

January 7, 2016

SEC Proposes New Rule Concerning Registered Funds' Use of Derivatives

On December 11, 2015, the SEC issued its long-anticipated release (the "[Release](#)") proposing Rule 18f-4 ("the Proposed Rule") under the 1940 Act regarding the use of derivatives and certain related instruments by registered investment companies (collectively, "funds"). The stated objective of the Release is to "address the investor protection purposes and concerns underlying section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives" in light of the increased participation by funds in today's large and complex derivatives markets.

We provide an executive summary of the Proposed Rule and other aspects of the Release below and, in the Appendix, we discuss the Proposed Rule in more detail.

Some Early Thoughts:

- The Proposed Rule is something of a blunt instrument. In many respects, it does not distinguish among the reasons investment companies may use derivatives – a forward currency hedge is for all intents and purposes treated the same as a speculative equity total return swap. We expect that industry commentary will seek greater levels of nuance because different types and uses of derivatives create very different risks.
- Some early client feedback has focused on the Proposed Rule's hard 150% limit on notional exposure. In conjunction with the Release, the SEC published a report by its Division of Economic and Risk Analysis ("DERA"), based on a random sample of roughly 10% of funds, that indicated that relatively few funds will be affected by the limit – but this remains to be seen as the broader universe of funds applies the limit to particular portfolios. For example, a broader sampling of bond funds that manage duration, currency and credit risks through derivatives may show that a significantly greater percentage of more traditional funds would have to alter their investment programs to comply with the 150% limit than the DERA study suggests.
- The SEC's recognition of a "value-at-risk" ("VaR") tool is an important development, although its application may be seen as too limited (*note* – the Proposed Rule would allow an exception to the 150% notional exposure limit, to 300%, if a VaR analysis shows that the effect of all of a fund's derivatives transactions in effect at a particular time is to reduce overall portfolio risk). Some market participants may suggest that the VaR analysis should be applied separately to different types of derivatives activities – so that, for example, a fund's currency or interest rate hedging transactions that reduce portfolio risk should not count against any limit on other derivatives use by the fund.
- The Proposed Rule's asset segregation requirements are complicated and not especially clear. A number of our clients have expressed concern about the effort and expense that will be required to monitor a fund's ongoing compliance with the proposed new requirements.
- Like other recent rulemakings, the Proposed Rule will impose significant new responsibilities on fund directors/trustees and on fund personnel (most notably, the Proposed Rule's required individual who serves as derivatives risk manager). Many funds will be required to adopt detailed, board-approved policies and procedures designed to assess and manage the risks associated with the funds' derivatives transactions.
- Depending on how the comment process proceeds, there is at least some chance of a legal challenge to the Proposed Rule. Although the SEC went to some length to find support for its authority, principally under Section 18 of the 1940 Act, that position may be weakened by the SEC's proposed approach to the regulation of derivatives, finding "senior securities" even in transactions where portfolio risk is clearly reduced and

where the risks commonly associated with senior securities – leverage, preferential claims on fund assets and increases in a fund’s speculative character – are minimal.

Executive Summary

Proposed Rule 18f-4 would supplant a significant volume of SEC no-action and other guidance on derivatives use by funds, and would introduce a range of specific, technical restrictions:

- The Proposed Rule defines and **distinguishes between derivatives transactions¹ and a newly defined category of “financial commitment transactions”** (consisting of reverse repurchase agreements, short sale borrowings, firm or standby commitments, and similar agreements).
- Each fund that utilizes any derivatives transactions would have to **comply with one of two alternative portfolio limitations** designed to impose a limit on the aggregate amount of leverage the fund may obtain through all derivatives transactions, financial commitment transactions, and other senior securities transactions (such as permitted borrowings).
 - Under an **exposure-based portfolio limit**, the fund would be subject to a limit of 150% (relative to its net assets) on its aggregate notional “exposure” to senior securities transactions, measured after each transaction in accordance with a prescribed calculation methodology.
 - Alternatively, under a **risk-based portfolio limit**, the fund could have exposure of up to 300%, provided it also meets a value at risk (VaR) test intended to ensure that the fund’s use of derivatives reduces, rather than magnifies, the fund’s overall exposure to market risk.
- In addition, each fund would have to **maintain a specified value of “qualifying coverage assets”** identified on its books and records (*i.e.*, “earmarked”) to manage the risks associated with its derivatives transactions and financial commitment transactions.
 - **For derivatives transactions**, the required amount of qualifying coverage assets would be based on mark-to-market value of derivatives transactions, *plus* an additional risk-based amount, but could only consist of cash and cash equivalents and particular assets that may be delivered by a fund to satisfy its obligations (*e.g.*, if the fund has written a call option on a particular security that the fund owns, then the security would be considered qualifying coverage assets for that transaction).
 - **For financial commitment transactions**, the required amount of qualifying coverage assets would be calculated based on the fund’s full notional financial commitment obligations but, unlike derivatives transactions, **may also include assets** that (i) are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund is required to pay the obligation, or (ii) have been pledged with respect to the financial commitment obligation and can be expected to satisfy the obligation.
- Depending on the extent and complexity of its derivatives usage, **a fund may be required to adopt and implement a board-approved written derivatives risk management program** reasonably designed to assess and manage the risks associated with the fund’s derivatives transactions.
 - The program would include, among other things, an assessment of specified risks, the designation of an individual as derivatives risk manager and oversight by the fund’s board.
- The Release also would amend (i) proposed Form N-PORT to require funds that must implement a derivatives risk management program to report certain portfolio- and position-level risk metrics; and (ii) proposed Form N-CEN to require funds engaging in derivatives transactions to identify the portfolio limitation category (*i.e.*, the 150% exposure-based limitation or the 300% risk-based limitation) on which the fund has relied.

¹ “Derivatives transaction” means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (“derivatives instrument”) under which the 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 a margin or settlement payment or otherwise. Derivatives, such as purchased options, that do not obligate a fund to make future payments or to deliver a fund asset, are not “derivatives transactions” under the Proposed Rule.

Each of these requirements is discussed in more detail in the Appendix below.

Existing Guidance and Compliance Dates

If Proposed Rule 18f-4 is adopted, the SEC would rescind Release IC-10666 and the staff's no-action letters addressing derivatives transactions and financial commitment transactions. Funds would only be permitted to enter into derivatives transactions and financial commitment transactions to the extent consistent with the requirements of Rule 18f-4 or Sections 18 or 61 of the 1940 Act. However, prior to Rule 18f-4's effective date, a fund may still rely on Release IC-10666 and existing no-action letters. The Release does not propose a compliance date or transition period, but requests comments on whether a proposed compliance period of 18 months for larger entities (30 total months for smaller entities) would provide sufficient time for funds to transition to operation under the Proposed Rule.

* * *

We expect a significant number of comments on the Release and Proposed Rule from various industry participants and other interested parties. Comments must be filed with the SEC *no later than March 28, 2016*.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

Appendix

SEC Proposes New Rule Concerning Registered Funds' Use of Derivatives

I. Current Regulation and an Overview of Significant Departures Under the Proposed Rule

The current regulation of funds' use of derivatives is based on a patchwork of SEC no-action letters and other guidance stretching back several decades. In a seminal 1979 release, IC-10666, and through subsequent staff no-action letters, staff comments on registration statements and other pronouncements, the SEC and the staff provided guidance on permissible approaches to compliance with Section 18, often on an instrument-by-instrument basis. More recently, the SEC issued a [2011 Concept Release](#),² in which it articulated areas of concern and solicited public comment on the existing regulatory framework for funds' use of derivatives. In light of this disparate body of guidance, which is often subject to interpretation and does not specifically address a variety of derivatives types that are used by funds, industry participants have faced challenges in trying to apply a consistent approach with respect to derivatives and other instruments under Section 18.

Note: The Release does not cover many of the 1940 Act interpretive questions on which the 2011 Concept Release sought comment, including regarding how to treat derivatives and related instruments for purposes of testing such requirements as fund diversification, portfolio concentration, investments in securities-related issuers, and the name-test rule (Rule 35d-1).

Under the current framework for compliance with Section 18, a fund typically looks to its exposure under a given instrument, taking into account the fund's anticipated future obligation to make payments (either under the terms of the particular instrument or, in some cases, under the market conditions for closing out the trade), and then seeks to cover the full amount of that obligation by either identifying an offsetting instrument or position within its portfolio, or by earmarking sufficient unencumbered liquid assets within its portfolio. Amounts that must be earmarked differ based on the particular investment and its characteristics (*e.g.*, mark-to-market values versus notional values), and there appears to be considerable variation across the industry in how funds approach the designation of offsetting positions. The development of SEC guidance on an instrument-by-instrument basis, coupled with the dramatic growth in the derivatives markets, has led to situations in which there is no specific guidance from the SEC or its staff. As a result, different funds may treat the same kind of derivative differently, based on their particular interpretation of the existing guidance. Accordingly, the SEC believes that there is a need for an updated and more comprehensive approach to regulating funds' use of derivatives and financial commitment transactions. If the Proposed Rule is adopted, it would supersede, and the SEC would rescind, Release IC-10666 and other existing guidance on derivatives.

A detailed description of the Release appears beginning in Section II, below. The following bullet-point list highlights some key areas where the Proposed Rule would depart from current SEC guidance and industry practice.

- **Risk-Based Regulation.** Consistent with other recent SEC initiatives, such as the October 2015 proposed new liquidity risk management rules (discussed by Ropes & Gray [here](#)), the Proposed Rule reflects a significant focus on risk management requirements. While many funds already have a derivatives risk management program of some sort, none is currently required by specific regulation. Examples of the risk management focus of the Proposed Rule include the following:
 - reliance on value-at-risk (“VaR”) testing for certain portfolio limitation calculations;
 - special or enhanced treatment for certain types of “complex” derivatives transactions;
 - a “risk-based” coverage amount added to the value of assets to be earmarked for derivatives transactions;
 - the Proposed Rule's wording, which requires a fund to “manage[] the risks associated with its derivatives transactions by maintaining” a certain level of qualifying coverage assets; and

² Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Rel. No. IC-29776 (Aug. 31, 2011).

- a requirement to create a written derivatives risk management program, and to designate an individual as derivatives risk manager, for funds with significant exposure.
- **Portfolio-Level Limitations.** The introduction of the alternative 150%/300% portfolio limitations departs from current regulation by introducing an objective test applicable to the entire notional exposure of derivatives transactions, financial commitment obligations and all other senior securities, while the current framework relies principally on earmarking (or segregation) of assets and offsetting positions with respect to individual transactions to serve as a practical limit on leverage.
- **Distinguishing Between Derivatives Transactions and Financial Commitment Transactions.** The Proposed Rule defines “derivatives transactions” and a newly designated category of “financial commitment transactions,” and treats the two types of instruments differently for purposes of asset coverage and with respect to other aspects of the Proposed Rule.
- **Asset Coverage Requirements.** The Proposed Rule would require a fund to earmark qualifying coverage assets to cover **derivatives transactions** on a **mark-to-market basis**. However, for derivatives transactions, the Proposed Rule would also impose a requirement that the fund have additional coverage to account for situations in which a fund may have to exit derivatives transactions under “stressed conditions.” In contrast, for **financial commitment transactions**, a fund would have to earmark qualifying coverage assets equal to the aggregate **notional value** of the fund’s financial commitment obligations, although the scope of assets that constitute qualifying coverage assets for financial commitment transactions would be broader than for derivatives transactions, as noted below.
- **Assets Eligible for Use as Cover.** For **derivatives transactions and financial commitment transactions**, qualifying coverage assets consist of cash and cash equivalents and, with respect to any transaction in which a fund may satisfy its obligations by delivering a particular asset, the particular asset. **In addition, solely for financial commitment transactions**, qualifying coverage assets also may consist of assets that (i) are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund is required to pay the obligation or (ii) have been pledged with respect to the financial commitment obligation and can be expected to satisfy the obligation.
- **Classifying Funds Differently on the Basis of Derivatives Use.** While current SEC guidance treats all funds uniformly for purposes of compliance with Section 18 as it relates to derivatives, the Proposed Rule would require a formal derivatives risk management program only for funds that exceed a prescribed threshold of notional derivatives exposure or enter into “complex derivatives transactions.”

II. Fund Portfolio-Level Limitations on Derivatives Transactions

Under the Proposed Rule, a fund may enter into derivatives transactions or financial commitment transactions, provided the fund’s board, including a majority of board members who are not interested persons of the fund (“independent members”), would be required to approve one of two alternative portfolio limitations for the fund: an **exposure-based portfolio limitation** or a **risk-based portfolio limitation**. The two alternative limitations are described below.

Exposure-Based Portfolio Limitation. A fund that relies on the exposure-based portfolio limitation would be required to operate so that its aggregate “*exposure*” from “*senior securities transactions*,” measured immediately after entering into any senior securities transaction, does not exceed 150% of the fund’s net assets.

- **Senior securities transactions** are the combination of (i) derivatives transactions; (ii) financial commitment transactions (*i.e.*, any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement or similar agreement); and (iii) any transaction involving a senior security entered into by the fund pursuant to Section 18 (or Section 61 in the case of a business development company or “BDC”) of the 1940 Act without regard to Rule 18f-4 (such as bank borrowings or, for closed-end funds and BDCs, issuances of other debt securities or preferred shares).
- **Exposure** means the sum of:
 - the aggregate “*notional amounts*” of the fund’s derivatives transactions;

- the aggregate financial commitment obligations of the fund (*i.e.*, the amount of cash and or the value of other assets that the fund is obligated to pay or deliver under financial commitment transactions); and
- the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any senior securities transaction entered into by the fund pursuant to Section 18 without regard to Rule 18f-4.

In determining the aggregate notional amounts of a fund's derivatives transactions, proposed Rule 18f-4 would permit a fund 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 (the offsetting derivatives transactions are not required to be with the same counterparty).

- In general, the *notional amount* of a derivatives transaction is 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 is calculated.
- However, *for the following types of derivatives transactions*, Rule 18f-4 would require *an adjustment to the notional amount*:
 - For derivatives transactions that provide a *return based on the leveraged performance of a reference asset*, the notional amount must be multiplied by the leverage factor (*e.g.*, 2x or 3x);
 - For derivatives transactions for which the *reference asset is a managed account or entity formed for the purpose of investing in derivatives* transactions (or an index that reflects the performance of such a managed account or entity), the notional amount must be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity; and
 - For "*complex derivatives transactions*," the notional amount is an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transactions.
 - *Complex derivatives transactions* are derivatives transactions for which the amount payable by either party upon settlement date, maturity or exercise (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction,³ or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.⁴

Note: The Release (at page 69, 80 FED. REG. at 80902-3) includes a table listing a method for determining the notional amount of certain types of derivatives transactions that the SEC believes would generally be permitted under the Proposed Rule. Among other things, the notional amount for options is determined on a delta-adjusted basis.

Note: The proposed approach to earmarking does not include flexibility to discount for instruments used as part of a hedging strategy or where the instruments' economic effect is to offset other positions (absent compliance with the relatively narrow conditions that permit directly offsetting positions to be netted, as noted above).

Risk-Based Portfolio Limitation. A fund that relies on the risk-based portfolio limitation (instead of the exposure-based portfolio limitation) would be required to operate so that both (i) its "*full portfolio VaR*" is less than the fund's "*securities VaR*" and (ii) the aggregate exposure of the fund to senior securities transactions does not exceed 300% of the value of the fund's net assets, measured immediately after entering into any senior securities transaction (the second part of this test would be calculated in the same manner as the exposure-based portfolio limitation described above, except that the percentage limit is 300% rather than 150%).

³ This provision is designed to capture derivatives whose payouts depend on the path taken by the value of the underlying asset. The Release cites as examples "barrier options" (also known as knock-in or knock-out options) and "Asian options."

⁴ The Release cites a variance swap as an example.

- Value-at-risk or “VaR” is 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 level.
- A fund’s full portfolio VaR is the VaR of the fund’s entire portfolio, including securities, other investments and derivatives transactions.
- A fund’s securities VaR is the VaR of the fund’s portfolio of securities and other investments, **but excluding any derivatives transactions**.

A **VaR model used by a fund** for purposes of determining the fund’s full portfolio VaR and securities VaR must:

- take into account and incorporate all significant, identifiable market risk factors associated with a fund’s investments (including, as applicable, (i) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (ii) material risks arising from the nonlinear price characteristics of a fund’s investments, including options and positions with embedded optionality; and (iii) the sensitivity of the market value of the fund’s investments to changes in volatility);
- use a 99% confidence level and a time horizon of not less than 10 nor more than 20 trading days;
- if using historical simulation, include at least three years of historical market data; and
- be applied consistently when calculating the fund’s securities VaR and full portfolio VaR (*i.e.*, the same VaR model must be used for both).

Note: The 150% and 300% limitations are measured immediately after entering into senior securities transactions. As proposed, this would appear to limit an adviser’s options for managing a fund back into compliance in instances where the fund has exceeded the limitation due to market movements. For example, if the exposure of fund relying on the exposure-based portfolio limitation increases to 170% due to market movements, the fund would be precluded from entering into a senior securities transaction intended to reduce exposure if the reduced exposure would be greater than 150%.

III. Qualifying Coverage Assets

Proposed Rule 18f-4 also would require a fund to maintain a specified value of “**qualifying coverage assets**” identified on its books and records in connection with the fund’s derivatives transactions and financial commitment transactions, pursuant to policies and procedures that the fund’s board, including a majority of the independent members, have approved. Qualifying coverage assets is defined more broadly for financial commitment transactions than for derivatives transactions.

- Qualifying coverage assets consist of the following, provided that **the total amount of a fund’s qualifying coverage assets may not exceed the fund’s net assets** and, further, that fund assets maintained as qualifying coverage assets shall not be used to cover both a derivatives transaction and a financial commitment transaction.
- **For derivatives transactions and financial commitment transactions, qualifying coverage assets may consist of:**
 - cash and cash equivalents (which, according to the Release, include “certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds”); and
 - a particular asset in any transaction in which a fund may satisfy its obligations by delivering the particular asset.
- **In addition, for financial commitment transactions only, qualifying coverage assets also include** assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay the obligation, or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy the obligation.

Note: The definitions of “derivatives transactions” and “financial commitment transactions” both include a catch-all for “similar” instruments or agreements. As a result, it may be unclear how to categorize certain instruments. There may also be situations in which two different instruments that have substantially similar characteristics are categorized differently.

Note: By setting the upper limit of qualifying coverage assets at the net assets of a fund, the Proposed Rule would impose an additional effective limit on leverage by precluding a fund from using assets obtained through leverage or senior securities transactions to cover new positions without limit.

IV. Qualifying Coverage Assets Required For Derivatives Transactions

Proposed Rule 18f-4 would require a fund to “**manage[] the risks associated with its derivatives transactions by maintaining” qualifying coverage assets**, identified on its books and records and determined pursuant to policies and procedures that each fund’s board, including a majority of the independent members, have approved. For its derivatives transactions, a fund would be required to maintain qualifying coverage assets, determined at least once each business day, with a value at least equal to the sum of the fund’s aggregate “**mark-to-market coverage amounts**” and “**risk-based coverage amounts.**”

- For each derivatives transaction, the **mark-to-market coverage amount** equals the amount that would be payable by the fund if it were to exit the derivatives transaction at the time of determination, provided that:
 - if the fund has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, the mark-to-market coverage amount for those derivatives transactions may be calculated as the net amount that would be payable by the fund, if any, with respect to all derivatives transactions covered by the netting agreement; and
 - the fund may reduce its mark-to-market coverage amount for a derivatives transaction by the value of any assets that represent variation margin or collateral to cover the fund’s mark-to-market payment obligation with respect to that particular transaction.
- For each derivatives transaction, the **risk-based coverage amount** equals the amount (in addition to the derivatives transaction’s mark-to-market coverage amount) that represents, at the time of determination, a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction **under stressed conditions**, taking into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset, provided that:
 - the risk-based coverage amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, in accordance with the terms of the netting agreement; and
 - a fund may reduce its risk-based coverage amount for a derivatives transaction by the value of any assets that represent initial margin or collateral for potential amounts payable with respect to the risk-based coverage amount.

Note: The Proposed Rule does not define “netting agreement,” and it is not clear what netting rights have to be available under the agreement in order for the mark-to-market coverage amount (and risk-based coverage amount) to be calculated on a net basis. For example, a typical ISDA Master Agreement provides for netting of obligations in an event of a default or termination event, and netting of collateral, but may not provide for netting of other payments (generally, under an ISDA Master Agreement, the parties net ordinary course payments only if they are due on the same day and in the same currency and, in some cases, only if the payments are with respect to the same transaction). It is also not clear whether a typical futures and cleared swaps account agreement would qualify as a netting agreement.

Note: Variation margin and initial margin posted with respect to a transaction can reduce the mark-to-market coverage amount and risk-based coverage amount with respect to such transaction, respectively, even if such margin is not in the form of “qualifying coverage assets.”

V. Qualifying Coverage Assets Required for Financial Commitment Transactions

Proposed Rule 18f-4 would also impose asset coverage requirements on a fund's financial commitment transactions, which resemble, but depart in important ways from, the coverage requirements applicable to derivatives transactions. Under the Proposed Rule, the fund's board, including a majority of the independent members, would be required to approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, determined at least once each business day and identified on the fund's books and records, for its financial commitment transactions.

- Under Proposed Rule 18f-4, a fund would be required to maintain qualifying coverage assets equal to at least the amount of the financial commitment obligation associated with each of its financial commitment transactions (*i.e.*, the notional value of the obligation).
- As noted in Section II, qualifying coverage assets for financial commitment transactions consist of a **broader range of assets than can be used to cover derivatives transactions** – *i.e.*, assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay the obligation, or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy the obligation.

VI. Derivatives Risk Management Program

The Proposed Rule provides that a fund that engages in more than a limited amount of derivatives transactions, or that engages at all in complex derivatives transactions, must adopt and implement a written derivatives risk management program. Proposed Rule 18f-4 sets forth some particular requirements regarding such a program, but it allows for customization by a fund to address the risks posed by the specific range of derivatives used by the fund.

Note: A fund's use of financial commitment transactions or other senior securities that are not derivatives transactions does not trigger the derivatives risk management program requirement.

For a fund that utilizes any derivatives transactions, the fund must adopt a written derivatives risk management program, unless the fund adopts and complies with a portfolio limitation under which (i) immediately after entering into any derivatives transaction, the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets; and (ii) the fund does not enter into any complex derivatives transactions. To avoid the program requirement, the fund's board, including a majority of the independent members, must approve a 50% portfolio limitation and approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets with respect to the fund's derivatives transactions (as described in Section IV, above).

The requirement to adopt a program applies on a fund-by-fund basis. As a result, some funds within a complex might be exempt from the requirement while others would be required to adopt a program.

A derivatives risk management program would be required to include various elements, including the following:

- as designated by the fund and approved by its board, a single person (not a group) appointed to administer the derivatives risk management program (the appointed manager **must** be an employee or officer of the fund or its investment adviser or sub-adviser and **cannot** be a portfolio manager of the fund);
- written policies and procedures reasonably designed to:
 - **reasonably segregate the fund's derivatives risk management functions from the fund's portfolio management.**
 - **assess specific risks**, including leverage risk, market risk, counterparty risk, liquidity risk and operational risk, as well as other risks that are applicable to a fund's derivatives transactions; and
 - **review and update the program at least annually**, including any models (including any VaR calculation models used by the fund during the period covered by the review), measurement tools or policies and

procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time. The Release states that an **annual review is a minimum requirement**, and that a fund should consider whether more frequent reviews are appropriate depending on the circumstances.

The Release suggests that the written policies and procedures to manage the risks of a fund's derivatives transactions might include portfolio tracking systems, exception reporting and other mechanisms designed to monitor derivatives risks and deliver current information to the relevant risk management personnel. The Release also notes that the management of derivatives risk could involve the evaluation of counterparties, maintenance of contingency plans and communication between derivatives risk management personnel and the fund's portfolio managers or board members.

Note: The Release does not make clear whether a fund that seeks to comply with the 50% limit but inadvertently violates its own policy would then be required to adopt a derivatives risk management program.

Note: The Release acknowledges that the 50% threshold does not distinguish between a fund that uses derivatives solely for hedging purposes and one that uses derivatives for a broader range of objectives.

Board Review, Approval and Oversight. The Release states that a fund's board would be responsible for general oversight of the derivatives risk management program, and notes that this responsibility would resemble the board's proposed oversight role described in the SEC's recent liquidity release (described [here](#)) relating to proposed Rule 22e-4. Proposed Rule 18f-4 would require a board, including a majority of the independent members, initially to approve each fund's derivatives risk management program, as well as any material changes thereto, to approve the designation (but not the compensation or removal) of the derivatives risk manager, and to review at least quarterly a written report from the derivatives risk manager concerning the adequacy and effectiveness of the program.

Note: The requirement that the board "review" a fund's derivatives management program is distinguishable from, and appears more demanding than, analogous board responsibilities under Rule 38a-1, which requires that the chief compliance officer "provide" a written report to the board at least annually concerning the adequacy and effectiveness of a fund's compliance policies and procedures.

VII. New Recordkeeping Requirements

The Proposed Rule would impose new requirements that require a fund to maintain records with respect to a variety of topics, including:

- determinations made by the fund's board that the fund will comply with one of the portfolio limitations under the proposed rule;
- policies and procedures approved by the board regarding the fund's maintenance of qualifying coverage assets;
- mark-to-market and risk-based coverage amounts and the fund's financial commitment obligations, which identify the qualifying coverage assets maintained by the fund to cover these amounts;
- evidence that immediately after entering into any senior securities transaction, the fund complied with the applicable portfolio limitation; and
- the fund's derivatives risk management program policies and procedures (if applicable), including any materials provided to the board in connection with its approval of the program, as well as any written reports provided to the board relating to the program.

VIII. Amendments to Proposed Forms N-PORT And N-CEN

The Release also includes amendments to proposed Forms N-PORT and N-CEN that would (i) require funds that must implement a formalized risk management program under Proposed Rule 18f-4 to report on Form N-PORT certain portfolio- and position-level risk metrics; and (ii) require all funds engaging in derivatives transactions to identify on Form N-CEN the portfolio limitation (either the exposure-based portfolio limitation or the risk-based portfolio limitation) on which the fund relied during the reporting period.