



The SEC's New Derivatives Rule: Practical Implications for Funds



February 25, 2021

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Introductions



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Agenda

- Overview of the new SEC's New Derivatives Rule
- Approving a Derivatives Risk Manager
- Understanding the Derivatives Risk Management Program
- What to Expect in Board Reporting
- Board Obligations When Funds Fall Out of Compliance



Regulatory Background



Rule 18f-4 – Adopted October 28, 2020

- Permits a fund to enter into derivatives transactions notwithstanding 1940 Act restrictions if it:
 - Adheres to limits on fund leverage risk set forth in the rule
 - Adopts a derivatives risk management program (“DRMP”) and appoints a derivatives risk manager (“DRM”) to administer DRMP
 - Complies with board oversight and reporting requirements
- Exception for “limited derivatives users”
- Alternative requirements for certain leveraged and inverse funds
- Adopted substantially as proposed, except that the SEC did not adopt proposed sales practices rules for leveraged and inverse funds



Regulatory Background

- Section 18 of the 1940 Act imposes various limits on the capital structure of funds, including, in part, by prohibiting open-end funds from issuing or selling any “senior security,” other than borrowing from a bank (subject to a requirement to maintain 300% “asset coverage”).
 - “Senior security” is defined, in part, as “any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness.”
 - The SEC takes the position that, where the fund has entered into a derivatives transaction and has a future payment obligation, that transaction involves an “evidence of indebtedness” that is a senior security for purposes of Section 18.



Regulatory Background (cont.)

- Section 18 is intended to protect investors against the potentially adverse effects of a fund's issuance of senior securities, and in particular the risks associated with excessive leverage by funds when these activities unduly increase the speculative character of a fund's shares.
- Notwithstanding the restrictions in Section 18, the SEC historically has permitted funds to use derivatives subject to certain constraints.
- These constraints relied on funds' use of "segregated accounts" to "cover" senior securities, which "if properly created and maintained, would limit the [fund's] risk of loss."



Regulatory Background (cont.)

- The SEC also stated that the segregated account functions as “a practical limit on the amount of leverage which the [fund] may undertake and on the potential increase in the speculative character of its outstanding common stock” and that it “[would] assure the availability of adequate funds to meet the obligations arising from such activities.”
- New Rule 18f-4 replaces the existing “asset segregation”/“cover” regime.
 - Greater focus on managing a fund’s derivatives risk in light of a fund’s investment strategies and use of derivatives.



Overview of Rule 18f-4





Derivatives Transactions

- The Rule defines “derivatives transactions” as:
 - any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument, under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise;
 - any short sale or borrowing; and
 - (optionally) reverse repos and similar financing transactions.



Limit on Fund Leverage Risk

- Funds generally must limit their leverage risk based on a fund's "Value at Risk" or "VaR," using either a relative or absolute test.
- Fund may choose any VaR model that meets certain conditions:
 - Incorporates all significant, identifiable market risk factors
 - Uses a 99% confidence level and a time horizon of 20 trading days
 - Contains at least 3 years of historical market data
- The Fund's Derivatives Risk Manager (DRM) must determine a fund's compliance with the applicable VaR test at least once each business day.



Limit on Fund Leverage Risk

- Relative VaR Test -- Fund VaR may not exceed 200% of an unleveraged “designated reference portfolio.”
 - Increase from the proposed rule, which limited fund VaR to 150%
 - May use an index or fund’s own portfolio as the reference portfolio
- Absolute VaR Test -- Fund VaR may not exceed 20% of NAV
 - This alternative is available only if the DRM determines that the Relative VaR Test is not appropriate
 - Increase from the proposed rule, which limited fund VaR to 15%



Limit on Fund Leverage Risk (cont.)

- If the fund is not in compliance, it must come back into compliance promptly after such determination, in a manner in the best interests of the fund and shareholders.



Derivatives Risk Management Program

- Written program with policies and procedures reasonably designed to manage the fund's derivatives risks.
- Administered by DRM, who is an individual or group approved by the board.
- Board is not required to approve DRMP.



Derivatives Risk Management Program (Cont.)

- Must include designated components, tailored to a fund's use of derivatives:
 - Risk identification and assessment
 - Risk guidelines
 - Stress testing
 - Backtesting
 - Internal reporting and escalation of material risks to portfolio management and board
 - Periodic review of DRMP to evaluate effectiveness and reflect changes in risks over time



Derivatives Risk Management Program (Cont.)

- Funds may involve sub-advisers in derivatives risk management, including in certain cases as the DRM or as part of a DRM group, or otherwise providing information and assistance.



Reporting

- DRM must provide a number of different reports to the board:
 - Report upon/before implementation, and at least annually, including:
 - Representation that the DRMP is reasonably designed to manage derivatives risks and to incorporate Rule 18f-4 requirements, and the basis therefor
 - Effectiveness of the DRMP's implementation
 - Basis for determinations regarding designated reference portfolios
 - Regular reports (with frequency determined by the board) of DRM's analysis of exceedances of guidelines, stress testing and backtesting.
 - Additional reporting required if a fund exceeds VaR test for more than 5 business days.



Exceptions: Limited Derivatives Users

- A fund is exempt from VaR testing, DRMP and board oversight and reporting requirements if:
 - It adopts and implements written policies and procedures reasonably designed to manage derivatives risk; and
 - Its derivatives exposure does not exceed 10% of the fund's net assets, generally excluding:
 - Certain interest rate or currency hedges
 - Borrowings
 - Closed-out positions that were closed with the same counterparty
- If a fund exceeds this exposure for more than 5 business days, adviser must report to the board whether:
 - The fund will reduce the exposure below 10% within 30 days; or
 - The fund will comply with the other Rule 18f-4 requirements.



Exceptions: Leveraged and Inverse Funds

- SEC did not finalize proposed requirements with respect to sales practices of leveraged and inverse funds.
- Leveraged and inverse funds that seek to provide exposure less than 200% of the return of an index must comply with Rule 18f-4
 - Must use relative VaR test and must use the index it tracks as the designated reference portfolio
- Existing leveraged and inverse funds that provide exposure greater than 200% of the return of an index are exempt from VaR requirement, but must comply with all other requirements and additional conditions.
- ETF Rule amended to permit leveraged and inverse ETFs.



Additional Requirements

- Recordkeeping requirements
- Funds are permitted to enter reverse repurchase agreements and unfunded commitments, subject to conditions
- Final rule and related amendments take effect 60 days after publication in the Federal Register, and funds must comply 18 months after that date
- Prior SEC releases and staff guidance will be rescinded at the end of the transition period
- Amendments to Forms
 - “Big data” reporting
 - Confidential reporting to the SEC if a fund is out of compliance with VaR test for more than 5 business days



Role of the Board





Board Oversight Background

- SEC rulemaking has created greater board responsibility for oversight of fund risks.
 - Historically, the 1940 Act and rules thereunder have focused on the board's role in mitigating conflicts of interest.
 - Rule 38a-1 (the “Compliance Rule”): board responsibility for approval of compliance policies and procedures, annual review.
 - Rule 22e-4 (the “Liquidity Rule”): board responsibility for approval of liquidity risk management program (“LRMP”), approval of LRMP administrator, annual review.



Board Oversight Background (cont.)

- The board is responsible for overseeing a fund's compliance with Rule 18f-4.
 - This oversight is also consistent with the board's obligations under the Compliance Rule.
- Important for boards to take an oversight role, not day-to-day management of the appropriateness of a fund's derivatives risks.



Board Oversight

- Board must approve DRM and oversee derivatives risk
 - Unlike Liquidity Rule, board is not required to approve DRMP
- Not designed to be a passive activity. Per Adopting Release, directors should:
 - Understand the DRMP and the derivatives risks it is designed to manage
 - Ask questions and seek relevant information regarding the program's adequacy and effectiveness
 - Receive sufficient information on a regular basis to remain informed about specific risks
 - Request follow-up information when appropriate, depending on facts and circumstances
 - Inquire about material risks arising from derivatives transactions and follow up regarding the steps the fund has taken to address these risks



Board Oversight (cont.)

How do the Board's oversight responsibilities for a fund's **Derivatives Risk Management Program** compare to the Board's oversight responsibilities for a fund's **Liquidity Risk Management Program**?



Board Oversight (cont.)

- Should be an “iterative process”
 - The Adopting Release clarifies that the board is not responsible for day-to-day derivatives risk management.
 - Instead, this characterization is intended to clarify the importance of regular engagement, rather than a one-time assessment.
- In response to comments on the proposed rule, the SEC clarified that “the role of the board under the rule is one of general oversight, and consistent with that obligation, we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund’s investors.”



Approval of the DRM

- Must be an officer or officers of the fund's adviser.
 - Unlike Liquidity Rule, the board may not appoint the adviser or an adviser committee or entity.
 - The adviser may participate in the selection process but may not be responsible for the designation.
- May not be a portfolio manager.
 - If multiple DRMs, may not be majority portfolio managers.



Approval of the DRM (cont.)

- A DRM must have “relevant experience” regarding the management of derivatives risk.
 - Removed the requirement from the proposed rule that the board specifically take into account the DRM’s relevant experience regarding the management of derivatives risk.
 - SEC expects that the board’s consideration of DRM “necessarily would take into account the candidate’s experience, among all other relevant factors.”



Board Reporting

- In order to fulfill its oversight duties, the board should receive regular reports from the DRM regarding the implementation and effectiveness of the DRMP, analysis of exceedances of guidelines, and results of stress testing and backtesting.
 - Annual report
 - Must also be provided on or before implementation.
 - Representation that the DRMP is reasonably designed to manage fund's derivatives risk and to incorporate the Rule 18f-4 requirements.
 - Must include the DRM's basis for this representation and information reasonably necessary for the board to evaluate the DRMP's adequacy and effectiveness.
 - May be based on DRM's reasonable belief after due inquiry.
 - DRM's basis for: the approval of a designated reference portfolio; any changes to a designated reference portfolio; or a determination that a designated reference portfolio would not be appropriate.



Board Reporting (cont.)

- Regular written reports at frequency determined by the board.
- Analysis of (1) exceedances of the fund's risk guidelines, (2) results of stress tests and (3) results of backtesting.
- In a change from the proposed rule, the board is not required to receive a report of “any” exceedance of the risk guidelines or all results of stress tests and backtesting. The report can be provided in summary form.



Board Reporting (cont.)

- Reports of noncompliance with VaR testing requirements.
 - If noncompliance exceeds 5 business days, DRM must report how and when DRM expects fund to return to compliance.
 - Within 30 calendar days of exceedance, DRM must report how fund came back into compliance, DRM's analysis of circumstances, and any program updates.
 - Similar requirements in Liquidity Rule, although there is no automatic requirement for a report 30 days after exceeding liquidity parameters.
- Escalation of material risks by DRM.



Board and Complex Considerations

- Selection of the DRM and level of participation by adviser.
 - What does the board consider “relevant experience” managing derivatives risk?
 - Capacity of individual selected as DRM/other roles of DRM with adviser and fund.
 - Smaller fund complex considerations.
- Ability to adapt components of existing board derivatives oversight.



Board and Complex Considerations (cont.)

- Frequency and level of detail of periodic reports, including any fund-by-fund differences, necessary for the board to remain informed.
- Board knowledge necessary to evaluate the DRM's conclusions.
- Follow-up necessary for the board to satisfy itself that the fund has addressed its material risks, including any fund-by-fund differences.
- Maintenance of board's oversight role, rather than taking on a management role.

The slide features a white background with several geometric shapes. In the top-left corner, there is a small, partially visible 3D-style shape composed of green and blue triangles. On the right side, there is a large, stylized graphic consisting of overlapping light blue and light green shapes that resemble a large, tilted letter 'A' or a similar abstract form. The word "QUESTIONS?" is centered in the middle of the slide in a bold, dark blue font.

QUESTIONS?



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