

# **NEW SEC RULE WILL REGULATE REGISTERED FUND INVESTMENTS IN DERIVATIVES**

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## NEW SEC RULE WILL REGULATE REGISTERED FUND INVESTMENTS IN DERIVATIVES

On October 28, 2020, the US Securities and Exchange Commission (SEC) voted 3–2 to adopt Rule 18f-4 (the Rule) under the Investment Company Act of 1940 (the Investment Company Act), which will replace decades-old SEC and staff guidance with an updated, comprehensive framework for registered funds' use of derivatives.<sup>1</sup> The Rule, which applies to mutual funds (other than money market funds), exchange-traded funds (ETFs) registered under the Investment Company Act, and registered closed-end funds, as well as business development companies (collectively, Funds),<sup>2</sup> responds to growth in the use, complexity, and variation of derivative instruments, and stands to substantially change the compliance and operations landscapes for Funds and their boards of directors or trustees (Boards).

### KEY TAKEAWAYS

- Funds won't have to comply with the Rule for at least 20 months (and probably 21–22 months, depending on the *Federal Register* publication schedule), but many Funds may need a significant portion of that time to build a compliance infrastructure necessary to comply with the Rule by fall 2022.
- Funds that use derivatives to a limited extent (i.e., 10% or less of net assets, excluding currency and interest rate hedges) will have to adopt written risk management programs, but will not be required to comply with the more onerous elements of the Rule.
- All other Funds must designate a derivatives risk manager (which can be an individual or a group of persons) to administer a Derivatives Risk Management Program.
- Derivatives Risk Management Programs could be a substantial buildout for existing compliance structures at many Funds, and will require risk assessments and guidelines, as well as stress testing, backtesting, Board reporting and escalation, and program review elements.
- Boards will not be required to approve risk programs, but will be required to approve the derivatives risk manager and will receive periodic reports about the program.
- Permitted levels of investment in derivatives will be subject to either a relative Value-at-Risk test based on a designated reference portfolio, or an absolute Value-at-Risk test, with at least daily compliance testing.
- Leveraged and inverse Funds will be permitted, but effectively will be limited to 200% Value-at-Risk, and an expansion of the ETF Rule (Rule 6c-11) that the SEC simultaneously adopted will permit new leveraged and inverse ETFs to come to market if they comply with the Rule.
- Leveraged and inverse Funds currently in the market that exceed 200% Value-at-Risk will be permitted to continue, subject to certain conditions, but the SEC is further considering

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<sup>1</sup> Although the Rule does not define "derivative," it defines "derivative transactions" as (1) any swap, security-based swap, futures contract, forward contract, or 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; (2) any short sale borrowing; and (3) for applicable Funds, any reverse repurchase agreement or similar financing transaction if the applicable Fund elects to treat them as such.

<sup>2</sup> The Rule does not apply to exchange-traded products that are not registered under the Investment Company Act, such as exchange-traded commodity pools and exchange-traded currency funds.

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whether additional measures are needed to protect investors who invest in these Funds, particularly in the context of retail investors.<sup>3</sup>

- The SEC did not adopt the sales practice rules that were proposed in November 2019 for inverse and leveraged Funds, which would have applied to intermediaries recommending such Funds to retail investors.
- Funds will be permitted to treat reverse repurchase agreements and similar financing transactions as derivatives for purposes of the Rule, or can subject those transactions to the asset coverage requirements of Section 18.
- Unfunded commitments and forward-settling transactions will be regulated by the Rule.
- The SEC did not adopt asset segregation requirements, such as the mark-to-market coverage and risk-based coverage amounts proposed in December 2015.

## BACKGROUND

Although the Investment Company Act does not specifically regulate investments in derivatives, Section 18 of the Investment Company Act does impose limitations on the ability of registered closed-end and open-end funds to issue or sell “senior securities.”<sup>4</sup> The SEC has long applied these limitations on “senior security” transactions to derivative-like investments, beginning with a 1979 General Statement of Policy that provided guidance on how a registered fund could avoid creating a prohibited “senior security” for purposes of Section 18.<sup>5</sup> However, as derivative products and practices evolved beyond those identified in Release 10666, it became more difficult for Funds and the SEC to evaluate compliance with Section 18.

In 2011, the SEC issued a Concept Release to solicit comments on a broad range of topics relating to the use of derivatives by registered investment companies in connection with a comprehensive review by the SEC and its Staff.<sup>6</sup> In 2015, the SEC voted 3–1 in favor of proposing Rule 18f-4.<sup>7</sup> After receiving approximately 200 comment letters in response to the 2015 Release—which largely criticized the proposal as being too onerous to implement—and after subsequent Staff engagement with large and small fund complexes and investor groups, the SEC re-proposed Rule 18f-4 in November 2019.<sup>8</sup> The final Rule retains each element of the version of the rule that was proposed in November 2019, only slightly modified based on additional comments received, and is intended to be flexible enough that it can be tailored by various fund complexes to suit their structure, and not become outdated as derivatives markets continue to evolve.<sup>9</sup>

In this White Paper, we provide an overview of the critical components of the Rule, specifically the Derivatives Risk Management Program and compliance with the new limits on the amount of leverage-related risk. We discuss the impact of the Rule on Funds that conduct few or no transactions in

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<sup>3</sup> See Chairman Jay Clayton; Dalia Blass, Director, Division of Investment Management; William Hinman, Director, Division of Corporation Finance; Brett Redfearn, Director, Division of Trading and Markets, [Joint Statement Regarding Complex Financial Products and Retail Investors](#) (Oct. 28, 2020).

<sup>4</sup> Section 61 of the Investment Company Act imposes similar limitations on business development companies.

<sup>5</sup> See Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 (Apr. 18, 1979) (Release 10666).

<sup>6</sup> See Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Rel. No. 29776 (Aug. 31, 2011) (Concept Release).

<sup>7</sup> See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 31933 (Dec. 11, 2015) (2015 Release).

<sup>8</sup> See 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, Investment Company Act Rel. No. 33704 (Nov. 25, 2019) (Proposing Release).

<sup>9</sup> See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 34078 (Oct. 28, 2020) (Adopting Release).

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derivatives. And we also summarize the Rule's treatment of special instruments (such as reverse repurchase agreements and unfunded commitments) and leveraged and inverse Funds. Also of note are those aspects of the Proposing Release relating to sales practice rules with respect to leveraged and inverse products, which the SEC notably did not adopt. Finally, we will note the Rule's attendant reporting obligations, the status of existing guidance, compliance dates, and next steps.

## **DERIVATIVES RISK MANAGEMENT PROGRAM**

To take advantage of the exemptive relief from Section 18 offered by the Rule, Funds that engage in transactions covered by the Rule must develop and implement a written Derivatives Risk Management Program (DRM Program). Unlike liquidity risk management programs required by Rule 22e-4 under the Investment Company Act, a Fund's Board will *not* be required to approve the DRM Program. Although the SEC noted in the Adopting Release that Funds should tailor their DRM Programs based on their use of derivatives, every DRM Program must, at a minimum, include the following seven elements.

### **1. DRM PROGRAM ADMINISTRATION**

As part of its DRM Program, a Fund's Board, including a majority of those directors or trustees who are not interested persons of the Fund, is required to appoint a derivatives risk manager for the Fund. The derivatives risk manager will be responsible for the administration of the DRM Program and is required to provide regular written reports to the Board. Such written reports must be provided at or before the implementation of the DRM Program and at least annually thereafter, but may be provided on a more frequent basis as deemed appropriate by the derivatives risk manager. Furthermore, the derivatives risk manager is also required to provide the Board, at a frequency determined by the Board, with written reports analyzing instances where a Fund exceeded its risk guidelines as well as the results of stress testing and back testing. Such reports must include information reasonably necessary for the Board to evaluate the Fund's response to such instances and the results of such testing.

The derivatives risk manager must be an officer or officers of the Fund's investment adviser. If a single person serves as a Fund's derivatives risk manager, such person may not be a portfolio manager for the Fund. However, if the derivatives risk manager is structured as a committee of multiple officers, then portfolio managers may be appointed to such committee, so long as a majority of the persons are not portfolio managers of the Fund. The SEC considered comments in support of allowing a third party to serve as a Fund's derivatives risk manager, but declined to adopt such an approach, noting that only an officer of a Fund's investment adviser would have a sufficient amount of authority within the adviser to carry out the responsibilities of the derivatives risk manager.

The derivatives risk manager must have relevant experience regarding the management of derivatives risks. This requirement is designed to provide flexibility such that the derivatives risk manager may have experience that is relevant in light of the derivatives risks unique to the Fund. The SEC declined to outline specific types of experience that would satisfy this requirement, deeming such an exercise impractical given the wide variety of different approaches taken by Funds with respect to the use of derivatives.

Although the derivatives risk manager must be an officer of the Fund's investment adviser, certain derivatives risk management activities—such as performing risk identification and risk assessment, conducting stress tests and backtesting, and monitoring the DRM Program's risk guidelines—may be delegated to other employees of the Fund's adviser, a Fund's sub-adviser or appropriate personnel thereof.

### **2. RISK IDENTIFICATION AND ASSESSMENT**

The DRM Program must be designed to provide for the identification and assessment of a Fund's derivatives risks. This assessment must take into account the Fund's derivatives transactions and other investments. In the Adopting Release, the SEC noted its belief that a comprehensive assessment of a Fund's derivative investments, including the purpose of derivatives transactions (e.g., to speculate or to

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gain exposure), and how those derivatives transactions interact with or compliment (e.g., hedging) the Fund's other investments.

Furthermore, the Rule identifies the following derivatives risks that must be identified and managed by a Fund's DRM Program: (1) leverage risk, (2) market risk, (3) counterparty risk, (4) liquidity risk, (5) operational risk, and (6) legal risk. Although the risks identified by the Rule are common to most derivatives transactions, the list is not exhaustive and the DRM Program should identify and assess any additional risks within the context of the Fund's use of derivatives.

## 3. RISK GUIDELINES

The Rule also requires that Funds establish, maintain, and enforce investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds related to a Fund's derivatives risks, such as investment size limits or lists of approved counterparties, transactions, or instruments that may be used by the Fund. These guidelines should specifically state the level of a given criteria or threshold that the Fund does not typically expect to exceed and the corrective measures to be taken in the event that they are exceeded. The Rule does not impose specific risk limits for the guidelines, but, instead, requires Funds to adopt guidelines that are specifically tailored to the derivatives risks of the Fund.

## 4. STRESS TESTING

Under the Rule, a DRM Program must provide for stress testing designed to evaluate the potential losses to the Fund's portfolio under stressed market conditions. The stress tests should anticipate potential losses resulting from extreme, but plausible, market conditions or market changes that would have a significant adverse effect on the Fund's portfolio. Stress testing must be conducted no less frequently than weekly, but the frequency of such testing should be determined by taking into account the Fund's investment strategy and current market conditions. The SEC noted in the Adopting Release that more frequent testing may be appropriate during periods of increased market stress or for a Fund whose investment strategy involves high portfolio turnover. Accordingly, DRM Programs will not only need to include detailed stress testing provisions, but also a process for assessing the adequacy of stress testing frequency, including whether changed market circumstances dictate more frequent stress testing.

## 5. BACKTESTING

In addition to stress testing, the Rule also requires a DRM Program to backtest the results of the Value-at-Risk (VaR) calculation model used by the Fund in connection with the relative or absolute VaR, as applicable (as further discussed later on).<sup>10</sup> To satisfy the backtesting requirement under the Rule, a Fund must compare, on a weekly basis, its actual gain or loss for each business day with the VaR calculated for that day. The Fund must identify as an exception any instance in which the Fund experienced a loss exceeding the corresponding VaR's estimate loss. The results of backtesting, and any exceptions noted therein, should be communicated to a Fund's Board through the derivatives risk manager's regular reports to the Board.

Additionally, because the backtesting requirement is intended to allow Funds to validate their VaR models, consistent or repeated exceptions should inform a derivatives risk manager's evaluation of the effectiveness of the VaR model and determine the necessity of any adjustments thereto. Although every business day must be covered by a backtest, Funds would not need to run such backtests more frequently than weekly, unless the derivatives risk manager determines to run backtests more frequently.

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<sup>10</sup> Under the Rule, Value-at-Risk, or VaR, is defined as the estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's assets (or net assets when computing a Fund's VaR), over a specified time horizon and at a given confidence level. The Rule requires that any VaR model used by a Fund for purposes of determining the Fund's compliance with its VaR test must (1) take into account and incorporate all significant, identifiable market risk factors associated with a Fund's investments; (2) use a 99% confidence level and a time horizon of 20 trading days; and (3) be based on at least three years of historical market data.

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In determining the frequency of backtesting, the derivatives risk manager may consider market trends, whether markets are stressed, or additional risk factors as deemed appropriate.

## 6. INTERNAL REPORTING AND ESCALATION

Under the Rule, a DRM Program must include mechanisms for internal reporting and escalation. Specifically, the DRM Program must address the circumstances under which portfolio managers will be informed of risk guidelines having been exceeded and the results of stress testing. In the Adopting Release, the SEC highlighted the importance of communication between the Fund's portfolio managers and the Fund's derivatives risk manager. Furthermore, the derivatives risk manager is responsible for informing the Fund's Board of material risks arising from the Fund's derivatives use, including instances where risk guidelines are exceeded and risks indicated by stress testing. The SEC declined to set an explicit standard for the escalation of material risks to the Fund's Board, noting only that the derivatives risk manager must escalate such material risks "as appropriate" and do so in a "timely manner." This general approach was likely intentional so that fund complexes can implement DRM Programs that are tailored to their unique circumstances, but it may be an area where additional guidance from the Staff, perhaps through an FAQ related to the Rule, could be helpful.

## 7. PERIODIC REVIEW OF THE PROGRAM

Finally, the derivatives risk manager must review the DRM Program at least annually to evaluate the DRM Program's effectiveness and to implement changes to the DRM Program based on changes to the Fund's derivatives risks over time. Although the review must apply to the DRM Program as a whole, the SEC specifically noted that periodic review must include a review of the Fund's VaR calculation model and any designated reference portfolio to evaluate whether it remains appropriate.

## LEVERAGED-RELATED RISK: VALUE-AT-RISK

Consistent with the November 2019 proposal, the Rule limits Fund leverage risk based on a Fund's VaR. A Fund relying on the Rule to engage in derivatives transactions must satisfy a "relative VaR test," which requires that the Fund's VaR from its derivatives exposure not exceed 200% of the VaR of a designated reference portfolio.<sup>11</sup> For purposes of the relative VaR test, a designated reference portfolio may be either an index that meets certain requirements or, for an actively managed Fund, the Fund's own securities portfolio, excluding derivatives transactions.<sup>12</sup> The purpose of the relative VaR test is to measure how much additional risk is created by a Fund's investments in derivatives compared to an index or a portfolio that does not include derivatives. Commenters noted that such a "securities VaR" option would be appropriate where a Fund's portfolio differs from its benchmark index so significantly that the Fund's own nonderivative securities would be a better representation of the Fund's unleveraged portfolio. However, like the Proposing Release, the Adopting Release acknowledged that there may be instances in which the relative VaR test is impractical, given the nature of a Fund's portfolio.<sup>13</sup> To accommodate these situations,

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<sup>11</sup> The Rule defines the term "derivatives exposure" to mean the sum of (1) the gross notional amounts of a fund's derivatives transactions such as futures, swaps, and options; and (2) in the case of short sale borrowings, the value of any asset sold short. If a fund chooses to treat reverse repurchase agreements or similar financing transactions as derivatives, the fund must also include when calculating its derivatives exposure the proceeds the fund has received but has not yet repaid or returned in connection with each such transaction. In the case of a closed-end fund that has outstanding shares of a senior security that is a stock, the fund's VaR may not exceed 250% of the VaR of a designated reference portfolio for purposes of the relative VaR test.

<sup>12</sup> The Rule sets forth several requirements with respect to indexes that serve as designated reference portfolios. An index must be unleveraged and approved by the derivatives risk manager. An index must also reflect the markets or asset classes in which the Fund invests, and cannot be administered by an affiliated person of the Fund, fund manager, or distributor. An index also cannot have been created at the request of the Fund or fund manager, unless it is widely recognized and used. Although a blended index may serve as a designated portfolio index, none of the underlying indexes may be administered by an affiliated person of the Fund, fund manager, or distributor, and none of the underlying indexes may have been created at the request of the Fund or fund manager, unless the underlying index is widely recognized and used.

<sup>13</sup> For example, the Adopting Release states that, where a fund makes frequent changes to its allocation of assets across markets and asset classes, it may be impractical to change the index that is used as the designated reference portfolio with equal



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the Rule states that where a Fund's derivatives risk manager reasonably determines that neither an index nor the Fund's securities portfolio would provide an appropriate reference portfolio for purposes of the relative VaR test, the Fund may instead employ an "absolute VaR test" that limits the Fund's VaR to 20% of its net assets.<sup>14</sup>

The relative and absolute VaR limits in the Rule are less onerous than the November 2019 proposal. Whereas the November 2019 proposal would have limited the relative VaR test to 150% and the absolute VaR test to 15%, the Rule increased these limits to 200% and 20%, respectively. Commenters reasoned, and the SEC agreed, that increasing the relative VaR limit was appropriate because factors other than derivatives and leverage can cause a Fund's VaR to exceed its limit, and a higher limit would help ensure that factors other than leverage risk would not be the reason that a Fund would exceed its VaR limit. The SEC similarly agreed with commenters' recommendations to make a commensurate increase to the absolute VaR limit because, as the Adopting Release noted, the relative and absolute VaR tests are intended to provide approximately comparable treatment among Funds, and also because raising the absolute VaR limit from 15% to 20% would achieve regulatory and compliance efficiencies by aligning with the 20% absolute VaR limit that applies to UCITS funds, which many fund managers offer in overseas markets and manage alongside their US-registered Funds.

The Adopting Release also clarified other elements of the Rule based on comments on the November 2019 proposal, as follows.

## **INDIRECT INVESTMENTS**

The Adopting Release clarified that Funds that invest in other funds (i.e., funds of funds) need only comply with the Rule if the Fund itself directly engages in derivatives transactions, and need not look through to the holdings of its underlying funds. The SEC acknowledged that calculating a fund of funds' VaR on a look-through basis would present challenges where the underlying funds did not provide daily transparency of their portfolios. Where a fund of funds both holds underlying fund interests and enters into its own derivatives transactions in excess of 10% of its net assets, the SEC stated that the fund of funds may meet its VaR obligations under the Rule by calculating the VaR with reference to the historic returns of the underlying funds, rather than aggregating the VaR of the underlying funds. The SEC noted, however, that it does not believe it would be appropriate for a fund of funds to use its own historic return for calculating VaR. Finally, where a Fund enters into derivatives transactions indirectly through controlled foreign corporations, the SEC noted that such derivatives transactions would be treated as direct investments of the Fund for purposes of Section 18 and the Rule.

## **USE OF VaR VERSUS ALTERNATIVES**

Commenters asked whether a metric other than VaR might be more effective in measuring derivatives risk, given that VaR is calculated at a "confidence level" that estimates losses in a given percentage of scenarios and does not estimate a portfolio's maximum losses in every scenario. For example, a VaR of \$100 calculated at a 99% confidence level indicates that, in 99% of scenarios, the portfolio in question would not be expected to lose more than \$100. In the 1% of scenarios not reflected in the VaR, however, losses could exceed \$100, perhaps substantially. To account for this small risk of significant loss, commenters suggested alternative means of measuring risk in periods of stress.

The SEC opted to retain VaR instead of the proposed alternatives because, unlike the alternatives, VaR is a widely recognized metric that "enables risk to be measured in a reasonably comparable and consistent manner" across investment types.

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frequency. Similarly, the Adopting Release notes that where a fund obtains investment exposure through a combination of cash-market investments and derivatives transactions, the exclusion of the derivatives transactions for purposes of the relative VaR test would result in a designated reference portfolio that does not accurately reflect the markets or asset classes in which the fund is actually invested, and is therefore inappropriate as the basis of comparison for purposes of the relative VaR test.

<sup>14</sup> In the case of a closed-end fund that has outstanding shares of a senior security that is a stock, the fund's VaR may not exceed 25% of net assets for purposes of the absolute VaR test.

## **RELATIVE VAR AS DEFAULT TEST**

Commenters urged the SEC to consider removing the requirement in the November 2019 proposal that the relative VaR test be the default means of limiting leverage risk, with the absolute VaR test available only where a derivatives risk manager is “unable to identify” an appropriate index for purposes of performing the relative VaR test. Commenters noted that both the relative and absolute VaR tests would protect investors, and that the lack of clarity on what it means for a derivatives risk manager to be “unable to identify” an appropriate index could pose compliance and regulatory challenges for Funds seeking to use the absolute VaR test.

The SEC noted that retaining the relative VaR test as the default would prevent Funds from favoring the absolute VaR test where the relative VaR test would reflect a significantly higher level of leverage risk, thereby limiting their ability to invest in derivatives more so than the absolute VaR test might. The SEC addressed commenters’ other primary concern—ambiguity about when a derivatives risk manager is deemed “unable to identify” an appropriate index—by replacing this language with a standard allowing the absolute VaR test to be used when a derivatives risk manager “reasonably determines,” after taking into account the Fund’s investments, investment objectives, and strategy, that a designated reference portfolio would not provide an appropriate reference for purposes of the relative VaR test.

## **NO EXEMPTION FOR FUNDS LIMITED TO CERTAIN INVESTORS**

A number of commenters argued that the Rule should exempt Funds that limit their investors to “qualified clients” as defined in Rule 205-3 under the Advisers Act and/or are sold exclusively to “qualified clients,” “accredited investors,” or “qualified purchasers.” Commenters reasoned that the Rule is not necessary to protect such investors because they are sophisticated enough to appreciate the risks of derivatives investments. The SEC declined to add an exemption of this type, noting that if a Fund has limited its investor base in this way, it typically would be able to avoid the requirements of the Rule by qualifying for an exclusion from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

The Rule requires a Fund to determine compliance with the applicable VaR test at least once each business day. If a Fund falls out of compliance with its VaR test and does not come back into compliance within five business days, the derivatives risk manager must submit a written report to the Fund’s Board explaining how and when the Fund will come back into compliance. The derivatives risk manager must also consider whether to update the DRM Program in light of the circumstances that caused the VaR breach, and must submit a report to the Board within 30 calendar days of the breach explaining how the breach occurred and how it was resolved or, if the breach is ongoing, how and when it will be resolved, and also identifying any enhancements made to the DRM Program.

In addition to these internal remediation requirements, a Fund that does not come back into compliance with its VaR limit within five business days will also be required to file a nonpublic report to the SEC on Form N-RN. In a change from the November 2019 proposal, however, the Rule does not prohibit a Fund from engaging in additional derivatives transactions during the period that it is out of compliance with its VaR limit.

## **FUNDS THAT USE DERIVATIVES ON A LIMITED BASIS**

Under the Rule, a Fund that only uses derivatives on a limited basis will be excepted from the DRM Program, the VaR-based limits, and Board requirements. To rely on the exception, a Fund would have to limit its derivatives exposure to 10% of its net assets, where the Fund’s derivatives exposure would be calculated by using absolute values and gross notional amounts, with certain adjustments and exclusions. Additionally, any Fund relying on the limited user exception will be required to adopt and implement written policies and procedures reasonably designed to manage the Fund’s derivatives risks. As stated in the Adopting Release, the SEC believes, based on the Staff’s analysis of Form N-PORT filings as of September 2020, approximately 79% of all Funds have adjusted notional amounts below 10%, with 60%



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of Funds having no derivatives exposure and 19% of Funds likely to qualify as limited derivatives users.<sup>15</sup> Accordingly, many Funds should be able to avail themselves of the Rule's exception.

When calculating a Fund's derivatives exposure under the exception, a Fund may use certain adjustments and exclude certain amounts. First, a Fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents.<sup>16</sup> Second, a Fund may delta-adjust the notional amounts of options contracts.<sup>17</sup> Third, a Fund may exclude closed-out derivatives positions, so long as the positions are closed out with the same counterparty and result in no credit or market exposure to the Fund. This is intended to allow for the netting of offsetting derivatives transactions, given that Funds sometimes exit existing derivatives positions by entering into offsetting positions, thereby eliminating the Fund's market exposure.

Finally, and in a significant change from the November 2019 proposal, when calculating its derivatives exposure a Fund may exclude currency and interest rate derivatives used to hedge currency and interest rate risks, respectively, associated with a Fund's specific equity or fixed-income investments.<sup>18</sup> To be excluded from a Fund's derivatives exposure, the notional amounts of such derivatives may not exceed the value<sup>19</sup> of the hedged instruments by more than 10% and, for currency hedges only, the equity or fixed-income investment being hedged must be foreign-currency denominated.<sup>20</sup>

A Fund relying on the limited derivatives user exception must ensure that its derivatives exposure does not exceed 10% of net assets. If a Fund relying on the exception exceeds the 10% threshold for five business days after the initial threshold breach, the Rule requires the Fund's investment adviser to prepare a written report to the Fund's Board stating that the investment adviser intends to either (1) reduce the Fund's derivatives exposure to comply with the exception within 30 days, or (2) no longer rely on the exception and comply with the full provisions of the Rule as soon as reasonably practicable. Although the five-day period before reporting to the Board provides some flexibility, the SEC noted in the Adopting Release that a Fund's compliance policies and procedures should be designed to prevent repeated instances of a Fund exceeding the 10% net asset level. If a Fund were to exceed the 10% threshold repeatedly, and particularly if those instances occurred over a long period of time and did not occur in connection with extreme market events, the Fund would not appear to be using derivatives in a limited manner as intended by the exception.

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<sup>15</sup> Although business development companies (BDCs) do not file Form N-PORTs, the Staff reviewed financial statements of 48 BDCs and found that 59.1% did not report derivative holdings and a further 31.8% reported using derivatives with gross notional amounts below 10% of net assets.

<sup>16</sup> Although the Adopting Release does not describe how to convert the notional amount of interest rate derivatives to 10-year bond equivalents, the adjustment typically would be made in the market by dividing the duration of the interest rate derivative by that of a 10-year equivalent position and applying this conversion factor to the unadjusted notional amount.

<sup>17</sup> Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta-adjust an option by multiplying the option's unadjusted notional amount by the option's delta.

<sup>18</sup> This exclusion is one of the most significant changes to the limited derivatives users exception from the November 2019 proposal, which only allowed two mutually exclusive bases: (1) maintaining derivatives exposure to less than 10% of net assets; or (2) limiting derivatives use solely to currency hedging transactions. Several commenters were concerned that, under the November 2019 proposal, a Fund with currency derivatives exposure exceeding 10% of its net assets would be unable to use a single derivative for any other purpose while remaining a limited derivatives user. Additionally, certain commenters also successfully asserted that interest rate hedging is conceptually the same as currency hedging. In response to those comments, the final Rule allows Funds to exclude currency and interest rate hedges when calculating derivatives exposure under the exception.

<sup>19</sup> In the case of fixed-income investments, the "value" would be the par value. In the case of borrowings, the "value" would be the principal amount.

<sup>20</sup> The SEC noted in the Adopting Release that funds may take a "look through" approach with respect to American depositary receipts (ADRs) and look to the underlying foreign security for purposes of identifying currency hedges.

## SPECIAL INSTRUMENTS

The Rule also has implications for Funds' use of reverse repurchase agreements, similar financing transactions, and unfunded commitment agreements. Generally, the Rule permits Funds (including money market funds) to invest in these instruments, but lays out certain conditions and obligations that Funds must follow to do so. Funds can enter into reverse repurchase agreements or similar financing transactions if they either meet the relevant asset coverage requirements of Section 18 of the Investment Company Act for senior securities representing indebtedness, or elect to treat such arrangements as derivatives transactions for all purposes of the Rule. The Rule gives Funds flexibility to choose the approach that is best suited to their investment strategy and operational needs.

The SEC explained that reverse repurchase agreements<sup>21</sup> and similar financing transactions<sup>22</sup> are common methods of obtaining financing and are economically equivalent to bank borrowings or other borrowings. Accordingly, the SEC believes it is appropriate to allow Funds to engage in reverse repurchase agreements, but to treat them equally to bank borrowing. This position is a departure from the asset segregation approach of Release 10666, which viewed reverse repurchase agreements as separate from the limitations established on bank borrowings by the asset coverage requirements of Section 18. However, in response to comments on the November 2019 proposal, as well as concerns that use of reverse repurchase agreements beyond the asset coverage limits of Section 18 raises the same issues that prompted the adoption of the Rule in the first place, the Rule will allow a Fund to choose instead to treat such transactions as derivatives transactions under the Rule for all purposes. A Fund will be able to choose which approach to take based on its particular circumstances, but the election will apply to all of its reverse repurchase agreements or similar financing transactions. Which choice a Fund elects will likely depend on the extent to which the Fund is otherwise engaged in borrowings under Section 18 or otherwise uses derivatives. A Fund can change the approach it takes, but is required to memorialize that choice and any changes on its books and records and to maintain that record for five years.

The Rule also permits a Fund to enter into unfunded commitment agreements<sup>23</sup> if the Fund reasonably believes,<sup>24</sup> at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to such agreement. The SEC noted in the Adopting Release that unfunded commitments generally do not involve leverage and the other risks associated with derivative transactions. The Rule requires that a Fund, when forming its reasonable belief, take into account its reasonable expectations with respect to other obligations, including any obligation with respect to senior securities or redemptions. A Fund cannot take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those instruments, and cannot consider cash that may become available from issuing additional equity.<sup>25</sup>

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<sup>21</sup> In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage value of the security and agrees to repurchase the transferred security at a later date by paying an amount equal to the proceeds of the initial sale transaction plus interest.

<sup>22</sup> The SEC indicated that under the Rule "similar financing transactions" would include, among other things, a fund engaging in securities lending and investing the cash collateral in securities other than cash or cash equivalents.

<sup>23</sup> The Rule defines an unfunded commitment as "a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."

<sup>24</sup> It is somewhat unclear in the Adopting Release and the text of the Rule who at the "Fund" must hold this reasonable belief. The Rule requires that the basis for this reasonable belief must be documented for each such transaction, which, together with the scope of information required in such documentation, would imply that the Fund manager (or an officer thereof) must hold this reasonable belief, and not the Board. Nonetheless, this is an item that the Staff may consider clarifying through additional guidance.

<sup>25</sup> The Rule does not preclude a Fund from considering the issuance of debt in forming its reasonable belief because such borrowings would be limited by the asset coverage requirements of Section 18.

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As examples of items that could contribute to a reasonable belief, the SEC indicated that a Fund could consider its strategy, its assets' liquidity, its borrowing capacity under existing lines of credit, and the contractual provisions of its unfunded commitment agreements, and the Fund's historical experience with comparable obligations, among other factors. Unfunded commitment agreements entered in compliance with the Rule's provisions will not be considered for computing the asset coverage limitations of Section 18.

The Rule also clarifies that Funds (as well as money market funds) may invest in when-issued or forward-settling instruments, as well as instruments that settle on a nonstandard settlement cycle, without such transactions being deemed to involve a "senior security" for Section 18 purposes, provided that (1) a Fund intends to physically settle the transactions, and (2) the transaction will settle within 35 days of the trade date.

## **LEVERAGED AND INVERSE FUNDS**

In addition to adopting the Rule, the SEC amended Rule 6c-11 under the Investment Company Act to permit ETF sponsors to offer products with leverage exposures at or below 200% without the need to obtain an exemptive order; provided, however, that such leveraged or inverse ETFs also comply with the applicable provisions of Rule 18f-4. Prior to the amendments, Rule 6c-11 excluded leveraged and inverse ETFs and only two ETF sponsors currently rely on exemptive relief permitting them to operate such products in ETF form. In amending Rule 6c-11, the SEC stated that it believes Rule 6c-11 should no longer exclude leveraged or inverse ETFs because they are similar in structure and operation to the other ETFs currently within the scope of Rule 6c-11. In connection with this amendment to Rule 6c-11, 18 months after the Rule's effective date, the SEC will rescind the exemptive orders previously issued to sponsors of leveraged or inverse ETFs.

New leveraged or inverse ETFs, which will now be allowed to rely on Rule 6c-11, also will be subject to Rule 18f-4, including the VaR-based limit on Funds' leverage risk. As a result, the limit of leveraged or inverse ETFs' targeted daily return will be limited to 200% of the return (or inverse of the return) of the ETFs' underlying index. Funds in operation as of October 28, 2020 that seek an investment return in excess of 200% of the return (or inverse of the return) of the ETFs' underlying index will be grandfathered in and will not have to comply with the VaR requirement. The SEC believes this will allow such Funds to continue to operate in their current form, but will prohibit them from changing their index or increasing the amount of their leveraged or inverse market exposure. The Rule also requires such a Fund to disclose in its prospectuses that it is not subject to the Rule's limit on leverage risk if it provides leveraged or inverse market exposure exceeding 200% of the return or inverse return of the relevant index. The parallel amendment to Rule 6c-11 represents a significant market opportunity for new product offerings in the ETF space.

In a departure from the November 2019 proposal, the SEC determined not to adopt the proposed sales practice rules, or a proposed exception from the leverage risk limit that was predicated on broker-dealers' and investment advisers' compliance with sales practice rules. In November 2019, the SEC had proposed new rules under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, which would have required broker-dealers, investment advisers, and their associated persons to exercise due diligence before accepting or placing orders for a leveraged/inverse investment vehicle on behalf of a retail investor (which the SEC would have defined as all natural persons, including high-net-worth individuals and nonprofessional legal representatives of natural persons). The proposed sales practices rules resembled FINRA Rule 2360 governing options and would have, for the first time, established a sales practice rule for investment advisers. Under the proposed sales practices rules, a broker-dealer or investment adviser would have only been able to approve retail investors for transacting in leveraged/inverse investment vehicles if the firm had exercised due diligence to ascertain certain facts regarding the retail investor and, as a result, had a reasonable basis for believing that the retail investor had the knowledge and experience in financial matters to be capable of evaluating the risks associated with these vehicles.

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Despite not adopting such rules, the SEC's statements in the Adopting Release articulated its concerns with leveraged and inverse products in the retail space, echoing sentiments along the same lines in the adopting release for Regulation Best Interest and the SEC's so-called Fiduciary Interpretation under the Advisers Act. For example, the SEC stated in the Adopting Release that "broker-dealers recommending such products should understand that leveraged/inverse products that are reset daily may not be suitable for, and as a consequence also not in the best interest of, retail customers who plan to hold them for longer than one trading session, particularly in volatile markets. A broker-dealer cannot establish a reasonable basis to recommend leveraged/inverse products to retail customers without understanding the terms, features, and risks of these products." In referencing the care obligation of Regulation Best Interest, which requires a broker-dealer to have a reasonable basis to believe that a recommendation provided to a retail customer is in the customer's best interest, the SEC stated that "[l]everaged/inverse products may not be in the best interest of a retail customer *absent an identified, short-term, customer-specific trading objective.*" The SEC also stated that "to the extent that such products are in the best interest of a retail client initially, they would require daily monitoring by the adviser," echoing similar comments made in the Fiduciary Interpretation.

The SEC also directed the Staff to review the effectiveness of the existing regulatory requirements in protecting investors who invest in leveraged/inverse Funds and other complex investment products. In an unusual move, Chairman Clayton and the Directors of the SEC's Divisions of Investment Management, Corporation Finance, and Trading and Markets jointly issued a nonbinding statement in parallel with the Adopting Release regarding complex financial products and retail investors, focusing on the potential risks that such products represent to the retail market, particularly self-directed investors. All of this could be read to signal that inverse and leveraged Funds remain keenly within the regulatory focus of the SEC and its Staff, and that more SEC (or FINRA) rulemaking, guidance, and examination scrutiny might potentially be coming in this space. In the interim, based on the SEC's statements in the Adopting Release, financial intermediaries that recommend leveraged and inverse Funds to their customers may want to revisit their policies and procedures around such recommendations and make appropriate enhancements.

## REPORTING REQUIREMENTS

In parallel with the Rule, the SEC adopted corresponding changes to Forms N-PORT, N-LIQUID (which will be renamed to Form N-RN), and N-CEN.

Form N-PORT will be amended to include new reporting items regarding derivatives exposure for limited derivatives users, information regarding a Fund's median VaR, number of days beyond the five-business-day period provided by the Rule that the Fund's derivative exposure exceeded 10% of the Fund's net assets, information regarding the designated reference portfolio for a Fund subject to the relative VaR test, and backtesting results. Only information regarding a Fund's designated reference portfolio will be public; all other information provided will be nonpublic.

Form N-LIQUID is being retitled as Form N-RN and will be amended to include reporting items related to the VaR test breaches. A Fund must report any breaches of its daily VaR test within one business day. Such reports for all Funds subject to a VaR testing requirement must include (1) the dates the portfolio exceeded the threshold and (2) the portfolio's VaR for each of those days. A Fund subject to the relative VaR test must also provide the VaR of the Fund's designated reference portfolio on the day of the breach<sup>26</sup> and a Fund subject to the absolute VaR test must also provide the value of the Fund's net assets on the days of the breach. Information provided on Form N-RN will not be made public.

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<sup>26</sup> Funds subject to the relative VaR test must also provide the index name and identifier for the designated index or a statement that the designated reference portfolio is the Fund's portfolio.

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Form N-CEN is being amended with “check the box” items in which a Fund must identify whether it is relying on the Rule, is relying on any exceptions to the Rule, or has conducted any transactions covered by the Rule.<sup>27</sup> All information provided on Form N-CEN will be public.

## KEY DATES AND RESCISSION OF PRIOR GUIDANCE

The Rule will be effective 60 days following the publication of the Rule in the *Federal Register* and Funds will have 18 months thereafter to come into compliance with the Rule, at which time the SEC will also rescind Release 10666. In addition, the Staff has reviewed its no-action letters and other guidance regarding the use of derivatives transactions and other transactions covered by the Rule to determine whether any of its guidance, or portions thereof, should be withdrawn in connection with Rule.<sup>28</sup> The

Staff will rescind any prior guidance that is moot, superseded by, or inconsistent with the Rule when the SEC rescinds Release 10666. The SEC’s and Staff’s approach of rescinding prior guidance that has been superseded by the Rule is consistent with recent rulemaking approaches, including the valuation rule that was proposed in April.

## NEXT STEPS

Many fund managers will have substantial work to do related to the Rule over the next 18–24 months. Piggybacking on the approaches that many fund complexes took with respect to the Liquidity Rule, managers may want to consider forming a cross-disciplinary team of portfolio managers, operations specialists, and legal, compliance, and risk management professionals to analyze the Rule and its impact on their Funds.

As an early step, fund complexes may want to determine which of their Funds are eligible to rely on the limited user exclusion, or could be moderately adjusted so that they are eligible for the limited user exclusion. For those Funds that use derivatives more significantly, a designated reference portfolio will have to be reasonably determined (or otherwise the absolute VaR must be used). Accordingly, such cross-disciplinary teams will need to start considering designated reference portfolios.

With respect to the DRM Program, a derivatives risk manager will have to be approved by the Board, so fund managers should think about who that person (or persons) should be, given the expertise required and the need for familiarity with their Funds’ use of derivatives. For many fund managers, a committee

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<sup>27</sup> Specifically, a Fund must identify whether it (1) is relying on the Rule; (2) has entered into reverse repurchase agreements or similar financing transactions pursuant to the Rule that (i) require compliance with coverage requirements or (ii) allow the fund to treat such a transaction as a derivative transaction for all purposes; (3) has entered into any unfunded commitment agreements under the Rule; or (4) is relying on the provision of Rule 18f-4 that addresses investments in securities on a when-issued or forward-settling basis, or with a nonstandard settlement cycle.

<sup>28</sup> The specific no-action letters and guidance reviewed by the Staff include but are not limited to Dreyfus Strategic Investing & Dreyfus Strategic Income (pub. avail. June 22, 1987); Merrill Lynch Asset Management, L.P. (pub. avail. July 2, 1996); Robertson Stephens Investment Trust (pub. avail. Aug. 24, 1995); Claremont Capital Corp (pub. avail. Sept. 16, 1979); Emerald Mgmt. Co. (pub. avail. Jan. 21, 1978); Sanford C. Bernstein (pub. avail. June 25, 1990); Hutton Options Trading, L.P. (pub. avail. Feb. 2, 1989); Prudential-Bache Income Vertible Plus Fund (pub. avail. Nov. 20, 1985); State Street Income Fund, State Street Balanced Fund (pub. avail. Oct. 21, 1985); New England Life Government Securities Trust (pub. avail. Sept. 26, 1985); Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Thomson McKinnon Government Securities Fund (pub. avail. Sept. 23, 1985); GMO Core Trust (pub. avail. Aug. 19, 1985); Bartlett Capital Trust (pub. avail. Aug. 19, 1985); Continental Option Income Plus Fund (pub. avail. Aug. 12, 1985); Colonial High Yield Securities Trust, Colonial Enhanced Mortgage Trust (pub. avail. July 25, 1985); Putnam High Income Government Trust (pub. avail. June 3, 1985); Bartlett Mgmt. Trust (pub. avail. May 17, 1985); Drexel Series Trust – Government Securities Series (pub. avail. Apr. 25, 1985); Koenig Tax Advantaged Liquidity Fund (pub. avail. Mar. 27, 1985); Colonial Tax-Managed Trust (pub. avail. Dec. 31, 1984); Monitrend Fund (pub. avail. Nov. 14, 1984); Pilot Fund (pub. avail. Sept. 14, 1984); Colonial Government Securities Plus Trust (pub. avail. June 15, 1984); Z-Seven Fund (pub. avail. May 21, 1984); Pension Hedge Fund (pub. avail. Jan. 20, 1984); Steinroe Bond Fund (pub. avail. Jan. 17, 1984); IDS Bond Fund (pub. avail. Apr. 11, 1983); Safeco Municipal Bond, Inc. (pub. avail. Nov. 26, 1982); “Dear Chief Financial Officer” Letter, from Lawrence A. Friend, Chief Accountant, Division of Investment Management (pub. avail. Nov. 7, 1997).



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may be more practical than an individual person—which is similar to what many fund managers have done with the Liquidity Rule. However, fund managers should note that the Rule potentially requires more frequent activity by the derivatives risk manager as compared to the Liquidity Rule (especially under normal market conditions). Therefore, a committee structure may need to err on the side of being nimble to be effective. Funds may also need to assess whether to hire additional quantitative, modeling, and/or risk management specialists to serve on their derivatives risk management committee.

Down the road, once these teams are assembled, a derivatives risk manager is approved, and decisions start to be made, operations will need to be involved to codify changes to the compliance and trading infrastructure as a result of the DRM Program. Funds that invest in reverse repurchase agreements and similar financing transactions, unfunded commitment agreements, when-issued or forward-settling instruments, or instruments that settle on nonstandard settlement cycles will also need to consider what enhancements will need to be made to their trading and compliance procedures, as well as investment disclosures, in order to comply with the Rule. In preparing compliance timelines, fund managers may also want to build in plenty of leeway to accommodate beta testing for stress tests and backtests, and related Board reporting, so that any kinks can be ironed out well in advance of the compliance date of the Rule.

Throughout the course of the next two years, Boards should be kept apprised with periodic updates and may want to provide feedback and input as the DRM Program begins to take shape. Fund managers and Boards will want to build into their meeting agendas the approval of the derivatives risk manager (at which point it would also be advisable for the fund managers to have made substantial progress on the DRM Program). Fund managers and Boards may also want to consider whether to calendar one or more educational sessions about the new Rule, developments in the derivatives markets generally, and/or their Funds' current uses of derivative instruments.

The Rule will also indirectly affect fund custodians and administrators, as well as derivatives counterparties and similar service providers. Some Funds may determine to reduce their use of derivatives in order to fit the limited user exclusion, which could result in such Funds using fewer trading counterparties. On the other hand, enabling new leverage and inverse ETFs to come to market could spur product development in that space, which could result in additional opportunities for derivatives trading counterparties. Fund administrators and custodians likely will need to be in close, ongoing contact with derivatives risk managers for purposes of the DRM Program's testing and reporting requirements, including VaR calculations. Depending on which designated reference portfolios a fund complex uses to calculate relative VaR, the fund manager or administrator may need to enter into new licensing agreements to ensure that data is consistently readily available for the VaR calculation.

Fund managers and compliance teams should also make a note to update their compliance manuals and related processes to incorporate any technical revisions that may be necessitated, including to the Liquidity Rule, which will be amended to refer to "collateral" and remove references to asset segregation, on the same timetable as the Rule.



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## Contacts

If you have any questions or would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis lawyers:

### Boston

Lea Anne Copenhefer	+1.617.951.8515	<a href="mailto:leanne.copenhefer@morganlewis.com">leanne.copenhefer@morganlewis.com</a>
Katherine Dobson Buckley	+1.617.341.7531	<a href="mailto:katherine.buckley@morganlewis.com">katherine.buckley@morganlewis.com</a>
Barry N. Hurwitz	+1.617.951.8267	<a href="mailto:barry.hurwitz@morganlewis.com">barry.hurwitz@morganlewis.com</a>
Roger P. Joseph	+1.617.951.8247	<a href="mailto:roger.joseph@morganlewis.com">roger.joseph@morganlewis.com</a>
Jeremy B. Kantrowitz	+1.617.951.8458	<a href="mailto:jeremy.kantrowitz@morganlewis.com">jeremy.kantrowitz@morganlewis.com</a>
Paul B. Raymond	+1.617.951.8567	<a href="mailto:paul.raymond@morganlewis.com">paul.raymond@morganlewis.com</a>
Toby R. Serkin	+1.617.951.8760	<a href="mailto:toby.serkin@morganlewis.com">toby.serkin@morganlewis.com</a>
Mari Wilson	+1.617.951.8381	<a href="mailto:mari.wilson@morganlewis.com">mari.wilson@morganlewis.com</a>

### Chicago

Michael Philipp	+1.312.324.1905	<a href="mailto:michael.philipp@morganlewis.com">michael.philipp@morganlewis.com</a>
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### New York

Thomas V. D'Ambrosio	+1.212.309.6964	<a href="mailto:thomas.dambrosio@morganlewis.com">thomas.dambrosio@morganlewis.com</a>
Elizabeth Belanger	+1.212.309.6353	<a href="mailto:elizabeth.belanger@morganlewis.com">elizabeth.belanger@morganlewis.com</a>

### Orange County

Laurie A. Dee	+1.714.830.0679	<a href="mailto:laurie.dee@morganlewis.com">laurie.dee@morganlewis.com</a>
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### Philadelphia

Sean Graber	+1.215.963.5598	<a href="mailto:sean.graber@morganlewis.com">sean.graber@morganlewis.com</a>
Timothy W. Levin	+1.215.963.5037	<a href="mailto:timothy.levin@morganlewis.com">timothy.levin@morganlewis.com</a>
John J. O'Brien	+1.215.963.4969	<a href="mailto:john.obrien@morganlewis.com">john.obrien@morganlewis.com</a>
David W. Freese	+1.215.963.5862	<a href="mailto:david.freese@morganlewis.com">david.freese@morganlewis.com</a>

### Washington, DC

Laura E. Flores	+1.202.373.6101	<a href="mailto:laura.flores@morganlewis.com">laura.flores@morganlewis.com</a>
Thomas S. Harman	+1.202.373.6725	<a href="mailto:thomas.harman@morganlewis.com">thomas.harman@morganlewis.com</a>
Christopher D. Menconi	+1.202.373.6173	<a href="mailto:christopher.menconi@morganlewis.com">christopher.menconi@morganlewis.com</a>
W. John McGuire	+1.202.373.6799	<a href="mailto:john.mcguire@morganlewis.com">john.mcguire@morganlewis.com</a>
Joseph (Beau) Yanoshik	+1.202.373.6133	<a href="mailto:beau.yanoshik@morganlewis.com">beau.yanoshik@morganlewis.com</a>
Mana Behbin	+1.202.373.6599	<a href="mailto:mbehbin@morganlewis.com">mbehbin@morganlewis.com</a>
Magda El Guindi-Rosenbaum	+1.202.373.6091	<a href="mailto:magda.elquindi-rosenbaum@morganlewis.com">magda.elquindi-rosenbaum@morganlewis.com</a>
Monica L. Parry	+1.202.373.6179	<a href="mailto:monica.parry@morganlewis.com">monica.parry@morganlewis.com</a>

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