, the discussion of the board oversight and reporting requirements in the Proposing Release states that board oversight should not be a passive activity; it further states that board members should understand the Program and derivatives risks, ask questions and seek information about the adequacy and effectiveness of the Program, and view oversight as an iterative process. In addition, many of the numerous reports to the fund's board required under the Proposed Rule would call for information "necessary to evaluate the contents of the report."

Given these views on board members' oversight role and the volume of board reporting that would be required under the Proposed Rule, the Proposing Release would place fund board members in a more active and time-consuming role relating to funds' use of derivatives than they currently have under the Release 10666 framework. Certain of these requirements could be viewed as assigning fund boards with responsibilities more appropriately handled by management.

Additionally, as noted above, the board oversight and board reporting requirements also might cause some funds, particularly those in smaller fund complexes, to limit their use of derivatives to avoid the increased financial and human capital resources dedicated to derivatives risk management needed to comply with the Proposed Rule.

In addition, the Proposing Release states that Rule 38a-1 "would encompass a fund's compliance obligations with respect to" the Proposed Rule, which would place on the fund board the responsibility of initially approving the relevant compliance policies and procedures. This statement appears to be inconsistent with the spirit of the Proposed Rule, under which there is no explicit requirement for board approval of the Program or the policies and procedures thereunder. Thus, it is not clear what the Board's obligations with respect to approval of the Program and policies and procedures thereunder would be.

Key Issues under the Limit on Fund Leverage Risk

Fund managers that sponsor United States funds and Undertaking for Collective Investing in Transferable Securities (UCITS) funds using parallel strategies would potentially face significant operational issues in continuing to manage such funds under regulatory structures that impose similar but different technical requirements. Further, several of

the requirements under the limit on fund leverage risk would create potential additional risks and compliance burdens for funds.

UCITS Approach

As background, many features of the proposed VaR-based limit on fund leverage risk are similar to requirements applicable to UCITS funds under the Committee of European Securities Regulators (CESR) (now European Securities and Markets Authority (ESMA)) Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS (UCITS Guidelines). However, the requirements under the limit on fund leverage risk would diverge from those under the UCITS Guidelines, in that the UCITS Guidelines:

- State that a UCITS fund should set the maximum VaR limit according to its defined risk profile, subject to 200 percent and 20 percent upper limits on the relative and absolute VaR approaches, respectively;
- Provide that the UCITS fund is responsible for deciding whether a relative or absolute VaR approach is the most appropriate methodology given the risk profile and investment strategy of the UCITS, and does not disallow the use of an absolute VaR approach if a relevant reference portfolio is potentially available; and
- Do not limit a UCITS fund's derivatives investments during or after a breach of the fund's VaR test.[6]

150 Percent or 200 Percent Relative VaR Test

Fund managers currently managing parallel UCITS and US funds that would each use a relative VaR test might need to change the US fund's use of derivatives and maintain a different portfolio compared to the corresponding UCITS fund in order to comply with the Proposed Rule's more limiting 150 percent relative VaR test. This could reduce efficiency for the fund compared to the corresponding UCITS fund and be detrimental to fund returns and investors.

As of the date this article was submitted for publication, asset managers were still assessing the potential harm their funds could experience as a result of the selection of a 150 percent relative VaR test, as opposed to a 200 percent VaR test. While the Proposing Release draws an analogy between the relative VaR test and the Section 18 limits on bank borrowing,[7] the authors believe that the discussion in the Proposing Release demonstrates only a loose connection between the 150 percent test and Section 18, and that the reasoning discussed therein is thin and unconvincing Section 18 is designed not just to limit leverage but also the amounts that a fund could owe to a third party and thus potentially have to repay.

However, VaR is not designed to address this risk, and thus a 150 percent limit on VaR may be more risk-limiting than Section 18. Furthermore, a fund obtaining the full amount of bank borrowings permissible under Section 18(f) may have more or less than 150 percent of the VaR of the particular designated reference index selected for the fund, depending on the composition of the fund's pre- and post-borrowing portfolio of investments. Moreover, the Proposing Release does not discuss any specific benefits to funds and investors that would be gained from establishing this particular limit for funds that could be viewed as outweighing the potential inefficiencies discussed above. Nor does the Proposing Release make a convincing case or provide a quantitative, data-driven cost-benefit analysis showing that this lower limit would have prevented harms to investors that outweigh the benefits of derivatives use above the limit.

Identifying an Appropriate Designated Reference Index and the Determinations Relating to the Relative VaR Test

As noted above, in executing the Program, the derivatives risk manager would be required to select

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a designated reference index for the fund or determine that it is unable to identify an index that is appropriate. The derivatives risk manager also would be required to explain in board reports the basis for the selection of the designated reference index or why the derivatives risk manager was unable to identify a designated reference index.

The Proposed Rule and the Proposing Release provide generally that the selection of a designated reference index would have to be based on "the markets or asset classes in which the fund invests." There is no substantive instruction on what type of index may be an appropriate designated reference index for specific funds. Further, the Proposed Rule and the Proposing Release do not provide further guidance on how a derivatives risk manager should make a determination that it is unable to identify a designated reference index. In addition, until there is more guidance or experience with SEC administration of the Proposed Rule, there are reasonable questions as to the level of deference the SEC and its Examinations Staff would give to the judgments of derivatives risk managers in such situations.

As a result of these issues, it may be difficult for some derivatives risk managers to definitively identify whether there is or is not an appropriate designated reference index for certain funds. Accordingly, it is possible that the absolute VaR test would only be used in very limited circumstances as it is proposed. This may raise particular issues for fund managers currently managing parallel UCITS and US funds where the UCITS fund currently uses the absolute VaR approach, which may have to use the relative VaR approach under the Proposed Rule. Similar to the above, this could reduce efficiency for the fund and be detrimental to fund returns and investors. The Proposing Release states that the SEC proposed the relative VaR test "as a default means of limiting leverage risk because it resembles the way that section 18 limits a fund's leverage risk." Statements elsewhere in the Proposing Release describe that the SEC set the absolute VaR test at 15 percent of a fund's net assets with the intent of providing comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the S&P 500 as their designated reference index.[8] The discussion of the SEC's economic analysis in the Proposing Release notes that allowing a choice between the tests depending on the derivatives risk manager's preference "may result in less uniformity in the outer limit on funds' leverage risk across the industry" and that certain funds could obtain significantly more leverage under an absolute VaR test, causing investors in such funds to be less protected from leverage-related risks than under the Proposed Rule. However, the authors believe that the SEC has not made a convincing case or provided any meaningful data-driven analysis showing that any such additional leverage presents significant risks or that such risks outweigh the benefits of the additional use of derivatives.

Based on the above, the authors do not believe the use of the relative VaR test necessarily would be more likely to be consistent with investor protection; moreover, any benefits identified by the SEC in the Proposing Release may be outweighed by the significant reductions of efficiency that could result from the proposed framework, and the SEC has not met its obligation to demonstrate otherwise.

Remedial Limit on New Derivatives Transactions

The Proposing Release states that the three-business-day remediation provision, which would allow a fund to avoid engaging in remedial activities if it comes back into compliance with its VaR test within three business days, is similar to the remediation approach for asset coverage compliance with respect to bank borrowings under Section 18. The Proposing Release does not, however, provide similar justification for the requirement that the fund not enter into derivatives transactions other than those designed to reduce the fund's VaR for three business days during the continuing breach and until coming back into compliance and satisfying the

other remedial requirements. The Proposing Release merely cites a concern that funds could come back into compliance and immediately increase their market risk, which "could potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test." This requirement could be very disruptive to a fund that uses derivatives transactions as a primary manner in which the fund seeks to implement its investment objectives and strategies. Also, similar to the concerns noted above, this requirement presents practical challenges for funds that manage parallel UCITS and US funds and could also require the portfolio management of the two funds to diverge for periods of time.

For these reasons, the costs and disadvantages of the SEC's proposed approach to VaR may outweigh the investor protection and other policy benefits articulated by the SEC in the Proposing Release, and in either case, the SEC does not appear to have met its cost-benefit analysis burdens. Because of the difficulties that the SEC will face in gathering and analyzing the relevant data, as well as in articulating a "one size fits all" rule that gets the balance right for all funds and strategies, we are not convinced that the SEC can carry this burden. Thus, it would be more advisable for the SEC to adopt an approach toward VaR that allows the derivatives risk manager, subject to board oversight, to determine whether to use the relative or absolute VaR tests and to set the VaR limits themselves, based on the risk manager's own assessment of the benefits and risks of derivatives use. These limits would be subject to the stress testing and back-testing requirements proposed by the SEC as part of the risk management program requirement and would be reviewed by the fund's board. This approach would be analogous to the approach that the SEC adopted for setting a highly liquid investment minimum under Rule 22e-4, under which the liquidity risk manager, which is in the best position to assess a fund's liquidity risk, sets the HLIM, under the watchful eye of the fund board.

Key Issues Related to Exceptions to the Proposed Derivatives Regime

Elements of the Limited Derivatives User Exception

As noted above, the limited derivatives user exception would only be available to a fund that either limits its derivatives exposure to 10 percent of its net assets (the exposure-based exception) *or* uses derivatives transactions solely to hedge certain currency risks (the currency hedging exception). The Proposing Release explains that the SEC considered allowing a fund to rely on the exposure-based exception if the notional amount of the fund's derivatives transactions, excluding currency hedges, was below 10 percent of its net assets. The Proposing Release states that the SEC determined instead to adopt two separate bases for qualifying for the limited derivatives user exception "to preclude a fund that is operating as a limited derivatives user from engaging in a broad range of derivatives transactions" that the SEC believes should be addressed through the Program and limit on fund leverage risk requirements. Accordingly, a fund that invests in both currency derivatives and other types of derivatives would only be eligible to rely on the exposure-based exception, and would only be able to do so as long as the total notional amount of its derivatives exposure, including currency derivatives, is below 10 percent of its net assets.

Commenters have reasonably suggested that the limited derivatives user exception should be re-formulated to combine the exposure-based and currency hedging exceptions. The exclusion of currency hedges from the relevant calculation under the exposure-based exception would align with the statement in the Proposing Release that "currency hedges are not intended to leverage [a] fund's portfolio" and thus do not raise the relevant underlying concerns of Section 18 that the Proposed Rule is intended to address. In addition, currency derivatives are commonly used for hedging purposes by certain types of funds in an amount up to the full

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value of foreign-currency denominated investments held by the fund. Depending on the fund's strategy, a fund may often hold an amount of foreign-currency denominated investments that is more than 10 percent of the fund's net assets and make some limited use of other types of derivatives for other reasons. These funds would not be able to comply with the exposure-based exception as proposed, even though they may use other types of derivatives in a limited fashion that would otherwise comply with the exposure-based exception. A fund that generally uses derivatives (other than currency derivatives for hedging) in a limited manner could be forced to alter its investment and portfolio management strategies to avoid the requirement to implement a full-fledged Program. This may result in inefficiencies and be detrimental to such a fund's returns and its investors.

Remediation of Non-Compliance with the Limited Derivatives User Exception

The discussion in the Proposing Release regarding the exposure-based exception highlights that the Proposed Rule does not include a provision addressing exceedances of the 10 percent threshold or remediation. Unlike the specificity of the three-business-day remediation provision included in the Proposed Rule with respect to the limit on fund leverage risk, the Proposing Release states that a fund would have to "promptly" reduce its derivatives exposure to the 10 percent threshold or comply with the Program and limit on fund leverage risk requirements. This lack of guidance could cause confusion within the industry as to whether and when a fund would be deemed to be non-compliant with the exception by the SEC. This may also lead to funds having divergent policies and procedures to address exceedances of the exposure-based exception. In addition, the SEC Examination Staff could raise questions on whether the fund's remediation activities were timely during the exam process without the fund having adequate notice of the Staff's views.

Key Issues Related to New Proposed Limits for Non-Derivative Instruments

The Proposal would significantly change the method for determining compliance with the Section 18 asset coverage requirements for the use of reverse repurchase agreements, which could have significant implications for funds that use these instruments for short-term financing and in some instances for leveraging purposes. The Proposing Release does not provide much explanation for changing the treatment of reverse repurchase agreements or for treating reverse repurchase agreements differently from other financing transactions that are similar in nature, such as securities lending.

Under the SEC's current long-standing guidance in Release 10666, a fund may engage in reverse repurchase agreements and "all comparable trading practices" to the extent the fund segregates certain liquid assets equal to the fund's obligations arising under the agreement. The value of the segregated assets would have to equal the value of the proceeds received from any sale subject to repurchase plus accrued interest, or if the reverse repurchase agreement has a specified repurchase price, an amount equal to the repurchase price, which price will already include interest charges. Critically, under the current treatment of reverse repurchase agreements, if a fund complies with the asset segregation condition, it is not required to count the obligation created under the reverse repurchase agreement toward its Section 18 300 percent asset ratio requirement for borrowings. The Proposal would change this guidance to require a fund to count the obligation created under its reverse repurchase agreements toward its Section 18 asset coverage requirement for indebtedness. This change could have a significant limiting impact on certain funds' operations.

To explain the new treatment, the Proposing Release notes that reverse repurchase agreements are used by funds as a means to obtain financing and are economically equivalent to a secured borrowing.

The Proposing Release voices the concern that reverse repurchase agreements may have the effect of introducing leverage into a fund's portfolio if the fund uses the proceeds to invest in additional investments. While some funds use reverse repurchase agreements to finance other investments and leverage themselves, other funds generally use reverse repurchase agreements transactions on a short-term basis to provide liquidity. Reverse repurchase agreement transactions often can be a more efficient means to obtain short-term liquidity than using a traditional secured borrowing under a credit facility. In its cost-benefit analysis, the SEC noted the number of funds it anticipates will need to adjust their operations in response to this change and concluded that the change could decrease fund use of reverse repurchase agreements which in turn could reduce capital formation. The SEC did not provide any data or analysis addressing the degree to which funds use reverse repurchase agreements to leverage themselves. The SEC also did not address the lost efficiency from limiting funds' ability, especially to obtain short-term liquidity through using reverse repurchase agreements, but also funds' ability to obtain leverage through use of the same. Thus, the SEC did not provide sufficient cost-benefit analysis to support this change.

The Proposal also addresses the treatment of securities lending and TOBs. The Proposing Release looks to how the proceeds of securities lending transactions are used in order to determine how they should be treated for purposes of the asset coverage ratio requirement (that is, whether it will be a "similar financing transaction" or not). If the cash proceeds from the securities lending are solely cash and cash equivalents, the transaction would not be treated the same as a reverse repurchase agreement; however, if the proceeds are used to purchase other assets, then the transaction would be a similar financing transaction and would be subject to the asset coverage requirement. Without giving a reason, the Proposal does not permit the same differentiation of use of proceeds with regard to reverse repurchase agreements even though, as the Proposing Release notes, reverse repurchase agreement transactions "can" have a leveraging effect on a fund's portfolio, but do not always do so. With regard to TOBs, the Proposing Release leaves it up to a fund to conclude whether there are economic similarities between a TOB financing and a reverse repurchase agreement, and if it does, based on the relevant facts and circumstances, would have the fund treat the TOB as a similar financing transaction under the Proposal. Based on the reasoning the SEC uses for securities lending and TOBs, funds should be able to differentiate their treatment of reverse repurchase agreements for Section 18 purposes based on how the proceeds of the transaction are used or other economic characteristics of the transaction.

Key Issues Related to Additional Reporting Requirements

Public Reporting of VaR Information

As discussed above, the Proposal would require all funds subject to the limit on fund leverage risk to publicly report certain information on Form N-RN when the VaR of a fund exceeds its VaR-based limit for three business days, as well as when the fund is back in compliance with the VaR-based limit. The Proposal also would require all funds (except BDCs) subject to the limit on fund leverage risk to report the fund's derivatives exposure at the end of the reporting period and the number of VaR backtesting exceptions the fund identified during the relevant reporting period on Form N-PORT. Information reported for the third month of a fund's fiscal quarter on Form N-PORT would be made publicly available 60 days after the end of the fiscal quarter.

The SEC and public reporting requirements generally are very detailed and could result in increased administrative and compliance costs and burdens for applicable funds, particularly smaller fund complexes that may need to significantly increase the financial and human capital resources dedicated to the fund reporting function to meet

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these detailed requirements. In addition, public reporting of exposure amounts and VaR backtesting exceptions, regardless of the magnitude of the fund's derivatives exposure or number of exceptions, could cause confusion among investors who may not understand the import of or context for the data. The exposure reported would simply give investors access to a point-in-time, blunt notional figure for derivatives exposure (as adjusted under the definition for limited categories of derivatives). That figure would not differentiate between derivatives transactions used for hedging, to obtain unleveraged investment exposure, or to obtain leverage. The VaR backtesting information would not provide any indication to investors as to whether a fund is adequately managing its derivatives risks or whether the reported exceptions are isolated instances that are not reflective of the fund's overall risk profile.

In addition, while the time lag on which the information is reported is discussed in the Proposing Release as being protective of funds, the time lag may also reduce or eliminate any potential value to be derived by investors from receiving information on derivatives exposure as of a single point in time. The Proposing Release did not cite any reason that derivatives exposure amounts should be publicly available, and merely notes in support of making certain VaR backtesting information public that such public disclosure would be delayed and would not provide any details other than the number of instances of an exceedance, and therefore would not produce adverse effects for the fund. Accordingly, the Proposing Release posits that it appears that the cost of the investor confusion inherent in making this information public would be outweighed by the potential public benefit to be derived from making this information public.

Public Reporting of Internal Guidelines

In the Proposing Release, the SEC requested comment on whether exceedances of guidelines should be required to be publicly reported. Public disclosure of a fund's guidelines (or exceedances thereof) may involve the potential disclosure of proprietary information (particularly with respect to quantitative models and similar methodologies), which would harm competitive interests of funds and would not necessarily provide meaningful or significant information to investors. In addition, as noted by the SEC in its request for comments, a requirement to publicly report information with respect to guidelines could incentivize funds to set guidelines that would not be useful for purposes of risk monitoring and management (that is, funds could set restrictions that are too loose or too strict). Funds subject to any such reporting requirements could use complex and divergent methodologies for setting guidelines, and this information would inherently be subjective and based on estimates that could cause investor confusion.

Key Issues Related to the Proposed New Sales Rules for Leveraged/Inverse Funds

In the Proposing Release, the SEC explained that "most" leveraged/inverse funds would be unable to satisfy Rule 18f-4, so the Commission is "proposing a set of alternative requirements" to protect investors and to allow sales of interests in such vehicles to continue. The sales practices rules would be separate from and different than the best interest standard proposed by the SEC in Regulation Best Interest (Reg BI) and its companion interpretive release, the investment adviser standard of conduct (Standard of Conduct), and would be the first of their kind.

Potential for Inconsistency and Conflict with Regulation Best Interest and the Standard of Conduct

The SEC requested comment in the Proposing Release on the scope of the sales practices rules, including whether the sales practices rules should apply to "retail investors" (as defined in the Proposing Release) or should be narrowed to exclude accredited investors or expanded to include institutional investors, and whether the information requested that mirrors Financial Industry Regulatory Authority

(FINRA) rules should more generally track Regulation BI definition of "retail customer investment profile."

The due diligence and account approval requirement as proposed present numerous inconsistencies with Regulation BI and the Standard of Conduct, and these nuances could burden firms and their systems. First, the definition of retail investor in the proposed sales practices rules as a natural person (or legal representative of a natural person) does not incorporate by reference or directly track the definition of "retail customer" in Regulation BI or "retail investor" in Form CRS. Instead, the rules would introduce a variation of those definitions that is not limited by whether the transaction or account is "primarily for personal, family, or household purposes." Additionally, the SEC did not define "retail client" in the Standard of Conduct; however, the SEC suggested that the nature and scope of duties owed, and how those duties are discharged, require consideration of the client's sophistication (rather than merely whether the client is a natural person). Second, broker-dealers and investment advisers would be required to request from retail investors information that is analogous to information required under FINRA's options account approval process, which information requested generally does not track the BI definition of "retail customer investment profile" or the Standard of Conduct's retail client's investment profile. Third, the determination that would have to be made under the proposed sales practices rules is whether "the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles," which is more prescriptive and specific than whether the firm is acting in the customer's or client's best interest. Fourth, the proposed sales practices rules would apply to a broader set of transactions, since they would apply without regard to whether a recommendation or investment advice is provided to the retail investor, including to self-directed brokerage transactions, than does Regulation BI or the Standard of Conduct. Fifth, the proposed sales practices rules' requirement that firms maintain required records for at least six years after an account closing is consistent with Rule 17a-4(c) under the Exchange Act but is generally inconsistent with the recordkeeping rules governing investment advisers.

These inconsistencies will present conflicting operational parameters for firms implementing Regulation BI and the Standard of Conduct, which could impose further burdens on systems still in their infancy, and could present confusion for the associated persons and supervised persons administering these side-by-side regimes that is not easily alleviated by training. These inconsistencies are predictable when importing a different regime from a different regulator (in this case, FINRA), and it is unresolved how the proposed sales practices rules would be reconciled with Regulation BI and the Standard of Conduct, all of which appear aimed at addressing the same relationship between a firm and their customer or client.

The Sales Practices Rules are Premature in Light of Implementation of Regulation BI and the Standard of Conduct, and Offer Slender Benefits

Firms already have an obligation to act in their customer or client's best interest under Regulation BI and the Standard of Conduct. In light of this point, the Proposing Release requests comment on whether the same rules should apply to broker-dealers and investment advisers (for example, to investment advisers with discretionary and non-discretionary authority, and to firms where transactions are client-directed without any recommendation or advice), whether such rules are necessary in light of an investment adviser's fiduciary duty and when a broker-dealer's recommendations are subject to Regulation BI, and how the rules should apply in specific situations (for example, when a broker dealer is asked to transact on behalf of an investment adviser's client).

Commenters have noted that proposing and potentially adopting proposed sales practices rules

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before an assessment can be made of the impact of Regulation BI and of the Standard of Conduct may be premature. The new sales practices rules would be costly to implement, and seem likely to far exceed the Proposing Release's cost-benefit analysis. The cost-benefit analysis states that the estimated total one-time costs for a broker-dealer or investment adviser under these proposed requirements "would range from $9,116 to $15,193," with estimated total ongoing costs ranging "from $2,271 to $3,915 per year." Based on our experience, these estimates are likely (significantly) too low. As acknowledged in the Proposing Release, this "approach may provide some efficiencies and reduced compliance costs for broker-dealers that already have compliance procedures in place for approving options accounts, although we recognize that these efficiencies and reduced compliance costs would not apply to investment advisers that are not dually registered as, or affiliated with, broker-dealers subject to FINRA rules." Additionally, the SEC does not provide a meaningful empirical analysis of the potential benefits that the sales practices rules could bring or of the similar benefits that already will be realized in light of Regulation BI and the Standard of Conduct, which already govern these firms' interactions with customers and clients, respectively. For example, the Standard of Conduct explains that as part of an adviser's duty of care that an adviser has a duty to act in the client's best interest including an obligation to give advice that is appropriate to the client's objectives; forming a reasonable belief of a client's best interest requires (among other considerations) that an adviser apply heightened scrutiny to certain products for retail clients, including complex investments or products such as inverse and leverage exchange-traded products.

The proposed sales practices rules could introduce inefficiencies, confusion, and undermine and interfere with the implementation of Regulation BI and the Standard of Conduct, which take a more overarching approach to the best interest of customers and clients by accounting for all products where a recommendation or advice is given. In particular, the proposed sales practices rules are more prescriptive than the principles-based rules that typically govern advisers, which the SEC has recognized is key to regulating this diverse population of registrants. Firms are in the midst of preparing the large scale and complex compliance programs necessitated by Regulation BI and the Standard of Conduct, and the proposed sales practices rules could sow confusion and steer resources away from sewing these compliance regimes into the fabric of applicable firms.

Precedent for Treatment of Disfavored Products Deemed "Complex Financial Products"

In the proposing release, the SEC requested comment on whether the leveraged/inverse investment vehicle definition is appropriate or if additional complex financial products similar to those discussed in FINRA Regulatory Notice 12-03 should be subject to the same standards. At its core, one of the greatest strengths of the federal securities laws is that they do not form a regime of merit regulation: the SEC does not use its immense powers to favor or disfavor certain investments. Rather, the regime imposes certain neutral, rule-based protections, fosters investor education and choice through a full-disclosure system, and then allows investors to make informed investment decisions. Adopting the proposed sales practices rules would be a departure from this regime, has a tinge of paternalism and could be replicated in the future to regulate any disfavored product. The FINRA regime for options accounts is an exception that proves the rule, because (unlike leveraged/inverse funds, which are investment companies, and virtually all other securities), they present an unlimited risk of loss.

Before importing a regime emulating the FINRA regulation of options accounts and imposing a form of merit regulation, it seems to us to be more prudent to allow the Regulation BI and Standard of Conduct regime to take full effect and then analyze the degree to which leveraged/inverse vehicles

are unsafe, misunderstood and risky to investors in a manner that warrants imposing a heavier-handed regulatory regime.

Significant Regulatory Issues that the Proposed Rule Does Not Address

The SEC and its Staff have over time considered the application of the broader 1940 Act regulatory framework (beyond Section 18) to funds that use derivatives. These include 1940 Act requirements regarding diversification, investments in securities issued by securities-related issuers, concentration, and fund names, among other requirements, and whether the regulatory framework "continues to fulfill the purposes and policies underlying the [1940] Act and is consistent with investor protection."[9]

Funds commonly consider a range of issues and face interpretive challenges in determining how to assess compliance with these requirements. These issues include identifying the appropriate value to assign to a derivatives instrument (that is, the current market or fair value, the notional value, or some other value) and the appropriate issuer or investment exposure to consider (that is, the counterparty, the reference asset, or both) for purposes of a specific requirement, among other matters. The SEC and its Staff have never issued public guidance on many of these issues and interpretive challenges. While the 2011 Derivatives Concept Release discussed requested in-depth feedback from the public to help determine whether regulatory initiatives or guidance were necessary under certain of these requirements, neither the 2015 proposal nor this Proposal provides for such a rulemaking or guidance. Issues and interpretive challenges continue to arise under these requirements, for example, under the prohibition on purchase or acquisition of securities issued by securities-related issuers under Section 12(d)(3) and Rule 12d3-1, which was, in part, designed to limit a fund's exposure to the entrepreneurial risks of securities-related issuers,[10] and the "names rule" set forth in Rule 35d-1 under the 1940 Act.[11]

The authors believe that certain issues previously considered relevant to these aspects of the 1940 Act framework may be addressed by the derivatives risk management framework that the Proposed Rule would require for funds that use derivatives. Accordingly, the authors believe that it would be helpful if the SEC provided guidance in issuing a final rule or guidance to the effect that funds would satisfy the derivatives-related policy purposes of these sections of the 1940 Act by implementing a reasonable derivatives risk management program, and that such funds could take reasoned views in assessing fund investments in derivatives transactions and compliance with these other aspects of the 1940 Act regulatory framework.

Mr. Perlow and **Mr. Hinkle** are Partners, **Ms. Wagner** is Counsel, and **Ms. Zakaria** and **Ms. Rodriguez** are Associates, at Dechert LLP.

NOTES

1. *Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles* (Proposing Release), SEC Rel. Nos. 34-87607; IA-5413; IC-33704, 85 Fed. Reg. 4445 (Jan. 24, 2020). The SEC's proposal is a re-proposal of a 2015 SEC rulemaking effort that would have permitted a fund to enter into derivatives transactions and "financial commitment transactions" subject to certain conditions, and which was ultimately withdrawn in part due to comments that highlighted that certain conditions in the 2015 proposed rule were problematic for certain funds.
2. *Securities Trading Practices of Registered Investment Companies*, SEC Release No. IC-10666 (Apr. 18, 1979) (Release 10666).
3. *See Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, SEC Release No. IC-29776, 76 F.R. 55237 (Sept. 7,

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2011) (Derivatives Concept Release); "The Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities," ABA Section of Business Law (July 6, 2010) (2010 ABA Derivatives Report).

4 Under the proposed sales practices rules, a "leveraged/inverse investment vehicle" is defined 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." Note that this definition excludes trusts or funds that hold only commodities and currencies.

5 The Proposing Release states that the term "firm" "collectively refers to Commission-registered broker-dealers and investment advisers" as well as "associated persons of such broker-dealers" and "supervised persons of such investment advisers."

6 The UCITS Guidelines also require monthly VaR model backtesting, with retroactive comparison for each business day, rather than daily backtesting as under the Proposed Rule.

7 The Proposing Release states that the SEC proposed the relative VaR test "as a default means of limiting leverage risk because it resembles the way that section 18 limits a fund's leverage risk." The Proposing Release goes on to state that the SEC set the relative VaR test limit at 150 percent based on an analogy to the hypothetical VaR of a fund that obtains the full amount of bank borrowings permissible under Section 18(f) and has total assets equal to 150 percent of the fund's net assets. The Proposing Release states that such a fund's VaR would be approximately 150 percent of the VaR of the fund's designated reference index. Statements elsewhere in the Proposing Release describe that the SEC set the absolute VaR test at 15 percent of a fund's net assets with the intent of providing comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the S&P 500 as their designated reference index. Together, these statements suggest that the SEC's view is that the relative VaR test is more closely tied to Section 18 than the absolute VaR test.

8 The Proposing Release asserts that investors may understand the risk inherent in the S&P 500 or similar indexes as the level of risk inherent in the markets generally, and that "an absolute VaR test set to approximate, or not substantially exceed, this level of risk would therefore often approximate the level of risk that investors may understand, and frequently choose to undertake, through investments in funds."

9 *See* Derivatives Concept Release, *supra* n.3.

10 *See* Derivatives Concept Release, *supra* n.3 at 55252. The 2010 ABA Derivatives Report, *supra* n.3, observed that the need to limit counterparty risk should be limited to the extent that a counterparty's obligations to the fund are secured by collateral provided by the counterparty. The SEC and its Staff acknowledged this view in the Derivatives Concept Release but have never explicitly endorsed this view.

11 In the authors' experience, the SEC Staff has in recent years issued comments to many funds that the appropriate method of valuing certain derivatives for purposes of assessing compliance with the names rule is market value. However, many funds continue to believe that the use of the notional value of a derivative transaction can be more appropriate, *e.g.*, if a derivative creates economic exposure equivalent to a cash investment in the underlying issuer equal to the notional value of the derivatives transaction.

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