December 11, 2015

SEC Proposes Limits on Fund Use of Derivatives and Leverage

The Securities and Exchange Commission (the "Commission") today voted, by a three-to-one margin, to propose rules that would limit the amount of leverage that mutual funds may obtain through derivatives. The proposals also require funds and business development companies (BDCs) to manage the risks of investing in derivatives by clarifying requirements to segregate liquid assets to "cover" their potential exposure to derivatives. We will prepare a more detailed analysis shortly after the Commission publishes the text of the proposals.

The proposals would clarify how Section 18 of the Investment Company Act of 1940, as amended (the "1940 Act") would apply to derivatives transactions with future payment obligations, such as forwards, futures, swaps, and written options, as well as "financial commitment" transactions, like reverse repurchase agreements. Section 18 generally prohibits funds from issuing "senior securities," which can be thought of as transactions that create a preference in a bankruptcy proceeding. The proposals would allow funds to enter into derivatives transactions despite the Section 18 prohibitions, if they comply with certain conditions. These conditions would codify some existing Commission guidance, but would impose some significant new ones.

At the open meeting, Commission Chair Mary Jo White said that the current regulatory framework for derivatives must be revised because investment companies "can experience substantial and rapid losses from investments in derivatives." These losses, she said, could harm investors.

REQUIREMENTS FOR DERIVATIVES

The proposals consist of three primary elements: specific limitations on derivatives transactions; segregation of assets; and risk management.

Portfolio limitations. Proposed rule 18f-4 would require funds to comply with one of two alternative portfolio limitations that would limit their ability to obtain leverage through investments in derivatives and certain other instruments.

Exposure-based portfolio limit. A fund would be required to limit its aggregate exposure to 150 percent of the fund's net assets. "Exposure" for these purposes generally means the aggregate notional amount of the fund's derivatives transactions, together with the fund's obligations under "financial commitment transactions" (such as reverse repurchase agreements and other similar transactions).

Risk-based portfolio limit. Alternatively, a fund could obtain "exposure" by means of derivatives in an aggregate notional amount up to 300 percent of the fund's net assets, provided that the fund satisfies a risk-based test based on "value-at-risk," or VaR. This test would determine whether a fund's derivatives transactions, in the aggregate, result in a portfolio that is subject to less market risk than if the fund did not use derivatives. Generally, VaR attempts to quantify the amount an investor is likely to lose over a period of time, based on historic probability levels. Other national and supranational securities regulators, including in Europe, have adopted a VaR-based approach to regulate fund use of derivatives.

Asset segregation. In addition to the portfolio limitations, the Commission would require funds to manage derivatives risks by segregating liquid assets (generally cash and cash equivalents) equal to the sum of the following two amounts.

Mark-to-market coverage amount. A fund would be required to segregate assets at any time equal to the amount that the fund would pay if it exited the derivatives transaction at the time of the termination.

Risk-based coverage amount. A fund also would be required to segregate an additional risk-based coverage amount. This "cushion" would represent a reasonable estimate of the potential amount that the fund would pay if the fund exited the derivatives transaction under stressed conditions.

Derivatives risk management program. Funds that engage in more than limited derivatives transactions (exceeding 50 percent of net assets), or that use complex derivatives, would be required to establish and maintain a formalized derivatives risk management program and designate a "derivatives risk manager," both segregated from the fund's portfolio management operation and approved by the fund's board of directors.

The proposed rules would add to a board's responsibilities in overseeing fund use of derivatives. Specifically, the rules would require fund boards, when applicable, to approve a fund's derivatives risk management program, any material changes to the program, and the designation of a "derivatives risk manager." The program must be reasonably designed to assess the risks of derivatives transactions, manage and monitor risks, and require periodic updates and reviews, among other things. In addition, the rule would require fund boards to review written reports prepared by the derivatives risk manager, at least quarterly, and review the adequacy and effectiveness of the derivatives risk management program.

REQUIREMENTS FOR "FINANCIAL COMMITMENT TRANSACTIONS"

Funds that enter into "financial commitment transactions," such as reverse repurchase agreements or short sale agreements, would be required to segregate an amount equal to the full notional amount of the instrument.

DISCLOSURE

The Commission proposed further amendments to two reporting forms that it proposed in May 2015: Form N-PORT and Form N-CEN. Form N-PORT amendments would require enhanced reporting on portfolio-wide and position-level investments in derivatives. Funds that are required to adopt derivatives risk management programs would be required to disclose additional risk metrics related to derivatives. Amendments to Form N-CEN would require funds to disclose whether they relied on rule 18f-4 during the reporting period and, if so, the applicable portfolio limitation.

COMMISSIONER PIWOWAR'S DISSENT

Commissioner Michael Piwowar opposed the proposals concerning limits on leverage for two reasons. He said that the proposed asset segregation requirements should function as a leverage limit on funds, and that absent data indicating that a separate specified leverage limit is warranted, "there is no justification for imposing any additional requirements or burdens on funds." He also questioned the timing of the proposal in light of other recently proposed rules, such as the reporting modernization proposal and the liquidity risk management proposal.

DERA WHITE PAPER

The SEC's Division of Economic and Risk Analysis published a white paper called "Use of Derivatives by Registered Investment Companies." The paper analyzes the use of derivatives by a random sample of ten percent of all registered funds.

OUR TAKE

The much-anticipated proposals come more than four years after the Commission sought public comment on the topics. Fund use of derivatives presents regulatory challenges because fund-specific laws and regulations have not kept pace with rapid innovations in portfolio management techniques and growing use of derivatives.

The Commission seeks both to limit fund use of leverage and at the same time provide some flexibility for funds to use derivatives. Funds that use derivatives must limit leverage (determined by aggregate notional amount) to 150 percent of their net assets, but could increase their leverage to 300 percent of their net assets if they satisfy a risk-based test based on VaR. It appears that the Commission has tried hard to strike a balance between the desire to manage potential risks of derivatives and the desire of fund managers to meet investor demands for innovative investment strategies. It is not especially clear, however, how the new rule would interact with other recent rulemaking initiatives from the Commission, such as those governing reporting modernization and liquidity risk management programs, as well as the many Dodd-Frank Title VII rules that the Commission is yet to propose or adopt.

In any event, assuming the Commission does not significantly modify the proposals before adopting them, funds that use derivatives will face new compliance challenges in establishing required derivatives risks policies and procedures to be administered by a derivatives risk manager. The adviser's trading floor will become even more crowded as the new derivatives risk manager must squeeze into a tight space between the chief compliance officer and the fund's new liquidity risk manager.

And then there are the fund directors. As Commissioner Luis Aguilar suggested in his remarks at the Commission's open meeting, rule 18f-4 would add new responsibilities to fund directors who are already faced with growing responsibilities. "Every time the Commission votes to add responsibilities to boards of directors, I consider whether boards are prepared and equipped to take on those added responsibilities, which seem only to increase in number and complexity over time," he said. We hope that the full Commission embraces Commissioner Aguilar's concerns and does not set the bar for fund directors so high that even the most diligent fund directors cannot meet it. This is especially true when it comes to board oversight of derivatives.

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