CARLTON FIELDS

A New Beginning for Fund Derivative Regulation

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SEC Replaces Rather than Revises

In late October, the SEC approved a wholesale replacement for the patchwork of interpretive and no-action positions it had developed over more than 40 years to regulate fund use of derivatives. The process of developing these derivative reforms has itself taken many years, including a subsequently withdrawn 2015 rule proposal, and a 2019 rule proposal that the SEC has now adopted with modifications.

The nature and approach of these derivative reforms very much echo other major SEC brush-clearing projects that have recently come to fruition. See, for example, the SEC's "fund of fund" reforms, discussed in our article on page 4, and the SEC's reform of fund liquidity regulation, discussed in "SEC Adopts Liquidity Risk Programs for Funds," Expect Focus – Life, Annuity, and Retirement Solutions (Dec. 2016). Indeed, the latter reform, requiring that funds have liquidity risk programs, works in tandem with the derivative reforms, as these initiatives address closely intertwined fund liquidity and risk issues.

Applicability of the Reforms

The derivative reforms apply to funds (other than money market funds) that are registered with the SEC as "management-type" investment companies. The reforms will not apply, for example, to insurance company separate accounts, except to those very few separate accounts that are registered as management-type investment companies. Accordingly, the reforms will not have any direct relevance for most insurance company separate accounts, although the reforms will be highly significant for many of the underlying funds in which most such separate accounts invest.

As adopted, the derivative reforms do not provide any exclusion for exchange traded funds, which will impose constraints on certain "inverse" or "leveraged" ETFs (although the reforms do provide "grandfathering" relief in this regard for certain existing ETFs). Subject to the reforms' constraints, however, the reforms include a rule amendment that now will permit such inverse or leveraged ETFs to commence operation without being covered by an exemption order from the SEC.

Funds can now rely on the derivative reforms at any time, but must be in compliance within 18 months after the final rule has been published in the Federal Register (which it has not been at the date hereof). Also as of that same compliance date, most of the prior SEC interpretations and no-action positions that previously have been relevant in this area will be withdrawn.

Nature of the Reforms

The derivative reforms govern funds' use of a wide variety of instruments or transactions under which funds may incur an obligation to make payments at a future time, thus exposing the fund to risk or enabling the fund to "leverage" its investment returns. Although the reforms generally refer to all of these as "derivatives," in other contexts that term is not necessarily commonly applied to some of the instruments or transactions covered by the reforms.

The reforms' main component is a new Investment Company Act Rule 18f-4, which imposes extensive requirements on funds that have "derivative exposure" (calculated as provided in the rule) equal to more than 10% of the fund's net assets. The rule requires that such a fund's "value at risk" (calculated as the rule provides, the "VaR") generally not exceed (a) 200% of the VaR of a reference index that "reflects the markets or asset classes in which the fund invests" or (b) in the absence of an appropriate reference index meeting the rule's requirements, 20% of the fund's net assets. The fund must determine compliance with the applicable VaR test at least once a day.

Funds are also required to adopt and implement a written derivatives risk management program that must, among other things, provide for:

- Establishment and enforcement of risk guidelines that specify levels of identified criteria, metrics, or thresholds that the fund does not normally expect to exceed, and measures to be taken if those are exceeded.
- Stress testing (at least weekly) to evaluate potential losses to the fund's portfolio in response to extreme but plausible changes in market or risk factors.
- Back testing (at least weekly) of the validity of the model the fund is using to make the above-mentioned VaR computations.

The derivatives management program must be administered by one or more natural persons that the fund board approves as the fund's "derivatives risk manager." Each such natural person must be an officer of the fund's investment adviser (or, in many cases, a sub-adviser) and have "relevant experience regarding the management of derivatives risk." Moreover, the derivatives risk manager cannot be a portfolio manager of the fund (or, where multiple persons serve as derivative risk manager, at least a majority must be persons who are not a portfolio manager of the fund).

The responsibilities that Rule 18f-4 assigns to the derivatives risk manager include:

- Prior to implementation of the derivatives management program, and at least annually thereafter, representing to the board that the program is reasonably designed to comply with all of the rule's requirements applicable to the program, including the appropriateness of any reference index for VaR calculation purposes.
- At least annually reviewing and reporting to the board on those matters, as well as reporting to the board as to other matters and at other times as provided in the rule.

As noted previously, funds having derivative exposure that does not exceed 10% of their net assets generally are not subject to the most of Rule 18f-4's above-summarized requirements. The rule, however, does require funds that have this type of limited derivative exposure to, among other things, adopt and implement written policies and procedures "reasonably designed to manage the fund's derivatives risk."

Rule 18f-4 also requires funds to maintain records relating to their use of derivatives and to file current reports with the SEC of breaches of the above-mentioned VaR limits on Form N-RN. Form N-RN, which formerly was entitled Form N-LIQUID, now also has been amended to add items relating to the VaR limits. Forms N-PORT and N-CEN also have been amended to reflect fund derivative use.

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