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Skadden

Investment Management Alert

Contacts

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Thomas A. DeCapo
Boston
617.573.4814
thomas.decapo@skadden.com

Michael K. Hoffman
New York
212.735.3406
michael.hoffman@skadden.com

Kevin T. Hardy
Chicago
312.407.0641
kevin.hardy@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

SEC Proposes Rule Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies

On December 11, 2015, the Securities and Exchange Commission (SEC) voted to propose a new rule (the Proposed Rule) that significantly modifies the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs) and closed-end funds, and business development companies (BDCs).

Overview of the Proposed Rule

Portfolio Limitations for Derivatives Transactions

The Proposed Rule would require a fund that engages in derivatives transactions to comply with one of two alternative portfolio limitations:

- **Exposure-Based Portfolio Limit.** Under the exposure-based portfolio limit, a fund would be required to limit its aggregate exposure to 150 percent of the fund's net assets. A fund's "exposure" generally would be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and certain other transactions.
- **Risk-Based Portfolio Limit.** Under the risk-based portfolio limit, a fund would be permitted to obtain exposure up to 300 percent of the fund's net assets, provided that the fund satisfies a risk-based test (based on value-at-risk (VaR)). The risk-based portfolio limit is designed to indicate whether a fund's derivatives transactions, in aggregate, have the effect of reducing the fund's exposure to market risk, as measured by the VaR test.

Asset Segregation for Derivatives Transactions

The Proposed Rule also would require a fund to segregate assets in connection with derivative transactions. The Proposed Rule would require segregated assets to be "qualifying coverage assets," which would be limited to cash and cash equivalents or, with respect to any derivatives transaction under which the fund may satisfy its obligations by delivering a particular asset, that particular asset. The amount a fund would be required to segregate would equal the sum of:

- **Mark-to-Market Coverage Amount.** The amount the fund would pay if the fund exited the derivatives transaction at the time of the determination.
- **Risk-Based Coverage Amount.** An additional risk-based coverage amount representing a reasonable estimate of the potential amount the fund would pay if the fund exited the derivatives transaction under stressed conditions.

Derivatives Risk Management Program

Under the Proposed Rule, a fund that engages in more than a limited number of derivatives transactions or uses complex derivatives would be required to establish a formalized derivatives risk management program consisting of certain components administered by a designated derivatives risk manager (who must be an employee of the fund or its investment adviser, but cannot be a portfolio manager of the fund) approved by the fund's board of directors. The fund's board of directors also would be required to review and approve the derivatives risk management program. The formalized risk management program requirements would be in addition to certain requirements related to derivatives risk management that would apply to every fund that enters into derivatives transactions in reliance on the rule.

Requirements for Financial Commitment Transactions

Under the Proposed Rule, a fund that enters into financial commitment transactions (such as reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement, including unfunded loan commitments) would be required to segregate assets with a value equal to the full amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under those transactions. For this purpose, "qualifying coverage assets" would include (1) cash and cash equivalents; (2) 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; or (3) 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 fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation.

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The full text of the Proposed Rule release is available here: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

The Proposed Rule release was accompanied by a white paper titled "Use of Derivatives by Investment Companies," prepared by SEC staff in the Division of Economic and Risk Analysis, which is available here: http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

Comments on the Proposed Rule will be due 90 days after its publication in the Federal Register.

We expect that the fund industry will spend the coming weeks analyzing the Proposed Rule. This alert is offered to help familiarize those who would be affected by the Proposed Rule with the key changes to existing regulation. We anticipate publishing a more in-depth analysis of the Proposed Rule in the coming weeks.