Regulation of Derivatives and Other Transactions by Registered Investment Companies and Business Development Companies

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In December of 2015, the Securities and Exchange Commission proposed new rules ("Proposed Rules") on the use of derivatives and financial commitment transactions by registered investment companies, including open-end and closed-end companies, and business development companies (collectively, "Regulated Funds"). The Proposed Rules are designed to permit Regulated Funds to enter into derivative and financial commitment transactions without violating the prohibitions and restrictions on the issuance of senior securities under the Investment Company Act. The Proposed Rules will require additional structural, compliance, and reporting programs on the part of Regulated Funds and may, in some cases, require a change to a Regulated Fund's use of derivatives and financial commitment transactions.

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Covered transactions

The Proposed Rules cover both derivatives transactions and financial commitment transactions. "Derivatives transactions" include any swap, securities-based swap, futures contract, forward contract, option, combination of those instruments and any similar instrument under which a Regulated Fund may be required to make a payment or delivery of cash or assets during the life of the transaction or at the maturity or termination of a transaction, whether as a margin or settlement payment. "Financial commitment transactions" include reverse repurchase agreements, short sale borrowings, firm or standby commitments or similar agreements, such as an obligation to make a capital commitment to a private fund.

General rules

Under the Proposed Rules, a Regulated Fund may enter into derivatives transactions if the fund:

(1) complies with the portfolio limitations of the Proposed Rules described below immediately after entering into any derivatives transaction, financial commitment transaction or transaction involving a senior security; and

(2) manages the risks associated with derivatives transactions by maintaining and identifying qualifying coverage assets with a value, determined at least once each business day, equal to at least the sum of the aggregate mark-to-market coverage amounts and risk-based coverage amounts described below; and

(3) adopts and implements a written derivatives risk management program that is reasonably designed to assess and manage the risks associated with the Regulated Fund's derivatives transactions, with records relating to such program being maintained in accordance with the record retention provisions described below.

Financial commitment transactions will have a similar but slightly different treatment under the Proposed Rules. Under the Proposed Rules, a Regulated

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Fund may enter into financial commitment transactions if:

(1) the fund maintains and identifies qualifying coverage assets with a value, determined at least once each business day, equal to at least the fund's aggregate conditional and unconditional obligations under all financial commitment transactions; and

(2) the fund's board of directors, including a majority of the directors who are not interested persons of the fund, has approved policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets; and

(3) the fund maintains a written copy of the policies and procedures approved by its board of directors and a written record reflecting the amount of each conditional and unconditional obligation associated with each financial commitment transaction and identifying the qualifying coverage assets that are maintained with respect to such financial commitment transaction for the record retention periods described below.

Portfolio limitations

With respect to derivatives transactions, a Regulated Fund may comply with portfolio limitations where, immediately after entering into the derivative transaction, either:

(1) the aggregate exposure of the fund does not exceed 150% of the value of the fund's net assets; or

(2) the VaR (or value-at-risk) of the fund's full portfolio is less than the VaR of the fund's securities and the aggregate exposure of the fund does not exceed 300% of the fund's net assets.

The Regulated Fund's board of directors will have to elect which of the foregoing options to utilize and will also have to approve any switch between the two options.

Determining a fund's exposure under the Proposed Rules will not necessarily be an easy task. Exposure will have to be determined immediately after the fund enters into a derivatives transaction, financial commitment transaction or transaction involving a senior security transaction. Moreover, exposure will have to be calculated based upon the notional amounts of derivatives transactions, aggregate obligations under financial commitment transactions and indebtedness under senior security transactions. Generally, the exposure generated by simple derivatives transactions will be measured by their notional amount (multiplied by their underlying delta, in the case of options). However, complex derivatives are subject to different exposure measurement rules and the determination of whether a derivative transaction is a simple derivative or a complex derivative may be challenging. Complex derivatives are those derivatives transactions in which the amount payable is generally dependent upon the value of the underlying reference asset at multiple points in time or is a non-linear function of the value of the underlying reference asset.

If a Regulated Fund decides to rely upon the second portfolio limitation described above, it will have to determine the VaR for both its portfolio (which would include its securities and its derivatives) and its securities (without reference to its derivatives). VaR is a model-based estimate of potential losses on an instrument or portfolio over a specified time horizon (10-20 trading days in the case of the Proposed Rules) and at a given confidence interval (99% in the case of the Proposed Rules). VaR must take into account and incorporate all significant, identifiable market risk factors, including equity price risk, interest rate risk, credit spread risk, foreign currency risk, commodity price risk, sensitivity to changes in volatility and other risks arising from non-linear price characteristics of an investment. Preparing appropriate VaR models may be a challenging task.

Mark-to-market coverage and risk-based coverage

For purposes of derivatives transactions, the mark-to-market coverage amount that would be required by the Proposed Rules would be the amount that would be payable by the Regulated Fund if it were to exit the derivatives transaction at the time of determination. Netting of amounts would be permitted under this requirement, if there is an enforceable netting agreement governing the relevant derivatives transactions. A Regulated Fund would also get credit for variation margin or collateral posted to secure its obligations under the derivatives transactions.

The risk-based coverage amount is an amount, in addition to the mark-to-market amount, that represents a reasonable estimate of the potential amount payable by the Regulated Fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures approved by the fund's board of directors. Netting of amounts would be permitted under this requirement, if there is an enforceable netting agreement governing the relevant derivatives transactions. A Regulated Fund would also get credit for initial margin or collateral posted to secure its potential obligations under the derivatives transactions.

Both of these coverage amounts may be difficult to calculate on a daily basis.

Qualifying coverage assets

A Regulated Fund will have to identify qualifying coverage assets in order to rely upon the Proposed Rules. Qualifying coverage assets primarily consist of cash or cash equivalents, but may

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also include: the assets to be delivered in connection with a derivatives transaction or financial commitment transaction; assets that are convertible into cash or that will generate cash prior to the date when the Regulated Fund can be expected to pay an obligation under a transaction; and assets that have been pledged by the Regulated Fund to secure its obligations under the transaction. The fund's board of directors must approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets. Qualifying coverage assets cannot be used to cover both a derivatives transaction and a financial commitment transaction, and the total amount of qualifying coverage assets cannot exceed the fund's net assets.

Risk management program

A large portion of the Proposed Rules consists of granular provisions relating to the derivatives risk management program that must be adopted and implemented by the Regulated Fund seeking to rely on the Proposed Rules. The derivatives risk management program must be reasonably designed to assess the risks associated with derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, operational and other relevant risks. The program must also manage the risks associated with derivatives transactions, including by:

- monitoring whether the use of derivatives transactions is consistent with investment guidelines established by the fund or the investment adviser of the fund, the relevant portfolio limitation election, and relevant disclosure to investors; and

- informing persons responsible for portfolio management or the board of directors regarding material risks arising from derivatives transactions.

Furthermore, the program must reasonably segregate the functions associated with the program from the portfolio management of the fund. The program must be periodically reviewed and updated at least annually, including any models (including VaR models), measurement tools, policies or procedures that are used in the program, in order to evaluate effectiveness and reflect changes in risk over time.

The board of directors, including a majority of directors who are not interested persons of the Regulated Fund, must approve the program as well as any material changes to the program. The Regulated Fund must designate, with the approval of the board of directors, an employee or officer of the fund or the fund's investment adviser, other than a portfolio manager of the fund, who will be responsible for administering the derivatives risk management program (the "Program Administrator"). The board of directors must also review, no less frequently than quarterly, a written report prepared by the Program Administrator that describes the adequacy of the fund's program and the effectiveness of its implementation.

A Regulated Fund will not have to adopt and maintain a derivatives transaction risk management program if it complies and monitors compliance with a limitation, approved by the board of directors, under which immediately after entering into any derivatives transaction the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets and the fund does not enter into complex derivatives.

Records

The records retention provisions of the Proposed Rules are quite detailed. A Regulated Fund must maintain:

- a written record of each determination made by the board of directors with respect to the portfolio limitation election for a period of not less than five years (the first two in an easily accessible place) following each determination; and

- a written copy of the policies and procedures relating to the maintenance of qualifying coverage assets that have been in effect within the past five years, in an easily accessible place; and

- a written copy of the policies and procedures adopted in connection with the derivatives risk management program at any time in effect within the past five years in an easily accessible place; and

- copies of any materials provided to the board of directors in connection with its approval of the derivatives risk management program, including material changes to the program and any written reports provided to the board of directors relating to the program for at least five years after the end of the fiscal year in which the documents were provided (the first two years in an easily accessible place); and

- records documenting the periodic reviews and updates of the derivatives risk management program, including any models and measurement tools (including updates to VaR models) for a period of not less than five years (the first two in an easily accessible place) following each review or update; and

- a written record demonstrating that immediately after the fund entered into any derivatives transaction, financial commitment transaction or transaction involving a senior security, the fund complied with the portfolio limitation applicable to the fund immediately after entering into the transaction, reflecting the fund's aggregate exposure, the value of the fund's net assets and, if applicable,

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the fund's portfolio VaR and securities VaR, for a period of not less than five years (the first two in an easily accessible place) following each transaction; and

- a written record reflecting the mark-to-market coverage amount and the risk-based coverage amount for each derivatives transaction and identifying the qualifying coverage assets maintained by the fund with respect to such coverage amounts, as determined at least once each business day, for a period of not less than five years (the first two years in an easily accessible place); and

- with respect to financial commitment transactions, a written copy of the policies and procedures approved by the board of directors reasonably designed to provide for the fund's maintenance of qualifying coverage assets that have been in effect within the past five years in an easily accessible place; and

- a written record reflecting the amount of each conditional and unconditional obligation associated with each financial commitment transaction and identifying the qualifying coverage asset with respect to such financial commitment transaction for a period of not less than five years (the first two years in an easily accessible place).

Reporting

Proposed amendments to Form N-PORT would require certain Regulated Funds to report certain risk metrics, such as vega and gamma, on a monthly basis. Additionally, proposed amendments to Form N-CEN would require Regulated Funds to identify the specific portfolio limitation that it relied upon to effect derivatives transactions on an annual basis.

Comments

Because of the scope of the Proposed Rules and the potential effect of the rules on Regulated Funds, particularly ETFs, we expect numerous comments to be filed with the SEC prior to the March 28, 2016 expiration of the comment period for the Proposed Rules.

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