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Legal Update
January 28, 2016

US Securities and Exchange Commission Rule Proposal for Registered Funds' Use of Derivatives

On December 11, 2015, the US Securities and Exchange Commission ("SEC") approved a rule proposal (the "Rule Proposal") that is intended to provide a modernized and more comprehensive approach to regulating the use of derivatives and financial commitment transactions[1] by registered investment companies—i.e., mutual funds, exchange-traded funds ("ETFs") and closed-end funds ("fund" or "funds")—for purposes of Section 18 of the Investment Company Act of 1940 (the "Investment Company Act").[2] The Rule Proposal includes a new rule, Rule 18f-4, which is an exemptive rule that would allow funds to enter into certain derivatives and financial commitment transactions notwithstanding the asset coverage restrictions of Section 18.[3] If adopted, Proposed Rule 18f-4 would:

- Impose three primary conditions on derivatives usage (portfolio limits, asset segregation requirements and certain compliance policy requirements including, if required, formalized derivatives risk management programs), as well as other conditions such as approval by the board of directors and recordkeeping requirements; and
- Impose asset segregation and certain compliance policy requirements for financial commitment transactions (e.g., reverse repurchase agreements, short sale borrowing, firm or standby commitment agreements, etc.).

Additionally, the Rule Proposal would amend proposed Form N-PORT and proposed Form N-CEN. The amended proposed Form N-PORT would require any fund that must implement a formalized derivatives risk management program under proposed Rule 18f-4 to report certain risk metrics about its derivatives usage. The amended proposed Form N-CEN would require a fund that engages in derivatives transactions in reliance on proposed Rule 18f-4 to report which of the proposed rule's two portfolio limitations (discussed below) were relied upon by the fund.

The comment period for the Rule Proposal will close on March 28, 2016. The following provides a general summary of the Rule Proposal.

Background

Under Section 18, funds are restricted in their ability to issue "senior securities." As defined under that section, senior securities generally include bonds, debentures, notes, any stock of a class having priority over any other class as to the distribution of assets or payment of dividends, or any other instrument constituting a security and evidencing indebtedness.[4] The SEC and its staff have found that derivatives and other leveraged transactions also give rise to senior securities concerns.

Over the years, the SEC and its staff have provided guidance about the treatment of derivatives and other leveraged transactions for Section 18 purposes through a 1979 interpretive release ("Release 10666")[5] and myriad no-action letters, which allow funds to engage in these transactions without having to comply with Section 18's asset coverage requirements, provided that certain asset segregation or offsetting transaction requirements were met.[6] In 2010, the American Bar Association submitted to the SEC Division of Investment Management a report that summarized funds' use of derivatives and leverage, and that suggested possible approaches to derivatives regulation under the Investment Company Act.[7] This report was followed by a 2011 SEC concept release, requesting industry comment on the treatment of derivatives for various regulatory purposes under the Investment Company Act.[8]

For now, funds can continue to rely on existing guidance. In the Rule Proposal, the SEC stated that, at the present time, funds are able to rely on Release 10666, the no-action letters and other guidance from SEC staff. However, the SEC stated that if it adopts proposed Rule 18f-4, then the SEC will rescind Release 10666 and staff no-action letters addressing the treatment of derivatives and financial commitment transactions under Section 18.[9] The SEC did not indicate *when* such rescission would go into effect and is requesting comment on the appropriateness of a transition period and what would be an appropriate amount of time before rescinding Release 10666 and staff no-action letters.[10]

The SEC May Grandfather Certain Funds

In the Rule Proposal, the SEC recognized that the limits under proposed Rule 18f-4 could cause certain funds to change their principal strategies or close. For example, the SEC anticipates that if proposed Rule 18f-4 were adopted, then particular alternative strategy funds and certain leveraged exchange-traded funds ("ETFs") would need to modify their portfolios to reduce their derivatives usage in order to comply with the proposed rule's portfolio exposure limitations.[11] (These portfolio limitations are discussed below in further detail.) The SEC stated that it is considering grandfathering funds that are operating in excess of the proposed rule's portfolio limits as of a specified date (e.g., the date of the Rule Proposal).[12]

The SEC is seeking comments on which funds (if any) should be grandfathered and, more specifically, whether leveraged ETFs should be grandfathered on the basis that they operate in accordance with the terms and conditions of SEC exemptive orders. The SEC also requested comments on whether there should be conditions on grandfathering and whether grandfathered funds should be required to comply with certain provisions of proposed Rule 18f-4 (e.g., complying with the requirements for asset segregation or developing a formalized derivatives risk management program).

Relationship Between Proposed Rule 18f-4 and Section 18

Funds are not required to comply with proposed Rule 18f-4 in order to engage in "senior securities transactions" (i.e., any derivatives transaction, financial commitment transaction, or senior security transaction under Section 18[13]), because the proposed rule is an exemptive rule.[14] Funds would still be able to engage in senior securities transactions in reliance on Section 18 (i.e., by satisfying the 300 percent asset coverage requirement). It should be noted, however, that proposed Rule 18f-4's definition of a "senior securities transaction" would apply irrespective of whether or not a fund was relying on the exemption in the proposal.[15] Further, in the Rule Proposal, the SEC stated that it is considering providing guidance on the application of the asset coverage requirements under Section 18 for funds that enter into senior securities transactions in reliance on Section 18 and that also enter into derivatives transactions and financial commitment transactions in reliance on proposed Rule 18f-4.[16]

Proposed Definitions of "Derivatives Transactions" and "Financial Commitment Transactions"

Under proposed Rule 18f-4, "derivatives transactions" would be defined to include swaps, security-based swaps, futures contracts, forward contracts, options, any combination of the foregoing and similar instruments 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. In the Rule Proposal, the SEC stated that it preferred to define derivatives transactions by the incorporation of a list, rather than using a "more conceptual definition," because not all derivatives raise Section 18 concerns.[17]

"Financial commitment transactions" would be defined to include those trading practices addressed in Release 10666, which are reverse repurchase agreements, short sale borrowing, firm or standby commitment agreements or similar agreements. A similar agreement would be defined to include "an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."[18]

In the Rule Proposal, the SEC requested comments on whether its proposed definitions of derivatives transactions and financial commitment transactions were sufficiently clear and whether any other transactions should be included in the definitions.

Conditions for Derivatives Transactions

Funds would be able to engage in derivatives transactions under proposed Rule 18f-4, so long as they satisfy the following three conditions: (i) portfolio limitations; (ii) asset segregation requirements; and (iii) derivatives risk management processes, as well as a formalized derivatives risk management program under certain circumstances. In addition to the three primary conditions, proposed Rule 18f-4 also requires approval by the board of directors for, among other things, policies and procedures for determining the maintenance of sufficient segregated assets for derivatives transactions, as well as, if required under the rule, a formalized derivatives risk management program. Further, funds that engage in any derivatives transaction under proposed Rule 18f-4 must comply with certain recordkeeping requirements.[19]

Portfolio limitations. Funds would be required to impose one of the following two limitations on their portfolio holdings, which are designed to limit the amount of leverage they may obtain from the use of derivatives transactions, financial commitment transactions, and indebtedness through other Section 18 senior securities (collectively defined in the rule as "senior securities transactions"):

- An exposure-based portfolio limit; or
- A risk-based portfolio limit.

Under the exposure-based portfolio limit, a fund must limit the "aggregate exposure" of its senior securities transactions to 150 percent of the fund's net assets.[20]

Under the risk-based portfolio limit, a fund must limit the "aggregate exposure" of its senior securities transactions to 300 percent of the fund's net assets, and must ensure that its full portfolio value at risk ("VaR") is less than its securities VaR (i.e., the VaR of its portfolio of securities and other investments, but excluding derivatives transactions). This VaR test is designed to determine whether the fund's derivatives transactions result in an investment portfolio that is subject to less market risk than if the fund did not use derivatives.

A fund's "exposure" for purposes of the rule's portfolio limitations is measured using the aggregate *notional* amount of its derivatives transactions, plus the fund's aggregate financial commitment obligations, and aggregate indebtedness under other Investment Company Act Section 18 senior securities (collectively, senior securities transactions).[21] The aggregate exposure must be measured immediately after the fund enters into any senior securities transaction. This means that a fund would not be required to terminate or unwind a senior securities transaction solely because the fund's exposure subsequently increased beyond the relevant portfolio limitation. In determining the aggregate exposure resulting from derivatives transactions, a fund may net directly offsetting transactions in the same type of instrument with the same underlying reference asset, maturity and other material terms.[22]

The fund's board of directors, including a majority of the directors who are not "interested persons" of the fund, as that term is defined in the Investment Company Act ("independent directors"), would need to approve the applicable portfolio limit for the fund.

The SEC is requesting comment on many aspects of the portfolio limits, including the following:

- Whether the 150 percent exposure limit is appropriate;
- Whether there are any other types of funds or circumstances under which the SEC should provide higher or lower exposure limits and whether there should be a higher exposure limit for ETFs;
- The effect of the 150 percent exposure limit on alternative funds that have exposures exceeding 150 percent;[23]
- Whether proposed Rule 18f-4 should even include a risk-based limit as an alternative to the 150 percent exposure limit; and
- Whether VaR, as used in the VaR test, is an effective approach for determining whether a fund's derivatives transactions, in aggregate, result in an overall portfolio with less risk than if the fund did not use derivatives.[24]

Asset segregation. The SEC is proposing to require funds to segregate "qualifying coverage assets" (i.e., cash and cash equivalents, or with respect to any derivatives transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset[25]) for each derivatives transaction equal to the sum of:

- The fund's aggregate daily mark-to-market coverage amounts; and
- A daily risk-based coverage amount.

The daily mark-to-market coverage amount for a particular derivatives transaction is the amount that the fund would be required to pay if it were to exit the derivatives transaction on that day.[26] Under proposed Rule 18f-4, funds would be required to calculate the mark-to-market coverage amount at least once each business day in order to have a reasonably current estimate of the amount that would be payable by the fund to exit the derivatives transaction.[27] In the Rule Proposal, the SEC stated that it understands that, in many cases, funds can readily calculate their mark-to-market coverage amounts, because they are already calculating their liability under derivatives transactions for purposes of determining their net asset value ("NAV").[28] Accordingly, the SEC stated that it expects that funds that calculate their NAV each day would also calculate their mark-to-market coverage amount as part of that NAV determination.[29]

The risked-based coverage amount is the reasonably estimated amount that the fund would expect to pay if it were to exit the derivatives transaction under "stressed conditions." Under proposed Rule 18f-4, a fund would be required to determine the risk-based coverage amount at least once each business day, consistent with the timing applicable to the calculation of the mark-to-market coverage amount as described above, in order to provide the fund with a reasonably current estimate of the potential amounts payable under the derivatives transaction, based on the current market values and conditions existing at the time the fund makes this determination.

The SEC stated that the risk-based coverage amount would need to be based on a fund's "careful assessment of [its] own particular facts and circumstances."[30] This risk-based amount would be determined in accordance with policies and procedures approved by the fund's board of directors, along with a majority of the independent directors.[31]

Although the proposed rule did not define "stressed conditions," the SEC suggested possible approaches for a fund to calculate its risk-based coverage amount, such as: (i) including stress testing in the policies and procedures for derivatives risk management and determining the potential amount payable by the fund to exit a derivatives transaction by estimating the effects of various adverse events; or (ii) including in its policies and procedures a provision that the fund's adviser is to use a stressed VaR model (i.e., a VaR model calibrated to a period of market stress) to estimate the potential loss that the fund could incur on a particular derivatives transaction under stressed conditions.[32] Under proposed Rule 18f-4, the total amount of the fund's segregated qualifying coverage assets (whether for derivatives transactions or for financial commitment transactions) could not exceed the amount of the fund's net assets on any given business day.

In contrast to the existing no-action letter guidance,[33] under the Rule Proposal, funds would not be allowed to address Section 18 concerns by entering into offsetting coverage positions (e.g., a CDS on a bond cannot be offset by a purchased CDS on the same bond entered into with a different counterparty).[34]

Netting of multiple transactions subject to a netting agreement may be taken into account in determining the required coverage amounts. The required amounts may be reduced by:

- In the case of the mark-to-market coverage amount, the value of the assets representing variation margin or collateral for the amount that would be payable for each derivatives transaction at any time of determination by the fund if the fund were to exit the derivatives transaction at such time;[35] and
- In the case of the risk-based coverage amount, the value of the assets representing initial margin or collateral for the *potential* amount payable, which is determined in accordance with policies and procedures providing for a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.[36]

Under proposed Rule 18f-4, the qualifying coverage assets must be identified on the fund's books and records. Funds would not be required to place qualifying coverage assets in a separate segregated account.[37]

The fund's board of directors, including a majority of independent directors, would be required to approve policies and procedures that are reasonably designed to provide for the maintenance of qualifying coverage assets with a value equal to at least the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts.[38] Funds cannot, however, use the same qualifying coverage assets to cover both a financial commitment transaction and a derivatives transaction.[39]

The SEC is requesting comments on many aspects of the asset segregation requirements, including whether:

- The definitions of mark-to-market coverage amount and risk-based coverage amount are sufficiently clear;
- The mark-to-market coverage amount should be based on accounting standards;
- The risk-based coverage amount could also be determined according to certain prescribed

standards (e.g., should proposed Rule 18f-4 designate a specific financial model);[40]

- The term "stressed conditions" is clear and, if not, how the term could be clarified;
- There should be stress testing or back-testing of the risk-based coverage amount;
- Proposed Rule 18f-4 should allow funds to segregate other assets as qualifying coverage assets; and
- The prohibition on offsetting coverage positions for derivatives transactions is appropriate.[41]

Derivatives Risk Management Policies and Procedures

Formalized derivatives risk management program. Under the Rule Proposal, funds that have more than a limited use of derivatives transactions (i.e., if a fund's notional derivatives exposure immediately after entering into a derivatives transaction exceeds 50 percent of its net assets, then it would have more than a limited use[42]) or that use *any* "complex" derivatives[43] (collectively, the "program-related limitations") would be required to establish a formalized derivatives risk management program and appoint a derivatives risk manager. Funds' boards of directors (including a majority of independent directors) would be responsible for reviewing and approving the program and appointing the risk manager.

The derivatives risk manager could be an employee or officer of the fund or the investment adviser, but may not be the portfolio manager of the fund.[44] Funds that are required to develop a formalized derivatives risk management program must have policies and procedures that are "reasonably designed to reasonably segregate" the functions of the program from portfolio management functions.[45] The SEC stated that segregation of the derivatives risk management function from the portfolio management function was necessary because it would create "important checks and balances" (e.g., independent reporting chains, oversight arrangements, separate monitoring systems and personnel, and compensation arrangements for risk management personnel that would not be contingent on fund performance).[46]

If the fund chooses to comply with the program-related limitations (i.e., avoiding the requirement for a formalized derivatives risk management program), the fund's board of directors (including a majority of independent directors) would need to approve the program-related limitations for the fund (i.e., no more than 50 percent and no complex derivatives).

Other policies and procedures. Every fund that enters into *any* derivatives transaction in reliance on proposed Rule 18f-4 would be required to implement board-approved policies and procedures for determining the risk-based coverage amount and for the maintenance of qualifying coverage assets.[47]

A fund that is not required to establish a formalized derivatives risk management program and have a derivatives risk manager (i.e., because its notional derivatives exposure does not exceed 50 percent of its net assets and it does not use complex derivatives) would still need to monitor its derivatives usage for purposes of maintaining compliance with the program-related limitations.[48] In addition, the SEC stated that, under Investment Company Act Rule 38a-1, funds would be required to have policies and procedures that are reasonably designed to prevent them from exceeding applicable portfolio limitations (exposure or risk based, or program-related limitations) under proposed Rule 18f-4. The SEC stated that a breach of a portfolio limit would likely be a "material compliance matter" that would be required to be disclosed in writing to the fund's board of directors in the CCO's annual report to the board. The SEC further stated that a fund's exceeding its portfolio limit could be a "serious compliance issue" that should be "promptly" brought to the attention of the fund's board of directors.[49]

The SEC is requesting comment on many aspects of the proposed derivatives risk management processes, including whether:

- The requirement for a formalized risk management program should apply to all senior securities transactions, not just derivatives;
- The requirement for a formalized derivatives risk management program should be triggered at a lower or different threshold from the currently proposed limited use threshold; and
- Proposed Rule 18f-4 should allow funds to have a limited amount of exposure to complex derivatives transactions without being required to implement a formalized program (the current proposal requires a formalized program for funds that engage in *any* complex derivatives transactions).

Conditions for Financial Commitment Transactions

Under the Rule Proposal, funds that enter into financial commitment transactions[50] must maintain "qualifying coverage assets" to cover the full amount of the funds' obligations under such transactions.[51] The types of qualifying coverage assets that can be used to cover financial commitment transactions are: (i) cash and cash equivalents; (ii) with respect to any financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; and (iii) with respect to financial commitment obligations (e.g., firm or standby commitment agreements), assets that are cash convertible (e.g., a fixed-income security that would mature in time for the fund to use the principal payment to complete the firm commitment transaction[52]) or that will generate cash (e.g., a fixed-income security that would generate $100 or more in interest payments[53]) equal in amount to the financial commitment obligation (i.e., the value of the stated purchase price).[54]

The required amount of qualifying coverage assets must be determined at least once each business day and must be sufficient to cover the full amount of the fund's obligations under its financial commitment transactions.[55] The SEC stated that this approach would generally be the same as the approach that was taken in Release 10666.[56]

As noted above, funds cannot use the same qualifying coverage assets to cover both a financial commitment transaction and a derivatives transaction. The fund's board of directors, including a majority of independent directors, would be required to approve policies and procedures that are reasonably designed to provide for the maintenance of qualifying coverage assets with a value equal to at least the fund's aggregate financial commitment obligations.[57]

The SEC is requesting comments on many aspects of the requirements for financial commitment transactions, including whether, under proposed Rule 18f-4, funds should still be required to segregate their full potential financial commitment obligation, consistent with Release 10666, or whether financial commitment transactions should have segregation requirements similar to those for derivatives transactions (i.e., mark-to-market plus risk-based coverage amounts).

Amendments to Proposed Forms N-PORT and N-CEN

The SEC is also proposing amendments to proposed Form N-PORT and proposed Form N-CEN.[58] Under the Rule Proposal, previously proposed Form N-PORT, which would require funds to provide, on a monthly basis, data concerning portfolio-wide and position-level holdings, would be amended to require funds that must maintain a formalized derivatives risk management program (i.e., the fund's derivatives exposure exceeds 50 percent or the fund uses complex derivatives) to report risk metrics concerning certain derivatives.

Similarly, previously proposed Form N-CEN, which would require funds to report census-type information on an annual basis, would be amended to disclose whether the fund relied on proposed Rule 18f-4 and the particular portfolio limitation applicable to the fund during the reporting period.

White Paper: Use of Derivatives by Registered Investment Companies

The SEC's Division of Economic and Risk Analysis staff has released a white paper that reports on findings concerning funds' derivatives positions, financial commitment transactions, and certain other transactions.[59] The data was collected from a random sample of 10 percent of funds based on Form N-CSR filings in 2014.

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Endnotes

1 Derivatives transactions and financial commitment transactions are defined below.

2 Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933, 80 Fed. Reg. 80883 (Dec. 11, 2015) [hereinafter Rule Proposal], *available at* http://www.sec.gov/rules/proposed/2015/ic-31933.pdf; *see also* Press Release, SEC, SEC Proposes New Derivatives Rules for Registered Funds and Business Development Companies (Dec. 11, 2015), http://www.sec.gov/news/pressrelease/2015-276.html.

3 The Rule Proposal relates to Section 18, and does not address how derivatives are to be treated for other regulatory purposes under the Investment Company Act, despite industry calls for such guidance. *See, e.g.*, Committee on Federal Regulation of Securities, ABA Section of Business Law, Report of the Task Force on Investment Company Use of Derivatives and Leverage (2010) [hereinafter ABA Report], *available at* https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf. Although not the focus of this legal update, proposed Rule 18f-4 would also provide an exemption for business development companies ("BDCs") from certain provisions of Section 61 of the Investment Company Act.

4 *See* 15 U.S.C. § 80a-18(g).

5 Securities Trading Practices of Registered Investment Companies; General Statement of Policy, Release No. IC-10666, 44 Fed. Reg. 25128 (Apr. 18, 1979) [hereinafter Release 10666], *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf (addressing the Section 18 concerns regarding reverse repurchase agreements, firm commitment agreements, and standby commitment agreements).

6 For a discussion of staff no-action letters, see section I of the SEC's 2011 concept release. Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776, 76 Fed. Reg. 55237 (Aug. 31, 2011) [hereinafter Concept Release], *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

7 *See* ABA Report, *supra* note 3.

8 Concept Release, *supra* note 6.

9 Rule Proposal, *supra* note 2, at 260.

10 Rule Proposal, *supra* note 2, at 261.

11 Rule Proposal, *supra* note 2, at 101.

[12] Rule Proposal, *supra* note 2, at 110.

[13] *See* Rule Proposal, *supra* note 2, at 418. These terms are discussed below in greater detail.

[14] *See* Rule Proposal, *supra* note 2, at 52 n.139 ("The proposed rule *would provide an exemption* from certain provisions of section 18 and 61 of the Act, subject to conditions. The proposed rule *could be used by any fund* subject to the requirements of section 18 or 61, including mutual funds, closed-end funds, BDCs, most ETFs, and exchange-traded managed funds.") (emphasis added). Also, see the text of proposed Rule 18f-4: "A registered open-end or closed-end company or [BDC] may enter into derivatives transactions, notwithstanding the requirements of section 18(a)(1), section 18(c), section 18(f)(1) and section 61, provided that …." Rule Proposal, *supra* note 2, at 408.

[15] Proposed Rule 18f-4(c)(10) would define "senior securities transaction" to mean any "derivatives transactions, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to section 18 or section 61 of the [1940] Act *without regard to the exemption provided by this section*." Rule Proposal, *supra* note 2, at 418 (emphasis added) (explanatory parentheticals omitted).

[16] Rule Proposal, *supra* note 2, at 63.

[17] Rule Proposal, *supra* note 2, at 58 (e.g., purchased options).

[18] Rule Proposal, *supra* note 2, at 59. Financial commitment transaction would be defined in proposed Rule 18f-4(c)(4).

[19] There are also recordkeeping requirements for funds engaging in financial commitment transactions. *See* Rule Proposal, *supra* note 2, at 413 (proposed Rule 18f-4(b)(3)).

[20] *See, e.g.*, Rule Proposal, *supra* note 2, at 64.

[21] See proposed Rule 18f-4(c)(3).

[22] Rule Proposal, *supra* note 2, at 80.

[23] Rule Proposal, *supra* note 2, at 106.

[24] Rule Proposal, *supra* note 2, at 129–31.

[25] Rule Proposal, *supra* note 2, at 178. As discussed further below, this definition mirrors the definition of "qualifying coverage assets" for purposes of financial commitment transactions, except that financial commitment transactions could also include as "qualifying coverage assets" those assets that are convertible to cash or that will generate cash equal in amount to the financial commitment obligation prior to the date on which the obligation must be satisfied. *See* Rule Proposal, *supra* note 2, at 238.

[26] See proposed Rule 18f-4(c)(6). In the Rule Proposal, the SEC recognized that "although the proposed rule does not require a fund to calculate the mark-to-market coverage amount more than once each business day, a fund may determine to calculate this amount more frequently." Rule Proposal, *supra* note 2, at 158 n.335.

[27] Rule Proposal, *supra* note 2, at 158.

[28] Rule Proposal, *supra* note 2, at 163.

[29] Rule Proposal, *supra* note 2, at 158 n.335.

[30] Rule Proposal, *supra* note 2, at 167–68.

[31] The SEC stated that, when determining the risk-based coverage amount, funds' policies and procedures would need to address the structure, terms, and characteristics of the derivatives transaction, as well as the underlying reference asset. Rule Proposal, *supra* note 2, at 168–69.

[32] Rule Proposal, *supra* note 2, at 170 & n.357.

[33] *See, e.g.*, Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf.

[34] *See* Rule Proposal, *supra* note 2, at 182. However, certain offsets would be allowed, subject to conditions, for purposes of determining aggregate notional exposure to derivatives for portfolio limitation purposes, see above at note 22 and accompanying text.

[35] See proposed Rule 18f-4(c)(6).

[36] See proposed Rule 18f-4(c)(9).

[37] Rule Proposal, *supra* note 2, at 179 n.366.

[38] See proposed Rule 18f-4(a)(2) and proposed Rule 18f-4(a)(5)(ii).

[39] Rule Proposal, *supra* note 2, at 238 n.464.

[40] Rule Proposal, *supra* note 2, at 175.

[41] Rule Proposal, *supra* note 2, at 185–86.

[42] Rule Proposal, *supra* note 2, at 193, 196.

[43] Complex derivatives are defined under the rule as derivatives transactions where the amount payable by either party to a derivatives transaction depends upon either (a) the underlying asset's value at multiple points in time, or (b) the non-linear function of the value of the

underlying asset (e.g., variance swaps). Rule Proposal, *supra* note 2, at 75.

44 See proposed Rule 18f-4(a)(3)(ii)(C).

45 Rule Proposal, *supra* note 2, at 216.

46 Rule Proposal, *supra* note 2, at 217 & n.434.

47 Rule Proposal, *supra* note 2, at 195–96.

48 Rule Proposal, *supra* note 2, at 196.

49 Rule Proposal, *supra* note 2, at 196 n.397.

50 See the discussion above, defining financial commitment transactions.

51 Compare this coverage requirement to that for derivatives transactions, under which funds must maintain qualifying coverage assets for the mark-to-market and risk-based coverage amounts. The SEC has imposed differing coverage requirements, in proposed Rule 18f-4, for financial commitment transactions and derivatives transactions, because "a fund may in many cases be required to fulfill its full obligation under a financial commitment transaction as compared to a derivatives transaction . . . [where] a fund would generally *not* expect to make payments or deliver assets equal to the full notional amount." Rule Proposal, *supra* note 2, at 232 (emphasis added).

52 Rule Proposal, *supra* note 2, at 240.

53 Rule Proposal, *supra* note 2, at 240.

54 Proposed Rule 18f-4(c)(8); *see also* Rule Proposal, *supra* note 2, at 231. Additionally, proposed Rule 18f-4 would require funds that use cash convertible assets or assets that generate cash as qualifying coverage assets to have board-approved policies and procedures for the purpose of determining such assets' convertibility to cash or ability to generate cash. Rule Proposal, *supra* note 2, at 241.

55 Rule Proposal, *supra* note 2, at 235.

56 *See* Rule Proposal, *supra* note 2, at 230.

57 See proposed Rule 18f-4(b).

58 For the initial proposing release for proposed Form N-PORT and proposed Form N-CEN, see Investment Company Reporting Modernization, Release Nos. 33-9776; 34-75002; IC-31610, 80 Fed. Reg. 33589 (May 20, 2015), *available at* https://www.sec.gov/rules/proposed/2015/33-9776.pdf.

59 Daniel Deli et al., Use of Derivatives by Registered Investment Companies (Dec. 2015), *available at* http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.