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Some Thoughts on the SEC's Re-Proposal of Rule 18f-4 and Proposed Sales Practices Rules

We asked the attorneys in our Asset Management Group to share their views on the SEC's much-anticipated re-proposal of Rule 18f-4 under the Investment Company Act of 1940 as well as its two new proposed sales practices rules relating to leveraged and inverse investment vehicles. We previously published a summary of the Rule and the sales practices rules and now would like to share some additional thoughts.

As a reminder, the Rule, very generally, would regulate the use of derivatives and other similar instruments by mutual funds, ETFs, closed-end funds, and business development companies. Some significant elements of the Rule include:

- Elimination of asset segregation requirements and rescission of Release 10666 and related Staff guidance;
- Requirement to appoint a derivatives risk manager and adopt a derivatives risk management program;
- Requirement to calculate and comply with limits on a fund's "value-at-risk";
- Requirement to combine reverse repurchase transactions with bank borrowings (and similar transactions) for purposes of calculating asset coverage under Section 18.

The Rule provides an exception from most of its requirements to "limited derivatives users."

It appears that the Commission and its Staff considered and responded to feedback provided by asset managers during the public comment process for the previous proposal. Our attorneys, and many of our clients for that matter, believe that a number of the Rule's provisions have been improved over the previous proposal, both in substance and in ease of administration. Below is some additional food for thought.

Who will serve as derivatives risk managers? What's a fund board to do?

The Rule requires a fund that uses derivatives on more than a limited basis to appoint a derivatives risk manager responsible for administering the fund's derivatives risk management program. The derivatives risk manager must have "relevant experience regarding the management of derivatives risk." A majority of the fund's board, including a majority of independent directors/trustees, must approve the designation of the derivatives risk manager, "taking into account the derivatives risk manager's relevant experience regarding the management of derivatives risk."

The SEC's Division of Economic and Risk Analysis ("DERA") estimates that approximately 22% of funds will be required to designate derivatives risk managers. Where will these managers come from? Presumably risk experts in the derivatives field are already gainfully employed in positions—like portfolio manager, quantitative analyst, or trader—that provide more attractive compensation and bonus opportunities than a mutual fund compliance role. And in any event, it's unclear what kinds of qualifications will be required. The Rule doesn't say what "relevant experience regarding the management of derivatives risk" means or what qualifications or experience the derivatives risk manager must possess—indeed, the Commission notes in the release accompanying the Rule that "any specification in the [R]ule of the specific experience required to serve as a derivatives risk manager likely would be over- or under-inclusive…." Is derivatives trading experience alone "experience regarding the management of derivatives risk"? Is general compliance or risk management experience sufficient? Does the person need quantitative analytical expertise or is procedural oversight sufficient? Depending on where the industry lands on these questions (assuming the Rule is adopted as proposed), this requirement might result in a mad dash for the relatively limited number of qualified candidates willing to

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take the position, especially in light of the Rule's limits on the ability of a fund's own portfolio manager to serve as derivatives risk manager. Compensation levels will potentially be exorbitant and not factored into the SEC's initial cost estimates. Some funds might be left out in the cold.

The Rule places fund boards in the middle of this potential scramble, since boards will need to approve the designation of derivatives risk managers. How will a board determine whether a candidate has "relevant experience regarding the management of derivatives risk"? Can a board rely on the investment adviser's recommendation? Should a board hire an outside consultant more familiar with management of derivatives risk, to help evaluate potential candidates? Can (or should) a board define its own criteria for consideration of candidates? Some commenters have argued that placing this responsibility on fund boards is in line with the approach taken recently by the Commission in other oversight rules, like Rule 22e-4 (the "Liquidity Rule"). But there's a big difference: under the Liquidity Rule, there is no similar requirement that boards take into account relevant liquidity risk experience in designating liquidity risk management program administrators. Additionally, whereas the investment adviser itself may be designated as the administrator of a liquidity risk management program under the Liquidity Rule, the investment adviser, which would have a high level of familiarity with the derivatives program and related risks, cannot be the derivatives risk manager under the Rule. The Liquidity Rule offers appropriate flexibility that, in our view, is currently lacking under the Rule and that the Commission might do well to add.

We expect funds and fund boards to push back on this requirement.

Board oversight

The Rule requires a fund that uses derivatives on more than a limited basis to adopt and implement a written derivatives risk management program, with policies and procedures reasonably designed to manage the fund's derivatives risks. A fund's board is required to oversee the fund's derivatives risk management on an ongoing basis, and the derivatives risk manager is required to provide periodic reports to the board regarding the program's implementation and effectiveness. The Commission states in the Rule's proposing release that:

Board oversight ***should not be a passive activity****. Consistent with that view, we believe that directors should* ***understand the program and the derivatives risks it is designed to manage*** *as well as participate in determining who should administer the program. They also should* ***ask questions and seek relevant information*** *regarding the adequacy of the program and the effectiveness of its implementation. The board should view oversight as* ***an iterative process****. Therefore, the board should* ***inquire about material risks*** *arising from the fund's derivatives transactions and* ***follow up*** *regarding the steps the fund has taken to address such risks, including as those risks may change over time. To facilitate the board's oversight, the [Rule]…would require the fund's derivatives risk manager to provide reports to the board. (emphasis supplied)*

This language appears to contemplate a level of board involvement in the derivatives risk management program that goes at least a step beyond the general oversight role historically played by boards and contemplated generally by the 1940 Act and prior rules. Still, the Rule's proposing release does not provide any real guidance as to how this role is to be fulfilled. Compare, for example, Rule 38a-1 under the 1940 Act, which requires a board to approve a fund's compliance program "based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund." In adopting that rule, the Commission expressly contemplated that a board could rely on third parties in making its determination and did not require a continuing "iterative" involvement by the board as part of the approval process. The Liquidity Rule also seems to call for far less board involvement, requiring initial approval of a liquidity risk management program, followed by an annual "review" of a report by the program administrator regarding the operation and effectiveness of the program. In adopting the Liquidity Rule, the Commission stated that "the final rule retains a role for the board in overseeing the fund's liquidity risk management program, but in response to commenters, eliminates certain of the more specific and detailed approval requirements." The Commission

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could make similar changes to the Rule instead of pushing boards into a direct oversight role of funds' derivatives use, a role to which they do not necessarily (nor should they be expected to) bring any special expertise.

The move to VaR-based limits

In a move likely to be welcomed by many industry participants, the Commission eliminated the previously proposed limit on funds' derivatives use based on gross notional exposure. The Rule instead requires a fund that engages in derivatives transactions to cap (at 150%) the extent to which the fund's "value-at-risk" (VaR) may exceed the VaR of an appropriate unleveraged reference index selected by the fund's derivatives risk manager (the "relative VaR test"). If the derivatives risk manager is unable to select an appropriate designated reference index, the VaR of the fund's portfolio may not exceed 15% of the fund's net asset value (the "absolute VaR test"). If a fund exceeds the applicable VaR test limit for three business days, the fund would need to report certain information to the Commission via Form N-RN (currently, Form N-LIQUID).

A VaR-based limit means that the extent to which any given fund may use derivatives may be affected by other, non-derivatives-related risks in its portfolio. For example, a fund with more concentrated holdings than its designated reference index could, in theory, approach (or exceed) 150% of its designated reference index's VaR without using *any* derivatives. This could present a new challenge to actively managed funds that make significant use of derivatives and seek to maintain a large "active share" relative to their benchmarks. Although DERA identified only six funds that would fail the relative VaR test based on the funds' currently disclosed primary benchmarks, it remains to be seen how current derivatives risk management practices and strategies of various funds will fare when VaR limits are in place.

Under the Rule, there is also no flexibility to select an absolute VaR test if a relative VaR test is available, meaning that a fund may only use the absolute VaR test if the derivatives risk manager determines that it is unable to identify an appropriate designated reference index. Does that make sense? The derivatives risk manager would appear to be in the best position to select which VaR test is appropriate for a particular fund. Instead of the proposed default to the relative VaR test if *any* appropriate designated reference index can be identified, the Commission could give derivatives risk managers the flexibility to choose which test to apply—based on the fund, its portfolio, and other circumstances.

Limited derivatives users

A fund would be able to rely on the limited derivatives user exception—and be exempt from requirements to adopt a comprehensive derivatives risk management program, designate a derivatives risk manager, and comply with VaR-based limits—if the sum of the notional amounts of its derivatives instruments and the value of any securities sold short does not exceed 10% of the fund's net assets ***or*** if the fund limits its use of derivatives exclusively to currency derivatives for hedging purposes.

Consider the following scenario: assume that an open-end fund invests 100% of its assets in securities and then borrows money with a value up to 50% of its net assets to invest in additional securities. This strategy would be entirely consistent with Section 18 and would not subject the fund to any special requirements or limits under the 1940 Act. Now, consider a different scenario: an open-end fund invests 100% of its assets in securities and then enters into a single, plain-vanilla total return swap providing additional long exposure to securities with a notional value of 11% of the fund's net assets. This strategy would subject the fund to the full panoply of the Rule's requirements. Over the years, the Commission has tied its authority to regulate derivative instruments to the 1940 Act's stated policy to limit "excessive borrowing." But, even though the fund would achieve the same economic ends under both scenarios, the Rule would subject a fund to substantial regulation under the second scenario, just for engaging in leverage activities through the use of a single total return swap (as opposed to borrowing). That makes little sense to us, and might even be seen to raise questions regarding the Commission's authority to impose such a low threshold for the exception. While it is understandable that the Commission would propose a simple and highly prophylactic minimum threshold that can be

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easily measured, it's far from clear that such a difference in regulatory outcomes between these two scenarios is justified. Raising the notional exposure threshold for the limited derivatives user exception to at least 50% of a fund's net assets would better align the Rule to the purpose of Section 18.

Some additional observations and potential issues raised by the limited derivatives user exception:

- The notional-based prong of the proposed exception does not allow a fund to adjust exposures to take into account netting arrangements, offsetting positions (including offsetting transactions entered into for the purpose of closing out or reducing exposures), or hedging or other risk-reducing transactions. At the very least, the limited user exception should account for netting arrangements, close-out transactions, and certain hedging transactions.

- Funds that use derivatives are required to include currency hedging transactions in calculating notional exposure, even though a fund that exclusively uses currency hedging transactions would be considered a limited derivatives user and would not be subject to most of the Rule's requirements. This means that if a fund using only currency derivatives to hedge currency risk adds a single interest rate swap to hedge the fund's interest rate exposure, and together those exposures exceed, by even a *de minimis* amount, 10% of the fund's NAV, the Rule applies in its entirety to the fund.

- A fund that limits derivatives to currency hedging (subject to certain conditions) may rely on the limited derivatives user exception. The Commission asks whether this hedging prong should be expanded to include interest rate or other types of hedging transactions. Given the extensive use of interest rate, credit, and other derivatives for hedging purposes among mutual funds, we expect that many commenters will favor an expansion of the hedging prong of the limited derivatives user exception.

- If a single fund in a complex doesn't meet one of the two prongs under the limited derivatives user exception, the Rule would apply in full to that one fund (but not the other funds in the complex). Would this consideration alone cause an investment adviser to move away from more than a *de minimis* amount of derivatives use for a particular fund, when it might not otherwise do so? Investment advisers would need to balance out the costs of hiring a derivatives risk manager and implementing (and maintaining) a derivatives risk management program for a single fund with the market demand for that fund.

Big changes for reverse repurchase agreements

Many complexes, and closed-end funds in particular, use reverse repurchase agreements as an efficient way to add leverage to their portfolios. Reverse repurchase agreements offer a flexible, cost-effective means to leverage a fund without, for example, the time, expense, and more permanent commitment of making a preferred share offering or entering into a bank loan. Currently, pursuant to long-standing practice based on guidance in Release 10666, a fund that enters into reverse repurchase agreements may avoid Section 18 senior security status by segregating liquid assets in an amount at least equal to the fund's obligation to repurchase the securities subject to the agreement, plus any accrued interest. In effect, a fund may enter into reverse repurchase agreements up to the amount of liquid assets it has available to segregate against them. And because such covered reverse repurchase agreements are not themselves senior securities, their use generally does not reduce the amount of a fund's net assets available to serve as asset coverage against senior securities (such as bank loans or preferred shares) under Section 18.

The revised Rule would greatly limit the ability of funds to leverage by using reverse repurchase agreements. It would treat reverse repurchase agreements like bank borrowings, subject to the more restrictive asset coverage requirements of Section 18, including the 300% asset coverage requirement. That treatment would limit both the amount of reverse repurchase agreements a fund may enter into in combination with "other" senior securities and the amount of assets a

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fund using reverse repurchase agreements has available to serve as asset coverage for senior securities under Section 18. The Commission justifies this approach by saying that reverse repurchase agreements "achieve effectively identical results" to those of bank borrowings. The same can be said about leverage provided by most derivatives, but the Rule doesn't apply any similar asset coverage requirement to them. Under the Rule, two funds achieving the same amount of leverage—one using reverse repurchase agreements, the other using total return swaps—would be treated very differently for purposes of Section 18 compliance. Adoption of this provision may force many funds, especially closed-end funds, to change fundamentally the way they obtain leverage and operate, following a long period of responsible and generally prudent risk-taking under Release 10666.

We expect funds to push back on this change so that reverse repurchase agreements will be treated under the Rule like other derivatives.

Implementation costs

Just to say it, compliance with the Rule would be expensive. The Commission estimates that one-time (initial) costs to establish and implement a derivatives risk management program would range from $70,000 to $500,000 *per fund*. Ongoing program-related costs are estimated at 65% to 75% of one-time (initial) costs, meaning an estimated $45,500 to $375,000 *per fund, each year*. And that doesn't take into account the effect of any run-up in compensation payable to derivatives risk managers due to the potential demand created by the Rule. For funds that rely on the limited derivatives user exception, estimated one-time (initial) costs are lower but still substantial, at $1,000 to $100,000 *per fund*, with ongoing program-related costs estimated at 65% to 75% of one-time (initial) costs, meaning an estimated $650 to $75,000 *per fund, each year*.

Intersection with the Liquidity Rule

Readers might recall that the Liquidity Rule requires a fund to identify on Form N-PORT the percentage of its highly liquid investments that it has segregated against non-highly liquid derivatives or that it has pledged as margin for such transactions. Many funds have found that identifying this amount can present operational challenges. Because the Rule would dispense with the asset segregation framework in place since the publication of Release 10666, funds presumably will no longer segregate assets to cover derivatives transactions and the related Form N-PORT reporting requirement will go away (though funds would still be required to report pledged margin).

On leveraged and inverse products

The Commission also proposed two new sales practices rules relating to leveraged and inverse investment vehicles. These rules would generally prohibit both investment advisers and broker-dealers from accepting an order from a retail investor to buy or sell a leveraged or inverse investment vehicle unless the investment adviser or broker-dealer has approved the investor's account to engage in such transactions, based on an assessment of the investor's ability to evaluate the risks of investing in such vehicles. Patterned to a large extent on an existing FINRA rule for options investing, these rules may signal a new regulatory approach for the Commission—reflecting a view that certain securities, even though registered for public offering under the Securities Act of 1933, may not be appropriate for sale to all retail investors. The federal securities laws regulating the public offering of securities have historically, in theory if not always in practice, been a disclosure-based system: if the disclosure related to a securities offering is complete and not misleading, it is not the role of the Commission to dictate who may buy the securities. The proposed rules add a new gate-keeping function on top of the traditional disclosure-based system and are interesting because the Commission appears to be saying—uniquely as to leveraged and inverse products—that, no matter how complete the issuer's disclosures may be, there may be some investors who should not buy the products. The proposed rules suggest the possibility of more substantive rule-based regulation of public offerings by the Commission than we have seen historically. We expect a good amount of pushback during the comment phase.

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We welcome additional observations or reactions to our thoughts. Please feel free to reach out to your usual Ropes & Gray client team should you wish to discuss the matters raised in this Alert or if you have any other questions regarding the Rule.

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