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FUNDS' DERIVATIVES RULE STILL LOOMS—UNCERTAINTY PREVAILS

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Just over a year ago, the US Securities and Exchange Commission (SEC) proposed a new rule under the Investment Company Act of 1940 (1940 Act) that, if adopted, would represent a significant shift in the way the SEC regulates the use of derivatives by registered investment companies (i.e., mutual funds, exchange-traded funds (ETFs) and closed-end funds) and business development companies.[1] The proposed rule—Rule 18f-4 under the 1940 Act (Rule)—would also affect the investment strategies employed by many such registered funds and potentially alter the lineup of available investment products in the marketplace. But with the recent change in administration in the White House, Republican control in both the House of Representatives and the Senate, and many upcoming changes within the SEC and its staff, it is unclear whether the Rule will be adopted or, if adopted, what its final form will be. In this article, we will provide a brief update on the current status of the Rule, provide a quick refresher on the Rule and discuss some of the key comments received from the industry on the Rule.

Political Posturing

Even before the election results on November 8th, there were indications that the Rule was not quite ready to be voted on by the SEC. SEC Commissioner Michael Piwowar, a Republican, remarked on October 12th that he did not believe the Rule would be voted on before the end of President Obama's term, noting that questions remained about how the Rule would affect both leveraged funds and the ability of registered funds to hedge risk.[2] However, three weeks later on November 1st, the SEC released new economic analysis of the proposed Rule prepared by the SEC's Division of Economic Risk and Analysis (DERA), which was thought by many in the industry to signal that the SEC was gearing up to vote on the Rule.[3]

The presidential election on November 8th significantly changed the landscape of the SEC's rulemaking agenda. Just two weeks after DERA's memorandum was published, on November 15th, leaders from the House of Representatives issued a letter that encouraged government agencies to refrain "from acting with undue haste" to finalize rules during the last days of President Obama's administration,

warning that ignoring such advice would lead the House to "work with colleagues to ensure that Congress scrutinizes your actions—and, if appropriate, overturns them."[4] Similarly, Republican Senators Richard Shelby (Chairman of the Senate Banking Committee) and Mike Crapo reportedly asked the SEC not to adopt any rules until after President-elect Donald Trump is inaugurated and has an opportunity to review the SEC's rulemaking agenda.[5] In response, SEC Chair Mary Jo White reportedly sent a letter to the Senators in which she emphasized the SEC's need to "exhibit a spirit of independence" in its regulatory agenda and set forth a list of all rules ready for an SEC vote, including Rule 18f-4.[6] Chair White's letter reportedly did not indicate whether the SEC planned to vote on the Rule.[7]

Partial Commission

It is also worth remembering that throughout this period of political posturing, the SEC has been operating with two open Commissioner spots with a third spot, Chair White's, open as of January 20th.[8] Currently, the SEC is composed of Commissioner Piwowar and Commissioner Kara Stein (a Democrat).[9] Federal regulations provide that a quorum of the SEC shall consist of three Commissioners, but also if there are only two members in office, then those two members constitute a quorum.[10] Although three members remains the preferred quorum size to encourage deliberation in connection with SEC votes, in the unlikely situation of a single Commissioner holding office, a quorum of one still would be acceptable.[11] For a matter to pass, a majority vote by the SEC Commissioners participating in a meeting with a quorum is required. Accordingly, it is certainly possible for the SEC to adopt Rule 18f-4 with only two Commissioners, but given the change of administration on January 20th, it seems unlikely that the current SEC would call a meeting to initiate such action at the current time. Further, on January 4th, then President-elect Trump nominated Jay Clayton, a partner at a prominent Wall Street law firm, to head the SEC. Although SEC Commissioner appointments are typically a lower-level priority than certain other government posts (potentially taking several months), given the current composition of the SEC, Mr. Clayton's Senate confirmation could be fast-tracked. In any event, it seems unlikely that the Rule would be approved at this time. In addition, the White House issued a memorandum to all executive departments and agencies on January 20th, requesting that new and pending regulations be frozen until the new administration has time to review them. Although the SEC is not an executive agency, it could decide to follow the memorandum voluntarily.

Current Regulation of Funds' Use of Derivatives and Proposed Rule

In case you have forgotten the key aspects of the Rule in the year since it was proposed, here is a crash course. The use of derivatives by registered funds has been substantively regulated by the SEC and its staff through various provisions under the 1940 Act, even though most derivatives commonly used today were not contemplated at the time that Congress enacted the 1940 Act. The most direct source of regulation is Section 18 of the 1940 Act, which limits a registered investment company's ability to issue "senior securities," which essentially means that a registered fund cannot have an obligation to pay someone ahead of its shareholders.[12] Because derivative instruments may result in an obligation to pay in the future for consideration received at the incep-

tion of the transaction, they traditionally have been interpreted as evidence of indebtedness and thus a "senior security" for purposes of Section 18. In 1979, in a release that has since become known within the industry as "Ten-Triple-Six," the SEC provided guidance on how a registered fund could avoid this "senior security" problem in the context of three types of transactions: reverse repurchase transactions, firm commitment agreements and standby agreements.[13] In addition to discussing these specific transactions, the 1979 release also stated that it was intended to apply to "all comparable trading practices" that affect fund capital structures in an analogous way, which, coupled with a lack of subsequent formal guidance from the SEC, has resulted in the registered fund industry applying the principles set forth in the release to a broad and diverse range of derivative instruments. In addition to the 1979 release, the SEC staff has issued more than 30 no-action letters and has provided other informal guidance. This patchwork quilt of regulation, coupled with a highly sophisticated marketplace of derivative instruments, has led many to conclude that some clarifying guidance from the SEC in the form of a rule could be beneficial.

The proposed Rule would function as an exemption from the general prohibition from entering into senior securities transactions under Section 18. Under the Rule, "derivatives transactions" would be broadly defined to include swaps, security-based swaps, futures, forwards and options, as well as any combination of those instruments and any similar instrument under which a fund is or may be required to make any payment or delivery of cash or other assets. The Rule would also regulate funds' entry into "financial commitment transactions," which would include reverse repurchase agreements, short sales, and any firm or standby commitment agreements or similar agreements (including promises to make a loan or capital commitments). The Rule would regulate funds' use of these instruments in three key ways: (i) by imposing certain limitations on funds' portfolios, (ii) by requiring assets to be segregated, and (iii) by requiring certain funds to adopt derivatives risk management programs.

Portfolio Limitations. As proposed, funds would be required to comply with one of two alternative portfolio limitations: an exposure-based portfolio limit or a risk-based portfolio limit. Under the exposure-based portfolio limitation, a fund would be required to limit its aggregate exposure to senior securities transactions to 150% of its net assets, calculated immediately after entering into any senior securities transaction. Under the risk-based portfolio limitation, a fund would be permitted to obtain derivatives exposure up to 300% of its net assets, provided that the fund satisfies a risk-based test that would be calculated using a value-at-risk methodology. This risk-based test would be an alternative to the exposure-based test, meaning that a fund could obtain exposure in excess of the 150% exposure-based test if the fund's use of derivatives is designed to result in a portfolio that is subject to less market risk.

Asset Segregation. The Rule would also require a fund to manage the risks associated with its derivatives transactions by, among other things, segregating assets to ensure that the fund has sufficient assets to meet its obligations under those transactions. Within the funds industry, this practice if often referred to as "covering." Funds would be required to implement board-approved policies and procedures through which they

would maintain a required amount of qualifying coverage assets. The amount of qualifying coverage assets would be determined each business day on a transaction-by-transaction basis. A fund would be required to maintain qualifying coverage assets with a value equal to at least the sum of (i) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination (i.e., mark-to-market coverage amounts), and (ii) an amount reflecting a reasonable estimate of the potential amounts payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (i.e., risk-based coverage amounts). With one exception,[14] qualifying coverage assets would be limited to cash and cash equivalents, which would significantly narrow the assets available for segregation compared to current market practices under SEC staff guidance, which has generally been understood to permit funds to segregate any liquid asset.

Risk Management Programs. Funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives transactions would be required to adopt and implement a formalized derivatives risk management program and would have to implement written policies and procedures reasonably designed to: (i) assess the risks associated with the fund's derivative transactions, (ii) manage the risks of the fund's derivatives transactions, (iii) reasonably segregate the functions associated with the risk management program from the portfolio management of the fund, and (iv) periodically review and update the risk management program. The program would be administered by a derivatives risk manager and be approved by the fund's board.

Key Comments

Currently, there are 199 comment letters with respect to the proposed Rule posted to the SEC's website and another 68 memoranda from meetings with SEC officials.[15] Even though comments were due by March 28, 2016, they have continued to trickle in, with several being posted as recently as December 2016.

Many commenters were critical of particular aspects of the proposed Rule, but generally supported a substantive rulemaking on the topic. Several prominent names in the registered fund space submitted detailed response letters, including the Investment Company Institute (ICI), the leading global association of registered funds.[16] Among other positions, ICI supported the idea of formal asset segregation requirements, but advocated to permit funds to use highly liquid assets, not just cash and cash equivalents, for segregation purposes. ICI also suggested that the SEC should expand situations where a fund's obligations to counterparties are netted. Many other firms suggested that funds be allowed to use a range of assets other than cash and cash equivalents for segregation purposes, subject to haircuts to the value of the segregated assets, where the amount of such haircuts could be standardized.[17]

ICI also supported the risk management program, but stated that the proposed Rule places too heavy a burden on the shoulders of directors, expecting them to be familiar "with the minutia of portfolio management" instead of providing a more high-level oversight function. ICI also advocated that the SEC discard the portion of the proposed Rule that deals with portfolio limitations. ICI noted that if the SEC moves forward with the portfolio limitations, the SEC should increase the exposure-based limit to

200%. Many commenters also suggested that the Rule should use notional amounts adjusted to reflect the risks of the underlying reference assets to measure a fund's derivatives exposure.[18]

Other commenters stressed that the SEC should consider the proposed Rule in the context of the other recently proposed and adopted rules to ensure that there is a consistent approach and no redundancy. The proposed Rule was the SEC's third significant proposed rulemaking for the registered fund industry of 2015, having previously proposed rules on liquidity risk management and reporting modernization.[19] Both of those proposals were adopted in October 2016, and each includes elements relevant to funds that have derivative instruments.[20] For example, with respect to the issue of liquidity, commenters suggested that a consistent standard should be applied for both derivatives coverage requirements and for determining when a security is liquid for compliance with the new liquidity risk management rule.[21] In addition, commenters suggested that the SEC should consider the extent to which any new reporting and portfolio monitoring that will now be required under the reporting modernization changes can be leveraged for purposes of the derivatives Rule.

Several prominent registered fund firms expressed concern that the portfolio limitation aspects of the Rule, as proposed, would effectively prohibit certain products that are already very successful and important in the marketplace, including leveraged ETFs. These commenters reiterated the position of many other firms that notional exposure to derivatives does not reflect the actual risk that those transactions represent to a fund. Because the proposed Rule would substantially alter the businesses of certain existing firms and, accordingly, potentially remove certain investment products from the marketplace, it seems very likely that the SEC has been carefully considering the portfolio limitation aspects of the Rule as part of its ongoing economic analysis and comment review.

Concluding Thoughts

Ignoring the details of what a final version of the Rule might look like, there are three possible outcomes for the proposed Rule: (i) it will be adopted by the current two-Commissioner SEC, (ii) it will be adopted after additional Commissioners (or at least a Chair) are confirmed by the Senate to fill the empty seats at the SEC, or (iii) it will not be adopted in its current form. Given the number of comments received from the industry and the magnitude of the potential effect on the marketplace, combined with the current transitional political environment, it seems unlikely that the Rule would be adopted before a new Chair is in place at the SEC. However, the SEC and its staff have invested a substantial amount of time and effort in setting forth the data necessary to support adopting the Rule, likely with some modifications to the Rule designed to address industry concerns. Because there is general agreement between the industry and the SEC that the current regulatory space is confusing and full of navigational pitfalls, there is common ground on which a rulemaking could go forward with some industry support. But the general view of the industry is that the SEC's proposed attempt to bring clarity to a complex space was not reflective enough of current practices and sought to impose new requirements that are too restrictive and unnecessary. As a new presidential administration takes office and Commissioner vacancies are filled, many eyes will be fixed on the regula-

tory agenda and tone of a newly constructed SEC. Of particular interest will be where the derivatives Rule falls within that agenda. In the near future, we will know whether fund portfolio managers, operations personnel and compliance teams are facing new challenges with respect to the regulation of investments in derivatives, or whether the Rule will join a host of other historical proposals that fell through the gaps of political change.

ENDNOTES:

[1]*See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 31, 933 (Dec. 11, 2015) (Proposing Release).

[2]*See* Lisa Lambert and Trevor Hunnicutt, *Rule on funds' derivatives use unlikely this year: U.S. SEC commissioner*, Reuters (Oct. 12, 2015). The SEC voted 3-1 in favor of proposing the Rule, with Commissioner Piwowar voting against. Importantly, however, in his dissenting vote, Commissioner Piwowar noted his "strong support for Commission action in this area," stating that "[f]or too long now the fund community has been left to navigate the complex world of derivatives without clear guidance from the Commission on the use of such products." Commission Piwowar, SEC Public Statement, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015). However, Commissioner Piwowar stated that because some of the recommendations in the proposed Rule were not based on quality analysis of comprehensive data and did not take into consideration other recent regulatory actions, he was unable at the time to support all of the recommendations. *See id.*

[3]*See* SEC Press Release, SEC Staff Provides Additional Economic Analysis of Proposed Derivatives Rule, 2016-232 (Nov. 1, 2016); *see also* SEC Division of Economic and Risk Analysis, Memorandum re: Risk Adjustment and Haircut Schedules (Nov. 1, 2016). The proposal also relied significantly on a white paper from the Division of Economic and Risk Analysis, which was released in tandem with the proposing release. *See* Daniel Deli, et al., Division of Economic and Risk Analysis, Use of Derivatives by Registered Investment Companies (Dec. 7, 2015).

[4]Letter to Secretaries, Administrators, Directors and Commissioners from House Majority Leader and House Committee Chairs (Nov. 15, 2016).

[5]*See* Sarah N. Lynch, *SEC Chair White defies Republican requests to stall rulemaking*, Reuters (Dec. 12, 2016).

[6]*See id.*

[7]Interestingly, staff in the SEC's Division of Investment Management, Disclosure Review and Accounting Office, have recently been asking registered investment companies to acknowledge both the proposed Rule and the fact that the SEC could issue a new rule in Correspondence filings in connection with registration statement amendments. For example: "We note that the Fund discloses that it may engage in transactions involving derivatives, which are generally deemed to be a senior security for purposes of Section 18 of the 1940 Act. When a fund engages in such transactions, the fund will need to set aside an appropriate amount of liquid assets as determined by SEC and staff guidance to address Section 18 concerns. Please note that the SEC has issued a release proposing to update the regulation of fund use of derivatives for purposes of Section 18 of the 1940 Act. Accordingly, please be aware that the SEC could issue a new rule and/or guidance relating to fund use of derivatives such as total return swaps and leverage, including cover requirements, which could impact the manner in which the Fund operates."

[8]*See* SEC Press Release, SEC Chair Mary Jo White Announces Departure Plans, 2016-238 (Nov. 14, 2016).

[9]Commissioner Luis Aguilar (Democrat) left the Commission at the end of 2015 and Commissioner Dan Gallagher (Republican) left shortly before in October 2015. President Obama's nomi-

nees, Hester Peirce (Republican) and Lisa Fairfax (Democrat) sat in limbo since testifying before the Senate Banking Committee in March.

[10]17 C.F.R. § 200.41.

[11]*See* Establishment of Commission Quorum Requirement, Exchange Act Rel. No. 35,548 (Mar. 30, 1995). Courts have ruled that agencies have the power to determine their own quorum requirements. *See* Falcon Trading Group v. SEC, 102 F.3d 579, 582 (DC Cir. 1996) ("If not otherwise constrained by statute . . . an agency sufficiently empowered by its enabling legislation may create its own quorum rule.").

[12]For business development companies (BDCs), which were created by statute in 1980 by adding a series of new sections to the 1940 Act, the relevant prohibition on senior securities is found in Section 61 of the 1940 Act.

[13]*See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10,666 (Apr. 19, 1979).

[14]The exception is that qualifying coverage assets also include, with respect to a particular transaction in which the fund may satisfy its obligations by delivering a particular asset, that particular asset. For example, if a fund sells a call option on a security, then the security would be a qualifying coverage asset with respect to that particular transaction.

[15]Although many of these 199 comment letters originate from sophisticated, well-established firms in the financial services industry that submitted detailed, thoughtful and long responses, there are, of course, a handful of comment letters from less-established industry participants who exhibited a more casual dialogue. *See e.g.,* Comment Letter from K.Z. (Jan. 24, 2016) (reads in its entirety, "This is so cool").

[16]*See* SEC Comment Letter, Investment Company Institute (Mar. 28, 2016).

[17]The SEC's Division of Economic and Risk Analysis provided data on this issue in its November 1, 2016 memorandum

[18]The SEC's Division of Economic and Risk Analysis also provided data on this issue in its November 1, 2016 memorandum. *See also*, SEC Comment Letter, Investment Company Institute (July 28, 2016); SEC Comment Letter, Investment Company Institute (Sep. 27, 2016).

[19]*See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31,835 (Sep. 22, 2015); Investment Company Reporting Modernization, Investment Company Act Rel. No. 31,610 (May 20, 2015).

[20]*See* Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32,315 (Oct. 13, 2016); Investment Company Reporting Modernization, Investment Company Act Rel. No. 32,314 (Oct. 13, 2016).

[21]New Rule 22e-4 under the 1940 Act codifies a long-held SEC guidance that an open-end fund can only invest up to 15% of its assets in illiquid securities. *See* Revisions of Guidelines to Form N-1A, Investment Company Act Rel. No. 18,612 (Mar. 12, 1992). Prior to 1992, SEC guidance was that an open-end fund was limited to 10% investment in illiquid assets. *See* Statement Regarding "Restricted Securities," Investment Company Act Rel. No. 5847 (Oct. 21, 1969).