CARLTON FIELDS

SEC Proposes New Limits on Funds' Use of Derivatives

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Chip Lunde

The SEC recently proposed a new rule (Rule 18f-4) to govern the use of derivatives by mutual funds, ETFs, and closed-end funds (including BDCs). The proposed rule would subject funds that use derivatives to new leverage limits, asset segregation requirements, and risk management procedures.

Leverage Limits

A fund that uses derivatives would be required to limit its exposure to derivatives, financial commitments, and other senior securities transactions to either:

- 150 percent of its net assets, or
- 300 percent of its net assets, if the derivatives lower the fund's overall risk (e.g., derivatives used for hedging).

Importantly, these exposures would be based on the notional amounts of the derivatives transactions. However, the amounts would be calculated differently for different types of derivatives transactions.

Asset Segregation Requirements

Asset segregation requirements would apply to a fund's use of derivatives and financial commitment transactions. For derivatives, a fund would be required to segregate qualifying assets equal to:

- a mark-to-market amount equal to the amount needed to unwind the derivatives position, plus
- a risk-based amount equal to the reasonably estimated amount required to exit the position under stressed conditions.

However, the coverage amounts would be reduced by (i) derivatives covered by netting agreements and (ii) margin posted by the fund.

For financial commitment transactions, a fund would be required to segregate assets equal to 100 percent of its obligations under those transactions.

Perhaps most significantly, qualifying coverage assets would be limited to cash, cash equivalents, and other narrow categories of assets specified in the rule.

Risk Management Program

Under the proposed rule, a fund that either (i) has over 50 percent of its net assets exposed to derivatives or (ii) uses complex derivatives must implement a risk management program designed to address risks associated with derivatives.

The program would provide for quarterly updates to the board and be subject to annual board approval. The proposed rule also calls for the appointment of a derivatives risk manager (such as the fund's CCO) that must be independent of the fund's portfolio managers.

The comment period for the proposal concluded March 28.