Investment Company Use of Derivatives and Leverage: What It Could Mean for You

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Background

• The SEC and its staff historically have applied the prohibitions of Section 18 of the 1940 Act to a fund’s use of derivatives

• Section 18 generally prohibits an open-end fund from issuing any “senior security” although it allows funds to borrow from banks within certain limits
  • A “senior security” generally includes most claims senior to common stock in an insolvency
  • Open-end funds generally are limited to borrowing from banks if they maintain 300% asset coverage
  • Closed-end funds may issue or sell a senior security subject to asset coverage requirements
    • 300% for debt
    • 200% for equities
The Section 18 restrictions on senior securities are intended to prevent funds from exposing themselves and their shareholders to:

- Excessive borrowing and unduly increasing the speculative character of a fund’s junior securities
- Operating without adequate assets or reserves
- Potential abuse of the purchasers of senior securities

The SEC’s staff takes the position that use of certain derivative instruments may involve the issuance of prohibited senior securities.

Rather than prohibit funds from using derivatives, the SEC and its staff, through interpretive guidance, allowed funds to use derivatives if the funds enter into offsetting transactions or by segregating assets in amounts that would cover the fund’s potential liabilities under the instruments.
The Current State of Affairs

• Release 10666 ("Ten Triple Six") – 1979
  • Release 10666 does not specifically address derivatives
  • It focused on three types of financial instruments: reverse repurchase agreements, firm commitment agreements, and standby commitment agreements
    • Release 10666 was not limited to these trading practices, since the SEC wanted to address “all comparable trading practices” that could affect the capital structure of a fund
  • SEC said that if a fund “covered” its obligations under those transactions, SEC would not raise the issue that the fund issued a senior security
  • Funds could “cover” transactions by
    • Maintaining segregated assets sufficient to satisfy 100% of the fund’s obligations under the transaction, or
    • Entering into transactions that offset the fund’s obligations
  • SEC advised fund boards to analyze other transactions that should be subject to this “cover” arrangement due to implicit leverage
  • The obligation to cover effectively placed a ceiling on the amount of leverage a fund may employ
The Current State of Affairs

• For the types of transactions specifically addressed in Release 10666, the amount of assets required to be segregated was reasonably clear and based on the purchase price of the relevant security.

• Derivatives, however, raised additional issues:
  • How to calculate the value of assets to be segregated:
    • Based on notional amount, mark-to-market value, or something else?
  • Should the amount to be segregated depend on the purpose for which a particular derivative is used?
    • Uses of derivatives include seeking higher returns through increased investment exposures, hedging interest rate, credit, and other risks in investment portfolios, and greater transaction efficiency.
The Current State of Affairs

• Current guidance from the SEC and its staff on segregation of assets in connection with investments in derivatives is contained in more than 30 no-action letters, which address questions on an instrument-by-instrument basis.

• Market practice has evolved under which, in relation to certain derivatives, funds segregate the entire notional amount, and in relation to others, they segregate only the mark-to-market value.

• July 2010 – Task Force on Investment Company Use of Derivatives and Leverage of ABA Business Law Section’s Committee on Federal Regulation of Securities recommends reforms to SEC.

• August 2011 – the SEC, seeking to systematize its approach to regulating funds’ practices in relation to derivatives, publishes a concept release, which requested comment on a wide range of issues concerning investment companies’ uses of derivatives.
The Current State of Affairs

- Meanwhile, post-2008, banking regulators are concerned about systemic risk
- FSOC publishes study indicating that asset managers and mutual funds present systemic risk
- SEC announces a series of regulatory initiatives
  - Money market reforms
  - Liquidity risk management
  - Valuation guidance (embedded in money market reform rule release)
  - Stress testing of advisers
  - Succession planning (living wills)
  - Derivatives
  - Increased enforcement
Overview of Proposed Rule 18f-4

- December 2015 – SEC proposes Rule 18f-4, which would effectively regulate the use of derivatives by investment companies
  - Would apply to mutual funds, closed-end funds, ETFs, BDCs but not UITs
- Rule 18f-4 is an *exemptive rule*, which would
  - allow investment companies to enter into derivatives and financial commitment transactions notwithstanding the 1940 Act’s prohibitions and restrictions on the issuance of senior securities
  - would supersede and rescind previous guidance (e.g., Release 10666 and a long line of no-action letters)
- Rule 18f-4 would regulate “senior securities,” not all derivatives
Overview of Proposed Rule 18f-4

• A fund seeking to rely on Rule 18f-4 would have to:
  • Comply with one of two “exposure” tests
  • Maintain an appropriate amount of “qualifying coverage assets”
  • Establish a formal derivatives risk management program if fund
    • enters into derivatives transactions equal to or greater than 50% of fund’s net assets, or
    • utilizes certain complex derivatives
  • Seek various board approvals, some on a periodic basis
  • Comply with new recordkeeping, disclosure, and reporting requirements
Portfolio Limitations

• Rule 18f-4 would limit the notional amounts of derivatives that funds could transact
  • Portfolio limitations are a relatively blunt measurement, because derivatives can be put to many uses, and their risk profiles can vary dramatically
  • The SEC sought a reasonably practicable test, even if it may not be the most refined test possible

• To enter into transactions that would constitute “senior securities,” a fund would be required to conform to one of two portfolio limitations, each intended to prevent a fund from becoming excessively leveraged or speculative
  • Board approval would be required for the portfolio limitation under which the fund would operate
Portfolio Limitations

• Exposure-based limit
  • The first portfolio limitation would be based on a fund’s “exposure,” a term defined to include, but not be limited to, the notional amounts of a fund’s derivatives
  • A fund’s aggregate exposure would not exceed 150% of the fund’s net assets
  • Exposure for these purposes would equal the sum of
    • the notional amounts of a fund’s derivatives (subject to netting for directly offsetting derivatives)
    • the fund’s aggregate obligations, whether conditional or unconditional, under financial commitment transactions (such as reverse repurchase agreements, firm commitment agreements, and standby commitment agreements), and
    • aggregate indebtedness under other senior securities transactions
  • Exposure levels greater than 150% “could be used to take on additional speculative investment exposures that go beyond what would be expected to allow for hedging arrangements”
    • A 150% limit would allow a fund “to obtain a level of indirect market exposure solely through derivatives transactions that could approximate the level of market exposure that would be possible through securities investments augmented by borrowings as permitted under section 18”
Portfolio Limitations

• Risk-based limit
  • The second, risk-based portfolio limitation would permit greater exposure, up to 300% of a fund’s net asset value, but ONLY IF a fund’s derivatives transactions decrease the fund’s overall market risk as measured by a “Value-at-risk” or “VaR” test
  • VaR means “an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence interval”
  • A fund’s “full portfolio VaR” – that is, the VaR of the fund’s entire portfolio, including derivatives – must be less than the fund’s “securities VaR,” the VaR of the fund’s portfolio excluding any derivatives transactions
  • Requirements for VaR models must take into account all relevant risk factors, must have a minimum 99% confidence interval, must have a time horizon of not less than 10 and not more than 20 trading days, and, if using historical simulation, must have a minimum of three years of historical data
  • Compliance measured immediately after entering into the transaction
Asset Segregation Requirements

• Rule 18f-4 would clarify the amounts and nature of the assets that funds are required to segregate in connection with derivatives transactions
  • It would also offer a middle ground between requiring the segregation of, on the one hand, the entirety of a transaction’s notional amount and, on the other, its current mark-to-market value
• A fund would be required to identify on its books and records “qualifying coverage assets,” determined daily, with a value equal to the sum of the fund’s
  • aggregate mark-to-market coverage amounts, plus
  • risk-based coverage amounts
Asset Segregation Requirements

- What is “mark-to-market coverage amount”?  
  - For each derivatives transaction, the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the relevant time  
    - Amount can be reduced by variation margin pledged to counterparties

- What is “risk-based coverage amount”?  
  - For each derivatives transaction, an amount representing “a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions”  
    - Amount can be reduced by variation AND initial margin pledged to counterparties

- Limited netting  
  - In calculating both “mark-to-market coverage amounts” and “risk-based coverage amounts,” a fund could net transactions under the same netting agreement (and same asset, same maturity, etc.), thus reducing the amount of assets required to be segregated
Asset Segregation Requirements

- Financial Commitment Transactions
  - Financial commitment transactions (reverse repos, short sales) would follow the treatment under Release 10666
  - Funds would segregate full amount fund is obligated to pay (conditionally or unconditionally), not just mark-to-market.
Asset Segregation Requirements

• What assets can be segregated?
  • Derivatives transactions
    • cash and cash equivalents OR
    • the asset that may be deliverable under transaction
  • Financial commitment transactions
    • same as derivatives (cash/cash equivalents/assets to be delivered) PLUS
      • Broader set of assets that can be segregated
        • Segregate assets that are convertible to cash or that will generate cash in an amount equal to the financial commitment obligation prior to date fund would have to pay
        • Use assets that have already been pledged, so long as reasonably expected to satisfy fund’s obligation (as determined in accordance with policies and procedures approved by Board)
Risk Management Programs

- Rule 18f-4 would require many funds using derivatives to adopt and implement a written derivatives risk management program.
- The derivatives risk management requirement would apply to any fund that either
  - entered into a “complex derivatives transaction” or
  - did not implement and comply with a portfolio limitation under which the notional amount of its derivatives could not exceed 50% of its net asset value.
- A “complex derivatives transaction” is defined as one under which an amount payable by either party upon settlement, maturity, or exercise
  - is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction (e.g., an Asian option or barrier option) or
  - is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price (e.g., a variance swap).
Risk Management Programs

- Risk management programs must be reasonably designed to
  - assess the risks associated with a fund’s derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, operational risks, and any other risks considered relevant
  - manage the risks associated with the fund’s derivatives transactions including by:
    - monitoring whether the fund’s use of derivatives transactions is consistent with any investment guidelines established by the fund or its investment adviser, the portfolio limitations applicable to the fund, and disclosure to investors; and
    - informing persons responsible for portfolio management of the fund or the fund’s board of directors, as appropriate, regarding material risks arising from the fund’s derivatives transactions
- Rule 18f-4 would require a fund to segregate the functions associated with the program from the fund’s portfolio management
- Funds must review and update Program at least annually
Board Responsibilities

- Exposure – Board must approve which portfolio “exposure” limitation will apply to each fund
- Segregation – Board must approve policies and procedures for determining amount of “qualifying coverage assets” including how risk-based coverage is calculated
- Risk Management – Board must approve
  - Derivatives risk management program and any material changes to program
  - Designation of risk officer responsible for administering program (not PM)
  - Review, at least quarterly, written report prepared by administrator of program describing the accuracy of the fund’s program and the effectiveness of its implementation
- Overlap with Board responsibilities under liquidity rules
- Recordkeeping requirements include written records of board determinations
Record Retention

• Rule 18f-4 would require funds to maintain, generally for a period of at least five years, written records relating to, among other things:
  • the policies and procedures adopted by the fund
  • each determination made by the fund’s board of directors with respect to the portfolio limitation applicable to the fund
  • the mark-to-market coverage amount and the risk-based coverage amount for each derivatives transaction entered into by the fund, and the related qualifying coverage assets maintained by the fund, as determined on each business day, and
  • the fund’s compliance, after entering into any derivatives transaction, with the portfolio limitation applicable to the fund, reflecting the fund’s aggregate exposure, the value of the fund’s net assets, and, if applicable, the fund’s full portfolio VaR and securities VaR
Record Retention

- In addition, funds that are required to adopt a derivatives risk management program must also maintain, generally for a period of at least five years, copies of:
  - the policies and procedures adopted by the fund as part of its derivatives risk management program
  - any materials provided to the board of directors in connection with its approval of the derivatives risk management program, including any material changes to the program, and any written reports provided to the board of directors relating to the program
  - records documenting the periodic reviews and updates of the derivatives risk management program required by the Proposed Rule
Funds Likely to Be Affected

- Managed futures – many funds likely cannot meet exposure test measured on notional value
- Leveraged ETFs (seek to return a multiple of market performance on a daily basis) – certain ETFs likely cannot meet exposure test
- Non-traditional bond funds
- Long/Short? Unclear – depends on guidance about what can be segregated for financial commitment transactions
Challenges and Concerns

• What concerns is the SEC seeking to address that are not addressed under current market practice (i.e., segregation of assets)?
  • Higher level of leverage than contemplated under Release 10666
  • Concerns that a fund may not have adequate assets available to meet its obligations under its derivatives transactions
  • Current market approach developed on an instrument-by-instrument basis and there is not always staff guidance for certain types of derivatives; as a result, different funds may treat the same kind of derivative differently
• Is there a need for a separate derivatives risk management program (and related personnel) outside of existing section 38a-1 requirements that a fund adopt and implement policies and procedures to ensure compliance with the federal securities laws?
Challenges and Concerns

- Small advisers that invest in complex derivatives may find rules costly and burdensome.
- Notional values may not be the best indication of potential risk.
- Funds may report market values of certain derivatives holdings, which do not necessarily represent the potential exposures of the holdings or the extent of potential senior claims.
  - Valuation typically captures market valuation (appreciation/depreciation) as sourced from third-party pricing vendors.
- Is the role of the Board expanding beyond traditional oversight?