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FUND DERIVATIVES RULE: WHAT BOARDS AND MANAGERS NEED TO KNOW

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Presenters

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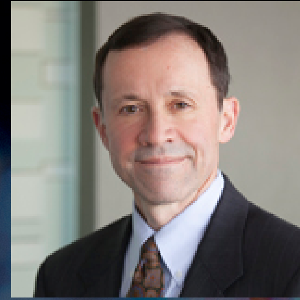
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Questions We'll Try to Answer Today…

- What funds are in, out, and partially in?
- What is a "derivatives transaction"?
- What are "Value at Risk" and "designated reference portfolios"?
- What must a derivatives risk management program entail and who oversees it?
- What will be the role of my fund's board?
- When do my funds have to comply with the new Rule?
- What about funds already in the market that exceed the levels of the new Rule?
- Do funds have to keep records of all of this stuff?
- Wasn't there a corresponding change to the ETF Rule?
- *PLEASE USE THE CHAT FUNCTION TO ASK US OTHER QUESTIONS!*

Funds in Scope

- Applies to open- and closed-end registered funds (including ETFs) and BDCs
  - *Does not apply to money market funds*
  - *Does not apply to private funds*
  - *Does not apply to exchange-traded products not registered under the 1940 Act*
- Funds that are limited derivatives users are not required to comply with the full provisions of Rule
  - *Derivatives exposure must be less than 10% of fund's net assets*
  - *Currency and interest rate derivatives used for hedging generally excluded*
  - *Funds still must adopt and implement policies and procedures for derivatives risk*
  - *Process required for derivatives exposure inadvertently exceeding 10% of net assets*
- Funds in existence as of October 28, 2020 are not required to reduce their limit on fund leverage risk to comply with the Rule
  - *But such funds are then locked in, and disclosures are required*

The New Derivatives Rule: An Exemptive Rule

- A fund that satisfies the conditions of the Rule is permitted to enter into "derivatives transactions," notwithstanding the 1940 Act limitations on senior securities
- "Derivatives transaction" means:
  - *Where the fund is or may be required to make any payment or delivery of cash or other assets (as margin, settlement payment, or otherwise) during the life of the instrument, at maturity, or early termination, any:*
    - ► Swap
    - ► Futures contract
    - ► Option
    - ► Any similar instrument
    - ► Security-based swap
    - ► Forward contract
    - ► Any combination of the foregoing
  - *Any short sale borrowing*
  - *Any reverse repurchase agreement or similar financing transaction (for funds that so select)*

Key Topic: Value at Risk

- The Rule requires a fund to compare its derivatives risk against a reference benchmark using the “Value at Risk” or “VaR” metric
- What is “VaR”?
  - An estimate of potential losses, calculated based on a given confidence level over a specified time horizon
    - *Fund calculations must use 99% confidence level and 20 trading day horizon*
  - Can be applied to a single instrument or to an entire portfolio
  - Expressed as a percentage of asset value (or net asset value, in the case of a fund)
  - Fund VaR calculations must take into account all significant, identifiable market risk factors associated with the fund’s investments (e.g., interest rate risk, credit spread risk)
  - Fund VaR calculations must be based on at least three years of historical market data

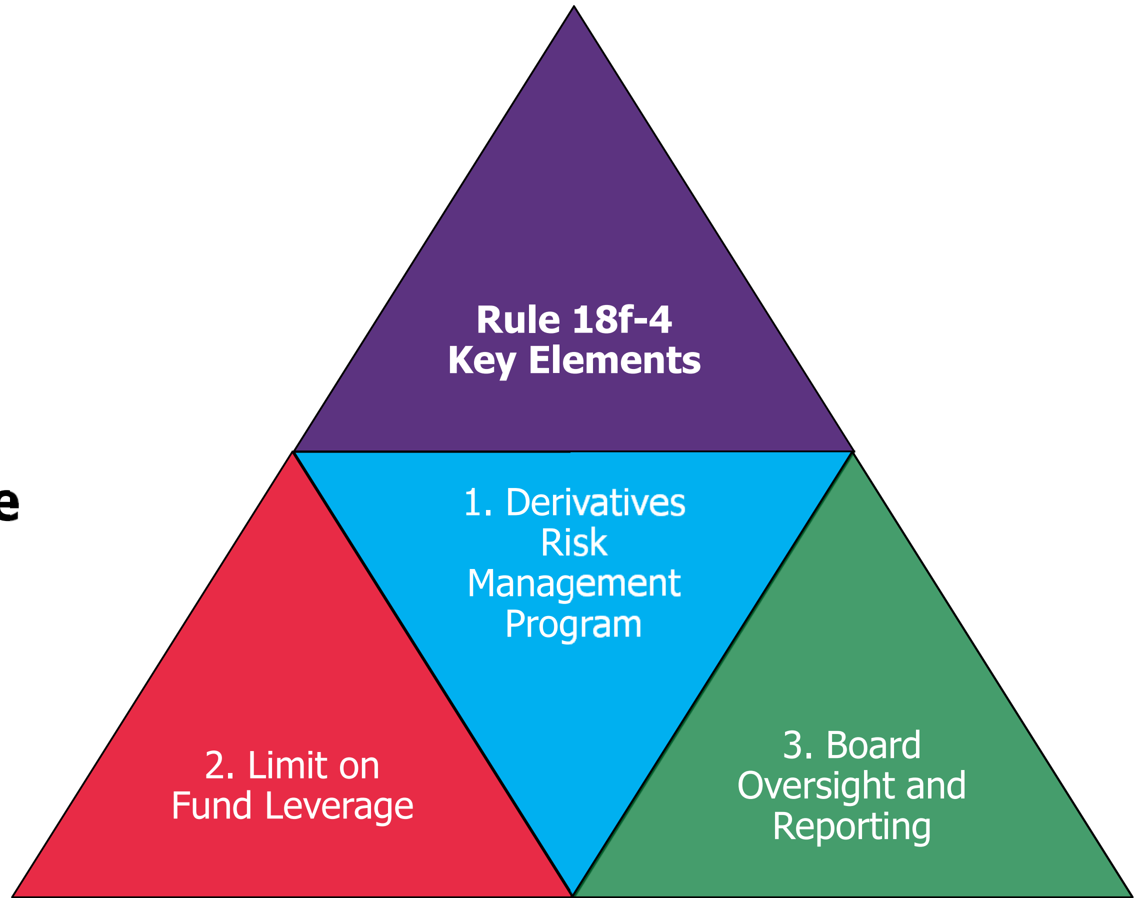
Key Topic: Relative VaR Test

- Relative VaR Test
  - The VaR of a fund's portfolio cannot exceed 200% of the VaR of the "designated reference portfolio" (250% of closed-end funds)
- "Designated Reference Portfolio" is either:
  - Designated Index
    - *Unleveraged*
    - *Approved by the derivatives risk manager*
    - *Reflects the markets or asset classes of the fund's investments*
    - *Not administered by an affiliated person*
    - *Not created at the request of the fund or its adviser (unless widely recognized and used)*
    - *If a blend, no component index can be administered by an affiliated person, and no component index could have been created at the request of the fund or its adviser (unless widely recognized and used)*
  - For actively managed funds, the fund's securities portfolio (securities and other investments, net derivatives)
  - An index-tracking fund must use its underlying index as the designated reference portfolio

Key Topic: Absolute VaR Test

- Absolute VaR
  - The VaR of a fund's portfolio cannot exceed 20% of the value of the fund's net assets (25% for closed-end funds)
  - Available where a fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, taking into account the fund's investments, investment objectives and strategy

Funds that are not "limited derivatives users" must meet three key elements of the Rule



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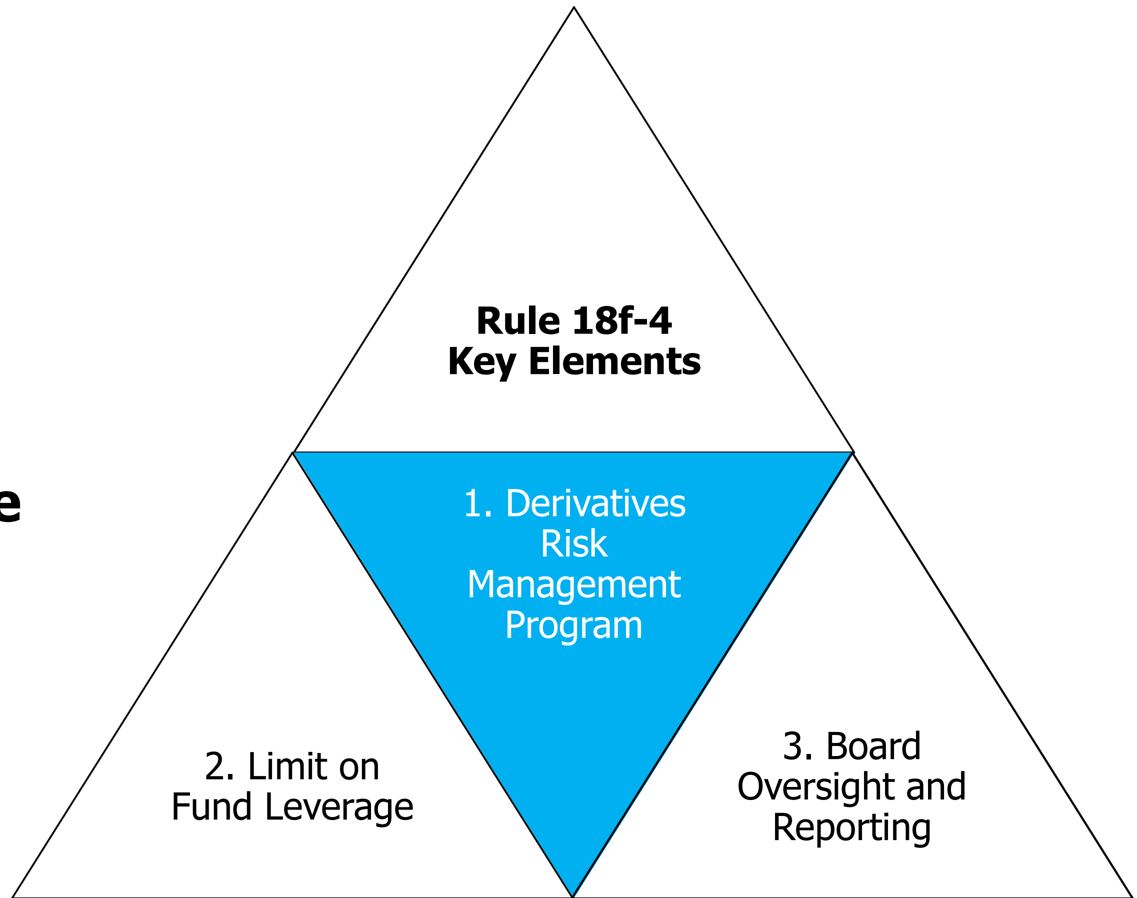


Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must be in writing and adopted by the fund (though no board adoption requirement)
   - Must include policies and procedures that are reasonably designed to:
     - Manage derivatives risk
       - *Leverage, market, counterparty, liquidity, operational, and legal risks*
       - *Any other risks the derivatives risk manager deems material*
     - Segregate the risk program functions from portfolio management
   - Must be overseen by a "Derivatives Risk Manager"
     - An officer or group of officers of the fund's adviser
     - If Risk Manager is a single officer, cannot be a portfolio manager
     - If Risk Manager is a team of officers, portfolio managers may not be majority
     - Must have relevant experience

Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - *Risk identification and assessment*
       - *Must identify and assess the fund's derivatives risks*
       - *Must consider the fund's derivatives transactions and other investments*
     - Risk guidelines
     - Stress testing
     - Backtesting
     - Internal reporting and escalation
     - Periodic Review

Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - Risk identification and assessment
     - *Risk guidelines*
       - *Establish, maintain, and enforce investment, risk management, and related guidelines*
       - *Guidelines must provide for quantitative or other measurable risk criteria*
       - *Must specify levels that fund does not normally expect to exceed*
       - *Must specify measures to be taken if levels are exceeded*
     - Stress testing
     - Backtesting
     - Internal reporting and escalation
     - Periodic review

Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - Risk identification and assessment
     - Risk guidelines
     - *Stress testing*
       - *Must evaluate potential portfolio losses based on "extreme but plausible" market changes or changes that would have a significant adverse effect on the portfolio*
       - *Must take into account correlations of risk factors and counterparty payments*
       - *Frequency of testing must consider strategy, investments, and current market conditions*
       - *Must be tested at least weekly*
     - Backtesting
     - Internal reporting and escalation
     - Periodic review

Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - Risk identification and assessment
     - Risk guidelines
     - Stress testing
     - *Backtesting*
       - *VaR calculation model (relative or absolute) must be backtested at least weekly*
       - *Must consider fund's gains/losses on each business day with the corresponding VaR calculation for that day*
       - *Must identify exceptions where fund losses exceed corresponding VaR loss*
     - Internal reporting and escalation
     - Periodic review

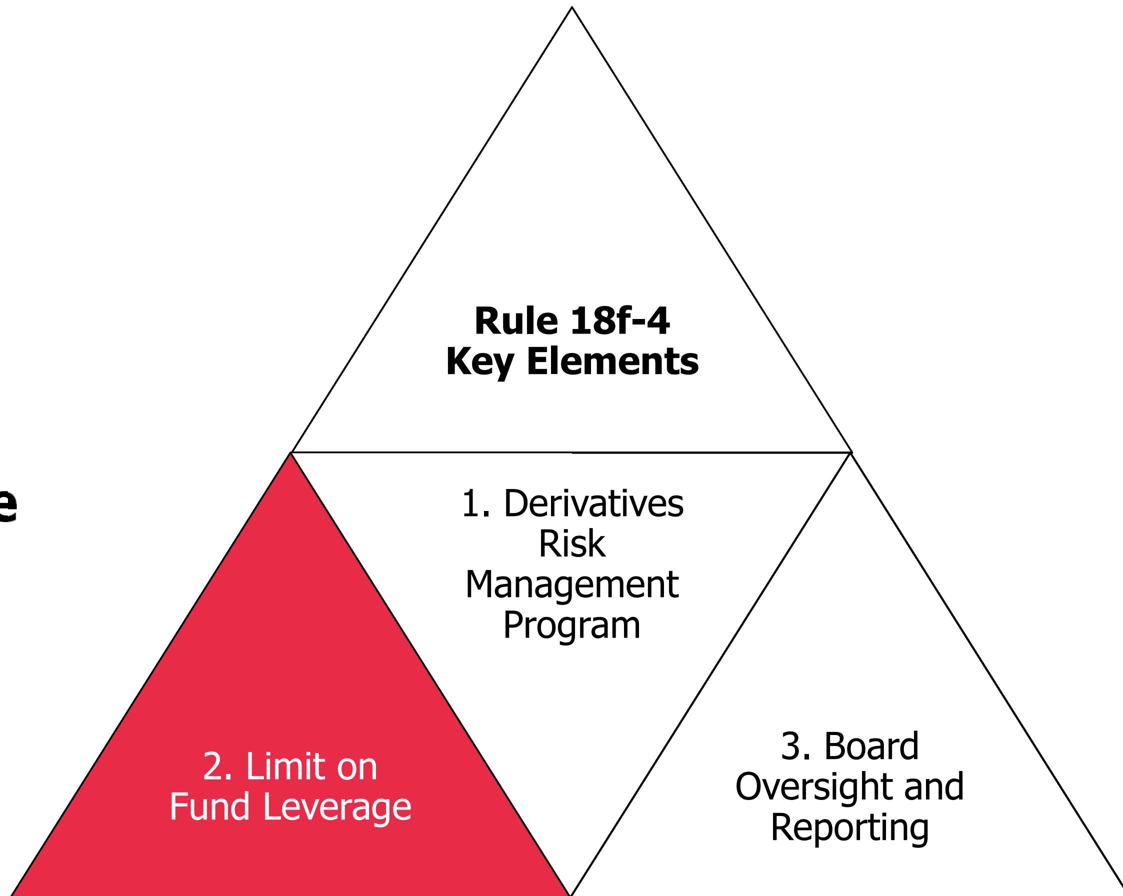
Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - Risk identification and assessment
     - Risk guidelines
     - Stress testing
     - Backtesting
     - *Internal reporting and escalation*
       - *Must have mechanism for reporting the operation of the program to portfolio management*
       - *Must report to portfolio management when risk guidelines are exceeded*
       - *Stress test results must be reported to portfolio management*
       - *Material risks must be reported to portfolio management and, as appropriate, to the board*
     - Periodic review

Conditions of the Rule: Risk Management Program

1. Derivatives Risk Management Program
   - Must include the following elements
     - Risk identification and assessment
     - Risk guidelines
     - Stress testing
     - Backtesting
     - Internal reporting and escalation
     - *Periodic review*
       - *Manager must review the program at least annually*
       - *Review must include VaR calculation model (including backtesting) and any designated reference portfolio to evaluate whether it remains appropriate*

Funds that are not "limited derivatives users" must meet three key elements of the Rule



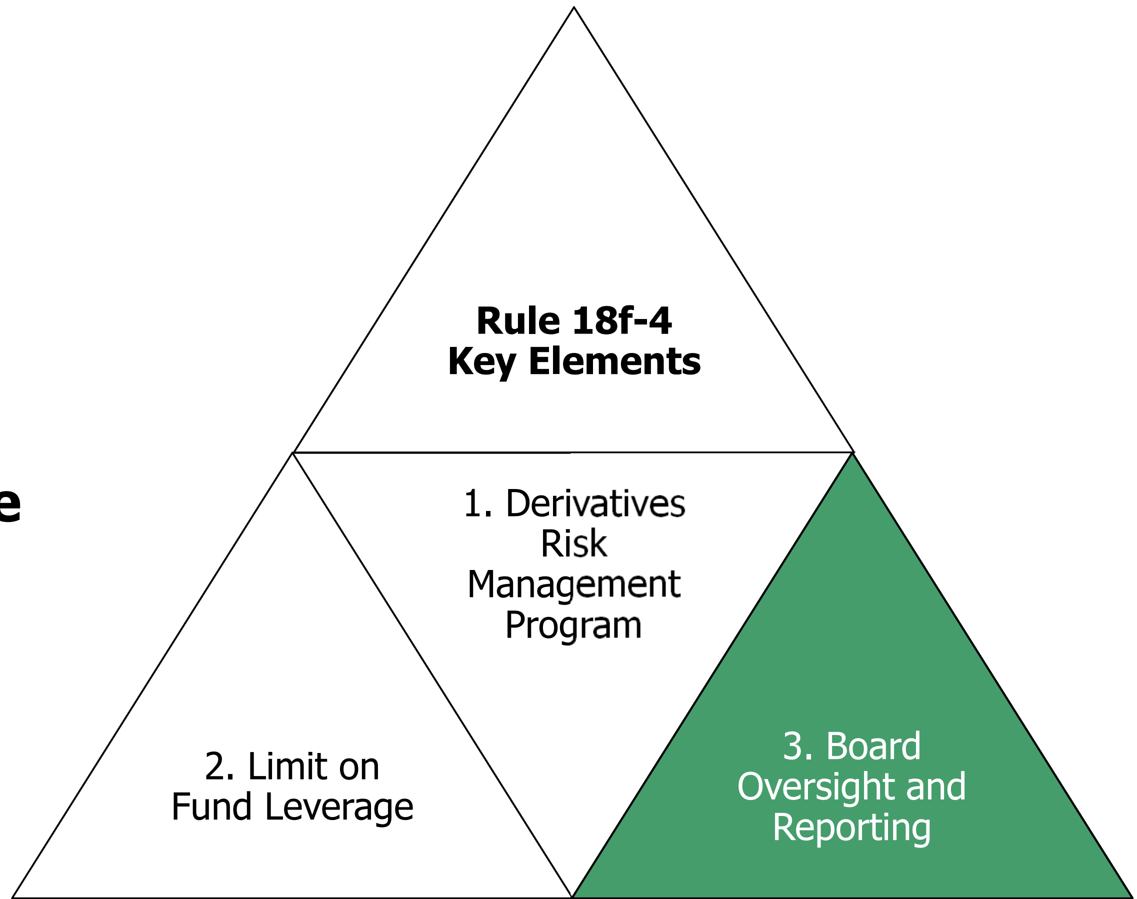
Conditions of the Rule: Limit on Fund Leverage Risk

2. Limit on Fund Leverage Risk
   - Fund must comply with a **relative** VaR test
     - *Unless, the Risk Manager reasonably determines that a designated reference portfolio would not provide an appropriate reference*
     - *The Risk Manager must consider the fund's investments, objectives, and strategy in making such a determination*
   - Otherwise, the fund must comply with an **absolute** VaR test

Conditions of the Rule: Limit on Fund Leverage Risk

2. Limit on Fund Leverage Risk
   - VaR test compliance must be determined at least once per business day
   - If out of compliance, must come back into compliance "promptly" in a manner that is in the best interests of the fund and its shareholders
   - If still out of compliance after five business days, the Risk Manager must:
     - *Report to the board, in writing, with an explanation of how and when the fund will be back in compliance*
     - *Update the risk management program elements as appropriate, based on the circumstances that caused the non-compliance*
     - *Report to the board, in writing, within 30 calendar days with an explanation of how the fund came back into compliance and changes to the program elements*
   - If still out of compliance after 30 calendar days, the Risk Manager must update its initial report and report back to the board with updates at intervals determined by the board

Funds that are not “limited derivatives users” must meet three key elements of the Rule



Conditions of the Rule: Board Oversight and Reporting

3. Board Oversight and Reporting
   - Board (including a majority of independents) must approve the designation of the Risk Manager
   - The Risk Manager must provide a written report to the board on or before the implementation of the program
   - The Risk Manager must provide an annual written report to the board on the program
   - Report must include a representation from the Risk Manager that it is reasonably designed to manage the fund's derivatives risks and incorporate the required elements of the Rule
   - Report must also address the designation reference portfolio requirement

Conditions of the Rule: Board Oversight and Reporting

3. Board Oversight and Reporting
   – Risk Manager must also report to the board, at a frequency determined by the board:
     - *Analysis of any risk guideline exceedances*
     - *Stress testing results*
     - *Backtesting results*
     - *Any information reasonably necessary for the board's evaluation of the fund's response to exceedances and the results of stress testing*

Board Perspectives

- Although risk management program does not require board approval, the board must approve the designation of the Risk Manager
- Consideration of the appropriateness of the Risk Manager’s structure (i.e., single person or committee), relevant experience, and capacity
- Ongoing reporting to the board adds more information, responsibility
- What are appropriate levels of inquiry with respect to program design, designated reference portfolio selection (or non-selection)?
- Expected level of derivatives experience on the part of the board
- Outsourcing considerations
- Facts and circumstances of the fund complex overseen by the board
- Availability and coordination for prompt reporting of exceedances and consideration of fund response planning

Reverse Repurchase Agreements

- Separate from the derivatives risk management program requirements, the Rule permits a fund to enter into reverse repos or similar financing transactions, notwithstanding Section 18 of the 1940 Act, provided that the fund:
  - Either:
    - *Complies with the asset coverage requirements of Section 18, and calculates its asset coverage ratio by combining the aggregate amount of indebtedness from reverse repos and similar financing transactions with other senior securities representing indebtedness, or*
    - *Treats all reverse repos and similar financing transactions as derivatives transactions*
- A fund must also maintain a record of which option it relies on
- Effectively, this gives funds flexibility to choose between Section 18 or the Rule with respect to their reverse repos and similar transactions

Unfunded Commitment Agreements

- The Rule also defines "unfunded commitment agreements" as a commitment by a fund to make a loan to a company or to invest equity in a company.
  - Such commitments can be conditional or unconditional
  - Capital commitments to a private fund that can be drawn down by the fund's general partner are included as "unfunded commitment agreements"
- The Rule permits a fund to enter into such an agreement, notwithstanding Section 18 of the 1940 Act, as long as the fund reasonably believes, at the time of the commitment, that it will have sufficient cash and cash equivalents to meet its obligations when due.
  - The fund's other obligations must be considered in forming this reasonable belief
  - Cash from the sale of an asset at a price that "deviates significantly" from market value may not be considered
  - Cash from issuing additional equity may not be considered
  - The basis for the fund's reasonable belief must be documented

Special Settlement Instruments

- The Rule also clarifies that a fund, and also a money market fund, may invest in a security that settles on a when issued, forward-settlement basis or non-standard settlement cycle without such investment being deemed to be a "senior security" for purposes of Section 18 of the 1940 Act, *provided that*
  - The fund intends to physically settle the transaction, and
  - The transaction will settle within 35 days of its trade date

Recordkeeping and Current Reports

- The Rule requires a fund to maintain records of:
  - Written policies and procedures
  - Stress test results
  - Backtest results
  - Internal reporting records or documentation of risk escalation
  - Board materials and reports
  - VaR and designated reference portfolio determinations
  - Updates to VaR calculation models and the basis for any changes
- The SEC also adopted new Form N-RN, which requires confidential reporting to the SEC of VaR test breaches that have not been resolved within five business days

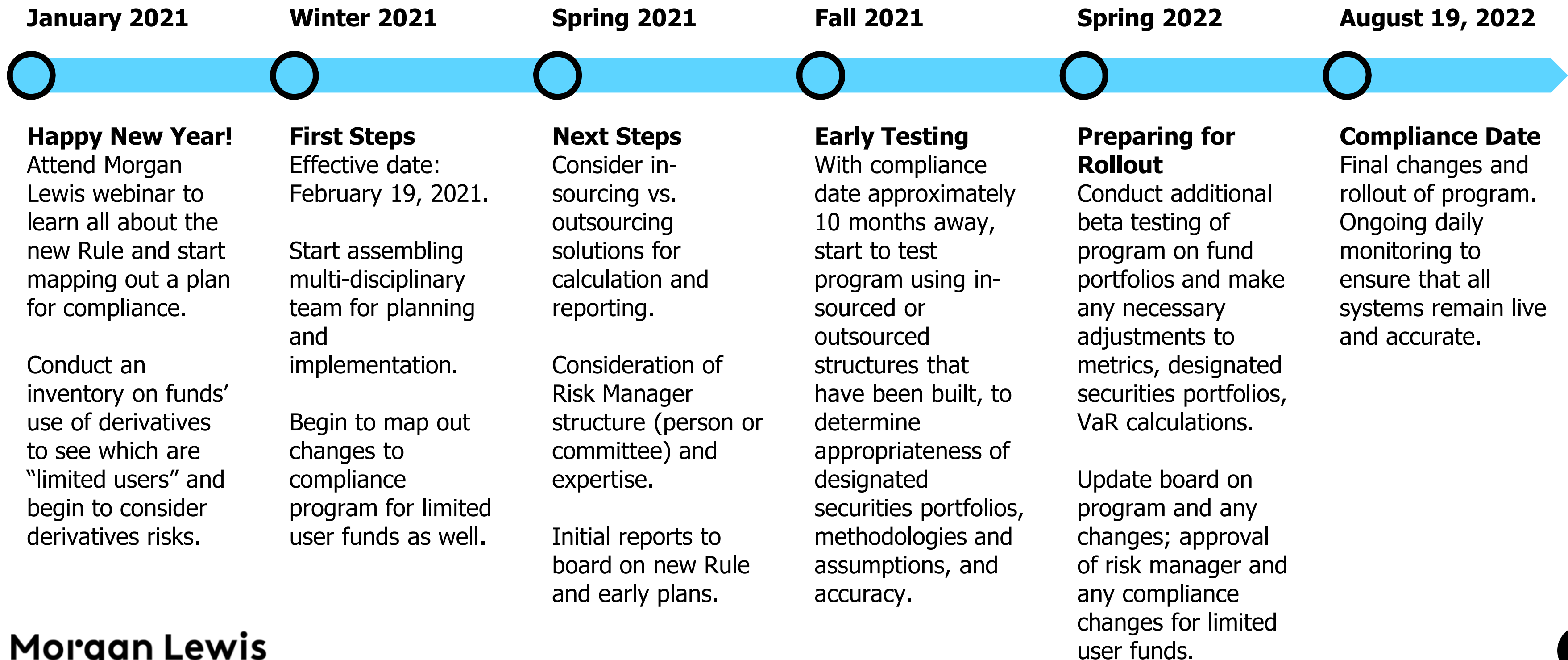
Effect on Existing Relief

- Section 18 of the 1940 Act restricts the ability of funds to issue "senior securities" (i.e., instruments creating indebtedness)
- Release 10666, issued by the SEC in 1979:
  - States that certain types of derivatives transactions create senior securities subject to Section 18; permits those transactions subject to asset coverage and segregation requirements
  - Subsequent guidance and no-action letters have caused disparate asset-segregation practices for derivatives transactions
- Rule 18f-4 will replace the current "multi-part guidance framework with a unitary rule"

Potential Market Impact

- Potential for increased regulatory certainty and transactional efficiency, as trading and compliance practices evolve and coalesce around the new Rule
- Potential for more information for investors on risk and testing results
- New vendor solutions for VaR calculation and other program and compliance services
- Increased liability for funds, compliance, and board – insurance implications, importance of compliance resources (early regulatory examination after compliance date is likely)
- Given ~20 month timeline, consider budgeting and resource implications
- New product development around 200%/20% limits, including for ETFs, given corresponding change to ETF Rule that will permit such products to come to market without an exemptive order
- Potential for closed-end funds to be a means of accessing greater leverage, depending the type of leverage employed
- Favoring of familiar derivative instruments and well-known counterparties, given requirements for testing to consider market environment and confidence level
- Potential implications of Congressional Review Act given recent political changes

Planning for Compliance



Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at **www.morganlewis.com/topics/coronavirus-covid-19**

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to **subscribe** using the purple "Stay Up to Date" button.

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Laura E. Flores' practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and "no-action" letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing "liquid alt" funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm's diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.

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Thomas S. Harman represents investment advisers (both publicly and privately held), mutual funds, closed-end funds, interval funds, unit investment trusts, and private investment funds on a variety of legal and compliance issues. Tom represents the board of directors of several fund families, including the board of several business development companies. He also advises issuers with respect to the availability of exemption from the Investment Company Act of 1940.

Tom previously served as chief counsel and then associate director (chief counsel) of the Securities and Exchange Commission's (SEC) Division of Investment Management.

A frequent speaker on investment management issues and the author of numerous articles on industry issues, Tom taught in the securities law program at the Georgetown University Law Center for more than a decade. He also served as co-planning chair of the Annual ALI-CLE Course on Investment Company Regulation and Compliance for more than a decade.

Based on feedback from clients, peers, and other industry professionals, *Chambers USA* has named Tom a leading US lawyer for investment management for the past eight years. *Chambers* noted that Tom is "a strong player" and that he is respected for "innovative and thoughtful work, coupled with encyclopedic knowledge."

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Jack counsels registered and private funds and fund managers in connection with organizational, offering, transactional, and compliance matters. He regularly works with a variety of different fund structures, including open-end and closed-end funds, exchange-traded funds, and hedge funds. He also counsels investment adviser and broker-dealer clients on various matters, particularly with respect to registration and disclosure, marketing regulations, pay-to-play issues, and transactions in exchange-traded funds.

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Jeremy Esperon focuses his practice on the regulation of investment companies and investment advisers. He advises clients on the formation, registration, and ongoing regulation of investment companies, with a focus on exchange-traded funds (ETFs), and provides ongoing advice regarding various regulatory compliance and securities law issues. Jeremy also advises on closed-end fund shelf offerings and related regulatory issues.

Prior to joining Morgan Lewis, Jeremy worked for six years as a paralegal for Legg Mason, a global investment management firm, where he advised the company and its affiliates worldwide on a wide range of intellectual property matters. Jeremy is proficient in French and Spanish and conversant in Mandarin Chinese.

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Leveraging her experience as a lawyer at the US Commodity Futures Trading Commission (CFTC), Sarah V. Riddell advises domestic and foreign exchanges, derivatives clearing organizations, swap execution facilities, and other financial institutions on a broad range of regulatory matters, including CFTC registration and compliance. Sarah also assists hedge fund clients with CFTC and National Futures Association (NFA) registration, compliance, and examination questions. While at the CFTC, Sarah worked on Dodd-Frank-related rulemakings and participated in examinations of derivatives clearing organizations, including those designated as systemically important.

In addition, Sarah helps clients understand and comply with the NFA's Information Systems Security Program interpretive notice and the New York Department of Financial Services Cybersecurity Regulation, as well as related cybersecurity questions. Sarah has assisted clients who have experienced cybersecurity attacks, assisted in the cybersecurity investigation including an assessment of the forensic analysis about the incident, and drafting and submitting notifications to customers and regulatory agencies.

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Kyle T. Sullivan represents mutual funds and investment advisers in a number of areas, including SEC filings, regulatory and compliance issues and reorganizations and restructurings.

Before joining Morgan Lewis, Kyle worked at a large custodial bank and administrator, where he advised mutual funds regarding their obligations under the Investment Company Act of 1940 and other federal securities laws. Prior to this, Kyle worked as a regulatory-compliance professional at a large investment adviser.

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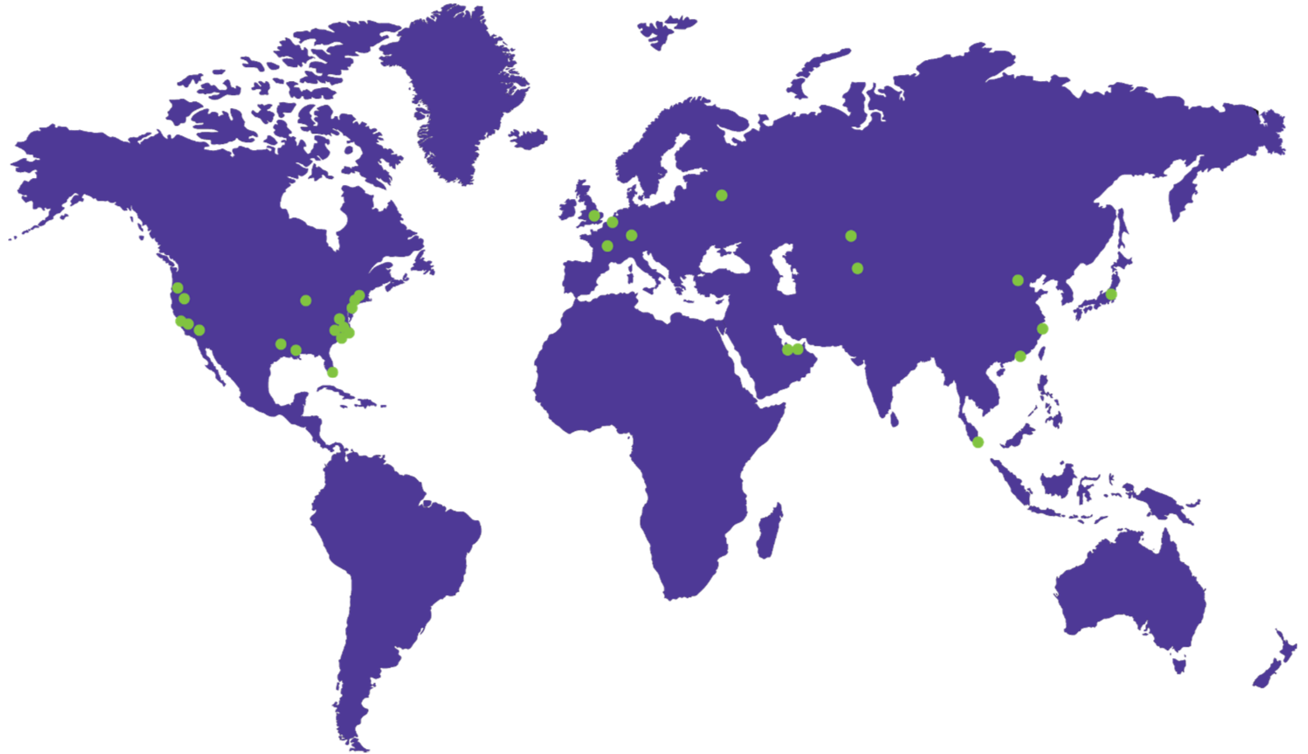

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