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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 240, 249, 270, 274 and 275

Release No. 34-87607; IA-5413; IC-33704; File No. S7-24-15

RIN: 3235-AL60

Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is re-proposing rule 18f-4, a new exemptive rule under the Investment Company Act of 1940 (the "Investment Company Act") designed to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives and the other transactions addressed in the proposed rule. The Commission is also proposing new rule 15*l*-2 under the Securities Exchange Act of 1934 (the "Exchange Act") and new rule 211(h)-1 under the Investment Advisers Act of 1940 ("Advisers Act") (collectively, the "sales practices rules"). In addition, the Commission is proposing new reporting requirements and amendments to Form N-PORT, Form N-LIQUID (which we propose to be re-titled as "Form N-RN"), and Form N-CEN, which are designed to enhance the Commission's ability to effectively oversee funds' use of and compliance with the proposed rules, and for the Commission and the public to have greater insight into the impact that funds' use of derivatives would have on their portfolios. Finally, the Commission is proposing to amend rule 6c-11 under the Investment Company Act to allow certain

leveraged/inverse ETFs that satisfy the rule's conditions to operate without the expense and delay of obtaining an exemptive order.

DATES: Comments should be submitted on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE *FEDERAL REGISTER*].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an email to *rule-comments@sec.gov*. Please include File No. S7-24-15 on the subject line.

Paper comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-24-15. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at www.sec.gov to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Asaf Barouk, Attorney-Adviser; Joel Cavanaugh, Senior Counsel; John Lee, Senior Counsel; Sirimal Mukerjee, Senior Counsel; Amanda Hollander Wagner, Branch Chief; Thoreau Bartmann, Senior Special Counsel; or Brian McLaughlin Johnson, Assistant Director, at (202) 551-6792, Investment Company Regulation Office, Division of Investment Management; and with respect to proposed rule 15*l*-2, Kelly Shoop, Senior Counsel; or Lourdes Gonzalez, Assistant Chief Counsel; Office of Chief Counsel, Division of Trading and Markets; Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

SUPPLEMENTARY INFORMATION: Proposed rule 18f-4 would apply to mutual funds (other than money market funds), exchange-traded funds (“ETFs”), registered closed-end funds, and companies that have elected to be treated as business development companies (“BDCs”) under the Investment Company Act (collectively, “funds”). It would permit these funds to enter into derivatives transactions and certain other transactions, notwithstanding the restrictions under sections 18 and 61 of the Investment Company Act, provided that the funds comply with the conditions of the rule. The proposed sales practices rules would require a broker, dealer, or investment adviser that is registered with (or required to be registered with) the Commission to exercise due diligence in approving a retail customer’s or client’s account to buy or sell shares of certain “leveraged/inverse investment vehicles” before accepting an order from, or placing an order for, the customer or client to engage in these transactions.

The Commission is proposing for public comment 17 CFR 270.18f-4 (new rule 18f-4) under the Investment Company Act, 17 CFR 240.15*l*-2 (new rule 15*l*-2) under the Exchange Act, 17 CFR 275.211(h)-1 (new rule 211(h)-1) under the Advisers Act; amendments to 17 CFR 270.6c-11 (rule 6c-11) under the Investment Company Act; amendments to Form N-PORT [referenced in 17 CFR 274.150], Form N-LIQUID (which we propose to re-title as "Form N-RN") [referenced in 17 CFR 274.223], Form N-CEN [referenced in 17 CFR 274.101], and Form N-2 [referenced in 17 CFR 274.11a-1] under the Investment Company Act.

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I. INTRODUCTION

The fund industry has grown and evolved substantially in past decades in response to various factors, including investor demand, technological developments, and an increase in domestic and international investment opportunities, both retail and institutional.[1] Funds today follow a broad variety of investment strategies and provide diverse investment opportunities for fund investors, including retail investors. As funds' strategies have become increasingly diverse, funds' use of derivatives has grown in both volume and complexity over the past several decades.[2] Derivatives may be broadly described as instruments or contracts whose value is based upon, or derived from, some other asset or metric.[3] Funds use derivatives for a variety of

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1 For example, the investment company industry consisted of more than 3,500 investment companies, and held over $1.3 trillion in assets, as of the end of 1991. *See* SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (1992), *available at* https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf. The assets held by U.S.-registered investment companies grew to approximately $7.1 trillion as of the end of 1999, and from then until the end of 2018 grew over 200%, to approximately $21.4 trillion. *See* Investment Company Institute, 2018 Investment Company Fact Book at 32, *available at* https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/2019_factbook.pdf. Similarly, the number of mutual funds, registered closed-end funds, and ETFs grew from 7,970, 512, and 30 (respectively) as of the end of 1999, to 9,599, 506, and 2,057 (respectively) as of the end of 2018. *See id.* at 50.

The diversity of fund strategies has also increased over time, including, more recently, the introduction of funds pursuing so-called "alternative strategies" (which tend to use derivatives more than other fund types). *See* Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies, Division of Economic and Risk Analysis* (2015), *available at* http://www.sec.gov/dera/staffpapers/white-papers/derivatives12-2015.pdf ("DERA White Paper").

2 *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015) [80 FR 80883 (Dec. 28, 2015)], at n.6 and accompanying text ("2015 Proposing Release").

3 The asset or metric on which the derivative's value is based, or from which its value is derived, is commonly referred to as the "reference asset," "underlying asset," or "underlier." *See id.* at n.3 and accompanying text (citing Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)], at n.3 ("2011 Concept Release")). The comment letters on the 2011

purposes. For example, funds use derivatives to seek higher returns through increased investment exposure, to hedge risks in their investment portfolios, or to obtain exposure to particular investments or markets more efficiently than may be possible through direct investments.[4] At the same time, derivatives can introduce certain new risks and heighten certain risks to a fund and its investors. These risks can arise from, for example, leverage, liquidity, markets, operations, legal matters (*e.g.*, contract enforceability), and counterparties.

Funds using derivatives must consider requirements under the Investment Company Act of 1940.[5] These include sections 18 and 61 of the Investment Company Act, which limit a fund's ability to obtain leverage or incur obligations to persons other than the fund's common shareholders through the issuance of "senior securities."[6] As we discuss more fully in this release, as derivatives markets have expanded and funds have increased their use of derivatives, the Commission and its staff have issued guidance addressing the use of specific derivatives

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Concept Release (File No. S7-33-11) are available at https://www.sec.gov/comments/s7-33-11/s73311.shtml.

4 *See, e.g.*, My Nguyen, *Using Financial Derivatives to Hedge Against Currency Risk*, Arcada University of Applied Sciences (2012).

5 15 U.S.C. 80a (the "Investment Company Act," or the "Act"). Except in connection with our discussion of proposed rule 15*l*-2 under the Securities Exchange Act of 1934 and proposed rule 211(h)-1 under the Advisers Act or as otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act, including proposed rule 18f-4, will be to title 17, part 270 of the Code of Federal Regulations, 17 CFR part 270.

6 *See infra* section I.B.1. Funds using derivatives must also comply with all other applicable statutory and regulatory requirements, such as other federal securities law provisions, the Internal Revenue Code, Regulation T of the Federal Reserve Board, and the rules and regulations of the Commodity Futures Trading Commission (the "CFTC"). *See also* Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act"), *available at* http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

Section 61 of the Investment Company Act makes section 18 of the Act applicable to BDCs, with certain modifications. *See infra* note 32 and accompanying text. Except as otherwise noted, or unless the context dictates otherwise, references in this release to section 18 of the Act should be read to refer also to section 61 with respect to BDCs.

instruments and practices, and other financial instruments, under section 18. In determining how they will comply with section 18, we understand that funds consider this Commission and staff guidance, as well as staff no-action letters and the practices that other funds disclose in their registration statements.[7]

In the absence of Commission rules and guidance that address the current broad range of funds' derivatives use, inconsistent industry practices have developed.[8] We are concerned that certain of these practices may not address investor protection concerns that underlie section 18's limitations on funds' issuance of senior securities. Specifically, certain fund practices can heighten leverage-related risks, such as the risk of potentially significant losses and increased fund volatility, that section 18 is designed to address. We are also concerned that funds' disparate practices could create an un-level competitive landscape and make it difficult for funds and our staff to evaluate funds' compliance with section 18.[9]

To address these concerns, in 2015 the Commission proposed new rule 18f-4 under the Investment Company Act, which would have permitted a fund to enter into derivatives

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7 Any staff guidance or no-action letters discussed in this release represent the views of the staff of the Division of Investment Management. They are not a rule, regulation, or statement of the Commission. Furthermore, the Commission has neither approved nor disapproved their content. Staff guidance has no legal force or effect; it does not alter or amend applicable law; and it creates no new or additional obligations for any person.

8 *See infra* section I.B.2.b (discussing the asset segregation practices funds have developed to "cover" their derivatives positions, which vary based on the type of derivatives transaction and with respect to the types of assets that funds segregate to cover their derivatives positions).

9 *See, e.g.*, Comment Letter of the Investment Company Institute on the 2011 Concept Release (Nov. 7, 2011) (File No. S7-33-11) at n.19 ("ICI Concept Release Comment Letter") (noting that funds segregate the notional amount of physically-settled futures contracts, while some funds disclose that they segregate only the marked-to-marked obligation in respect of cash-settled futures and agreeing with the concern reflected in the 2011 Concept Release that this "results in differing treatment of arguably equivalent products").

transactions and "financial commitment transactions," subject to certain conditions.[10] We received approximately 200 comment letters in response to the 2015 proposal.[11] In developing this re-proposal we considered those comment letters, as well as subsequent staff engagement with large and small fund complexes and investor groups.[12]

We are re-proposing rule 18f-4, which is designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and certain other transactions. The proposed rule would permit funds to enter into these transactions, notwithstanding the restrictions under section 18 of the Investment Company Act, provided that they comply with the conditions of the rule. The proposed rule's conditions are designed to require funds to manage the risks associated with their use of derivatives and to limit fund leverage risk consistent with

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10 For purposes of this release, we will refer to the version of rule 18f-4 that the Commission proposed in the 2015 Proposing Release as the "2015 proposed rule." We will generally refer to rule 18f-4 as we propose it here as the "proposed rule."

The 2015 proposed rule included four principal elements for funds entering into derivatives transactions: (1) a requirement to comply with one of two alternative portfolio limitations designed to limit the amount of leverage a fund may obtain through derivatives and other senior securities transactions; (2) asset segregation for derivatives transactions, designed to enable a fund to meet its derivatives-related obligations; (3) a derivatives risk management program requirement for funds that engage in more than limited derivatives transactions or that use complex derivatives; and (4) reporting requirements regarding a fund's derivatives usage.

The 2015 proposed rule included different requirements for derivatives transactions and "financial commitment transactions" (collectively, reverse repurchase agreements, short sale borrowings, or any firm or standby commitment agreement or similar agreement). Rule 18f-4 as we propose it here does not separately define "financial commitment transactions," although the proposed rule does address—either directly or indirectly—all of the types of transactions that composed that defined term in the 2015 proposed rule. *See infra* section II.

11 The comment letters on the 2015 proposed rule (File No. S7-24-15) are available at https://www.sec.gov/comments/s7-24-15/s72415.shtml.

12 *See also* Division of Economic and Risk Analysis, Memorandum re: Risk Adjustment and Haircut Schedules (Nov. 1, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-260.pdf ("2016 DERA Memo").

the investor protection purposes underlying section 18. Our proposal also includes requirements designed to address specific risks posed by certain registered investment companies and exchange-listed commodity- or currency-based trusts or funds that obtain leveraged or inverse exposure to an underlying index, generally on a daily basis.[13] The proposal also addresses funds' use of reverse repurchase agreements and similar transactions and certain so-called "unfunded commitments." Finally, we propose to amend rule 6c-11 under the Investment Company Act to allow certain leveraged/inverse ETFs that satisfy that rule's conditions to operate without the expense and delay of obtaining an exemptive order. Together, the rules we are proposing are designed to promote funds' ability to continue to use derivatives in a broad variety of ways that serve investors, while responding to the concerns underlying section 18 of the Investment Company Act and promoting a more modern and comprehensive framework for regulating funds' use of derivatives and the other transactions addressed in the proposed rule.

A. Overview of Funds' Use of Derivatives

Funds today use a variety of derivatives. These derivatives can reference a range of assets or metrics, such as: stocks, bonds, currencies, interest rates, market indexes, currency exchange rates, or other assets or interests. Examples of derivatives that funds commonly use include

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13 As discussed in more detail in section II.G, the proposed sales practices rules would cover transactions in "leveraged/inverse investment vehicles," which include registered investment companies and certain exchange-listed commodity- or currency-based trusts or funds that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time. For purposes of this release, we refer to leveraged, inverse, and leveraged inverse investment vehicles collectively as "leveraged/inverse."

forwards, futures, swaps, and options. Derivatives are often characterized as either exchange-traded or over-the-counter ("OTC").[14]

A common characteristic of most derivatives is that they involve leverage or the potential for leverage. The Commission has stated that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return."[15] Many fund derivatives transactions, such as futures, swaps, and written options, involve leverage or the potential for leverage because they enable the fund to magnify its gains and losses compared to the fund's investment, while also obligating the fund to make a payment or deliver assets to a counterparty under specified conditions.[16] Other derivatives transactions, such as purchased call options, provide the economic equivalent of leverage because they can magnify the fund's exposure beyond its investment but do not impose a payment obligation on the fund beyond its investment.[17]

Funds use derivatives both to obtain investment exposures as part of their investment strategies and to manage risk. A fund may use derivatives to gain, maintain, or reduce exposure

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14 Exchange-traded derivatives—such as futures, certain options, and options on futures—are standardized contracts traded on regulated exchanges. *See* 2015 Proposing Release, *supra* note 2, at nn.10-13 and accompanying text. OTC derivatives—such as certain swaps, non-exchange-traded options, and combination products such as swaptions and forward swaps—are contracts that parties negotiate and enter into outside of an organized exchange. *See id.* at nn.14-16 and accompanying text. Unlike exchange-traded derivatives, OTC derivatives may be significantly customized and may not be cleared by a central clearing organization. Title VII of the Dodd-Frank Act provides a comprehensive framework for the regulation of the OTC swaps market. *See supra* note 6.

15 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)], at n.5 ("Release 10666").

16 The leverage created by such an arrangement is sometimes referred to as "indebtedness leverage." *See* 2015 Proposing Release, *supra* note 2, at n.21 (citing 2011 Concept Release, *supra* note 3, at n.31).

17 This type of leverage is sometimes referred to as "economic leverage." *See id.* at n.22 (citing 2011 Concept Release, *supra* note 3, at n.32).

to a market, sector, or security more quickly, and with lower transaction costs and portfolio disruption, than investing directly in the underlying securities.[18] A fund also may use derivatives to obtain exposure to reference assets for which it may be difficult or impractical for the fund to make a direct investment, such as commodities.[19] With respect to risk management, funds may employ derivatives to hedge interest rate, currency, credit, and other risks, as well as to hedge portfolio exposures.[20]

At the same time, a fund's derivatives use may entail risks relating to, for example, leverage, markets, operations, liquidity (particularly with respect to complex OTC derivatives), and counterparties, as well as legal risks.[21] A fund's investment adviser, therefore, must manage (and the board of directors oversee) the fund's derivatives use, consistent with the fund's investment objectives, policies, restrictions, and risk profile. Furthermore, a fund's investment adviser and board of directors must bear in mind the requirements of section 18 of the Investment Company Act, as well as the Act's other requirements, when considering the use of derivatives.

Section 18 is designed to limit the leverage a fund can obtain or incur through the issuance of senior securities. Although the leverage limitations in section 18 apply regardless of

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18 *See, e.g.*, *id.* at n.24 and accompanying text (citing 2011 Concept Release, *supra* note 3, at section I).

19 *See, e.g.*, Comment Letter of Stone Ridge Asset Management LLC (Mar. 28, 2016) ("[I]t is not possible for AVRPX [a Stone Ridge fund] to trade many of the physical assets underlying the derivatives included in our portfolio—Stone Ridge does not maintain facilities to store oil or live hogs, for example."); Comment Letter of Vanguard (Mar. 28, 2016) ("Vanguard Comment Letter") (stating that a fund may use a derivative, such as commodity futures, when it is impractical to take delivery of physical commodities).

20 *See* 2015 Proposing Release, *supra* note 2, at n.25 and accompanying text; *see also* 2011 Concept Release, *supra* note 3, at section I.B.

21 *See* 2015 Proposing Release, *supra* note 2, at n.26 and accompanying text (citing 2011 Concept Release, *supra* note 3, at n.34).

whether the relevant fund actually experiences significant losses, several recent examples involving significant losses illustrate how a fund's use of derivatives may raise the investor protection concerns underlying section 18. The 2015 proposal discussed several circumstances in which substantial and rapid losses resulted from a fund's investment in derivatives.[22] For example, one of these cases shows that further losses can result when a fund's portfolio securities decline in value at the same time that the fund is required to make additional payments under its derivatives contracts.[23]

Similarly, last year the LJM Preservation and Growth Fund liquidated after sustaining considerable losses (with its net asset value declining approximately 80% in two days) when

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22 *See* 2015 Proposing Release, *supra* note 2, at section II.D.1.d. (discussing, among other things, the following settled actions: In the Matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc., Investment Company Act Release No. 30099 (June 6, 2012) (settled action) ("OppenheimerFunds Settled Action") (involving two mutual funds that suffered losses driven primarily by their exposure to certain commercial mortgage-backed securities, obtained mainly through total return swaps); In the Matter of Claymore Advisors, LLC, Investment Company Act Release No. 30308 (Dec. 19, 2012) and In the Matter of Fiduciary Asset Management, LLC, Investment Company Act Release No. 30309 (Dec. 19, 2012) (settled actions) (involving a registered closed-end fund that pursued an investment strategy involving written out-of-the-money put options and short variance swaps, which led to substantial losses for the fund); In the Matter of UBS Willow Management L.L.C. and UBS Fund Advisor L.L.C., Investment Company Act Release No. 31869 (Oct. 16, 2015) (settled action) (involving a registered closed-end fund that incurred significant losses due in part to large losses on the fund's credit default swap portfolio)).

See also In the Matter of Team Financial Asset Management, LLC, Team Financial Managers, Inc., and James L. Dailey, Investment Company Act Release No. 32951 (Dec. 22, 2017) (settled action) (involving a mutual fund incurring substantial losses arising out of speculative derivatives instruments, including losing $34.67 million in 2013 from trading in derivatives such as futures, options, and currency contracts); In the Matter of Mohammed Riad and Kevin Timothy Swanson, Investment Company Act Release No. 33338 (Dec. 21, 2018) (settled action) (involving a registered closed-end fund incurring substantial losses resulting from the implementation of a new derivatives trading strategy); In the Matter of Top Fund Management, Inc. and Barry C. Ziskin, Investment Company Act Release No. 30315 (Dec. 21, 2012) (settled action) (involving a mutual fund engaged in a strategy of buying options for speculative purposes contrary to its stated investment policy, which permitted options trading for hedging purposes, losing about 69% of its assets as a result of this activity before liquidating).

23 *See* OppenheimerFunds Settled Action, *supra* note 22.

market volatility spiked. The fund's principal investment strategy involved purchasing and selling call and put options on the Standard & Poor's ("S&P") 500 Futures Index.[24] S&P 500 options prices are determined in part by market volatility, and a volatility spike in early February 2018 caused the fund to incur significant losses. The fund closed to new investments on February 7, 2018 and announced on February 27, 2018 that it would liquidate its assets and dissolve on March 29, 2018.[25]

The losses suffered by this fund and in the other examples we discuss above are extreme. Funds rarely suffer such large and rapid losses. We note these examples to illustrate the rapid and extensive losses that can result from a fund's investments in derivatives absent effective derivatives risk management. In contrast, there are many other instances in which funds, by employing derivatives, have avoided losses, increased returns, and lowered risk.

B. Derivatives and the Senior Securities Restrictions of the Investment Company Act

1. Requirements of Section 18

Section 18 of the Investment Company Act imposes various limits on the capital structure of funds, including, in part, by restricting the ability of funds to issue "senior securities." Protecting investors against the potentially adverse effects of a fund's issuance of senior securities, and in particular the risks associated with excessive leverage of investment companies, is a core purpose of the Investment Company Act.[26] "Senior security" is defined, in

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24 *See* Prospectus, LJM Preservation and Growth Fund (Feb. 28, 2017), *available at* https://www.sec.gov/Archives/edgar/data/1552947/000158064217001225/ljm485b.htm.

25 *See* Supplement to the Prospectus dated Feb. 28, 2017, LJM Preservation and Growth Fund (Feb. 27, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1552947/000158064218001068/ljm497.htm.

26 *See*, *e.g.*, sections 1(b)(7), 1(b)(8), 18(a), and 18(f) of the Investment Company Act; *see also*

part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness."[27]

Congress' concerns underlying the limits in section 18 focused on: (1) excessive borrowing and the issuance of excessive amounts of senior securities by funds when these activities increase unduly the speculative character of funds' junior securities; (2) funds operating without adequate assets and reserves; and (3) potential abuse of the purchasers of senior securities.[28] To address these concerns, section 18 prohibits an open-end fund from issuing or selling any "senior security," other than borrowing from a bank (subject to a

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Provisions Of The Proposed Bill Related To Capital Structure (Sections 18, 19(B), And 21(C)), Introduced by L.M.C Smith, Associate Counsel, Investment Trust Study, Securities and Exchange Commission, *Hearings on S.3580 Before a Subcommittee of the Senate Committee on Banking and Currency,* 76th Congress, 3rd session (1940), at 1028 ("Senate Hearings") ("Because of the leverage influence, a substantial swing of the securities market is likely to deprive the common stock of a leverage investment company of both its asset and market value…. [H]ad investment companies been simple structure companies exclusively, a very substantial part of the losses sustained by investors in the common stock would have been avoided.").

27 *See* section 18(g) of the Investment Company Act. The definition of "senior security" in section 18(g) also includes "any stock of a class having priority over any other class as to the distribution of assets or payment of dividends" and excludes certain limited temporary borrowings.

28 For discussion of the excessive borrowing concern, *see* section 1(b)(7) of the Investment Company Act; Release 10666, *supra* note 15, at n.8; *see also* Senate Hearings, *supra* note 26, at 1028 ("The Commission believes that it has been clearly shown that it is the leverage aspect of the senior-junior capital structure in investment companies… which may be held accountable for a large part of the losses which have been suffered by the investor who purchases the common stock of a leverage company.").

For discussion of concerns regarding funds operating without adequate assets and reserves, *see* section 1(b)(8) of the Investment Company Act; Release 10666, *supra* note 15, at n.8.

For discussion of, among other things, potential abuse of the purchasers of senior securities, *see* Senate Hearings, *supra* note 26, at 265-78; *see also Mutual Funds and Derivative Instruments*, Division of Investment Management Memorandum transmitted by Chairman Levitt to Representatives Markey and Fields (Sept. 26, 1994), at 23, *available at* http://www.sec.gov/news/studies/deriv.txt ("1994 Letter to Congress") (describing practices in the 1920s and 1930s that gave rise to section 18's limits on leverage).

requirement to maintain 300% "asset coverage").[29] Section 18 similarly prohibits a closed-end fund from issuing or selling any "senior security [that] represents an indebtedness" unless it has at least 300% "asset coverage," although closed-end funds' ability to issue senior securities representing indebtedness is not limited to bank borrowings.[30] Closed-end funds also may issue senior securities that are a stock, subject to the limitations of section 18.[31] The Investment Company Act also subjects BDCs to the limitations of section 18 to the same extent as registered closed-end funds, except the applicable asset coverage amount for any senior security representing indebtedness is 200% (and can be decreased to 150% under certain circumstances).[32]

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[29] *See* section 18(f)(1) of the Investment Company Act. "Asset coverage" of a class of senior securities representing indebtedness of an issuer generally is defined in section 18(h) of the Investment Company Act as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." Take, for example, an open-end fund with $100 in assets and with no liabilities or senior securities outstanding. The fund could, while maintaining the required coverage of 300% of the value of its assets, borrow an additional $50 from a bank. The $50 in borrowings would represent one-third of the fund's $150 in total assets, measured after the borrowing (or 50% of the fund's $100 net assets).

[30] *See* section 18(a)(1) of the Investment Company Act.

[31] *See* section 18(a)(2) of the Investment Company Act. If a closed-end fund issues or sells a class of senior securities that is a stock, it must have an asset coverage of at least 200% immediately after such issuance or sale. *Id.*

[32] *See* section 61(a)(1) of the Investment Company Act. BDCs, like registered closed-end funds, also may issue a senior security that is a stock (*e.g.*, preferred stock), subject to limitations in section 18. *See* sections 18(a)(2) and 61(a)(1) of the Investment Company Act. In 2018, Congress passed the Small Business Credit Availability Act, which, among other things, modified the statutory asset coverage requirements applicable to BDCs (permitting BDCs that meet certain specified conditions to elect to decrease their effective asset coverage requirement from 200% to 150%). *See* section 802 of the Small Business Credit Availability Act, Pub. L. No. 115-141, 132 Stat. 348 (2018).

2. Evolution of Commission and Staff Consideration of Section 18 Restrictions as Applied to Funds' Use of Derivatives

a. Investment Company Act Release 10666

In a 1979 General Statement of Policy (Release 10666), the Commission considered the application of section 18's restrictions on the issuance of senior securities to reverse repurchase agreements, firm commitment agreements, and standby commitment agreements.[33] The Commission concluded that these agreements fall within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the Investment Company Act," noting "the unique legislative purposes and policies underlying Section 18 of the Act."[34] The Commission stated in Release 10666 that, for purposes of section 18, "evidence of indebtedness" would include "all contractual obligations to pay in the future for consideration presently received." The Commission recognized that, while section 18 would generally prohibit open-end funds' use of reverse repurchase agreements, firm commitment agreements, and standby commitment agreements, the Commission nonetheless permitted funds to use these and similar arrangements subject to the constraints that Release 10666 describes.

These constraints relied on funds' use of "segregated accounts" to "cover" senior securities, which "if properly created and maintained, would limit the investment company's risk of loss."[35] The Commission also stated that the segregated account functions as "a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock" and that it "[would]

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[33] *See* Release 10666, *supra* note 15.

[34] *See id.*

[35] *See* 2015 Proposing Release, *supra* note 2, at nn.45-47 and accompanying text (discussing Release 10666's discussion of segregated accounts).

assure the availability of adequate funds to meet the obligations arising from such activities."[36] The Commission stated that its expressed views were not limited to the particular trading practices discussed, but that the Commission sought to address the implications of comparable trading practices that could similarly affect funds' capital structures.[37]

We continue to view the transactions described in Release 10666 as falling within the functional meaning of the term "evidence of indebtedness," for purposes of section 18.[38] The trading practices that Release 10666 describes, as well as short sales of securities for which the staff initially developed the segregated account approach that the Commission applied in Release 10666, all impose on a fund a contractual obligation under which the fund is or may be required to pay or deliver assets in the future to a counterparty. These transactions therefore involve the issuance of a senior security for purposes of section 18.[39]

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36 *See* Release 10666, *supra* note 15, at 25132; *see also* 2015 Proposing Release, *supra* note 2, at n.48 and accompanying text.

37 *See* 2015 Proposing Release, *supra* note 2, at nn.49-50 and accompanying text.

38 *See* Release 10666, *supra* note 15, at "The Agreements as Securities" discussion. The Investment Company Act's definition of the term "security" is broader than the term's definition in other federal securities laws. *See* 2015 Proposing Release, *supra* note 2, at n.61. *Compare* section 2(a)(36) of the Investment Company Act with sections 2(a)(1) and 2A of the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) ("Securities Act") and sections 3(a)(10) and 3A of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) ("Exchange Act"). *See also* 2011 Concept Release, *supra* note 3, at n.57 and accompanying text (explaining that the Commission has interpreted the term "security" in light of the policies and purposes underlying the Investment Company Act).

39 *See* Release 10666, *supra* note 15, at "The Agreements as Securities" discussion; *see also* section 18(g) (defining the term "senior security," in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness").

The Commission received several comments on the 2015 proposal that objected to the Commission treating derivatives and financial commitment transactions as involving senior securities where a fund has "appropriately" covered its obligations under those transactions. These comments generally argued that this approach is not consistent with the Commission's views in Release 10666 and that funds have for many years addressed senior security concerns raised by these transactions by segregating assets or engaging in offsetting, or "cover," We apply the same analysis to all derivatives transactions that create future payment obligations. This is the case where the fund has a contractual obligation to pay or deliver cash or other assets to a counterparty in the future, either during the life of the instrument or at maturity or early termination.[40] As was the case for trading practices that Release 10666 describes, where the fund has entered into a derivatives transaction and has such a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18.[41]

The express scope of section 18 supports this interpretation. Section 18 defines the term "senior security" broadly to include instruments and transactions that other provisions of the

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transactions that take into account Release 10666 and staff guidance. *See, e.g.*, Comment Letter of the American Action Forum (Mar. 25, 2016) ("AAF Comment Letter"); Comment Letter of Financial Services Roundtable (Mar. 28, 2016) ("FSR Comment Letter"); Comment Letter of Franklin Resources, Inc. (Mar. 28, 2016) ("Franklin Resources Comment Letter"); Comment Letter of Dechert LLP (Mar. 28, 2016) ("Dechert Comment Letter"). Whether a transaction involves the issuance of a senior security will depend on whether that transaction involves a senior security within the meaning of section 18(g). A fund's segregation of assets, although one way to address policy concerns underlying section 18 as the Commission described in Release 10666, does not, itself, affect the legal question of whether a fund has issued a senior security.

40 These payments—which may include payments of cash, or delivery of other assets—may occur as margin, as settlement payments, or otherwise.

41 As the Commission explained in Release 10666, we believe that an evidence of indebtedness, for purposes of section 18, includes not only a firm and un-contingent obligation, but also a contingent obligation, such as a standby commitment or a "put" (or call) option sold by a fund. *See* Release 10666, *supra* note 15, at "Standby Commitment Agreements" discussion. We understand it has been asserted that a contingent obligation that a standby commitment or similar agreement creates does not involve a senior security under section 18, unless and until generally accepted accounting principles ("GAAP") would require the fund to recognize the contingent obligation as a liability on the fund's financial statements. The treatment of derivatives transactions under GAAP, including whether the derivatives transaction constitutes a liability for financial statement purposes at any given time or the extent of the liability for that purpose, is not determinative with respect to whether the derivatives transaction involves the issuance of a senior security under section 18. This is consistent with the Commission's analysis of a fund's obligation, and the corresponding segregated asset amounts, under the trading practices that Release 10666 describes. *See id*.

federal securities laws might not otherwise consider to be securities.[42] For example, section 18(f)(1) generally prohibits an open-end fund from issuing or selling any senior security "except [that the fund] shall be permitted to borrow from any bank."[43] This statutory permission to engage in a specific borrowing makes clear that such borrowings are senior securities, which otherwise section 18 would prohibit absent this specific permission.[44]

This interpretation also is consistent with the fundamental policy and purposes underlying the Investment Company Act expressed in sections 1(b)(7) and 1(b)(8) of the Act.[45] These respectively declare that "the national public interest and the interest of investors are adversely affected" when funds "by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character" of securities issued to common

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42 Consistent with Release 10666, and as the Commission stated in the 2015 Proposing Release, we are only expressing our views in this release concerning the scope of the term "senior security" in section 18 of the Investment Company Act. *See also* section 12(a) of the Investment Company Act (prohibiting funds from engaging in short sales in contravention of Commission rules or orders).

43 Section 18(c)(2) similarly treats all promissory notes or evidences of indebtedness issued in consideration of any loan as senior securities except as section 18 otherwise specifically provides.

44 The Commission similarly observed in Release 10666 that section 18(f)(1), "by implication, treats all borrowings as senior securities," and that "[s]ection 18(f)(1) of the Act prohibits such borrowings unless entered into with banks and only if there is 300% asset coverage on all borrowings of the investment company." *See* Release 10666, *supra* note 15, at "Reverse Repurchase Agreements" discussion.

45 The Commission received several comments on the 2015 proposal asserting that the provisions in section 1(b) of the Investment Company Act do not, themselves, provide us authority to regulate senior securities transactions. *See, e.g.*, AAF Comment Letter; Franklin Resources Comment Letter; Comment Letter of the Securities Industry and Financial Markets Association (Mar. 28, 2016) ("SIFMA Comment Letter").

The fundamental statutory policy and purposes underlying the Investment Company Act, as expressed in section 1(b) of the Act, inform our interpretation of the scope of the term "senior security" in section 18, as we discuss in the paragraph accompanying this note (and separately inform our consideration of appropriate conditions for the exemption that proposed rule 18f-4 provides, as we discuss in sections II.B-II.G *infra*). The authority under which we are proposing rules today is set forth in section VII of this release and includes, among other provisions, section 6(c) of the Act.

shareholders and when funds "operate without adequate assets or reserves." The Commission emphasized these concerns in Release 10666, and we continue to believe that the prohibitions and restrictions under the senior security provisions of section 18 should "function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock" and that funds should not "operate without adequate assets or reserves."[46] Funds' use of derivatives, like the trading practices the Commission addressed in Release 10666, may raise the undue speculation and asset sufficiency concerns in section 1(b).[47] First, funds' obtaining leverage (or potential for leverage) through derivatives may raise the Investment Company Act's undue speculation concern because a fund may experience gains and losses that substantially exceed the fund's investment, and also may incur a conditional or unconditional obligation to make a payment or deliver assets to a counterparty.[48] Not viewing derivatives that impose a future payment

46 *See* Release 10666, *supra* note 15, at "Segregated Account" discussion.

47 As the Commission stated in Release 10666, leveraging an investment company's portfolio through the issuance of senior securities "magnifies the potential for gain or loss on monies invested and therefore results in an increase in the speculative character of the investment company's outstanding securities" and "leveraging without any significant limitation" was identified "as one of the major abuses of investment companies prior to the passage of the Act by Congress." *Id*.

48 *See, e.g.*, *The Report of the Task Force on Investment Company Use of Derivatives and Leverage,* Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010), at 8 ("2010 ABA Derivatives Report") (stating that "[f]utures contracts, forward contracts, written options and swaps can produce a leveraging effect on a fund's portfolio" because "for a relatively small up-front payment made by a fund (or no up-front payment, in the case with many swaps and written options), the fund contractually obligates itself to one or more potential future payments until the contract terminates or expires"; noting, for example, that an "[interest rate] swap presents the possibility that the fund will be required to make payments out of its assets" and that "[t]he same possibility exists when a fund writes puts and calls, purchases short and long futures and forwards, and buys or sells credit protection through [credit default swaps]").

obligation on the fund as involving senior securities, subject to appropriate limits under section 18, would frustrate the concerns underlying section 18.[49]

Second, with respect to the Investment Company Act's asset sufficiency concern, a fund's use of derivatives with future payment obligations also may raise concerns regarding the fund's ability to meet those obligations. Many fund derivatives investments, such as futures contracts, swaps, and written options, pose a risk of loss that can result in payment obligations owed to the fund's counterparties.[50] Losses on derivatives therefore can result in counterparty payment obligations that directly affect the capital structure of a fund and the relative rights of the fund's counterparties and shareholders. These losses and payment obligations also can force a fund's adviser to sell the fund's investments to meet its obligations. When a fund uses derivatives to leverage its portfolio, this can amplify the risk of a fund having to sell its investments, potentially generating additional losses for the fund.[51] In an extreme situation, a fund could default on its payment obligations.[52]

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[49] One commenter on the 2011 Concept Release made this point directly. *See* Comment Letter of Stephen A. Keen on the 2011 Concept Release (Nov. 8, 2011) (File No. S7-33-11), at 3 ("Keen Concept Release Comment Letter") ("If permitted without limitation, derivative contracts can pose all of the concerns that section 18 was intended to address with respect to borrowings and the issuance of senior securities by investment companies."); *see also, e.g.*, ICI Concept Release Comment Letter, at 8 ("The Act is thus designed to regulate the degree to which a fund issues any form of debt—including contractual obligations that could require a fund to make payments in the future."). The Commission similarly noted in Release 10666 that, given the potential for reverse repurchase agreements to be used for leveraging and their ability to magnify the risk of investing in a fund, "one of the important policies underlying section 18 would be rendered substantially nugatory" if funds' use of reverse repurchase agreements were not subject to limitation. *See* 2015 Proposing Release, *supra* note 2, at text preceding n.76.

[50] Some derivatives transactions, like physically-settled futures and forwards, can require the fund to deliver the underlying reference assets regardless of whether the fund experiences losses on the transaction.

[51] *See, e.g.*, Markus K. Brunnermeier & Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity*, 22 The Review of Financial Studies 6, 2201-2238 (June 2009), *available at* https://www.princeton.edu/~markus/research/papers/liquidity.pdf (providing both empirical

b. Market and Industry Developments Following Release 10666

Following the issuance of Release 10666, Commission staff issued more than thirty no-action letters to funds concerning the maintenance of segregated accounts or otherwise "covering" their obligations in connection with various transactions otherwise restricted by section 18.[53] In these letters (issued primarily in the 1970s through 1990s) and through other staff guidance, Commission staff has addressed questions—generally on an instrument-by-instrument basis—regarding the application of the Commission's statements in Release 10666 to various types of derivatives and other transactions.

Funds have developed certain general asset segregation practices to cover their derivatives positions, based at least in part on the staff's no-action letters and guidance. Practices vary based on the type of derivatives transaction. For certain derivatives, funds generally segregate an amount equal to the full amount of the fund's potential obligation under the contract, or the full market value of the underlying reference asset for the derivative ("notional amount segregation").[54] For certain cash-settled derivatives, funds often segregate an amount equal to the fund's daily mark-to-market liability, if any ("mark-to-market segregation").[55]

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support as well as a theoretical foundation for how short-term leverage obtained through borrowings or derivative positions can result in funds and other financial intermediaries becoming vulnerable to tighter funding conditions and increased margins, specifically during economic downturns (as in the recent financial crisis), thus potentially increasing the need for the fund or intermediary to de-lever and sell portfolio assets at a loss).

52 *See* 2015 Proposing Release, *supra* note 2, at n.80.

53 *See id.* at n.51 and accompanying text (citing 2011 Concept Release, *supra* note 3, at section I).

54 *See id*. at nn.54-55 and accompanying text.

55 *See id*. at nn.56-58, 96-98 and accompanying text (stating that funds initially applied the mark-to-market approach to segregation to specific types of transactions addressed through guidance by our staff (interest rate swaps, cash-settled futures, non-deliverable forwards), but that funds now apply mark-to-market segregation to a wider range of cash-settled instruments, with our staff observing that some funds appear to apply the mark-to-market approach to any derivative that is

Similarly, funds use different practices regarding the types of assets that they segregate to cover their derivatives positions. Release 10666 states that the assets eligible to be included in segregated accounts should be "liquid assets" such as cash, U.S. government securities, or other appropriate high-grade debt obligations.[56] However, a subsequent staff no-action letter stated that the staff would not recommend enforcement action if a fund were to segregate any liquid asset, including equity securities and non-investment grade debt securities, to cover its senior securities-related obligations.[57]

As a result of these asset segregation practices, funds' derivatives use—and thus funds' potential leverage through derivatives transactions—does not appear to be subject to a practical limit as the Commission contemplated in Release 10666. Funds' mark-to-market liability often does not reflect the full investment exposure associated with their derivatives positions.[58] As a result, a fund that segregates only the mark-to-market liability could theoretically incur virtually unlimited investment leverage.[59]

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cash settled).

56 *See id.* at n.47 and accompanying text.

57 *See id.* at n.59 and accompanying text (citing Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf).

58 For example, for derivatives where there is no loss in a given day, a fund applying the mark-to-market approach might not segregate any assets. This may be the case, for example, because the derivative is currently in a gain position, or because the derivative has a market value of zero (as will generally be the case at the inception of a transaction). The fund may, however, still be required to post collateral to comply with other regulatory or contractual requirements.

59 *See, e.g.*, Comment Letter of Ropes & Gray LLC on the Concept Release (Nov. 7, 2011) (File No. S7-33-11), at 4 (stating that "[o]f course, in many cases [a fund's daily mark-to-market liability, if any] will not fully reflect the ultimate investment exposure associated with the swap position" and that, "[a]s a result, a fund that segregates only the market-to-market liability could theoretically incur virtually unlimited investment leverage using cash-settled swaps"); Keen Concept Release Comment Letter, at 20 (stating that the mark-to-market approach, as applied to cash settled swaps, "imposes no effective control over the amount of investment leverage created

These current asset segregation practices also may not assure the availability of adequate assets to meet funds' derivatives obligations, as the Commission contemplated in Release 10666. A fund using the mark-to-market approach could segregate assets that only reflect the losses (and corresponding potential payment obligations) that the fund would then incur as a result of transaction termination. This practice provides no assurances that future losses will not exceed the value of the segregated assets or the value of all assets then available to meet the payment obligations resulting from such losses.[60] We also recognize that when a fund segregates any liquid asset, rather than the more narrow range of high-quality assets the Commission described in Release 10666, the segregated assets may be more likely to decline in value at the same time as the fund experiences losses on its derivatives.[61] In this case, or when a fund's derivatives payment obligations are substantial relative to the fund's liquid assets, the fund may be forced to sell portfolio securities to meet its derivatives payment obligations. These forced sales could occur during stressed market conditions, including at times when prudent management could advise against such liquidation.[62]

3. Need for Updated Regulatory Framework

As the Commission observed in the 2015 proposal and for the reasons discussed above,

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by these swaps, and leaves it to the market to limit the amount of leverage a fund may use").

60 A fund's mark-to-market liability on any particular day, if any, could be substantially smaller than the fund's ultimate obligations under a derivative. *See* 2015 Proposing Release, *supra* note 2, at n.113.

61 *See id.* at n.115.

62 The Commission noted in Release 10666 that "in an extreme case an investment company which has segregated all its liquid assets might be forced to sell non-segregated portfolio securities to meet its obligations upon shareholder requests for redemption. Such forced sales could cause an investment company to sell securities which it wanted to retain or to realize gains or losses which it did not originally intend." *See* Release 10666, *supra* note 15, at "Segregated Account" discussion.

we continue to be concerned that funds' current practices regarding derivatives use may not address the undue speculation and asset sufficiency concerns underlying section 18.[63] Additionally, as recent events demonstrate, a fund's derivatives use may involve risks that can result in significant losses to a fund.[64] Accordingly, we continue to believe that it is appropriate for funds to address these risks and considerations relating to their derivatives use. Nevertheless, we also recognize the valuable role derivatives can play in helping funds to achieve their objectives efficiently or manage their investment risks.

We therefore believe funds that significantly use derivatives should adopt and implement formalized programs to manage the risks derivatives may pose. In addition, a more modern framework for regulating funds' derivatives use would respond to our concern that funds today are not subject to a practical limit on potential leverage that they may obtain through derivatives transactions. The risk management program requirement and limit on fund leverage risk we are proposing are designed to address these considerations, in turn.

A comprehensive approach to regulating funds' derivatives use also would help address potential adverse results from funds' current, disparate asset segregation practices. The development of staff guidance and industry practice on an instrument-by-instrument basis, together with growth in the volume and complexity of derivatives markets over past decades, has resulted in situations in which different funds may treat the same kind of derivative differently, based on their own view of our staff's guidance or observation of industry practice. This may

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63 *See* 2015 Proposing Release, *supra* note 2, at sections II.D.1.b and II.D.1.c; *see also supra* paragraphs accompanying notes 58-62.

64 *See supra* paragraph accompanying notes 22-25.

unfairly disadvantage some funds.[65] The lack of comprehensive guidance also makes it difficult for funds and our staff to evaluate and inspect for funds' compliance with section 18 of the Investment Company Act. Moreover, where there is no specific guidance, or where the application of existing guidance is unclear or applied inconsistently, funds may take approaches that involve an extensive use of derivatives and may not address the purposes and concerns underlying section 18.

C. Overview of the Proposal

Our proposal consists of three parts. Proposed rule 18f-4 is designed to provide an updated, comprehensive approach to the regulation of funds' use of derivatives and the other transactions that the proposed rule addresses. The proposed sales practices rules are designed to address investor protection concerns with respect to leveraged/inverse funds by requiring broker-dealers and investment advisers to exercise due diligence on retail investors before approving retail investor accounts to invest in leveraged/inverse funds. The proposed amendments to Forms N-PORT, N-LIQUID (which we propose to re-title as "Form N-RN"), and N-CEN are designed to enhance the Commission's ability to oversee funds' use of and compliance with the proposed rules, and for the Commission and the public to have greater insight into the impact that funds' use of derivatives would have on their portfolios.

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65 *See, e.g.*, Comment Letter of Davis Polk on the 2011 Concept Release (Nov. 11, 2011), at 1-2 (stating that "funds and their sponsors may interpret the available guidance differently, even when applying it to the same instruments, which may unfairly disadvantage some funds"); s*ee also* Comment Letter of Federated Investors, Inc. (Mar. 23, 2016) ("Federated Comment Letter"); Comment Letter of Salient Partners, L.P. (Mar. 25, 2016) ("Salient Comment Letter).

Proposed rule 18f-4 would permit a fund to enter into derivatives transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18 of the Investment Company Act, subject to the following conditions:[66]

- *Derivatives risk management program*.[67] The proposed rule would generally require a fund to adopt a written derivatives risk management program with risk guidelines that must cover certain elements, but that otherwise would be tailored based on how the fund's use of derivatives may affect its investment portfolio and overall risk profile. The program also would have to include stress testing, backtesting, internal reporting and escalation, and program review elements. The program would institute a standardized risk management framework for funds that engage in more than a limited amount of derivatives transactions, while allowing principles-based tailoring to the fund's particular risks. We believe that a formalized derivatives risk management program is critical to appropriate derivatives risk management and is foundational to providing exemptive relief under section 18.
- *Limit on fund leverage risk*.[68] The proposed rule would generally require funds when engaging in derivatives transactions to comply with an outer limit on fund leverage risk based on value at risk, or "VaR." This outer limit would be based on a relative VaR test

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66 *See* proposed rule 18f-4(b) and (d). Proposed rule 18f-4(b) would provide an exemption for funds' derivatives transactions from sections 18(a)(1), 18(c), 18(f)(1), and 61 of the Investment Company Act. *See supra* section I.B.1 of this release (providing an overview of the requirements of section 18). Because the proposed conditions are designed to provide a tailored set of requirements for derivatives transactions, the proposed rule would also provide that a fund's derivatives transactions would not be considered for purposes of computing asset coverage under section 18(h). Applying section 18(h) asset coverage to a fund's derivatives transactions appears unnecessary in light of the tailored restrictions we are proposing. *See also infra* section II.M.

67 *See* proposed rule 18f-4(c)(1); *infra* section II.A.2.

68 *See* proposed rule 18f-4(c)(2); *infra* section II.D.

that compares the fund's VaR to the VaR of a "designated reference index" for that fund. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test. These proposed requirements are designed to limit fund leverage risk consistent with the investor protection purposes underlying section 18 and to complement the proposed risk management program. Because VaR is a commonly-known and broadly-used industry metric that enables risk to be measured in a reasonably comparable and consistent manner across the diverse instruments that may be included in a fund's portfolio, the proposed VaR-based limit is designed to address leverage risk for a variety of fund strategies.

- *Board oversight and reporting*.[69] The proposed rule would require a fund's board of directors to approve the fund's designation of a derivatives risk manager, who would be responsible for administering the fund's derivatives risk management program. The fund's derivatives risk manager would have to report to the fund's board on the derivatives risk management program's implementation and effectiveness and the results of the fund's stress testing. The derivatives risk manager would have a direct reporting line to the fund's board. We believe requiring a fund's derivatives risk manager to be responsible for the day-to-day administration of the fund's program, subject to board oversight, is consistent with the way we understand many funds currently manage derivatives risks and is key to appropriately managing these risks.

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69 *See* proposed rule 18f-4(c)(5); *infra* section II.C.

- *Exception for limited derivatives users*.[70] The proposed rule would except limited derivatives users from the derivatives risk management program requirement and the VaR-based limit on fund leverage risk. This proposed exception would be available to a fund that either limits its derivatives exposure to 10% of its net assets or uses derivatives transactions solely to hedge certain currency risks and, in either case, that also adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks. Requiring a derivatives risk management program that includes all of the program elements specified in the rule for funds that use derivatives only in a limited way could potentially require these funds to incur costs and bear compliance burdens that are disproportionate to the resulting benefits.
- *Alternative requirements for certain leveraged/inverse funds.*[71] The proposed rule would provide an exception from the limit on fund leverage risk for certain leveraged/inverse funds in light of the additional safeguards provided by the proposed requirements under the sales practices rules that broker-dealers and investment advisers exercise due diligence on retail investors before approving the investors' accounts to invest in these funds.[72] The conditions of this exception are designed to address the investor protection concerns that underlie section 18 of the Investment Company Act, while preserving choice for investors the investment adviser or broker-dealer reasonably believes have

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70 *See* proposed rule 18f-4(c)(3); *infra* section II.E.

71 *See* proposed rule 18f-4(c)(4); *infra* section II.G.

72 In our discussion in this release of the entities subject to the proposed sales practices rules, we use "broker-dealer" to refer to a broker-dealer that is registered with, or required to register with, the Commission. Similarly, we use "investment adviser" to refer to an investment adviser that is registered with, or required to register with, the Commission.

such financial knowledge and experience that they may reasonably be expected to be capable of evaluating the risk of these funds.

- *Recordkeeping*.[73] The proposed rule would require a fund to adhere to recordkeeping requirements that are designed to provide the Commission's staff, and the fund's board of directors and compliance personnel, the ability to evaluate the fund's compliance with the proposed rule's requirements.

Proposed rule 18f-4 would also permit funds to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions.[74] A fund would be permitted to engage in reverse repurchase agreements and similar financing transactions so long as they meet the asset coverage requirements under section 18. If the fund also borrows from a bank or issues bonds, for example, these senior securities as well as the reverse repurchase agreement would be required to comply with the asset coverage requirements under the Investment Company Act. This approach would provide the same asset coverage requirements under section 18 for reverse repurchase agreements and similar financing transactions, bank borrowings, and other borrowings permitted under the Investment Company Act. A fund would be permitted to enter into unfunded commitment agreements if the fund reasonably believes that its assets will allow the fund to meet its obligations under these agreements. This approach recognizes that, while unfunded commitment agreements do raise the risk that a fund may be unable to meet its

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73 *See* proposed rule 18f-4(c)(6); *infra* section II.K.

74 *See* proposed rule 18f-4(d) and (e); *infra* sections II.I and II.J.

obligations under these transactions, such unfunded commitments do not generally involve the leverage and other risks associated with derivatives transactions.

The proposed sales practices rules are designed to address certain specific considerations raised by certain leveraged/inverse funds and listed commodity pools that obtain leveraged or inverse exposure to an underlying index, on a periodic (generally, daily) basis.[75] These rules would require broker-dealers and investment advisers to exercise due diligence in determining whether to approve a retail customer or client's account to buy or sell these products. A broker-dealer or adviser could only approve the account if it had a reasonable basis to believe that the customer or client is capable of evaluating the risk associated with these products. In this regard, the proposed sales practices rules would complement the leveraged/inverse funds exception from proposed rule 18f-4's limit on leverage risk by subjecting broker-dealers or advisers to the proposed sales practices rules' due diligence and approval requirements.

In connection with proposed rules 15*l*-2, 211(h)-1, and 18f-4, we are proposing amendments to rule 6c-11 under the Investment Company Act. Rule 6c-11 generally permits ETFs to operate without obtaining a Commission exemptive order, subject to certain conditions.[76] The rule currently excludes leveraged/inverse ETFs from relying on the rule, however, to allow the Commission to consider the section 18 issues raised by these funds' investment strategies as part of a broader consideration of derivatives use by registered funds and BDCs.[77] As part of this further consideration, we are proposing to remove this provision and

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75 *See infra* note 327 and accompanying text (defining "listed commodity pools").

76 *See generally* Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019) [84 FR 57162 (Oct. 24, 2019)] ("ETFs Adopting Release").

77 *See id.* at nn.72-74 and accompanying text.

permit leveraged/inverse ETFs to rely on rule 6c-11 because the proposed sales practices rules and rule 18f-4 are designed to address these issues. In this regard, we are also proposing to rescind the exemptive orders previously issued to the sponsors of leveraged/inverse ETFs. Amending rule 6c-11 and rescinding these exemptive orders would promote a level playing field by allowing any sponsor (in addition to the sponsors currently granted exemptive orders) to form and launch a leveraged/inverse ETF subject to the conditions in rule 6c-11 and proposed rule 18f-4, with transactions in the fund subject to the proposed sales practices rules.

The proposed amendments to Forms N-PORT, N-LIQUID, and N-CEN would require a fund to provide information regarding: (1) the fund's exposure to derivatives; (2) the fund's VaR (and, if applicable, the fund's designated reference index) and backtesting results; (3) VaR test breaches, to be reported to the Commission in a non-public current report; and (4) certain identifying information about the fund (*e.g.*, whether the fund is a limited derivatives user that is excepted from certain of the proposed requirements, or whether the fund is a "leveraged/inverse fund").

Finally, in view of our proposal for an updated, comprehensive approach to the regulation of funds' derivative use, we are proposing to rescind Release 10666. In addition, staff in the Division of Investment Management is reviewing certain of its no-action letters and other guidance addressing derivatives transactions and other transactions covered by proposed rule 18f-4 to determine which letters and other staff guidance, or portions thereof, should be withdrawn in connection with any adoption of this proposal. Upon the adoption of any final rule, some of these letters and other staff guidance, or portions thereof, would be moot, superseded, or otherwise inconsistent with the final rule and, therefore, would be withdrawn. We would expect to provide funds a one-year transition period while they prepare to come into compliance with rule 18f-4 before Release 10666 is withdrawn.

II. DISCUSSION

A. Scope of Proposed Rule 18f-4

1. Funds Permitted to Rely on Proposed Rule 18f-4

The proposed rule would apply to a "fund," defined as a registered open-end or closed-end company or a BDC, including any separate series thereof. The rule would therefore apply to mutual funds, ETFs, registered closed-end funds, and BDCs. The proposed rule's definition of a "fund" would, however, exclude money market funds regulated under rule 2a-7 under the Investment Company Act ("money market funds"). Under rule 2a-7, money market funds seek to maintain a stable share price or limit principal volatility by limiting their investments to short-term, high-quality debt securities that fluctuate very little in value under normal market conditions. As a result of these and other requirements in rule 2a-7, we believe that money market funds currently do not typically engage in derivatives transactions or the other transactions permitted by rule 18f-4.[78] We believe that these transactions would generally be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, and especially if used to leverage the fund's portfolio.[79] We therefore believe that excluding money market funds from the scope of the proposed rule is appropriate.

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[78] *See infra* note 583.

[79] *See* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) [79 FR 47735 (Aug. 14, 2014)] (discussing (1) retail and government money market funds, which seek to maintain a stable net asset value per share and (2) institutional non-government money market funds whose net asset value fluctuates, but still must stress test their ability to minimize principal volatility given that "commenters pointed out investors in floating NAV funds will continue to expect a relatively stable NAV").

Section 18 applies only to open-end or closed-end companies, *i.e.*, to management investment companies. Proposed rule 18f-4 therefore also would not apply to unit investment trusts ("UITs") because they are not management investment companies. In addition, as the Commission has noted, derivatives transactions generally require a significant degree of management, and a UIT engaging in derivatives transactions therefore may not meet the Investment Company Act requirements applicable to UITs.[80]

We request comment on all aspects of the proposed rule's definition of the term "fund," including the following items.

1. The proposed definition excludes money market funds. Should we include money market funds in the definition? Why or why not?

2. Do money market funds currently engage in any transactions that might qualify as derivatives transactions under the rule or any of the other transactions permitted by the rule? For example, do money market funds engage in reverse repurchase agreements, "to be announced" dollar rolls, or "when issued" transactions? If so, which transactions, to what extent, and for what purpose? For example, do money market funds engage in reverse repurchase agreements for liquidity management purposes but not to leverage the fund's portfolio? If so, what effects would the proposed rule have on money market funds' liquidity management if they are excluded from the rule's scope as proposed? To the extent money market funds engage in any of the transactions that the proposed rule would permit, how do money

[80] *See* section 4(2) of the Investment Company Act; *see also* Custody Of Investment Company Assets with Futures Commission Merchants And Commodity Clearing Organizations, Investment Company Act Release No. 22389 (Dec. 11, 1996), at n.18 (explaining that UIT portfolios are generally unmanaged). *See also* ETFs Adopting Release, *supra* note 76, at n.42.

market funds analyze them under rule 2a-7?

3. Should we permit money market funds to engage in some of the transactions that the rule would permit? If so, which transactions and why, and how would the transactions be consistent with rule 2a-7? If we were to include money market funds in the rule, or permit them to engage in specific types of transactions, should the rule provide specific conditions tailored to money market funds entering into those transactions? What kinds of conditions and why? Should they be permitted to engage in all (or certain types) of derivatives transactions, or reverse repurchase or similar financing transactions, for liquidity management or other purposes that do not leverage the fund's portfolio? If money market funds were permitted to rely on the rule for any transactions, should those transactions be limited in scale? For example, should that limit be the same as the proposed approach for limited derivatives users that limit the extent of their derivatives exposure, as discussed below in section II.E.1? Would even such limited use be consistent with funds that seek to maintain a stable share price or limit principal volatility?

4. If we were to include money market funds in the scope of rule 18f-4, should we revise Form N-MFP so that money market funds filing reports on the form could select among the list of investment categories set forth in Item C.6 of Form N-MFP derivatives and the other transactions addressed in the proposed rule 18f-4?[81] Why or why not?

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[81] *See infra* note 583.

2. Derivatives Transactions Permitted Under Proposed Rule 18f-4

The proposed rule would permit funds to enter into derivatives transactions, subject to the rule's conditions. The proposed rule would define the term "derivatives transaction" to mean: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives 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 margin or settlement payment or otherwise; and (2) any short sale borrowing.[82]

The first prong of this proposed definition is designed to describe those derivatives transactions that involve the issuance of a senior security, because they involve a contractual future payment obligation.[83] When a fund engages in these transactions, the fund will have an obligation (or potential obligation) to make payments or deliver assets to the fund's counterparty. This prong of the definition incorporates a list of derivatives instruments that, together with the

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[82] Proposed rule 18f-4(a). The 2015 proposal similarly defined a derivatives transaction as including enumerated derivatives instruments "under which the 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." 2015 proposed rule 18f-4(c)(2). Most commenters did not address the proposed definition of the term "derivatives transaction," although those commenters who did address the definition generally supported it. Some commenters more generally supported the view, or sought confirmation, that a derivative does not involve the issuance of a senior security if it does not impose an obligation under which the fund is or may be required to make a future payment (*e.g.*, a standard purchased option). *See, e.g.*, Comment Letter of The Options Clearing Corporation (Mar. 25, 2016); Comment Letter of Investment Adviser Association (Mar. 28, 2016) ("IAA Comment Letter"); FSR Comment Letter.

[83] *See supra* note 27 and accompanying text, and text following note 34 (together, noting that "senior security" is defined in part as "any . . .similar obligation or instrument constituting a security and evidencing indebtedness," and that the Commission has previously stated that, for purposes of section 18, "evidence of indebtedness" would include "all contractual obligations to pay in the future for consideration presently received"); *see also infra* notes 85-87 (recognizing that not every derivative instrument will involve the issuance of a senior security).

proposed inclusion in the definition of "any similar instrument," covers the types of derivatives that funds currently use and that the requirements of section 18 would restrict. This list is designed to be sufficiently comprehensive to include derivatives that may be developed in the future. We believe that this approach is clearer than a more principles-based definition of the term "derivatives transaction," such as defining this term as an instrument or contract whose value is based upon, or derived from, some other asset or metric.

This prong of the definition also provides that a derivatives instrument, for purposes of the proposed rule, must involve a future payment obligation.[84] This aspect of the definition recognizes that not every derivatives instrument imposes an obligation that may require the fund to make a future payment, and therefore not every derivatives instrument will involve the issuance of a senior security.[85] A derivative that does not impose any future payment obligation on a fund generally resembles a securities investment that is not a senior security, in that it may lose value but will not require the fund to make any payments in the future.[86] Whether a transaction involves the issuance of a senior security will depend on the nature of the transaction. The label that a fund or its counterparty assigns to the transaction is not determinative.[87]

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84 Under the proposed rule, a derivatives instrument is one where the 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 margin or settlement payment or otherwise."

85 *See* 2015 Proposing Release, *supra* note 2, at paragraph accompanying nn.82-83. A fund that purchases a standard option traded on an exchange, for example, generally will make a non-refundable premium payment to obtain the right to acquire (or sell) securities under the option. However, the option purchaser generally will not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option.

86 *See id.* at n.82.

87 For example, the Commission received a comment on the 2015 proposal addressing a type of total return swap, asserting that "[t]he Swap operates in a manner similar to a purchased option or structure, in that the fund's losses under the Swap cannot exceed the amount posted to its tri-party custodian agreement for purposes of entering into the Swap," and that, in the commenter's view,

Unlike the 2015 proposal, this proposal does not include references to, or a definition of, "financial commitment transaction" in addition to the proposed definition of "derivatives transaction." The 2015 proposal defined a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement.[88] Because our proposal addresses funds' use of reverse repurchase agreements and unfunded commitment agreements separately from funds' use of derivatives, the proposed definition of "derivatives transaction" does not include reverse repurchase agreements and unfunded commitment agreements.[89]

Short sale borrowings, however, are included in the second prong of the proposed definition of "derivatives transaction." We appreciate that short sales of securities do not involve derivatives instruments such as swaps, futures, and options. The value of a short position is,

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the swap should be "afforded the same treatment as a purchased option or structured note" because "[a]lthough the Swap involves interim payments through the potential posting of margin from the custodial account, the payment obligations cannot exceed the [amount posted for purposes of entering into the Swap]." *See* Comment Letter of Dearborn Capital Management (Mar. 24, 2016) ("Dearborn Comment Letter"). Unlike a fund's payment of a one-time non-refundable premium in connection with a standard purchased option or a fund's purchase of a structured note, this transaction appears to involve a fund obligation to make interim payments of fund assets posted as margin or collateral to the fund's counterparty during the life of the transaction in response to market value changes of the underlying reference asset, as this commenter described. The fund also must deposit additional margin or collateral to maintain the position if the fund's losses deplete the assets that the fund posted to initiate the transaction; if a fund effectively pursues its strategy through such a swap, or a small number of these swaps, the fund may as a practical matter be required to continue reestablishing the trade or refunding the collateral account in order to continue to offer the fund's strategy. The transaction therefore appears to involve the issuance of a senior security as the fund may be required to make future payments.

See also infra section II.J (discussing the characterization of "unfunded commitment" agreements for purposes of the proposed rule, and as senior securities).

88 *See* 2015 Proposing Release, *supra* note 2, at section III.A.2; 2015 proposed rule 18f-4(c)(4); *see also supra* note 10.

89 *See infra* section II.I.

however, derived from the price of another asset, *i.e.*, the asset sold short. A short sale of a security provides the same economic exposure as a derivatives instrument, like a future or swap, that provides short exposure to the same security. The proposed rule therefore treats short sale borrowings and derivatives instruments identically for purposes of funds' reliance on the rule's exemption.[90]

While this proposal does not specifically list firm or standby commitment agreements in the definition of "derivatives transaction," we interpret the definitional phrase "or any similar instrument" to include these agreements. A firm commitment agreement has the same economic characteristics as a forward contract.[91] Similarly, a standby commitment agreement has the same economic characteristics as an option contract, and the Commission has previously stated that such an agreement is economically equivalent to the issuance of a put option.[92] To the extent that a fund engages in transactions similar to firm or standby commitment agreements, they may fall within the "any similar instrument" definitional language, depending on the facts and circumstances.[93]

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90 *See* proposed rule 18f-4(b).

91 Indeed, the Commission noted in Release 10666 that a firm commitment is known by other names such as a "forward contract." *See* Release 10666, *supra* note 15, at nn.10-12 and accompanying text.

92 *See id.* at "Standby Commitment Agreements" ("The standby commitment agreement is a delayed delivery agreement in which the investment company contractually binds itself to accept delivery of a Ginnie Mae with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. . . . The Commission believes that the standby commitment agreement involves, in economic reality, the issuance and sale by the investment company of a 'put.'").

93 *See, e.g.*, *infra* paragraph accompanying notes 419-420 (discussing agreements that would not qualify for the proposed rule's treatment of unfunded commitment agreements because they are functionally similar to derivatives transactions).

We request comment on all aspects of the proposed rule's definition of the term "derivatives transaction," including the following items.

5. Is the definition of "derivatives transaction" sufficiently clear? Are there additional types of derivatives instruments, or other transactions, that we should include or exclude? Adding additional transactions to the definition would permit a fund to engage in those transactions by complying with the proposed rule, rather than section 18. Are there transactions that we should exclude from the definition so that funds must comply with the limits of section 18 (to the extent permitted under section 18) with respect to these transactions, rather than the proposed rule's conditions?

6. The proposed rule's definition of the term "derivatives transaction" is designed to describe those derivatives transactions that would involve the issuance of a senior security. Do commenters agree that derivatives transactions that involve obligations to make a payment or deliver assets involve the issuance of a senior security under section 18 of the Act? Does the rule effectively describe all of the types of derivatives transactions that would involve the issuance of a senior security? Conversely, are there any types of transactions that are included in the proposed definition of "derivatives transaction" that should not be considered to involve the issuance of a senior security? If so, which types of transactions and why?

7. Is it appropriate that the proposed rule's definition of "derivatives transaction" incorporates a list of derivatives instruments plus "any similar instrument," rather than a principles-based definition, such as an instrument or contract whose value is based upon, or derived from, some other asset or metric? Why or why not? Is the reference to "any similar instrument" in the proposed definition sufficiently clear to

address transactions that may be developed in the future? If not, how should we modify the rule to provide additional clarity?

8. Should the proposed definition of "derivatives transaction" include short sale borrowings? Would this approach cause any confusion because short sales are not typically understood as derivatives instruments? If the latter, what alternative approach would be preferable?

9. Should we specifically list firm or standby commitments in the proposed definition of "derivatives transaction"? Would funds understand the phrase "or any similar instrument" in the proposed definition to include these agreements? Do funds currently use the terms "firm commitment agreement" or "standby commitment agreement" to describe any of their transactions?

10. Are there any transactions similar to firm or standby commitments that we should specifically address, either in the proposed definition of "derivatives transaction" or otherwise as guidance? Are there any other types of transactions that the Commission should address—either in the proposed definition or as guidance—as transactions that fall within the "any similar instrument" definitional language?

B. Derivatives Risk Management Program

1. Summary

Fund investments in derivatives transactions can pose a variety of risks, and poor risk management can cause significant harm to funds and their investors. Derivatives can raise potential risks such as market, counterparty, leverage, liquidity, and operational risk. Although many of these risks are not limited to derivatives, the complexity and character of certain derivatives—such as their multiple contingencies and optionality, path dependency, and non-linearity—may heighten these risks.[94] Even simple derivatives without multiple contingencies and optionality, for example, can present additional risks beyond a fund's investment in the underlying reference assets, such as the risk that a fund must have margin-eligible assets on hand to meet margin or collateral calls. We also recognize the valuable role derivatives can play in helping funds to achieve their objectives efficiently or manage their investment risks.

An investment adviser of a fund that uses derivatives therefore should manage this use to ensure alignment with the fund's investment objectives, policies, and restrictions, its risk profile, and relevant regulatory requirements. In addition, a fund's board of directors is responsible for overseeing the fund's activities and the adviser's management of risks, including any derivatives risks.[95] Given the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds and their related risks, we believe that requiring funds that are users of derivatives (other than limited derivatives users) to have a formalized risk management program with certain specified elements (a "program") supports exempting these transactions from section 18.

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[94] *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, CESR/10-788 (July 28, 2010), at 12, *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf ("CESR Global Guidelines").

[95] *See, e.g.*, Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999) [64 FR 59877 (Nov. 3, 1999)]; Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816 (Jan. 2, 2001) [66 FR 3733 (Jan. 16, 2001)]; Independent Directors Council, *Fund Board Oversight of Risk Management* (Sept. 2011), *available at* http://www.ici.org/pdf/pub_11_oversight_risk.pdf ("2011 IDC Report").

Under the proposed program requirement, a fund would have to adopt and implement a written derivatives risk management program, which would include policies and procedures reasonably designed to manage the fund's derivatives risks.[96] A fund's risk management program should take into the account the way the fund uses derivatives, whether to increase investment exposures in ways that increase portfolio risks or, conversely, to reduce portfolio risks or facilitate efficient portfolio management.[97]

The program requirement is designed to result in a program with elements that are tailored to the particular types of derivatives that the fund uses and their related risks, as well as how those derivatives impact the fund's investment portfolio and strategy. The proposal would require a fund's program to include the following elements:

- *Risk identification and assessment*.[98] The program would have to provide for the identification and assessment of a fund's derivatives risks, which would take into account the fund's derivatives transactions and other investments.
- *Risk guidelines*.[99] The program would have to provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds related to a fund's derivatives risks.

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[96] Proposed rule 18f-4(c)(1).

[97] *See supra* note 4 and accompanying text; *infra* section II.B.3.a.

[98] Proposed rule 18f-4(c)(1)(i); *see also infra* section II.B.3.a.

[99] Proposed rule 18f-4(c)(1)(ii); *see also infra* section II.B.3.b.

- *Stress testing*.[100] The program would have to provide for stress testing of derivatives risks to evaluate potential losses to a fund's portfolio under stressed conditions.
- *Backtesting.*[101] The program would have to provide for backtesting of the VaR calculation model that the fund uses under the proposed rule.
- *Internal reporting and escalation.*[102] The program would have to provide for the reporting of certain matters relating to a fund's derivatives use to the fund's portfolio management and board of directors.
- *Periodic review of the program*.[103] A fund's derivatives risk manager would be required to periodically review the program, at least annually, to evaluate the program's effectiveness and to reflect changes in risk over time.

The proposed program requirement is drawn from existing fund best practices. We believe it would enhance practices for funds that have not already implemented a derivatives risk management program, while building off practices of funds that already have one in place.[104]

Most commenters generally supported the 2015 proposal's derivatives risk management program requirement, which had many similar foundational elements to those of the program we are proposing here. These commenters stated that the use of derivatives transactions by a fund should be subject to a comprehensive and appropriate written risk management program, which

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100 Proposed rule 18f-4(c)(1)(iii); *see also infra* section II.B.3.c.

101 Proposed rule 18f-4(c)(1)(iv); *see also infra* section II.B.3.d.

102 Proposed rule 18f-4(c)(1)(v); *see also infra* section II.B.3.e.

103 Proposed rule 18f-4(c)(1)(vi); *see also infra* section II.B.3.f.

104 *See, e.g.*, Aviva Comment Letter (discussing the implementation of formalized derivatives risk management programs); Vanguard Comment Letter.

would benefit investors.[105] Our proposal includes elements from the 2015 proposal's derivatives risk management program framework, and adds elements that take into account our analysis of the comments we received.

2. Program Administration

The proposed rule would require a fund adviser's officer or officers to serve as the fund's derivatives risk manager.[106] This requirement is designed to centralize derivatives risk management and to promote accountability. The designation of the derivatives risk manager must be approved by the fund's board of directors, and the derivatives risk manager must have direct communication with the fund's board of directors. Allowing multiple officers of the fund's adviser (including any sub-advisers) to serve as the fund's derivatives risk manager is designed to allow funds with differing sizes, organizational structures, or investment strategies to more effectively tailor the programs to their operations.[107] We understand that many advisers today involve committees or groups of officers in the vetting and analysis of portfolio risk and other types of risk.[108] Although the proposed rule would not permit a third party to serve as a fund's derivatives risk manager, the derivatives risk manager could obtain assistance from third parties

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105 *See, e.g.*, Comment Letter of AFG-French Asset Management Association (Mar. 25, 2016) ("AFG Comment Letter"); Comment Letter of American Beacon Advisors (Mar. 28, 2016) ("American Beacon Comment Letter"); Comment Letter of AQR Capital Management (Mar. 28, 2016) ("AQR Comment Letter"); Federated Comment Letter; Comment Letter of Fidelity (Mar. 28, 2016) ("Fidelity Comment Letter"); Comment Letter of AFL-CIO (Mar. 28, 2016); Comment Letter of Alternative Investment Management Association (Mar. 28, 2016) ("AIMA Comment Letter"); Comment Letter of Aviva (Mar. 28, 2016) ("Aviva Comment Letter"); Comment Letter of BlackRock (Mar. 28, 2016) ("BlackRock Comment Letter"); Comment Letter of Capital Research and Management Company (Mar. 28, 2016) ("CRMC Comment Letter").

106 Proposed rule 18f-4(a).

107 The term "adviser" as used in this release and rule 18f-4 generally refers to any person, including a sub-adviser, that is an "investment adviser" of an investment company as that term is defined in section 2(a)(20) of the Investment Company Act.

108 *See, e.g.*, IAA Comment Letter.

in administering the program. For example, third parties could provide data relevant to the administration of a fund's program or other analysis that may inform the fund's derivatives risk management.

The proposed rule would also require that the fund's derivatives risk manager have relevant experience regarding derivatives risk management.[109] This requirement is designed to reflect the potential complex and unique risks that derivatives can pose to funds and promote the selection of a derivatives risk manager who is well-positioned to manage these risks. As discussed below, under the proposed rule, a fund's board must approve the designation of the fund's derivatives risk manager, taking into account the derivatives risk manager's relevant experience regarding derivatives risk management.[110]

The proposed rule would require a fund to reasonably segregate the functions of the program from its portfolio management.[111] Segregating derivatives risk management from portfolio management is designed to promote objective and independent identification, assessment, and management of the risks associated with derivatives use. Accordingly, this element is designed to enhance the accountability of the derivatives risk manager and other risk management personnel and, therefore, to enhance the program's effectiveness.[112] We understand that funds today often segregate risk management from portfolio management. Many have observed that independent oversight of derivatives activities by compliance and internal audit

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109 Proposed rule 18f-4(a).

110 *See infra* section II.C.1.

111 Proposed rule 18f-4(c)(1).

112 *See*, *e.g.*, Comptroller of the Currency Administrator of National Banks, *Risk Management of Financial Derivatives: Comptroller's Handbook* (Jan. 1997), at 9 (discussing the importance of independent risk management functions in the banking context).

functions is valuable.[113] Because a fund may compensate its portfolio management personnel in part based on the returns of the fund, the incentives of portfolio managers may not always be consistent with the restrictions that a risk management program would impose. Keeping the functions separate in the context of derivatives risk management should help mitigate the possibility that these competing incentives diminish the program's effectiveness.

Separation of functions creates important checks and balances, and funds could institute this proposed requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel. The proposed rule would require reasonable segregation of functions, rather than taking a more prescriptive approach, such as requiring funds to implement strict protocols regarding communications between specific fund personnel, to allow funds to structure their risk management and portfolio management functions in ways that are tailored to each fund's facts and circumstances, including the size and resources of the fund's adviser. In this regard, the reasonable segregation requirement is not meant to indicate that the derivatives risk manager and portfolio management must be subject to a communications "firewall." We recognize the important perspective and insight regarding the fund's use of derivatives that the portfolio manager can provide and generally understand that the fund's derivatives risk manager would work with the fund's portfolio management in implementing the program requirement.

For similar reasons, the proposed rule would also prohibit the derivatives risk manager position from being filled solely by the fund's portfolio manager, if a single fund officer serves

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113 *See*, *e.g.*, Kenneth K. Marshall, *Internal Control and Derivatives*, The CPA Journal (Oct. 1995), *available at* http://archives.cpajournal.com/1995/OCT95/f461095.htm.

in the position.[114] The proposed rule also would prohibit a majority of the officers who compose the derivatives risk manager position from being portfolio managers, if multiple fund officers serve in the position.

Commenters generally supported the 2015 proposal's requirement that a fund's derivatives risk management program be administered by a derivatives risk manager and that the fund's derivatives risk management be segregated from the fund's portfolio management.[115] Commenters did, however, express concern about the 2015 proposal's requirement that there be a single derivatives risk manager and urged that the Commission permit a fund's portfolio managers to provide some input into the fund's derivatives risk management function.[116] This re-proposal addresses these concerns by permitting a group or committee to serve as a fund's derivatives risk manager, a portion of whom could be portfolio managers.

We request comment on the proposed requirements that a fund's derivatives risk manager administer the fund's program, and that the derivatives risk management function be reasonably segregated from the fund's portfolio management.

11. Is the proposed definition of "derivatives risk manager" sufficiently clear? Why or why not? Should the rule, as proposed, require that a fund's derivatives risk manager be an officer or officers of the fund's adviser, and would this requirement further the goals of centralizing derivatives risk management and promoting accountability? Why or why not? Should the rule, as proposed, permit a fund's derivatives risk

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114 Proposed rule 18f-4(a).

115 *See, e.g.*, BlackRock Comment Letter.

116 *See, e.g.*, BlackRock Comment Letter; Comment Letter of Morningstar (Mar. 28, 2016) ("Morningstar Comment Letter"); Comment Letter of the Investment Company Institute (Mar. 28, 2016) ("ICI Comment Letter I"); Comment Letter of WisdomTree (Mar. 28, 2016).

manager to be an officer or officers of the fund's sub-advisers? Why or why not? If so, should the rule require that at least one of the officers be an officer of the adviser or otherwise limit the number of sub-adviser officers? Why or why not? Would a fund's program be more effective if we required the derivatives risk manager to be a single individual? Why or why not? If so, should this individual be required to be an officer of a fund's adviser?

12. Should the rule, as proposed, require that a fund's derivatives risk manager have relevant experience regarding derivatives risk management? Why or why not? Is the proposed requirement that the derivatives risk manager have "relevant experience regarding the management of derivatives risk" sufficiently clear? Would this raise questions about whether portfolio management experience, or experience outside of formal derivatives risk management, would suffice for purposes of the rule? Should the rule, instead, require that a fund's derivatives risk manager simply have "relevant experience"? Should the rule specify that the derivatives risk manager must have relevant experience as determined by the fund's board, to allow a board to determine the experience that would be appropriate? Or should the rule identify specific qualifications, training, or experience of a fund's derivatives risk manager? Why or why not? If so, what should they be and why?

13. Should the rule, as proposed, require a fund to segregate derivatives risk management functions from portfolio management? Why or why not? If we were not to require independence between a fund's derivatives risk manager and the fund's portfolio managers, how could we ensure that a fund's portfolio management personnel, who may have conflicting incentives, do not unduly influence the fund's program

management?

14. Should we provide any additional clarification regarding the proposed reasonable segregation requirement? If so, what changes should we make? Should we add any specific requirements? For example, should we limit the extent to which fund risk management personnel can be compensated in part based on fund performance?

15. Is our understanding that many funds already segregate functions correct? If so, how and why do current approaches differ from the proposed rule's requirement to segregate functions?

16. Are there other ways to facilitate objective and independent risk assessment of portfolio strategies that we should consider? If so, what are they and how would these alternatives be more effective than the proposed rule's requirement to reasonably segregate functions?

17. Rule 22e-4 under the Investment Company Act, similar to the proposed rule, requires certain funds to implement a risk management program. In particular, rule 22e-4 requires person(s) designated to administer a fund's liquidity risk management program to be the fund's investment adviser, officer, or officers (which may not be solely portfolio managers of the fund) (the "liquidity risk manager"). Should we amend rule 22e-4 to more closely align the definition of "liquidity risk manager" with the proposed definition of "derivatives risk manager" by prohibiting a fund's adviser from serving as a liquidity risk manager? Why or why not? Conversely, should we align the standard for derivatives risk manager with the liquidity risk manager standard under rule 22e-4?

18. Would the proposed derivatives risk manager requirement raise any particular

challenges for funds with smaller advisers and, if so, what could we do to help mitigate these challenges? For example, should we modify the rule to permit funds to authorize the use of third parties not employed by the adviser to administer the program and, if so, under what conditions? Why or why not? Would allowing third parties to act as derivatives risk managers enhance the program by allowing specialized personnel to administer the program or detract from it by allowing for a derivatives risk manager who may not be as focused on the specific risks of the particular fund or as accountable to its board? Would the proposed requirement that a fund reasonably segregate derivatives risk management from portfolio management pose particular challenges for funds with smaller advisers? If so, how and why, and would additional guidance on this proposed requirement or changes to the proposed rule be useful? Conversely, would this proposed requirement (which does not prescribe how funds must segregate functions) provide appropriate flexibility for funds with smaller advisers?

19. Rule 38a-1(c) under the Investment Company Act prohibits officers, directors, and employees of the fund and its adviser from, among other things, coercing or unduly influencing a fund's chief compliance officer in the performance of his or her duties. Should we include such a prohibition on unduly influencing a fund's derivatives risk manager in the proposed rule? Why or why not?

20. Should we include any other program administration requirements? If so, what? For example, should we include a requirement for training staff responsible for day-to-day management of the program, or for portfolio managers, senior management, and any personnel whose functions may include engaging in, or managing the risk of,

derivatives transactions? If we require such training, should that involve setting minimum qualifications for staff responsible for carrying out the requirements of the program? Why or why not? Should we require training and education with respect to any new derivatives instruments that a fund may trade? Why or why not? Should we require a new instrument review committee?

3. Required Elements of the Program

a. Risk Identification and Assessment

The proposed program requirement would require a fund to identify and assess its derivatives risks in order to manage these risks.[117] It would require that the fund's identification and assessment take into account the fund's other investments as well as its derivatives transactions. An appropriate assessment of derivatives risks generally involves assessing how a fund's derivatives may interact with the fund's other investments or whether the fund's derivatives have the effect of helping the fund manage risks. For example, the risks associated with a currency forward would differ if a fund is using the forward to hedge the fund's exposure to currency risk associated with a fund investment denominated in a foreign currency or, conversely, to take a speculative position on the relative price movements of two currencies. We believe that by assessing its derivatives use holistically, a fund will be better positioned to implement a derivatives risk management program that does not over- or understate the risks its derivatives use may pose. Accordingly, we believe that this approach would result in a more-tailored derivatives risk management program.

[117] Proposed rule 18f-4(c)(1)(i).

The proposed rule would define the derivatives risks that must be identified and managed to include leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other risks the derivatives risk manager deems material.[118] In the context of a fund's derivatives transactions:

- Leverage risk generally refers to the risk that derivatives transactions can magnify the fund's gains and losses;[119]
- Market risk generally refers to risk from potential adverse market movements in relation to the fund's derivatives positions, or the risk that markets could experience a change in volatility that adversely impacts fund returns and the fund's obligations and exposures;[120]
- Counterparty risk generally refers to the risk that a counterparty on a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty;[121]

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118 Proposed rule 18f-4(a). In the case of funds that are limited derivatives users under the proposed rule, the definition would include any other risks that the fund's investment adviser (as opposed to the fund's derivatives risk manager) deems material, because a fund that is a limited derivatives user would be exempt from the requirement to adopt a derivatives risk management program (and therefore also exempt from the requirement to have a derivatives risk manager). *See infra* section II.E.

119 *See*, *e.g.*, Independent Directors Council, *Board Oversight of Derivatives Task Force Report* (July 2008), at 12 ("2008 IDC Report").

120 Funds should consider market risk together with leverage risk because leveraged exposures can magnify such impacts. *See*, *e.g.*, NAPF, *Derivatives and Risk Management Made Simple* (Dec. 2013), *available at* https://www.jpmorgan.com/cm/BlobServer/is_napfms2013.pdf?blobkey=id&blobwhere=1320663533358&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs.

121 *See*, *e.g.*, Nils Beier, *et al.*, *Getting to Grips with Counterparty Risk*, McKinsey Working Papers on Risk, Number 20 (June 2010).

- Liquidity risk generally refers to risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties;
- Operational risk generally refers to risk related to potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human error;[122] and
- Legal risk generally refers to insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract.[123]

We believe these risks are common to most derivatives transactions.[124]

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122 *See*, *e.g.*, 2008 IDC Report, *supra* note 119; RMA, *Statement on best practices for managing risk in derivatives transactions* (2004) ("Statement on best practices for managing risk in derivatives transactions"), *available at* http://www.rmahq.org/securities-lending/best-practices.

123 *See, e.g.*, Raimonda Martinkutė-Kaulienė, *Risk Factors in Derivatives Markets,* 2 Entrepreneurial Business and Economics Review 4 (2014); Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872 (Aug. 22, 2019), n.1055 ("Capital Margin Release") ("Market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions"); *see also* Office of the Comptroller of the Currency, Risk Management of Financial Derivatives, Comptroller's Handbook (Jan. 1997) (narrative), (Feb. 1998) (procedures).

Because derivatives contracts that are traded over the counter are not standardized, they bear a certain amount of legal risk in that poor draftsmanship, changes in laws, or other reasons may cause the contract to not be legally enforceable against the counterparty. *See, e.g.*, Comprehensive Risk Management of OTC Derivatives, *supra* note 124. For example, some netting agreements or qualified financial contracts contain so-called "walkaway" clauses, such as provisions that, under certain circumstances, suspend, condition, or extinguish a party's payment obligation under the contract. These provisions would not be enforceable where the Federal Deposit Insurance Act is applicable. *See* 12 U.S.C 1821(e)(8)(G). As another example, many derivatives contracts and prime brokerage agreements that hedge funds and other counterparties had entered into with Lehman Brothers included cross-netting that allowed for payments owed to and from different Lehman affiliates to be offset against each other, and cross-liens that granted security interests to all Lehman affiliates (rather than only the specific Lehman entity entering into a particular transaction). In 2011, the U.S. Bankruptcy Court for the Southern District of New York held that cross-affiliate netting provisions in an ISDA swap agreement were unenforceable against a debtor in bankruptcy. In the Matter of Lehman Brothers Inc., Bankr. Case No. 08-01420 (JPM) (SIPA), 458 B.R. 134, 1135-137 (Bankr. S.D.N.Y. Oct. 4, 2011).

124 *See* Numerix, *Comprehensive Risk Management of OTC Derivatives; A Tricky Endeavor* (July

The proposed rule would not limit a fund's identification and assessment of derivatives risks to only those specified in the rule. The proposed definition of the term "derivatives risks" includes any other risks a fund's derivatives risk manager deems material.[125] Some derivatives transactions could pose certain idiosyncratic risks. For example, some derivatives transactions could pose a risk that a complex OTC derivative could fail to produce the expected result (*e.g.*, because historical correlations change or unexpected merger events occur) or pose a political risk (*e.g.*, events that affect currencies).

Commenters to the 2015 proposal generally supported its requirement that a fund engage in a process of identifying and evaluating the potential risks posed by its derivatives transactions.[126]

We request comment on all aspects of the proposed requirement to identify and assess a fund's derivatives risks, as well as the proposed definition of the term "derivatives risks."

21. Is the proposed definition of "derivatives risks" sufficiently clear? Why or why not?

22. Are the categories of risks that we have identified in the proposed rule appropriate?

16, 2013), *available at* http://www.numerix.com/comprehensive-risk-management-otc-derivatives-tricky-endeavor ("Comprehensive Risk Management of OTC Derivatives"); Statement on best practices for managing risk in derivatives transactions, *supra* note 122; 2008 IDC Report, *supra* note 119; Lawrence Metzger, *Derivatives Danger: internal auditors can play a role in reigning in the complex risks associated with financial instruments*, FSA Times (2011), *available at* http://www.theiia.org/fsa/2011-features/derivatives-danger ("FSA Times Derivatives Dangers"). *See also* 17 CFR 240.15c3-4(a) ("An OTC derivatives dealer shall establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks."). Nonbank security-based swap dealers and broker-dealers authorized to use internal models to compute net capital also are subject to rule 15c3-4. *See* Capital Margin Release, *supra* note 123.

125 *See supra* note 118.

126 *See, e.g.*, ICI Comment Letter I; Comment Letter of the Consumer Federation of America (Mar. 28, 2016) ("CFA Comment Letter").

Why or why not? Should we remove any of the identified risk categories? If so, what categories should be removed, and why? Should we add any other specified categories of risks that should be addressed? If so, what additional categories and why? Should we provide further guidance regarding the assessment of any of these risks? If so, what should the guidance be, and why?

23. Do commenters believe the proposed approach with respect to risk identification and assessment is appropriate? Why or why not?

24. Do funds currently assess the risks associated with their derivatives transactions by taking into account both their derivatives transactions and other investments? If so, how do they perform this assessment? Are there certain derivatives transactions whose risks do not involve an assessment of other investments in a fund's portfolio? If so, which derivatives transactions, and why?

25. Should we require policies and procedures to include an assessment of particular risks based on an evaluation of certain identified risk categories as proposed? If not, why?

b. Risk Guidelines

The proposed rule would require a fund's program to provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks (the "guidelines").[127] The guidelines would be required to specify levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed and the measures to be taken if they are exceeded. The proposed guidelines requirement is designed to

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[127] Proposed rule 18f-4(c)(1)(ii).

address the derivatives risks that a fund would be required to monitor routinely as part of its program, and to help the fund identify when it should respond to changes in those risks. We understand that many funds today have established risk management guidelines, with varying degrees of specificity.

The proposed rule would not impose specific risk limits for these guidelines. It would, however, require a fund to adopt guidelines that provide for quantitative thresholds that the fund determines to be appropriate and that are most pertinent to its investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure.[128] Requiring a fund to establish discrete metrics to monitor its derivatives risks would require the fund and its derivatives risk manager to measure changes in its risks regularly, and this in turn is designed to lead to more timely steps to manage these risks. Moreover, requiring a fund to identify its response when these metrics have been exceeded would provide the fund's derivatives risk manager with a clear basis from which to determine whether to involve other persons, such as the fund's portfolio management or board of directors, in addressing derivatives risks appropriately.[129]

Funds may use a variety of approaches in developing guidelines that comply with the proposed rule.[130] This would draw on the risk identification element of the program and the scope and objectives of the fund's use of derivatives. A fund could use quantitative metrics that

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128 *See, e.g.*, Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* (Apr. 2010), *available at* http://www.mfdf.org/images/Newsroom/Risk_Principles_6.pdf ("MFDF Guidance").

129 *See* proposed rule 18f-4(c)(1)(v); *see also infra* section II.B.3.e.

130 *See, e.g.*, Comprehensive Risk Management of OTC Derivatives, *supra* note 124; Statement on best practices for managing risk in derivatives transactions, *supra* note 122; 2008 IDC Report, *supra* note 119.

it determines would allow it to monitor and manage its particular derivatives risks most appropriately. We understand that today funds use a variety of quantitative models or methodologies to measure the risks associated with the derivatives transactions. With respect to market risk, we understand that funds commonly use VaR, stress testing, or horizon analysis. Concentration risk metrics are also being used in connection with monitoring counterparty risk (*e.g.*, requiring specific credit committee approval for transactions with a notional exposure in excess of a specified amount, aggregated with other outstanding positions with the same of affiliated counterparties). In addition, liquidity models have been designed to address liquidity risks over specified periods (*e.g.*, models identifying margin outlay requirements over a specified period under specified volatility scenarios).

In developing the guidelines, a fund generally should consider how to implement them in view of its investment portfolio and the fund's disclosure to investors. For example, a fund may wish to consider establishing corresponding investment size controls or lists of approved transactions across the fund.[131] A fund generally should consider whether to implement appropriate monitoring mechanisms designed to allow the fund to abide by the guidelines, including their quantitative metrics.

While the 2015 proposal did not require funds to adopt risk guidelines, commenters on the 2015 proposal generally supported the concept of a requirement that a fund adopt and implement policies and procedures reasonably designed to manage the risks of its derivatives

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[131] A fund could also consider establishing an "approved list" of specific derivatives instruments or strategies that may be used, as well as a list of persons authorized to engage in the transactions on behalf of the fund. A fund may wish to provide new instruments (or instruments newly used by the fund) additional scrutiny. *See*, *e.g*., MFDF Guidance, *supra* note 128, at 8.

transactions, including by monitoring whether those risks continue to be consistent with any investment guidelines established by the fund or the fund's investment adviser.[132]

We request comment on the proposed rule's guidelines requirement.

26. Should we require, as proposed, a fund's program to provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines? Why or why not? Should we require, as proposed, that the guidelines provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks? Why or why not? If not, is there an alternative program element that would be more appropriate in promoting effective derivatives risk management? Should we prescribe particular tools or approaches that funds must use to manage specific risks related to their use of derivatives? For example, should we require funds to manage derivatives' liquidity risks by maintaining highly liquid assets to cover potential future losses and other liquidity demands?

27. Should we require a specific number or range of numbers of guidelines that a fund should establish? For example, should we require a fund to establish a minimum of 2, 3, 4, or more different guidelines to cover a range of different risks? Why or why not?

28. Do funds currently adopt, and monitor compliance with, such guidelines? If so, do these guidelines provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the funds' derivatives risks? If so, what criteria, metrics, or thresholds are provided for? Should we require that funds use specific risk management tools? If so, what tools should we require?

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[132] *See, e.g.*, BlackRock Comment Letter; CRMC Comment Letter; ICI Comment Letter I.

29. Should we specify a menu of guideline categories that all funds should use to promote consistency in risk management among funds? For example, should we identify certain commonly-used types of guidelines such as VaR, notional amounts, and duration, and require funds to choose among those commonly-used types? If we were to do so, which metrics should we allow funds to use? Would such a menu become stale as new risk measurement tools are developed?

30. Should we require, as proposed, that the guidelines specify set levels of a given criterion, metric, or threshold that the fund does not generally expect to exceed? Why or why not? If so, how would these levels be set or calculated? Should we instead set maximum levels for certain guidelines a fund would not exceed?

31. Should we require that a fund publicly disclose the guidelines it uses and the quantitative levels selected? If so, where (for example, in the fund's prospectus, website, or on Form N-PORT or N-CEN)? Should we instead require that funds confidentially report to us the guidelines they use and the quantitative levels selected? If so, on what form should they report this information?

32. Should we require, as proposed, that the guidelines identify measures to be taken when the fund exceeds a criterion, metric, or threshold in the fund's guidelines? Why or why not?

33. Should we require any form of public disclosure or confidential reporting to us if a fund were to exceed its risk guidelines? Would such reporting or disclosure result in funds setting guidelines that are so restrictive or lax that they would be unlikely to be useful as a monitoring and risk management tool?

34. Should the rule require the guidelines to provide for other elements? If so, what

elements and why?

c. Stress Testing

The proposed rule would require a fund's program to provide for stress testing to evaluate potential losses to the fund's portfolio.[133] We understand that, as a derivatives risk management tool, stress testing is effective at measuring different drivers of derivatives risks, including non-linear derivatives risks that may be understated by metrics or analyses that do not focus on periods of stress. Stress testing is an important tool routinely used in other areas of the financial markets and in other regulatory regimes, and we understand that funds engaging in derivatives transactions have increasingly used stress testing as a risk management tool over the past decade.[134] The Commission has also required certain types of funds to conduct stress tests or otherwise consider the effect of stressed market conditions on their portfolios.[135] We believe that requiring a fund to stress test its portfolio would help the fund better manage its derivatives risks and facilitate board oversight.

We also believe that stress testing would serve as an important complement to the proposed VaR-based limit on fund leverage risk, as well as any VaR testing under the fund's risk

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133 Proposed rule 18f-4(c)(1)(iii); *see also infra* section II.D.6.a (discussing an alternative to the proposed limit on fund leverage risk that would rely on a stress testing framework). The proposed rule would require a fund that is required to establish a derivatives risk mangement program to stress test its portfolio, that is, all of the fund's investments, and not just the fund's derivatives transactions.

134 *See, e.g.*, Comment Letter of Investment Company Institute (Oct. 8, 2019) ("ICI Comment Letter III") (stating that, based on a survey of member firms, many funds perform ex ante stress testing).

135 *See* rule 2a-7 under the Investment Company Act [17 CFR 270.2a-7]; *see also* rule 22e-4 under the Investment Company Act [17 CFR 270.22e-4] (requiring a fund subject to the rule to assess its liquidity risk by considering, for example, its investment strategy and portfolio investment liquidity under reasonably foreseeable stressed conditions).

guidelines.[136] During periods of stress, returns, correlations, and volatilities tend to change dramatically over a very short period of time. Losses under stressed conditions—or "tail risks"—would not be reflected in VaR analyses that are not calibrated to a period of market stress and that do not estimate losses that occur on the trading days with the highest losses.[137] Requiring funds to stress test their portfolios would provide information regarding these "tail risks" that VaR and other analyses may miss.

Under the proposed rule, the fund's stress tests would be required to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio.[138] The stress tests also would have to take into account correlations of market risk factors and resulting payments to derivatives counterparties.[139] We believe that these requirements would promote stress tests that produce results that are valuable in appropriately managing derivatives risks by focusing the testing on extreme events that may provide actionable information to inform a fund's derivatives risk management.[140] We understand that funds commonly consider the following market risk factors: liquidity, volatility, yield curve shifts, sector movements, or changes in the price of the underlying reference security or asset.[141] In addition, we believe it is

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136 *See* proposed rule 18f-4(c)(2); *infra* section II.D.

137 The proposed rule would not require a fund to implement a stressed VaR test. *See infra* section II.D.1.

138 Proposed rule 18f-4(c)(1)(iii).

139 *Id*.

140 Krishan Mohan Nagpal, *Designing Stress Scenarios for Portfolios*, 19 Risk Management 323 (2017).

141 *See, e.g.*, ICI Comment Letter I; Thomas Breuer, *et al*., *How to Find Plausible, Severe, and Useful Stress Scenarios*, International Journal of Central Banking 205 (Sept. 2009).

important for a fund's stress testing to take into account payments to counterparties, as losses can result when the fund's portfolio securities decline in value at the same time that the fund is required to make additional payments under its derivatives contracts.[142]

To inform a fund's derivatives risk management effectively, a fund should stress test its portfolio with a frequency that would best position the derivative risk manager to appropriately administer, and the board to appropriately oversee, a fund's derivatives risk management, taking into account the frequency of change in the fund's investments and market conditions. The proposed rule, therefore, would permit a fund to determine the frequency of stress tests, provided that the fund must conduct stress testing at least weekly. In establishing such frequency, a fund must take into account the fund's strategy and investments and current market conditions. For example, a fund whose strategy involves a high portfolio turnover might determine to conduct stress testing more frequently than a fund with a more static portfolio. A fund similarly might conduct more frequent stress tests in response to increases in market stress. The minimum weekly stress testing frequency is designed to balance the potential benefits of relatively frequent stress testing with the burdens of administering stress testing.[143] We also considered a less frequent requirement, such as monthly stress testing. A less frequent requirement, however, may fail to provide a fund's derivatives risk manager adequate and timely insight into the fund's derivatives risk, particularly where the fund has a high portfolio turnover. In determining this minimum frequency, we also took into account that this requirement would only apply to funds that do not qualify for the limited derivatives user exception because they use derivatives in more

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[142] *See* OppenheimerFunds Settled Action, *supra* note 22.

[143] We recognize that the costs associated with stress testing may increase with the frequency of conducting such tests. We understand, however, that once a fund initially implements a stress testing framework, subsequent stress tests could be automated and, as a result, be less costly.

than a limited way. In addition, in view of the proposed rule's internal reporting and periodic review requirements, the weekly stress testing minimum would provide a fund's derivatives risk manager and board with multiple sets of stress testing results, which would allow them to observe trends and how the results may change over time.[144]

Although the 2015 proposal's risk management program did not include a stress testing requirement, some commenters stated that stress testing would serve as an important component of derivatives risk management and recommended that the Commission require a fund's designated risk manager to perform stress testing and report the results to the fund's board.[145]

We request comment on the proposed rule's stress testing requirement.

35. Should we require, as proposed, that funds conduct stress testing as part of the program requirement? Why or why not? How, if at all, would stress testing serve as a complement for other risk measurement tools, such as VaR? What does stress testing capture as part of derivatives risk management that other tools do not, and why?
36. Should the rule require funds to conduct a particular type of stress testing? If so, what type, and what should the required elements be? For example, should the rule require funds to conduct scenario analysis?
37. Should the rule identify specific stress events to be applied? Should any required stress events vary based on the primary risks of particular funds?
38. Do funds currently conduct stress testing? If so, what types of stress testing, for what purposes, and how does the stress testing that funds currently conduct differ from the

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144 *See infra* sections II.B.3.e and II.C.

145 *See, e.g.*, Comment Letter of Blackstone Alternative Investment Advisors LLC (Mar. 28, 2016) ("Blackstone Comment Letter"); Comment Letter of Invesco Management Group, Inc. (Mar. 28, 2016) ("Invesco Comment Letter"); *see also* ICI Comment Letter III.

proposed rule's requirement?

39. For funds that currently conduct stress testing, how frequently do they conduct it? Daily, weekly, or monthly? Why? Does it depend on the type of stress testing? On the investment objective or strategy of a fund? With what minimum frequency should the rule require stress testing be conducted? For example, instead of weekly tests should we require daily tests? Conversely should we allow longer periods of time between tests, such as monthly, or quarterly? Why? Should we require more frequent testing for funds with some investment objectives or strategies than other funds? If so, for which objectives or strategies should we require more frequent testing?

40. Is the proposed rule's reference to "extreme but plausible market changes or changes in market risk factors" sufficiently clear? Should we identify more quantitative changes, such as the worst change in a specific risk factor seen in the last 10, 20, or 50 years? Is the proposed rule's reference to "significant adverse effect" sufficiently clear? Should we instead identify quantitative levels of NAV change, such as a drop of 20, 30, or 50% of the fund's NAV?

41. Should we require stress tests to include certain identified market risk factors such as changes in interest rates or spreads, market volatility, market liquidity, or other market factors? If so, which market risk factors should we identify, and why? If we were to identify certain market risk factors to be tested, should we require a fund to take action (such as reporting to its board or to the Commission, or reducing its derivatives usage) if a stress test were to show that one of these factors would result in the fund losing a certain percentage of its NAV? If so, what level of NAV, what types of risk factors, and what types of action should we consider?

42. Should we require, as proposed, that funds take into account their strategy, investments, and current market conditions in considering the appropriate frequency for a fund's stress tests? Why or why not? Should we require, as proposed, that funds to take into account correlations of market risk factors and payments to derivatives counterparties as part of the fund's stress tests? Why or why not? Would any additional guidance help funds to better understand, and more consistently conduct, the stress tests that the proposed rule would require?

43. We discuss and request comment below on the proposed rule's requirements to provide information to a fund's board of directors, including the derivatives risk manager's analysis of a fund's stress testing. In addition to providing this information to the board, should we require funds to disclose stress test results to investors or report them confidentially to us? If so, what information should be disclosed or reported?

d. Backtesting

The proposed rule would require a fund to backtest the results of the VaR calculation model used by the fund in connection with the relative VaR or absolute VaR test, as applicable, as part of the program.[146] This proposed requirement is designed to require a fund to monitor the effectiveness of its VaR model. It would assist a fund in confirming the appropriateness of its model and related assumptions and help identify when funds should consider model adjustments.[147] We are proposing this requirement in light of the central role that VaR plays in

146 *See* proposed rule 18f-4(c)(1)(iv).

147 Some commenters on the 2015 proposal suggested that the Commission require backtesting of a fund's VaR calculation models. *See, e.g.*, Blackstone Comment Letter; Comment Letter of

the proposed VaR-based limit on leverage risk. This also is consistent with the comments we received on the 2015 proposal suggesting that we require backtesting, which we had not included in that proposal.[148]

Specifically, the proposed backtesting requirement provides that, each business day, the fund must compare its actual gain or loss for that business day with the VaR the fund had calculated for that day. For purposes of the backtesting requirement, the VaR would be estimated over a one-trading day time horizon. For example, on Monday at the end of the trading day, a fund would analyze whether the gain or loss it experienced that day exceeds the VaR calculated for that day. In this backtesting example, the fund could calculate the VaR for Monday on Friday evening (after Friday trading closes) or Monday morning (before Monday trading begins). The fund would have to identify as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss. This approach is generally consistent with the practice of firms that use internal models to compute regulatory capital and other regulatory approaches.[149] Because the proposed rule would require that the fund's backtest

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Investment Company Institute (Sept. 27, 2016) ("ICI Comment Letter II"); Aviva Comment Letter; Comment Letter of the Global Association of Risk Professionals (Mar. 21, 2016) ("GARP Comment Letter").

148 *See, e.g.*, Blackstone Comment Letter; ICI Comment Letter II; Aviva Comment Letter; GARP Comment Letter.

149 *See, e.g.*, rule 15c3-1e under the Exchange Act [17 CFR 240.15c3-1e] (Appendix E to 17 CFR 240.15c3-1) ("On the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure."); CESR Global Guidelines, *supra* note 94 ("The UCITS should carry out the back testing program at least on a monthly basis, subject to always performing retroactively the comparison for each business day," *i.e.*, "provid[ing] for each business day a comparison of the one-day value-at-risk measure generated by the UCITS model for the UCITS' end-of-day positions to the one-day change of the UCITS' portfolio value by the end of the subsequent business day"); *see also infra* note 152 (discussing frequency variations for backtesting requirements).

be conducted using a 99% confidence level and over a one-day time horizon, and assuming 250 trading days in a year, a fund would be expected to experience a backtesting exception approximately 2.5 times a year, or 1% of the 250 trading days.[150] If the fund were consistently to experience backtesting exceptions more (or less) frequently, this could suggest that the fund's VaR model may not be effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund's investments, as required by the proposed rule.[151]

The proposed rule would require funds to conduct a backtest each day so that a fund and its derivatives risk manager could more readily and efficiently adjust or calibrate its VaR calculation model and, therefore, could more effectively manage the risks associated with its derivatives use. We understand that some funds perform these calculations less frequently than daily.[152] We are proposing a daily backtesting requirement because market risk factors and fund

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150 The proposed backtesting requirement would be based on a one-day time horizon. *See infra* section II.D.4 (discussing the proposed VaR model requirements that would be based on a twenty-day time horizon).

151 If 10 or more exceptions are generated in a year from backtesting that is conducted using a 99% confidence level and over a one-day time horizon, and assuming 250 trading days in a year, it is statistically likely that such exceptions are a result of a VaR model that is not accurately estimating VaR. *See, e.g.*, Philippe Jorion, *Value at Risk: The New Benchmark for Managing Financial Risk* (3d ed. 2006), at 149-150 ("Jorion"). *See also* rule 15c3-1e under the Exchange Act (requiring backtesting of VaR models and the use of a multiplication factor based on the number of backtesting exceptions).

152 *See, e.g.*, CESR Global Guidelines, *supra* note 94 ("The UCITS should carry out the back testing program at least on a monthly basis, subject to always performing retroactively the comparison for each business day," *i.e.*, "provid[ing] for each business day a comparison of the one-day value-at-risk measure generated by the UCITS model for the UCITS' end-of-day positions to the one-day change of the UCITS' portfolio value by the end of the subsequent business day"); Blackstone Comment Letter (suggesting monthly backtests); Aviva Comment Letter (recommending reporting to the Commission on a semi-annual basis if a fund experienced a certain number of backtest exceptions). *Cf.* rule 15c3-1e under the Exchange Act [17 CFR 240.15c3-1e] (Appendix E to 17 CFR 240.15c3-1) ("On the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the

investments are dynamic, which might result in frequent changes to the accuracy and effectiveness of a VaR model and calculations using the model. Some commenters on the 2015 proposal supported a backtesting requirement with a daily frequency.[153] We also believe that the additional costs associated with a daily backtesting requirement would be limited because a fund would be required to calculate its portfolio VaR each business day to satisfy the proposed limits on fund leverage discussed in section II.D of this release.

We request comment on the proposed backtesting requirement.

44. Is the proposed requirement that a fund backtest its VaR model each business day appropriate? Why or why not? Would less-frequent backtesting be sufficient? Is backtesting an effective tool to promote derivatives risk management and VaR model accuracy? Why or why not?

45. Should the rule specify the number of exceedances, or the number of consecutive days without an exceedance, that would require VaR model calibration? Why or why not?

46. How often do funds that currently use VaR backtest their VaR models and why? Should the backtesting requirement be less frequent? For example, should we require a fund to perform backtests weekly, monthly, or quarterly, in each case considering the one-day value change for each trading day in the period? Please explain.

47. For funds that currently backtest their VaR models, how often and for what reasons do funds recalibrate their VaR models? Are certain market risk factors or investment

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number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure.").

153 *See, e.g.*, GARP Comment Letter; Aviva Comment Letter; ICI Comment Letter II.

types particularly prone to requiring VaR model recalibrations (as well as backtesting)?

e. Internal Reporting and Escalation

The proposed rule would require communication between a fund's risk management and portfolio management regarding the operation of the program.[154] We believe these lines of communication are a key part of derivatives risk management.[155] Providing portfolio managers with the insight of a fund's derivatives risk manager is designed to inform portfolio managers' execution of the fund's strategy and recognize that portfolio managers will generally be responsible for transactions that could mitigate or address derivatives risks as they arise. The proposed rule also would require communication between a fund's derivatives risk manager and its board, as appropriate. We understand that funds today often have a dialogue between risk professionals and fund boards. Requiring a dialogue between a fund's derivatives risk manager and the fund's board would provide the fund's board with key information to facilitate its oversight function.

To provide flexibility for funds to communicate among these groups as they deem appropriate and taking into account funds' own facts and circumstances, the proposed rule would require a fund's program to identify the circumstances under which a fund must communicate with its portfolio management about the fund's derivatives risk management, including its program's operation.[156] A fund's program, in addition, could require that the fund's derivatives risk manager inform the fund's portfolio management, for example, by meeting with the fund's

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154 Proposed rule 18f-4(c)(1)(v).

155 *See* 2011 IDC Report, *supra* note 95.

156 Proposed rule 18f-4(c)(1)(v)(A).

portfolio management on a regular and frequent basis, or require that the fund's portfolio management is notified of the fund's exceedances or stress tests through software designed to provide automated updates.

The proposed rule would also require a fund's derivatives risk manager to communicate material risks to the fund's portfolio management and, as appropriate, its board of directors.[157] Specifically, the rule would require the derivatives risk manager to inform, in a timely manner, persons responsible for the fund's portfolio management—and the fund's board of directors, as appropriate—of material risks arising from the fund's derivatives transactions.[158] The proposed rule would not require a fund's derivatives risk manager to escalate these risks to the fund's board automatically, but would require that the derivatives risk manager directly inform the fund's board of directors regarding these material risks if the manager determines board escalation to be appropriate. A fund's derivatives risk manager, for example, could determine to inform the fund's adviser's senior officers of material derivatives risks after informing the fund's portfolio management, and before informing the fund's board. As another example, a fund's derivatives risk manager could determine that it would be appropriate to communicate certain material derivatives risks (for example, those that put more than a certain percentage of the fund's assets at imminent risk) to the board at the same time it informs the fund's portfolio management. We believe that a fund's derivatives risk manager is best positioned to determine when to appropriately inform the fund's portfolio management and board of material risks.

The proposed rule would require that these material risks include any material risks identified by the fund's guideline exceedances or stress testing. For example, an unexpected risk

[157] Proposed rule 18f-4(c)(1)(v)(B).

[158] *Id*.

may arise due to a sudden market event, such as a downgrade of a large investment bank that is a substantial derivatives counterparty to the fund. This requirement is designed to inform portfolio managers of material risks identified by a fund's derivatives risk management function so that portfolio managers can take them into account in managing the fund's portfolio and address or mitigate them as appropriate. It also would facilitate board oversight by empowering the derivatives risk manager to escalate a material risk directly to the fund's board where appropriate. Requiring that a fund's derivatives risk manager have this direct line of communication with the board regarding material risks arising from the fund's derivatives transactions is designed to foster an open and effective dialogue among the derivatives risk manager and the board.

We request comment on the internal reporting and escalation elements of the proposed program requirement.

48. Are the proposed internal reporting and escalation requirements appropriate? Why or why not? Should the rule describe the circumstances under which a fund must inform its portfolio management regarding the operation of the program, including any exceedances of its guidelines and the results of its stress tests? Why or why not? If so, what should the circumstances be and why? Should the rule require a fund to report to others at the fund or its adviser (*e.g.*, the fund's chief compliance officer)? If so, who should a fund report to and why?

49. Should we prescribe the types of internal reporting information that persons responsible for a fund's portfolio management or the fund's board should receive, and the means by which these persons receive such information? Why or why not? If so, what should we prescribe and why?

50. Are the proposed requirements to escalate material risks to the fund's portfolio management (and, as appropriate, the fund's board of directors) appropriate? Why or why not? Should these material risks include risks identified by the fund's guideline exceedances or stress testing? Why or why not? Should a fund's derivatives risk manager be required to report all material derivatives risks to the fund's board, as well as to its portfolio management? Why or why not?

51. Should the rule, as proposed, permit a fund to determine what risks arising from its derivatives transactions are material to the fund, for purposes of the proposed escalation requirement? Why or why not? If so, should the rule specifically require a fund's derivatives risk manager to make this determination?

52. Should the rule require the means by which internal reporting and/or material risk escalation occur? For example, should the rule specify that certain communications must be in writing? Why or why not?

53. Should the rule require a fund's derivatives risk manager to inform the fund's portfolio management regarding the operation of the program on a regular basis? Why or why not? If so, what should the frequency be and why?

54. Should the rule require a fund to report material risks to us? Why or why not? If so, what should a fund report and how should it be reported? For example, should a fund be required to report material exceedances to its guidelines? Why or why not? Should such a report be confidential?

55. Should the rule permit a fund to determine whether the material risk warrants informing the fund's board? Why or why not? If so, which person or persons at the fund or its adviser should be responsible for that determination? Should a fund's

board always be informed of material risks regarding the fund's derivatives use? Why or why not? If so, under what circumstances and frequency should the board be informed, and why?

56. Should we require that a fund's derivatives risk manager be permitted to communicate directly with the fund's board of directors? If not, how should we otherwise address the concern that a board may not receive the derivatives risk manager's independent risk assessments if the derivatives risk manager is not empowered to communicate directly with the board?

f. Periodic Review of the Program

The proposed rule would require a fund's derivatives risk manager to review the program at least annually to evaluate the program's effectiveness and to reflect changes in the fund's derivatives risks over time.[159] The review would apply to the overall program, including each of the specific program elements discussed above.

The periodic review would also cover the VaR model a fund uses to comply with the proposed VaR-based limit on fund leverage risk and related matters. As discussed below, the proposed rule would require a fund to comply with a relative or absolute VaR test.[160] For the relative VaR test, the fund would compare its VaR to a "designated reference index," as defined in the rule and selected by the fund's derivatives risk manager. The proposed periodic review would therefore include the VaR calculation model that the fund used in connection with either of the proposed VaR tests (including the fund's backtesting of the model) and any designated

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159 Proposed rule 18f-4(c)(1)(vi).

160 *See* proposed rule 18f-4(c)(2); *infra* section II.D.

reference index that the derivatives risk manager selected, to evaluate whether the calculation model and designated reference index remain appropriate.

We believe that the periodic review of a fund's program and VaR calculation model is necessary to determine whether the fund is appropriately addressing its derivatives risks. A fund's derivatives risk manager, as a result of the review, could determine whether the fund should update its program, its VaR calculation model, or any designated reference index. Commenters on the 2015 proposal generally supported a similar proposed requirement that a fund review and update its derivatives risk management program at least annually.[161]

The proposed rule would not prescribe review procedures or incorporate specific developments that a derivatives risk manager must consider as part of its review. We believe a derivatives risk manager generally should implement periodic review procedures for evaluating regulatory, market-wide, and fund-specific developments affecting the fund's program so that it is well positioned to evaluate the program's effectiveness.

We believe that a fund should review its program, VaR calculation model, and designated reference index on at least an annual basis, because derivatives and fund leverage risks, and the means by which funds evaluate such risks, can change. The proposed rule would require at least an annual review so that there would be a recurring dialogue between a fund's derivatives risk manager and its board regarding the implementation of the program and its effectiveness. This frequency also mirrors the minimum period in which the fund's derivatives risk manager would be required to provide a written report on the effectiveness of the program to the board.[162] A fund's derivatives risk manager could, however, determine that more frequent reviews are

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[161] *See, e.g.*, Vanguard Comment Letter.

[162] *See infra* section II.C.2.

appropriate based on the fund's particular derivatives risks, the fund's policies and procedures implementing the program, market conditions, or other facts and circumstances.[163]

We request comment on the proposed rule's periodic review requirement.

57. Should the rule, as proposed, specifically require that a fund's derivatives risk manager periodically review the program's effectiveness, including the program's VaR calculation model and any designated reference index? Why or why not?

58. Should the rule, as proposed, require this review to take place at least annually, or should it require a more frequent review, such as quarterly? Should we, instead, not prescribe a minimum frequency for the periodic review? Why or why not?

59. Are there certain review procedures that the proposed rule should require and/or on which the Commission should provide guidance? If so, what are they? For example, should the periodic review involve board input? Should the Commission provide any additional guidance on regulatory, market-wide, and fund-specific developments that a fund's review procedures might cover? Why or why not? If so, how?

60. Should the rule, as proposed, specifically require that other program elements be periodically reviewed? Why or why not? If so, which elements and why, and should they be reviewed with the same frequency?

C. Board Oversight and Reporting

The proposed rule would require: (1) a fund's board of directors to approve the designation of the fund's derivatives risk manager and (2) the derivatives risk manager to

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163 *See also* proposed rule 18f-4(c)(2)(iii)(A) (requiring, for a fund that is not in compliance with the applicable VaR test within three business days, the derivatives risk manager to report to the fund's board of directors and explain how and by when (*i.e.*, number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance).

provide regular written reports to the board regarding the program's implementation and effectiveness, and describing any exceedances of the fund's guidelines and the results of the fund's stress testing.[164] Requiring a fund's derivatives risk manager approved by the fund's board and with relevant experience as determined by the fund's board to be responsible for the day-to-day administration of the fund's program, subject to board oversight, is consistent with the way we believe many funds currently manage derivatives risks.[165] It is also consistent with a board's duty to oversee other aspects of the management and operations of a fund.

The proposed rule's requirements regarding board oversight and reporting are designed to further facilitate the board's oversight of the fund's derivatives risk management.[166] Board oversight should not be a passive activity. Consistent with that view, we believe that directors should understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program. They also should ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation. The board should view oversight as an iterative process. Therefore, the board should inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including as those risks may change

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164 Proposed rule 18f-4(c)(5). The board could designate a committee of directors to receive the report.

165 *See, e.g.*, Comment Letter of the Independent Directors Council (June 22, 2016) (providing views regarding the appropriate oversight role of fund directors).

166 Many commenters to the 2015 proposal expressed the view that the appropriate role of the board in the context of funds' derivatives risk management is one of oversight. *See, e.g.*, Comment Letter of Mutual Fund Directors Forum (Mar. 28, 2016) (stating it has long taken the position that boards and independent trustees have an important role to play in overseeing the risks associated with funds' use of derivatives, including the manner in which those risks are managed); *see also* Comment Letter of the Independent Directors Council (Mar. 28, 2016) ("IDC Comment Letter"); Morningstar Comment Letter.

over time. To facilitate the board's oversight, the proposed rule, as discussed below, would require the fund's derivatives risk manager to provide reports to the board.

A fund's board would also be responsible for overseeing a fund's compliance with proposed rule 18f-4. Rule 38a-1 under the Investment Company Act requires a fund's board, including a majority of its independent directors, to approve policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers.[167] Rule 38a-1 provides for oversight of compliance by the fund's adviser and other service providers through which the fund conducts its activities. Rule 38a-1 would encompass a fund's compliance obligations with respect to proposed rule 18f-4.

1. Board Approval of the Derivatives Risk Manager

The proposed rule would require a fund's board to approve the designation of the fund's derivatives risk manager, taking into account the derivatives risk manager's relevant experience regarding the management of derivatives risk.[168] This requirement is designed to establish the foundation for an effective relationship and line of communication between a fund's board and its derivatives risk manager, and to ensure that the board receives information it needs to approve the designation.[169] The requirement that the board consider the derivatives risk manager's relevant experience is designed to provide flexibility for a fund's board to take into account a derivatives risk manager's specific experience, rather than the rule taking a more prescriptive approach in identifying a specific amount or type of experience that a derivatives risk manager

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167 *See* rule 38a-1 under the Investment Company Act; Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (discussing the adoption and implementation of policies and procedures required under rule 38-1) ("Compliance Program Release").

168 Proposed rule 18f-4(c)(5)(i).

169 *Cf.* rules 22e-4 and 38a-1 under the Investment Company Act.

must have. Detailing a derivatives risk manager's required experience in the rule would not be practical, given the numerous ways in which a person could obtain experience with derivatives or risk management. Any specification in the rule of the specific experience required to serve as a derivatives risk manager likely would be over- or under-inclusive and would not take into account the way that any particular fund uses derivatives. We believe that a fund's board, in its oversight role, is best-positioned to consider a prospective derivatives risk manager's experience based on all the facts and circumstances relevant to the fund in considering whether to approve the derivatives risk manager's designation.

Commenters on the 2015 proposal generally supported a requirement that the board approve a fund's derivatives risk manager, although some of these commenters objected to the proposed requirement that only a single individual could serve in that role. These commenters asserted that requiring the board to approve a single individual as the derivatives risk manager would have required the board to participate too closely in the management function of the fund.[170] This re-proposal, in contrast, would permit a fund's board to approve the designation of a single individual or group of individuals, subject to the other proposed requirements about who may serve as a derivatives risk manager.

We request comment on the proposed requirement that a fund's board approve the designation of the fund's derivatives risk manager.

61. Should we require, as proposed, that a fund's board approve the designation of the fund's derivatives risk manager? Why or why not? Are there any specific

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170 *See, e.g.*, Comment Letter of Guggenheim (Mar. 28, 2016) ("Guggenheim Comment Letter"); Dechert Comment Letter; IDC Comment Letter; American Beacon Comment Letter; Fidelity Comment Letter; IAA Comment Letter; ICI Comment Letter I; Invesco Comment Letter.

requirements we should include with respect to the derivatives risk manager's relationship with the board? For example, should we require the board to meet with the derivatives risk manager in executive session? Should we also require the derivatives risk manager to be removable only by the fund's board? Should we require the derivatives risk manager's compensation be approved by the board, like a fund's chief compliance officer? If so, why? Would such a requirement pose undue burdens on fund boards or place the board in an inappropriate role? If so, why?

62. Should the rule permit a board committee to approve the designation of the derivatives risk manager, rather than the full board (and a majority of directors who are not interested persons of the fund) as proposed? Why or why not? If so, should there be any requirements or guidance with respect to such a board committee (*e.g.*, composition or responsibilities)?

63. Should the rule, as proposed, require that a fund's board in approving the fund's derivatives risk manager, take into account the derivatives risk manager's relevant experience regarding the management of derivatives risk? Why or why not? Would a fund's board, in approving the designation of the fund's derivatives risk manager, only approve individuals with relevant experience even without this express requirement? Is the proposed requirement that a fund's board must take into account the derivatives risk manager's "relevant experience regarding the management of derivatives risk" sufficiently clear? Would this raise questions for a fund's board about whether portfolio management experience, or experience outside of formal derivatives risk management, would suffice for purposes of the rule? Should the rule, instead, require that a fund's board take into account the derivatives risk manager's

"relevant experience"? Or should the rule identify specific qualifications or experience of a fund's derivatives risk manager that the fund's board must consider? Why or why not? If so, what should they be and why?

64. Should we require a fund's board, or a committee thereof, to approve the derivatives risk management program or any material changes to the program? Why or why not? If so, should we require that the committee have a majority that are disinterested? Would such an approval requirement promote greater board engagement and oversight? Do a fund's derivatives use and related derivatives risks present matters for which it would be appropriate to require the fund's board, or committee thereof, to approve the program or any material changes to the program? Why or why not?

2. Board Reporting

The proposed rule would require the derivatives risk manager to provide a written report on the effectiveness of the program to the board at least annually and also to provide regular written reports at a frequency determined by the board. This requirement is designed to facilitate the board's oversight role, including its role under rule 38a-1.[171]

Many commenters to the 2015 proposal did not support the proposal's requirement that the board approve material changes to the program. Many commenters did state, however, that a fund's board of directors should be provided with notices of changes to the policies and procedures implementing the derivatives risk management program and that the fund's derivatives risk manager should provide the board with a written report describing the adequacy

[171] *See* Compliance Program Release, *supra* note 166, at n.33 and accompanying text.

of the derivatives risk management program and the effectiveness of its implementation and the results of the fund's stress testing.[172]

Reporting on Program Implementation and Effectiveness

The proposed rule would require a fund's derivatives risk manager to provide to the fund's board, on or before the implementation of the program and at least annually thereafter, a written report providing a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program as well as the basis for the representation.[173] This requirement, as discussed below, is designed to provide a fund's board with information about the effectiveness and implementation of the program so that the board may appropriately exercise its oversight responsibilities, including its role under rule 38a-1.

To facilitate the board's oversight, the proposed rule would require the written report to include the basis for the derivatives risk manager's representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program and the effectiveness of its implementation. In addition, the representation may be based on the derivatives risk manager's reasonable belief after due inquiry. A derivatives risk manager, for example, could form its reasonable belief based on an assessment of the program and taking into account input from fund personnel, including the fund's portfolio management, or from third parties. We propose to require that the derivatives risk manager include this representation and its basis, because we believe the derivatives risk manager—rather than the board—is best positioned to make this determination. Requiring the derivatives risk manager to include the

172 *See, e.g.*, BlackRock Comment Letter; Vanguard Comment Letter.

173 Proposed rule 18f-4(c)(5)(ii).

information in a board report would also reinforce that the fund and its adviser are responsible for derivatives risk management while the board's responsibility is to oversee this activity. Reports following the initial implementation of the program must also address the effectiveness of the program. This requirement is designed to provide the board with appropriate and useful information so it can exercise its judgment in overseeing the program, and in light of its role under rule 38a-1.

The proposed rule would also require the written report to include a fund's derivatives risk manager's basis for the selection of the designated reference index used under the proposed relative VaR test or, if applicable, an explanation of why the derivatives risk manager was unable to identify a designated reference index appropriate for the fund such that the fund relied on the proposed absolute VaR test instead. The derivatives risk manager's selection of a particular designated reference index, or conclusion that one is not available, can affect the amount of leverage risk a fund may obtain under the proposed rule.[174] We therefore believe it is important that a fund's board have sufficient information to oversee this activity.

Regular Board Reporting

The proposed rule would require a fund's derivatives risk manager to provide to the fund's board, at a frequency determined by the board, a written report analyzing any exceedances of the fund's risk guidelines and the results of the fund's stress tests and backtesting.[175] Requiring the derivatives risk manager to provide information about how the fund performed

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174 *See infra* section II.D.2.b. The proposed rule would not limit a derivatives risk manager from receiving input from the fund's portfolio managers or others regarding the fund's designated reference index.

175 Proposed rule 18f-4(c)(5)(iii); *see also* proposed rule 18f-4(c)(1)(ii)–(iv); *see also supra* sections II.B.3.b, II.B.3.c, and II.B.3.d.

relative to these measures and at a board-determined frequency is designed to provide the board with timely information to facilitate its oversight of the fund and the operation of the program. The program's guidelines and stress testing requirements are designed to address a fund's particular derivatives risks and are areas the fund should routinely monitor. The program's backtesting requirement is designed to require a fund to monitor the effectiveness of the fund's VaR model, which plays a central role in the proposed VaR-based limit on fund leverage risk. Therefore, we believe that a board overseeing a fund's derivatives risk management should receive regular reporting regarding the derivatives risk manager's analysis of guideline exceedances and the results of stress testing and backtesting. We also understand that many fund advisers today provide regular reports to fund boards, often in connection with quarterly board meetings, regarding a fund's use of derivatives and their effects on a fund's portfolio, among other information.

Accordingly, the proposed rule would require that the report include the derivatives risk manager's analysis of any exceedances and stress testing and backtesting results, and to include such information as may be reasonably necessary for the board to evaluate the fund's response to any exceedances and the stress testing and backtesting results. This requirement is designed to provide the board with information in a format, and with appropriate context, that would facilitate the board's understanding of the information. A simple listing of exceedances and stress testing and backtesting results without context, in contrast, would provide less useful information for a fund's board and would not satisfy this proposed requirement.

Under the proposed regular board reporting requirement, a fund's board would determine the frequency of this written report. Boards should be allowed flexibility in determining the frequency of reporting so that they can tailor their oversight to their funds' particular facts and circumstances.

We request comment on the proposed board reporting requirements.

65. Are the proposed requirements for the fund's derivatives risk manager to provide written reports to the fund's board on the program's implementation and effectiveness appropriate? Why or why not? Should the board receive a written report on or before the implementation of the program? Why or why not? Should we modify the proposed rule to require funds to provide boards reports with greater frequency than annually? Why or why not?

66. Is the proposed representation that the derivatives risk manager would have to make in the report appropriate? Why or why not? What should the representation entail, and why? Should we provide guidance as to what the representation should look like? Why or why not? Would the representation be helpful for a fund's board in exercising its oversight responsibilities? Why or why not? What effect, if any, would the representation have on a fund's derivatives risk management apart from the board's oversight of such risk management?

67. Would the responsibilities the proposed rule allocates to a fund's derivatives risk manager affect a fund's ability to hire or retain a derivatives risk manager? If so, how?

68. Is the proposed requirement for the written report to include the basis for the derivatives risk manager's representation along with information to evaluate the program's adequacy and effectiveness, appropriate? Why or why not? Should the rule require specific information in the written report? Why or why not? If so, what

information and why? Should the rule, as proposed, permit the representation to be based on the derivatives risk manager's reasonable belief after due inquiry? Why or why not? Should we provide more guidance regarding the basis for the representation? If so, what should we provide? For example, should we provide guidance regarding the types of information on which a fund's derivatives risk manager may base this representation? Why or why not? Is the reference to due inquiry appropriate in this context? Is the reference sufficiently clear?

69. Should the rule require the written report to include a fund's derivatives risk manager's basis for the selection of the designated reference index or, if applicable, an explanation of why the derivatives risk manager was unable to identify a designated reference index appropriate for the fund? Why or why not? Should the rule require the written report to identify and explain any difference between the selected index and any indices that are used for performance comparisons in the fund's registration statement and shareholder reports? Why or why not?

70. Should the rule require a fund's derivatives risk manager to provide a written report regarding any exceedances to thresholds provided for in the fund's guidelines? Why or why not? Should the rule require a fund's derivatives risk manager to provide a written report regarding the results of the stress tests and backtests? Why or why not?

71. Should the rule require that a fund's derivatives risk manager report to the board? Why or why not? If not, should the fund determine who should report to the board, and why? Should the rule permit the derivatives risk manager to delegate its reporting obligations under the rule to other officers or employees of the adviser? Why or why not? If so, to whom should they be able to delegate these obligations?

72. Should the rule permit a fund's board to determine the frequency with which it receives the written report? Why or why not? Or should the rule require that the derivatives risk manager provide the written report with a certain frequency? Why or why not? If so, what frequency should the rule require, and why? Should the rule permit a fund's derivatives risk manager to determine to report to the board sooner than the frequency determined by the board if appropriate? Why or why not?

73. Should the rule require that the written report include such information as may be reasonably necessary for the board to evaluate a fund's response to any exceedances and the results of the fund's stress testing? Why or why not? What information may be reasonably necessary for the board's evaluation? Should the rule require certain information to be provided in the written report? Why or why not? If so, what information should be required to be provided?

74. Should the rule require the report to be written? Why or why not? Should the rule require that the derivatives risk manager prepare the written report? Why or why not?

75. Would the approach provided by the proposed rule's board oversight provisions appropriately provide the board the ability to oversee a fund's derivatives risk management? Why or why not? Does the proposed rule provide an appropriate balance between the board's role of general oversight and the fund's roles of day-to-day risk management and portfolio management? Why or why not?

76. Should the board be required to approve the program, including initially, and any material changes to the program? Why or why not? What is current industry practice with respect to the board's oversight of a fund's derivatives risk management?

D. Proposed Limit on Fund Leverage Risk

The proposed rule would also generally require funds relying on the rule when engaging in derivatives transactions to comply with a VaR-based limit on fund leverage risk. This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index." If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test.[176]

1. Use of VaR

VaR is an estimate of an instrument or portfolio's potential losses over a given time horizon and at a specified confidence level. VaR will not provide, and is not intended to provide, an estimate of an instrument or portfolio's maximum loss amount. For example, if a fund's VaR calculated at a 99% confidence level was $100, this means the fund's VaR model estimates that, 99% of the time, the fund would not be expected to lose more than $100. However, 1% of the time, the fund would be expected to lose more than $100, and VaR does not estimate the extent of this loss.

We propose to use VaR tests to limit fund leverage risk associated with derivatives because VaR generally enables risk to be measured in a reasonably comparable and consistent manner across diverse types of instruments that may be included in a fund's portfolio. One benefit of the proposed VaR-based approach is that different funds could, and would be required to, tailor their VaR models to incorporate and reflect the risk characteristics of their fund's

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176 A fund that is a leveraged/inverse investment vehicle, as defined in the proposed sales practices rules, would not be required to comply with the proposed VaR-based limit on fund leverage risk. Broker-dealers and investment advisers would be required to approve retail investors' accounts to purchase or sell shares in these funds. *See infra* section II.G (discussing leveraged/inverse investment vehicles). The proposed rule also would provide an exception from the proposed VaR tests for funds that use derivatives to a limited extent or only to hedge currency risks. *See infra* sections II.E and II.G (discussing the proposed rule's provisions regarding limited derivatives users and leveraged/inverse funds covered by the sales practices rules).

particular investments.[177] VaR is a commonly-known and broadly-used industry metric that integrates the market risk associated with different instruments into a single number that provides an overall indication of market risk, including the market risk associated with the fund's derivatives transactions.[178] We recognize that funds use many other risk analytic metrics suited to particular financial instrument categories.[179] Given the diverse portfolios of many funds, these more category-specific risk metrics may be less suitable for establishing a proposed limit on fund leverage risk that is applied more generally.

We recognize that VaR is not itself a leverage measure. But a VaR test, and especially one that compares a fund's VaR to an unleveraged index that reflects the markets or asset classes in which the fund invests, can be used to analyze whether a fund is using derivatives transactions to leverage the fund's portfolio, magnifying its potential for losses and significant payment obligations of fund assets to derivatives counterparties. At the same time, VaR tests can also be used to analyze whether a fund is using derivatives with effects other than leveraging the fund's portfolio that may be less likely to raise the concerns underlying section 18. For example, fixed-

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177 *See infra* section II.D.4 (discussing the choice of model and parameters for the VaR test).

178 *See* Kevin Dowd, *An Introduction to Market Risk Measurement* (Oct. 2002), at 10 ("Dowd") (VaR "provides a common consistent measure of risk across different positions and risk factors. It enables us to measure the risk associated with a fixed-income position, say, in a way that is comparable to and consistent with a measure of the risk associated with equity positions"); *see also* Jorion, *supra* note 151, at 159 (stating that VaR "explicitly accounts for leverage and portfolio diversification and provides a simple, single measure of risk based on current positions").

179 *See* Jorion, *supra* note 151. For example, risk measures for government bonds can include duration, convexity and term-structure models; for corporate bonds, ratings and default models; for stocks, volatility, correlations and beta; for options, delta, gamma and vega; and for foreign exchange, target zones and spreads. Certain funds are required to report on Form N-PORT some of these metrics, such as portfolio-level duration (DV01 and SDV01) and position-level delta. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (Oct. 13, 2016) [81 FR 81870 (Nov. 18, 2016)] ("Investment Company Reporting Modernization Adopting Release").

income funds use a range of derivatives instruments, including credit default swaps, interest rate swaps, swaptions, futures, and currency forwards. These funds often use these derivatives in part to seek to mitigate the risks associated with a fund's bond investments or to achieve particular risk targets, such as a specified duration. If a fund were using derivatives extensively, but had either a low VaR or a VaR that did not substantially exceed the VaR of an appropriate benchmark, this would indicate that the fund's derivatives were not substantially leveraging the fund's portfolio.

We also understand that VaR calculation tools are widely available, and many advisers that enter into derivatives transactions already use risk management or portfolio management platforms that include VaR capability.[180] Advisers to the funds that use derivatives transactions more extensively may be particularly likely to already use risk management or portfolio management platforms that include VaR capability, as compared to advisers to the funds that are within the scope of the proposed provision for limited derivatives users and that would not be subject to the proposed VaR tests.[181]

While we believe there are significant benefits to using the proposed VaR-based limit on fund leverage risk, we recognize risk literature critiques of VaR (especially since the 2007-2009

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180 *See, e.g.*, ICI Comment Letter III ("73 percent of respondents [to an Investment Company Institute survey of its member firms] use both some form of VaR and stress testing as derivatives risk management tools.)"; Comment Letter of OppenheimerFunds (Mar. 28, 2016) ("Oppenheimer Comment Letter"); Federated Comment Letter; Franklin Resources Comment Letter; *see also* Christopher L. Culp, Merton H. Miller & Andres M. P. Neves, *Value at Risk: Uses and Abuses*, 10 Journal of Applied Corporate Finance 26 (Jan. 1998) (VaR is "used regularly by nonfinancial corporations, pension plans and mutual funds, clearing organizations, brokers and futures commission merchants, and insurers."). Moreover, the proposed relative VaR test is similar to a relative VaR approach that applies to UCITS under European guidelines. *See infra* section II.D.6.c (discussing the UCITS approach).

181 *See, e.g.*, ICI Comment Letter III.

financial crisis). One common critique of VaR is that it does not reflect the size of losses that may occur on the trading days during which the greatest losses occur—sometimes referred to as "tail risks."[182] A related critique is that VaR calculations may underestimate the risk of loss under stressed market conditions.[183] These critiques often arise in the context of discussing risk managers' use of additional risk tools to address VaR's shortcomings. Our proposed VaR tests are designed to provide a metric that can help assess the extent to which a fund's derivatives transactions raise concerns underlying section 18, but we do not believe they should be the sole component of a derivatives risk management program.[184] We do not intend to encourage risk managers to over-rely on VaR as a stand-alone risk management tool.[185] Instead, as discussed above, the proposed rule would require a fund to establish risk guidelines and to stress test its

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182 *See* Chris Downing, Ananth Madhavan, Alex Ulitsky & Ajit Singh, *Portfolio Construction and Tail Risk*, 42 The Journal of Portfolio Management 1, 85-102 (Fall 2015), *available at* https://jpm.iijournals.com/content/42/1/85 ("for especially fat-tailed return distributions the VaR threshold value might appear to be low, but the actual amount of value at risk is high because VaR does not measure the mass of distribution beyond the threshold value").

With respect to VaR, the "tail" refers to the observations in a probability distribution curve that are outside the specified confidence level. "Tail risk" describes the concern that losses outside the confidence level may be extreme.

183 *See* Jorion, *supra* note 151, at 357 (VaR "quantif[ies] potential losses under 'normal' market conditions, where *normal* is defined by the confidence level, typically 99 percent. . . . In practice, [VaR] measures based on recent historical data can fail to identify extreme unusual situations that could cause severe losses.").

184 *See supra* section II.B.3.

185 *See*, *e.g.*, James O'Brien & Pawel J. Szerszen, *An Evaluation of Bank VaR Measures for Market Risk During and Before the Financial Crisis*, Federal Reserve Board Staff Working Paper 2014-21 (Mar. 7, 2014), *available at* https://www.federalreserve.gov/pubs/feds/2014/201421/201421pap.pdf ("Criticism of banks' VaR measures became vociferous during the financial crisis as the banks' risk measures appeared to give little forewarning of the loss potential and the high frequency and level of realized losses during the crisis period."); *see also* Pablo Triana, *VaR: The Number That Killed Us*, Futures Magazine (Dec. 1, 2010), *available at* http://www.futuresmag.com/2010/11/30/var-number-killed-us (stating that "in mid-2007, the VaR of the big Wall Street firms was relatively quite low, reflecting the fact that the immediate past had been dominated by uninterrupted good times and negligible volatility").

portfolio as part of its risk management program in part because of concerns that VaR as a risk management tool may not adequately reflect tail risks.[186] We also recognize that a fund's use of derivatives transactions may pose other risks (such as counterparty risk and liquidity risk) that VaR does not capture. A fund that adopts a derivatives risk management program under the proposed rule would have to consider these risks as part of its derivatives risk management program.[187]

We also considered proposing tests based on stressed VaR, expected shortfall, or both. Stressed VaR refers to a VaR model that is calibrated to a period of market stress. A stressed VaR approach would address some of the VaR test critiques related to tail risk and underestimating expected losses during stressed conditions. Calibrating VaR to a period of market stress, however, can pose quantitative challenges by requiring funds to identify a stress period with a full set of risk factors for which historical data is available. Expected shortfall analysis is similar to VaR, but accounts for tail risk by taking the average of the potential losses beyond the specified confidence level. For example, if a fund's VaR at a 99% confidence level is $100, the fund's expected shortfall would be the average of the potential losses in the 1% "tail." Because there are fewer observations in the tail, however, there is an inherent difficulty in estimating the expected value of larger losses. Expected shortfall analysis also could involve potentially greater sensitivity to extreme outlier losses because it is based on an average of a smaller number of observations that are in the tail. Taking these considerations into account, we are proposing tests based on VaR, which is commonly used and does not present all of the

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186 *See supra* section II.B.3.b.

187 *See supra* section II.B.3.a.

quantitative challenges associated with stressed VaR and expected shortfall, complemented by elements in the proposed risk management program designed to address VaR's limitations.

We request comment on the proposed definition of VaR, the proposed use of VaR as a means to limit funds' leverage risk, as well as alternative VaR-based methodologies (stressed VaR and expected shortfall). We also request comment and discuss alternatives to VaR and VaR-based methodologies in section II.D.6 below.

77. Is the proposed definition of the term "VaR" appropriate? Why or why not? If not, how should we define it?

78. Is a VaR-based test an appropriate way to limit funds' leverage risk? Why or why not? Do commenters agree with our observations regarding VaR's characteristics and its critiques? Do commenters believe that the proposed derivatives risk management program requirement would help to address VaR's limitations? Please explain.

79. Should we change the rule to require stressed VaR, either as part of the program's stress testing requirement or as part of the limit on fund leverage risk? If so, how should we implement a stressed VaR requirement? Should the rule provide, for example, that the historical data used to calculate VaR must include a period of market stress? What VaR model requirements should we include if the rule required stressed VaR? Please describe in detail. Are there any other corresponding changes we should make to the proposed VaR model requirements or proposed VaR tests if we used stressed VaR? Why or why not?

80. Should we change the rule to require expected shortfall or stressed expected shortfall, either as part of the program's stress testing requirement or as part of the limit on fund leverage risk? If so, how should we implement this element? What VaR model

requirements should we include if the rule required expected shortfall or stressed expected shortfall? Please describe in detail. Are there any other corresponding changes we should make to the proposed VaR model requirements or proposed VaR tests if we were to require expected shortfall or stressed expected shortfall? Why or why not?

81. Are there risk metrics or measurements other than VaR that similarly can be applied to a wide breadth of fund strategy types and investments and used to limit fund leverage risk? Please explain.

82. Should we use VaR as the only methodology to establish an outside limit on funds' leverage risk in rule 18f-4? We discuss below additional alternatives to VaR for this purpose. Should we include in rule 18f-4 some combination of the proposed VaR tests and the alternatives discussed in that section, and provide flexibility to funds to comply with the approach that they believe is most appropriate based on their strategies and investments? If so, which approaches should we include in the rule and why?

2. Relative VaR Test

The proposed relative VaR test would require a fund to calculate the VaR of the fund's portfolio and compare it to the VaR of a "designated reference index." As discussed in more detail below, a fund's designated reference index must be unleveraged and reflect the markets or asset classes in which the fund invests, among other requirements. This index is designed to create a baseline VaR that approximates the VaR of a fund's unleveraged portfolio. To the extent a fund entered into derivatives to leverage its portfolio, the relative VaR test is designed to identify this leveraging effect. If a fund is using derivatives and its VaR exceeds that of the designated reference index, this difference may be attributable to leverage risk.

A fund would be required to comply with the relative VaR test unless a designated reference index is unavailable. We propose a relative VaR test as the default means of limiting fund leverage risk because it resembles the way that section 18 limits a fund's leverage risk. Section 18 limits the extent to which a fund can potentially increase its market exposure through leveraging by issuing senior securities, but it does not directly limit a fund's level of risk or volatility. For example, a fund that invests in less-volatile securities and leverages itself to the maximum extent may not be as volatile as a completely unleveraged fund that invests in more-volatile securities. The proposed relative VaR test likewise is designed to limit the extent to which a fund increases its market risk by leveraging its portfolio through derivatives, while not restricting a fund's ability to use derivatives for other purposes. For example, if a derivatives transaction reduces (or does not substantially increase) a fund's VaR relative to the VaR of the designated reference index, the transaction would not be restricted by the relative VaR test.

In addition, allowing funds to rely on the proposed absolute VaR test may be inconsistent with investors' expectations where a designated reference index is available. For example, a fund that invests in short-term fixed income securities would have a relatively low level of volatility. The fund's investors could reasonably expect that the fund might exhibit a degree of volatility that is broadly consistent with the volatility of the markets or asset classes in which the fund invests, as represented by the fund's designated reference index. This fund's designated reference index would be composed of short-term fixed income securities, and could, for example, have a VaR of 4%. If the fund were permitted to rely on the absolute VaR test, however, the fund could substantially leverage its portfolio almost four times its designated reference index's VaR to achieve a level of volatility that substantially exceeds the volatility associated with fixed-income securities.

a. Designated Reference Index

A fund would satisfy the proposed relative VaR test if the VaR of its entire portfolio does not exceed 150% of the VaR of its designated reference index.[188] The proposed rule would define a "designated reference index" as an unleveraged index that is selected by the derivatives risk manager, and that reflects the markets or asset classes in which the fund invests.[189] The proposed definition also would require that the designated reference index not be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.[190] Additionally, the designated reference index must either be an "appropriate broad-based securities market index" or an "additional index" as defined in Item 27 of Form N-1A.[191] A fund would have to disclose its designated reference index in the annual report, together with a presentation of the fund's performance relative to the designated reference index.[192]

The requirement that the designated reference index reflect the markets or asset classes in which the fund invests is designed to provide an appropriate baseline for the relative VaR test. Because of this requirement, differences between the fund's VaR and the VaR of the designated

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188 *See* proposed rule 18f-4(a) (defining the term "relative VaR test"); proposed rule 18f-4(c)(2)(i); *infra* section II.D.2.b (discussing the 150% limit under the relative VaR test).

189 *See* proposed rule 18f-4(a) (defining the term "designated reference index").

190 Furthermore, for a blended index, none of the indexes that compose the blended index may be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used. *See id.*

191 *See* proposed rule 18f-4(a) (defining the term "designated reference index"); *see also* Instructions 5 and 6 to Item 27(b)(7)(ii) of Form N-1A (discussing the terms "appropriate broad-based securities market index" and "additional index").

192 *See* proposed rule 18f-4(c)(2)(iv).

reference index are more likely to represent leverage than other factors, like differences between the securities in the fund's portfolio and those in the index, as compared to a relative VaR test that compares the fund's VaR to an index that does not reflect the markets or asset classes in which the fund invests.[193] Take, for example, a fund that invests primarily in S&P 500 index options and uses that index as its designated reference index. Differences between the fund's VaR and the VaR of the S&P 500 would be more likely attributable to the leverage risk associated with the options than, for example, if the fund were permitted to use an index that did not reflect the markets or assets classes in which the fund invests, such as an index of small capitalization stocks in this example. The derivatives risk manager could select a designated reference index that is a blended index under the proposed rule (assuming that the blended index meets the proposed requirements for a designated reference index), which would give some flexibility in identifying or constructing a designated reference index that provides an appropriate baseline for the relative VaR test.[194] For example, the derivatives risk manager of a balanced

193 To the extent a fund discloses in its annual report an "appropriate broad-based securities market index" that does not reflect the markets or asset classes in which the fund invests, such a fund may satisfy the performance disclosure requirements of Form N-1A, but it would not satisfy the proposed designated reference index requirement. For example, a fund that pursues its strategy primarily through commodity futures contracts could select the S&P 500 to satisfy its performance disclosure requirement under Form N-1A, but such an index would not satisfy the proposed designated reference index requirement because a commodity fund would not invest in stocks included in the S&P 500 or large cap stocks generally.

194 If the derivatives risk manager selects a designated reference index that is a blended index, the designated reference index would have to be disclosed as an "additional index" (as opposed to an "appropriate broad-based securities market index") as defined in the instruction to Item 27 in Form N-1A. Form N-1A defines the term "appropriate broad-based securities market index" to mean an index "that is administered by an organization that is not an affiliated person of the [f]und, its investment adviser, or principal underwriter, unless the index is widely recognized and used." *See* Instruction 5 to Item 27(b)(7)(ii) of Form N-1A. A blended index that is administered by the fund's investment adviser, for example, would therefore not qualify as an "appropriate broad-based securities market index."

fund may determine that a blended index of an unleveraged equity index and an unleveraged fixed income index would be an appropriate designated reference index.

The requirement that the designated reference index be an unleveraged index also is designed to provide an appropriate baseline against which to measure a fund's portfolio VaR for purposes of assessing the fund's leverage risk. Conducting a VaR test on a designated reference index that itself is leveraged would distort the leverage-limiting purpose of the VaR comparison by inflating the volatility of the index that serves as the reference portfolio for the relative VaR test. For example, an equity fund might select as its designated reference index an index that tracks a basket of large-cap U.S. listed equity securities such as the S&P 500. But the fund could not select an index that is leveraged, such as an index that tracks 200% of the performance of the S&P 500. A relative VaR test based on this index would effectively permit additional leveraging inconsistent with the Investment Company Act.[195]

Our proposal would prohibit the designated reference index from being an index administered by an organization that is an affiliated person of the fund, its investment adviser, or its principal underwriter, or created at the request of the fund or its investment adviser. This proposed prohibition would not, however, extend to indexes that are "widely recognized and used."[196] We believe that the indexes permissible under the proposed rule would be less likely to be designed with the intent of permitting a fund to incur additional leverage-related risk.

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195 *See supra* section I.B.1. *But see infra* section II.G (discussing leveraged/inverse funds covered by the proposed sales practices rules).

196 *See* proposed rule 18f-4(a) (defining the term "designated reference index"). This "widely recognized and used" standard has historically been used to permit a fund to employ affiliated-administered indexes for disclosure purposes, when the use of such indexes otherwise would not be permitted. *See supra* note 193.

The proposed rule would require that a fund publicly disclose to its investors in its annual reports the designated reference index. An open-end fund would have to disclose its designated reference index in the fund's annual report as the fund's "appropriate broad-based securities market index" or an "additional index" that Form N-1A describes in the context of the annual report performance presentation requirements.[197] Form N-2, on the other hand, does not require closed-end funds to disclose a benchmark index for comparing a fund's performance. Nevertheless, some closed-end funds choose to disclose a benchmark index in their annual reports to shareholders. Under the proposed rule, a closed-end fund seeking to satisfy the relative VaR test would have to disclose the fund's designated reference index in its annual report together with a presentation of the fund's performance.[198] In proposing this approach, we considered the role of investor expectations in selecting funds that correspond to investors' desired level of investment risk.[199] We believe that investors could reasonably expect that their fund might exhibit a degree of volatility that is broadly consistent with the volatility of the markets or asset classes in which the fund invests, as represented by the fund's designated

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197 *See* proposed rule 18f-4(c)(2)(iv); Item 27(b)(7)(ii) of Form N-1A.

See also Instructions to Items 4 and 27(b)(7)(ii) of Form N-1A. Form N-1A provides that "New Funds," as defined in the form, are not required to disclose an appropriate broad-based securities market index and the fund's performance in the annual report because of the fund's limited operating history. *See* Instruction 6 to Item 3 of Form N-1A (defining a "New Fund" to mean a "Fund that does not include in Form N-1A financial statements reporting operating results or that includes financial statements for the Fund's initial fiscal year reporting operating results for a period of 6 months or less"). For the same reason, the proposed rule would provide that a fund would not be required to disclose its designated reference index in the fund's annual report if the fund is a "New Fund," or would meet that definition if it were filing on Form N-1A, at the time the fund files its annual report. *See* proposed rule 18f-4(c)(2)(iv).

198 *See* proposed rule 18f-4(c)(2)(iv).

199 To the extent a fund's use of derivatives transactions is part of its principal investment strategy or is a principal risk, it is required to be disclosed as such in the fund's prospectus. *See* Item 4 of Form N-1A; Item 8 of Form N-2.

reference index. Requiring a fund to select a designated reference index that it publicly discloses would promote the fund's selection of an appropriate index that reflects the fund's portfolio risks and its investor expectations.

Some registered closed-end funds currently elect to provide a Management's Discussion of Fund Performance ("MDFP") in their annual reports.[200] These registered closed-end funds could disclose their performance relative to the performance of the designated reference index in the fund's MDFP. BDCs that are publicly traded must disclose, in their annual reports filed on Form 10-K, a line graph comparing the yearly percentage change in fund share price with the return of a broad equity market index.[201] A publicly-traded BDC could choose to include its designated reference index in this line graph disclosure.

We recognize the concern that funds could have the incentive to select an inappropriate designated reference index composed of more volatile securities to allow the fund to obtain more leverage risk under the relative VaR test. The proposed rule includes three provisions designed to address this concern. In addition to requiring that the designated reference index reflect the markets or asset classes in which the fund invests, and that the index not be administered by certain affiliated persons or created at the request of the fund or its investment adviser, as described above, the proposed rule would require: (1) the derivatives risk manager to select the designated reference index and to periodically review it; (2) the fund to disclose the designated reference index, relative to its performance, in its annual report, creating the disincentive for a

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[200] The Commission recently proposed to amend Form N-2 to require registered closed-end funds to include MDFP disclosure in their annual reports. *See* Securities Offering Reform for Closed-End Investment Companies, Investment Company Act Release No. 33427 (Mar. 20, 2019) [84 FR 14448 (Apr. 10, 2019)], at 14471-72 ("Securities Offering Reform Proposing Release").

[201] 17 CFR 229.201(e)(1)(i).

fund to present performance that may be significantly lower than, or not related to, the disclosed index; and (3) the board of directors to receive a written report providing the derivatives risk manager's basis for selecting the designated reference index.[202] These requirements, collectively, are designed to require funds to use designated reference indexes that provide an appropriate baseline for the relative VaR test and to prohibit funds from, instead, selecting indexes solely for the purpose of maximizing the fund's permissible leverage risk under the proposed rule.

We recognize that some (but not all) popular benchmark indexes charge funds a licensing fee for their inclusion in fund prospectuses and annual reports. Funds could incur licensing fees if their derivatives risk managers select a designated reference index whose provider charges such a fee and the fund is not already using the index. We are nevertheless proposing this disclosure requirement because the relative VaR test's ability to limit a fund's leverage risk is directly tied to the appropriateness of its designated reference index. This disclosure requirement is designed to address concerns about inappropriate indexes, as discussed above, by creating the disincentive for a fund to select an inappropriate index because the fund would have to disclose its performance against that index in its annual report and likely would not want to present performance that is significantly lower than, or not related to, the disclosed index.[203] At the same time, the proposed rule provides funds flexibility to use any index that meets the proposed requirements. The proposed rule would provide this flexibility in light of the conditions discussed above designed to require that a fund use a designated reference index that is appropriate for the relative VaR test.

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202 *See* proposed rule 18f-4(a), (c)(1)(vi), (c)(2)(iii), (c)(5)(ii)-(iii); *see also supra* sections II.B.3.f, II.C.2.

203 *See supra* note 201 and accompanying paragraph.

The 2015 Proposing Release also included a risk-based portfolio limit based on VaR.[204] The 2015 proposal provided that a fund would satisfy its risk-based portfolio limit condition if a fund's full portfolio VaR was less than the fund's "securities VaR" (*i.e.*, the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions).[205] Our proposal, however, differs from the 2015 proposal in that the proposed relative VaR test compares the fund's VaR to the VaR of the fund's designated reference index, rather than the fund's "securities VaR." This is because some funds that use derivatives extensively hold primarily cash, cash equivalents, and derivatives. These funds' "securities VaRs" would be based primarily on the fund's cash and cash equivalents. As some commenters on the 2015 proposal noted, this would not provide an appropriate comparison for a relative VaR test because the VaR of the cash and cash equivalents would be very low and would not provide a reference level of risk associated with the fund's strategy.[206]

We request comment on the proposed requirements regarding the selection and disclosure of a designated reference index for purposes of compliance with the proposed relative VaR test.

83. Is the proposed definition of the term "designated reference index" appropriate? Why or why not? Should the Commission provide additional guidance, or requirements in the proposed rule, addressing when an index reflects the markets or asset classes in which a fund invests? Are there particular types of indexes that would not be appropriate as a designated reference index? Why or why not? If so, what types of

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[204] *See* 2015 Proposing Release, *supra* note 2, at section III.B.2.

[205] Under that proposal, a fund that satisfied this VaR test was also required to limit its aggregate exposure—including derivatives exposure—to 300% of the fund's net assets. *See id*.

[206] *See, e.g.*, AlphaSimplex Comment Letter; AQR Comment Letter; ICI Comment Letter I.

indexes and why would they be inappropriate for this purpose?

84. Should the rule require that the designated reference index be an unleveraged index? Should the rule specify with greater particularity what constitutes an unleveraged index? Please explain. Alternatively, should the Commission provide guidance on when an index will be "leveraged"?

85. Are there other considerations that would present challenges for funds in light of the proposed requirement to select a designated reference index for purposes of the proposed relative VaR test requirement? If so, what?

86. To what extent do funds expect that the requirement to disclose the designated reference index would result in additional licensing fees? Please explain. What consequences would such charges create?

87. Should we change the proposed definition of the term "designated reference index" to no longer track in part the definition of an "appropriate broad-based securities market index" in Form N-1A (Instruction 5 of Item 27(b)(7)) and allow a derivatives risk manager to select an index administered by an affiliated person of the fund, its investment adviser, or principal underwriter? Should we change the proposed definition to allow a derivatives risk manager to select an index created at the request of the fund or its investment adviser? Is it appropriate to exclude such indexes from the definition of "designated reference index," and is it appropriate that widely recognized and used indexes be carved out from this exclusion, as proposed? Would the proposed exclusion help ensure the selection of indexes that are appropriately designed to create a baseline VaR that approximates the VaR of a fund's unleveraged portfolio? Please explain. Would allowing funds to use indexes that would fall within

the proposed exclusion raise concerns that the indexes would not be appropriate, or—if the Commission were to permit the use of such indexes—would the rule's other proposed conditions designed to address this concern work equally well for all indexes? If the Commission were to permit the use of indexes that would fall within the proposed exclusion, would any additional limits on the use of these indexes be appropriate? If so, what limits and why?

88. If we were to further limit or restrict the types of indexes that a fund could select as its designated reference index under the proposed rule, what additional limits would be appropriate? Should we, for example, provide that a fund's designated reference index must meet the definition of an "appropriate broad-based securities market index" as defined in Form N-1A? Should we require that the index be widely recognized and used?

89. Similar to UCITS guidelines, should the proposed definition specifically require that the risk profile of the designated reference index be consistent with the fund's investment objectives and policies, as well as investment limits?[207] Why or why not?

90. Should the rule require funds to disclose their designated reference indexes in their annual reports to shareholders, as proposed? Should such disclosure also appear in the fund's prospectus? What reasons, if any, should the designated reference index *not* be an index a fund includes as part of its performance disclosure? Please explain. Should a fund be required to specify that the index it includes in its performance disclosure is the fund's designated reference index, which has been selected for purposes of the

[207] *See infra* section II.D.6.c (discussing the UCITS framework).

fund's compliance with rule 18f-4? If so, what other information or explanations should a fund also have to include (if any), in order to best promote investor understanding of how the fund's designated reference index affects the fund's ability to use leverage, and how this in turn affects the risks associated with an investment in the fund? For example, should a fund also be required to disclose the index's historical (*e.g.*, 1-year) average VaR? What accompanying narrative disclosure would help investors best understand the significance of this information? Would this disclosure be useful to supplement the VaR information that a fund would be required to disclose on Form N-PORT under the proposal?

91. Should the rule permit a fund to compare its portfolio VaR to its "securities VaR" for purposes of the rule's relative VaR test, as provided for in the 2015 proposed rule, in addition to its designated reference index?[208] Why or why not? If the relative VaR test permitted a fund to compare its porfolio's VaR against its designated reference index or its "securities VaR," would funds prefer to use their "securities VaRs"? If so, why? In what circumstances or what fund strategies would "securities VaR" be a more or equally appropriate baseline for funds calculating their relative VaR? What benefits or drawbacks are there with respect to this approach? Please explain.

92. For a registered closed-end fund, is the proposed requirement that it must disclose its designated reference index in its annual report together with a presentation of the fund's performance appropriate? Why or why not? What challenges, if any, would the proposed disclosure requirement have for closed-end funds that do not currently

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[208] *See supra* note 204 and accompanying text.

disclose their performance relative to a benchmark index in their annual reports? Please explain.

93. For a registered closed-end fund, should we prescribe in rule 18f-4 or Form N-2 where in the fund's annual report it must disclose its designated reference index? Why or why not?

94. What challenges, if any, would a BDC have in disclosing its designated reference index together with its performance in the BDC's annual report? Please explain.

95. Should we also amend Forms N-1A and/or N-2 to require a fund relying on rule 18f-4 and subject to the relative VaR test to disclose its performance relative to the performance of its designated reference index? Would it be helpful to have this requirement both in rule 18f-4 and in the registration forms?

96. What changes should we make to the rule in light of the concern that a fund could have an incentive to select an inappropriate designated reference index to obtain more leverage risk? Is the proposed requirement that the derivatives risk manager select the designated reference index useful for this purpose? Is the proposed requirement that the designated reference index be an appropriate broad-based securities index or an additional index effective for this purpose? Is the proposed requirement that the fund disclose the designated reference index relative to its performance in the annual report useful for this purpose? Is the proposed requirement that the board of directors receive a written report from the derivatives risk manager about the basis for the designated reference index subject to periodic review useful for this purpose? Please explain.

b. 150% Limit Under Proposed Relative VaR Test

We are proposing that a fund's VaR must not exceed 150% of the VaR of the fund's designated reference index.[209] In proposing a 150% limit, we first considered the extent to which a fund could borrow in compliance with the requirements of section 18. For example, a mutual fund with $100 in assets and no liabilities or senior securities outstanding could borrow an additional $50 from a bank. With the additional $50 in bank borrowings, the mutual fund could invest $150 in securities based on $100 of net assets. This fund's VaR would be approximately 150% of the VaR of the fund's designated reference index. The proposed 150% limit would therefore effectively limit a fund's leverage risk related to derivatives transactions similar to the way that section 18 limits a registered open- or closed-end fund's ability to borrow from a bank (or issue other senior securities representing indebtedness for registered closed-end funds) subject to section 18's 300% asset coverage requirement. We recognize that while a fund could achieve certain levels of market exposure through borrowings permitted under section 18, it may be more efficient to obtain those exposures through derivatives transactions. Allowing a fund to have a VaR that is 150% of its designated reference index, rather than a higher or lower relative VaR, is designed to provide what we believe is an appropriate degree of flexibility for funds to use derivatives.

We considered proposing different relative VaR tests for different types of investment companies, tied to the asset coverage requirements applicable to registered open-end funds, registered closed-end funds, and BDCs.[210] Registered closed-end funds, like open-end funds, are only permitted to issue senior securities representing indebtedness under section 18 subject to a 300% asset coverage requirement, although closed-end funds' indebtedness is not limited to

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209 *See* proposed rule 18f-4(a) (defining the term "relative VaR test").

210 *See supra* notes 29-32 and accompanying paragraph (discussing asset coverage requirements for different investment company types).

bank borrowings.[211] Using the example above, a registered closed-end fund with $100 in assets likewise could only borrow $50. Although registered closed-end funds also are permitted to issue senior securities that are stocks,[212] proposed rule 18f-4 is focused on the indebtedness leverage that derivatives transactions create. We do not believe that a registered closed-end fund's ability to issue preferred stock, for example, suggests that registered closed-end funds should be permitted to obtain additional indebtedness leverage through derivatives transactions.

The Investment Company Act also provides greater flexibility for BDCs to issue senior securities. BDCs, however, generally do not use derivatives or do so only to a limited extent. To help evaluate the extent to which BDCs use derivatives, our staff sampled 48 of the current 99 BDCs by reviewing their most recent financial statements filed with the Commission. The staff's sample included both BDCs with shares listed on an exchange and BDCs whose shares are not listed. The sampled BDCs' net assets ranged from $32 million to $7.4 billion. Of the 48 sampled, 54% did not report any derivatives holdings, and a further 29% reported using derivatives with gross notional amounts below 10% of net assets. A few BDCs used derivatives more extensively, when measured on a gross notional basis, mainly due to interest rate swaps—which likely would have lower adjusted notional amounts if they were converted to ten-year bond equivalents, as the proposed rule would permit.[213] Finally, two of the sampled BDCs used total return swaps to gain

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[211] *See supra* note 30 and accompanying text.

[212] *See supra* note 31 and accompanying text.

[213] Our staff did not have access to sufficient information to adjust the notional amounts of the BDCs' interest rate derivatives or options. Some of the 17% of the sampled BDCs with gross notional amounts exceeding 10% of net assets likely would have lower notional amounts after applying these adjustments.

a substantial portion of their exposure. We therefore believe that most BDCs either would not use derivatives or would rely on the exception for limited derivatives users.[214]

In addition, the greater flexibility for BDCs to issue senior securities allows them to provide additional equity or debt financing to the "eligible portfolio companies" in which BDCs are required to invest at least 70% of their total assets. Derivatives transactions, in contrast, generally will not have similar capital formation benefits for portfolio companies unless the fund's counterparty makes an investment in the underlying reference assets equal to the notional amount of the derivatives transaction. Allowing BDCs to leverage their portfolios with derivatives to a greater extent than other funds therefore would not appear to further the capital formation benefits that underlie BDCs' ability to obtain additional leverage under the Investment Company Act. We also understand that, even when BDCs do use derivatives more extensively, derivatives generally do not play as significant of a role in implementing the BDC's strategy, as compared to many other types of funds that use derivatives extensively. BDCs are required under the Investment Company Act to invest at least 70% of their total assets in "eligible portfolio companies," which may limit the role that derivatives can play in a BDC's portfolio relative to other kinds of funds that would generally execute their strategies primarily through derivatives transactions (*e.g.*, a managed futures fund). For these reasons, and to provide a consistent framework regarding funds' use of derivatives, we believe that it is appropriate to set a single limit on fund leverage risk under the proposed rule for derivatives transactions. The proposed

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214 *See infra* section II.E (discussing the proposed exception for limited derivatives users).

rule would not restrict a fund from issuing senior securities subject to the limits in section 18 to the full extent permitted by the Investment Company Act.[215]

We request comment on the following aspects of the proposed relative VaR test.

97. Is the proposed relative VaR test requirement appropriate? Why or why not? As proposed, should funds be required to comply with a relative VaR test, rather than an absolute VaR test, except where a designated reference index is unavailable?

98. Should the limit in the proposed relative VaR test be lower or higher than 150% of the VaR of the designated reference index, and if so why? For example, the relative VaR test applicable to UCITS funds allows a UCITS fund to have a relative VaR up to 200% of the VaR of the relevant index.[216] Should rule 18f-4 similarly permit a fund to have a VaR up to 200% of the VaR of its designated reference index? If so, how should the rule incorporate investor protection provisions consistent with section 18? Conversely, should the relative VaR test be set at a lower level, such as 125% of the VaR of the designated reference index? If so, why?

99. Should the proposed relative VaR test incorporate different leverage limit levels according to fund type and corresponding to the asset coverage requirements under

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215 For purposes of calculating asset coverage, as defined in section 18(h), BDCs have used derivatives transactions' notional amounts, less any posted cash collateral, as the "amount of senior securities representing indebtedness" associated with the transactions. We believe this approach—and not the transactions' market values—represents the "amount of senior securities representing indebtedness" for purposes of this calculation. Open-end funds cannot enter into derivatives transactions under section 18, absent relief from that section's requirements, because section 18 limits open-end funds' senior securities to bank borrowings. Section 18(c) also limits a registered closed-end fund's ability to enter into derivatives transactions absent such relief.

216 *See infra* section II.D.6.c (discussing the UCITS framework); *see also* ICI Comment Letter III (suggesting that a Commission rule limiting the use of derivatives by registered investment companies allow funds to use either ex ante stress testing or UCITS VaR for that purpose).

the Investment Company Act? Why or why not and how?

100. Are there any challenges in calculating the VaR of the designated reference index? If so, would certain types of funds particularly encounter these challenges, and if so which ones? How should we address any challenges?

101. Are there any fund-type specific challenges to open-end funds, registered closed-end funds, or BDCs complying with the VaR-based limit on fund leverage risk? For example, would registered closed-end funds or BDCs encounter any unique challenges in calculating VaR because of the nature of their investments? If so, what kinds of challenges and how should we address them? Please also explain specifically the nature of any challenges given that a number of financial institutions such as banks and UCITS funds calculate VaR for regulatory purposes, and these institutions' portfolios hold a wide range of assets.

3. Absolute VaR Test

We recognize that, for some funds, the derivatives risk manager may be unable to identify an appropriate designated reference index. For example, some multi-strategy funds manage their portfolios based on target volatilities but implement a variety of investment strategies, making it difficult to identify a single index (even a blended index) that would be appropriate. If a derivatives risk manager is unable to identify an appropriate designated reference index, a fund relying on the proposed rule would be required to comply with the absolute VaR test.[217]

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[217] *See supra* note 173 and accompanying text (discussing the proposed requirement for the fund's derivatives risk manager to provide written reports to the fund's board of directors that must include, among other things, the derivatives risk manager's basis for the selection of the designated reference index or, if applicable, an explanation of why the derivatives risk manager

To comply with the proposed absolute VaR test, the VaR of the fund's portfolio must not exceed 15% of the value of the fund's net assets. In proposing an absolute VaR test of 15% of a fund's net assets, we considered the comparison of a fund complying with the absolute VaR test and a fund complying with the relative VaR test. A fund that uses the S&P 500 as its benchmark index, as many funds do, would be permitted to have a VaR equal to 150% of the VaR of the S&P 500 if the fund also used that index as its designated reference index. The Division of Economic and Risk Analysis ("DERA") staff calculated the VaR of the S&P 500, using the parameters specified in this proposed rule over various time periods. DERA staff's calculation of the S&P 500's VaR since inception, for example, produced a mean VaR of approximately 10.4%, although the VaR of the S&P 500 varied over time.[218] Setting the level of loss in the proposed absolute VaR test at 15% of a fund's net assets would therefore provide approximately comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the S&P 500 as their designated reference index during periods where the S&P 500's VaR is approximately equal to the historical mean.

DERA staff analyzed the S&P 500 because funds often select broad-based large capitalization equities indexes such as the S&P 500 for performance comparison purposes, including funds that are not broad-based large capitalization equity funds.[219] Many investors may therefore understand the risk inherent in these indexes as the level of risk inherent in the markets

was unable to identify a designated reference index appropriate for the fund); *infra* notes 425-426 and accompanying text (discussing proposed recordkeeping requirements for such written reports provided to the fund's board).

[218] DERA staff calculated descriptive statistics for the VaR of the S&P 500 using Morningstar data from March 4, 1957 to June 28, 2019, based on daily VaR calculations, each using three years of prior return data and calculated using historical simulation at a 99% confidence level for a 20-day horizon using overlapping observations.

[219] This is based on staff experience and analysis of data obtained from Morningstar.

generally.[220] An absolute VaR test set to approximate, or not substantially exceed, this level of risk would therefore often approximate the level of risk that investors may understand, and frequently choose to undertake, through investments in funds. We are proposing a single absolute VaR limit that would apply to open-end funds and registered closed-end funds and BDCs for the same reasons we are proposing that all funds relying on the relative VaR test must limit their VaR to 150% of the VaR of their designated reference index.[221]

The proposed absolute VaR test is also broadly consistent with the European Union regulatory framework that that applies to UCITS funds.[222] Advisers that manage (or have affiliates that manage) UCITS funds may derive some efficiencies from reasonably comparable requirements across jurisdictions.[223] Commenters to the 2015 proposal also generally supported an absolute VaR test.[224]

We request comment on the proposed absolute VaR test requirement.

102. Is the proposed absolute VaR test requirement appropriate? Are we correct that in some cases a fund's derivatives risk manager may be unable to identify an

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220 Some commenters to the 2015 proposal also expressed the view that the S&P 500 Index is an appropriate risk-based reference point because it is widely used with a risk profile that is well understood and commonly acceptable to investors. *See, e.g.*, AQR Comment Letter; Comment Letter of Millburn Ridgefield Corporation (Mar. 28, 2016).

221 *See supra* section II.D.2.b.

222 *See* CESR Global Guidelines, *supra* note 94, at 26. The absolute VaR test for UCITS funds is similar to the proposed absolute VaR test in rule 18f-4, although it sets a 20% limit for UCITS funds, rather than 15% as we propose in rule 18f-4.

223 *See, e.g.*, ICI Comment Letter III (stating that, in response to the Investment Company Institute's survey, "45 percent of respondents indicated that it would be only slightly burdensome to implement a UCITS VaR test that used the same parameters as prescribed for UCITS. An additional 34 percent reported that it would be moderately burdensome.").

224 *See, e.g.*, ICI Comment Letter I*;* Franklin Resources Comment Letter; SIFMA Comment Letter; Comment Letter of T. Rowe Price Associates, Inc. (Mar. 28, 2016) ("T. Rowe Price Comment Letter").

appropriate designated reference index? Why or why not? What are examples of funds that would likely use the absolute VaR test because a derivatives risk manager would be unable to identify an appropriate designated reference index? Is it appropriate for these funds to use an absolute VaR test? Why or why not?

103. Should we provide additional guidance on the circumstances under which a fund's derivatives risk manager would be "unable" to identify an appropriate index? If so, what guidance should we provide? Should the rule include a different standard than the inability to identify a designated reference index for funds to be able to use the absolute VaR test instead of the relative VaR test? If so, what standard and why? For example, should we identify certain types of fund strategies that may not typically have appropriate reference indexes or for which absolute VaR would otherwise be appropriate? If so, which fund strategies, and how would we keep any list of fund strategies current over time?

104. Should the proposed absolute VaR test include a limit other than 15% of the fund's net assets? Please explain. For example, should it be 12, 18, 20, or 25%? If so, which limit, and why? Would funds using the absolute VaR test manage their VaRs to a certain amount below the limit the Commission sets? If so, to what extent and should we take this into account in determining the appropriate limit under this test? Should we look to different market data in determining an appropriate level of absolute VaR? Which other sources, and why would they be appropriate?

105. For funds that use an absolute VaR test as part of their risk management practices, do risk managers set internal absolute VaR limits, and if so, at what level and why? For funds that currently use both absolute VaR and relative VaR, are the internal limits

set at comparable levels? Why or why not? Please describe each internal level set with respect to these two VaR tests. Do certain fund types or strategies more commonly use either absolute VaR or relative VaR for risk management purposes? If so, why?

106. Should the rule include both a relative and absolute VaR test, as proposed, or should it include only a relative VaR test or an absolute VaR test? Why, and which test should the rule include? Should it use a different VaR-based test? If so, which one?

107. Should the rule permit funds to choose which VaR test to comply with regardless of the derivatives risk manager's ability or inability to identify a designated reference index? If so, would this be consistent with investor expectations and section 18?

4. Choice of Model and Parameters for VaR Test

The proposed rule would require that any VaR model a fund uses for purposes of the relative or absolute VaR test take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments.[225] The proposed rule includes a non-exhaustive list of common market risk factors that a fund must account for in its VaR model, if applicable. These market risk factors are: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility.[226] VaR models are often categorized according to three modeling methods—historical

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225 *See* proposed rule 18f-4(a) (defining the term "value-at-risk" or "VaR").

226 *See id.*

simulation, Monte Carlo simulation, or parametric models.[227] Each method has certain benefits and drawbacks, which may make a particular method more or less suitable, depending on a fund's strategy, investments and other factors. In particular, some VaR methodologies may not adequately incorporate all of the material risks inherent in particular investments, or all material risks arising from the nonlinear price characteristics of certain derivatives.[228] We believe it should be the responsibility of the derivatives risk manager to choose the appropriate VaR model for the fund's portfolio, and the proposed requirement is designed to allow funds to use a VaR model that is appropriate for the fund's investments. Commenters that addressed the same

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227 Historical simulation models rely on past observed historical returns to estimate VaR. Historical VaR involves taking a fund's current portfolio, subjecting it to changes in the relevant market risk factors observed over a prior historical period, and constructing a distribution of hypothetical profits and losses. The resulting VaR is then determined by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution.

Monte Carlo simulation uses a random number generator to produce a large number (often tens of thousands) of hypothetical changes in market values that simulate changes in market factors. These outputs are then used to construct a distribution of hypothetical profits and losses on the fund's current portfolio, from which the resulting VaR is ascertained by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution.

Parametric methods for calculating VaR rely on estimates of key parameters (such as the mean returns, standard deviations of returns, and correlations among the returns of the instruments in a fund's portfolio) to create a hypothetical statistical distribution of returns for a fund, and use statistical methods to calculate VaR at a given confidence level.

See, *e.g.*, Dowd, *supra* note 177; *see also* Thomas J. Linsmeier & Neil D. Pearson, *Value at Risk*, 56 Journal of Financial Analysts 2 (Mar.-Apr. 2000) ("Linsmeier & Pearson").

228 For example, some parametric methodologies may be more likely to yield misleading VaR estimates for assets or portfolios that exhibit non-linear returns, due, for example, to the presence of options or instruments that have embedded optionality (such as callable or convertible bonds). *See*, *e.g.*, Linsmeier & Pearson, *supra* note 226 (stating that historical and Monte Carlo simulation "work well regardless of the presence of options and option-like instruments in the portfolio. In contrast, the standard [parametric] delta-normal method works well for instruments and portfolios with little option content but not as well as the two simulation methods when options and option-like instruments are significant in the portfolio.").

proposed requirement for VaR models in the 2015 proposal generally supported it.[229]

The proposed rule also requires that a fund's VaR model use a 99% confidence level and a time horizon of 20 trading days.[230] We understand that market participants currently using VaR most commonly use 95% or 99% confidence levels and often use time horizons of 10 or 20 days. The proposed confidence level and time horizon requirements also are similar to those in other VaR-based regulatory schemes.[231] VaR models that use relatively high confidence levels and longer time horizons—as the proposed rule parameters reflect—result in a focus on more-"extreme" but less-frequent losses. We propose relatively high confidence level and longer time horizon requirements so that the VaR model is designed to measure, and seek to limit the severity of, these less-frequent but larger losses. This is because a fund's VaR model would be based on a distribution of returns, where a higher confidence level would go further into the tail

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229 *See, e.g.*, Oppenheimer Comment Letter; CFA Comment Letter.

230 *See* proposed rule 18f-4(a) (defining the term "value-at-risk" or "VaR").

We recognize that many market participants today also may calculate VaR over a one-day time horizon. *See also supra* section II.B.3.d (the proposed rule would require calculating a fund's one-day VaR as part of the proposed backtesting requirement). A VaR calculation based on a one-day time horizon can be scaled to a 20-day time horizon. For example, a common VaR model time-scaling technique is to multiply the one-day VaR by the square root of the designated time period (*i.e.*, for the proposed rule it would be the square root of 20). But for funds with returns that are not identically and independently normally distributed, simple time-scaling techniques may be inaccurate. If this inaccuracy results in meaningful underestimation of VaR, this simple time-scaling technique would be inappropriate.

231 *See, e.g.*, CESR Global Guidelines, *supra* note 94 (providing default VaR calculation standards that require funds that use the relative VaR or absolute VaR approach to calculate VaR using a "one-tailed confidence interval of 99%"); rule 15c3-1e under the Exchange Act [17 CFR 240.15c3-1e] (Appendix E to 17 CFR 240.15c3-1) (requiring VaR models to use "a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices"). *See also* the Basel Committee on Banking Supervision, *Amendment To The Capital Accord To Incorporate Market Risks* (Jan. 1996), *available at* https://www.bis.org/publ/bcbs24.pdf (contemplating banks' use of internal models for measuring market risk based on a 10-day time horizon); CESR Global Guidelines, *supra* note 94 (specifying generally a 20-day time horizon as a quantitative requirement when calculating VaR for risk measurement and the calculation of global exposure and counterparty risk for UCITS).

of the distribution (*i.e.*, more-"extreme" but less-frequent losses) and a longer time horizon would result in larger losses in the distribution (*i.e.*, losses have the potential to be larger over twenty days when compared, for example, to over one day).

In proposing a higher confidence level and longer time horizon, we considered whether this would result in a VaR model based on fewer data points in comparison to lower confidence levels and shorter time horizons. However, we understand that a longer trading day horizon only results in reduced data points if the fund uses historical simulation and measures historical losses using non-overlapping periods, which our proposal would not require. For example, a fund measuring non-overlapping twenty-day periods, assuming 250 trading days in a year, would expect approximately 12 or 13 data points (250 trading days / 20-day time horizons). But if the fund measured the twenty-day periods on a rolling and overlapping basis, it could expect as many as 250 data points where each data point captures the return over the trailing 20 trading days. A fund could use either a non-overlapping or overlapping approach under the proposed rule.

The 2015 proposal similarly specified the particular confidence level and time horizon parameters that funds would use in their VaR models for purposes of the proposed risk-based portfolio limit. These parameters were a 99% confidence level and a time horizon range of not less than 10 and not more than 20 trading days.[232] Comments were mixed but generally supported a confidence level in the range of 95% to 99%.[233] Rather than a time horizon range providing funds discretion to select the number of trading days for which to compute their VaR

[232] 2015 Proposing Release, *supra* note 2, at section III.B.2.b.

[233] *See, e.g.*, AQR Comment Letter; ICI Comment Letter II.

models, some commenters suggested that the rule should specify a particular number of days.[234] Because our proposal, unlike the 2015 proposal, includes an absolute VaR test, our proposed VaR model parameters reflect commenter suggestions by proposing a confidence level within the generally supported range and proposing a specific VaR model time horizon rather than a range of permissible time horizons.

In addition to specifying the confidence level and time horizon that a fund's VaR model would use, we are also proposing that the fund's chosen VaR model must be based on at least three years of historical market data. We understand that the availability of data is a key consideration when calculating VaR, and that the length of the data observation period may significantly influence the results of a VaR calculation. For example, a shorter observation period means that each observation will have a greater influence on the result of the VaR calculation (as compared to a longer observation period), such that periods of unusually high or low volatility could result in unusually high or low VaR estimates.[235] Longer observation periods, however, can lead to data collection problems, if sufficient historical data is not available.[236] We believe requiring a fund's chosen VaR model to be based on at least three years of historical market data strikes an appropriate balance.

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[234] *See, e.g.*, Morningstar Comment Letter; AIMA Comment Letter; AQR Comment Letter; ICI Comment Letter II.

[235] *See* Linsmeier & Pearson, *supra* note 226 (stating that, because historical simulation relies directly on historical data, a danger is that the price and rate changes in the last 100 (or 500 or 1,000) days might not be typical. For example, if by chance the last 100 days were a period of low volatility in market rates and prices, the VAR computed through historical simulation would understate the risk in the portfolio).

[236] *See* Dowd, *supra* note 177 (stating that "[a] long sample period can lead to data collection problems. This is a particular concern with new or emerging market instruments, where long runs of historical data don't exist and are not necessarily easy to proxy").

The proposed historical market data requirement would permit a fund to base its VaR estimates on a meaningful number of observations, while also recognizing the concern that requiring a longer historical period could make it difficult for a fund to obtain sufficient historical data to estimate VaR for the instruments in its portfolio.[237] The 2015 proposal would have required three years of market data for funds using historical simulation (but did not require three years of market data for VaR models based on Monte Carlo simulation or parametric methods).[238] A number of commenters supported our approach in the 2015 proposal to require three years of market data for funds using historical simulation.[239] However, some commenters suggested that the rule should require a longer period of historical market data.[240] As discussed above, we believe that three years strikes an appropriate balance. We also are proposing to require funds to use three years of market data for all VaR calculations under the proposed rule—rather than only historical simulation as in the 2015 proposal. We believe this is

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237 *See* Michael Minnich, *Perspectives On Interest Rate Risk Management For Money Managers And Traders* (Frank Fabozzi, ed.) (1998) (stating that for historical simulation, "[l]onger periods of data have a richer return distribution while shorter periods allow the VAR to react more quickly to changing market events" and that "[t]hree to five years of historical data are typical"); *see also* Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, FRBNY Economic Policy Review (Apr. 1996) (finding that, when using historical VaR, "[e]xtreme [confidence level] percentiles such as the 95th and particularly the 99th are very difficult to estimate accurately with small samples" and that the complete dependence of historical VaR models on historical observation data "to estimate these percentiles directly is one rationale for using long observation periods").

238 *See* 2015 Proposing Release, *supra* note 2, at section III.B.2.b; *see also supra* note 177 (discussing historical simulation, Monte Carlo simulation, and parametric methods).

239 *See, e.g.*, Comment Letter of Abbey Capital (Mar. 28, 2016); AIMA Comment Letter; Comment Letter of Aspect Capital Limited (Mar. 28, 2016); Comment Letter of Intercontinental Exchange (Apr. 15, 2016).

240 *See, e.g.*, materials attached to the memorandum included in the comment file concerning a meeting between representatives of AlphaSimplex Group LLC and members of the staff of the Division of Investment Management (July 8, 2016); AQR Comment Letter.

appropriate because all methods for calculating VaR—not just historical simulation—rely on historical data.

Unlike the 2015 proposal, the proposed rule does not require a fund to apply its VaR model consistently (*i.e.*, the same VaR model applied in the same way) when calculating the VaR of its portfolio and the VaR of its designated reference index.[241] The proposed rule would, however, require that VaR calculations comply with the same proposed VaR definition and its specified model requirements.[242] Our proposal does not include the 2015 proposal's model consistency requirement because if the proposed rule required funds to apply the same VaR model to its portfolio and the designated reference index, it could prevent funds from using less-costly approaches. For example, under the proposed approach, in many cases a fund could calculate the VaR of a designated reference index based on the index levels over time without having to obtain access to more-detailed information about the index constituents. A fund also would have the flexibility to obtain the VaR from a third-party vendor instead of analyzing it in-house. A model consistency requirement could preclude these approaches, however, because a fund might not be able apply the same approach to its portfolio. For example, if a fund invested significantly in options, it generally would not be appropriate to use certain parametric VaR models.[243] The fund might instead use Monte Carlo simulation, which is more computationally intensive and takes more time to perform. A model consistency requirement would require the

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[241] *See* 2015 Proposing Release, *supra* note 2, at section III.B.2.b.

[242] *See infra* section II.D.4 (discussing the proposed VaR model requirements).

[243] *See supra* note 227 (explaining that some parametric methodologies may be more likely to yield misleading VaR estimates for assets or portfolios that exhibit non-linear returns, due, for example, to the presence of options or instruments that have embedded optionality).

fund to apply the same Monte Carlo simulation model to its unleveraged designated reference index, for which a parametric or other simpler and less costly VaR model might be appropriate.

Although requiring a fund to apply the same VaR model to its portfolio and the designated reference index could result in a more precise comparison of the two values, we do not believe that the additional precision is necessary for the relative VaR test to identify where funds' use of derivatives is more likely to raise the concerns underlying section 18 because the proposed rule would provide certain common parameters for all VaR calculations under the rule. Because a fund's designated reference index must be unleveraged, we believe it is generally unlikely that different VaR models calibrated to these common parameters would produce substantially different results for a fund's designated reference index. Additionally, the derivatives risk manager would be responsible for administering and maintaining the derivatives risk management program, which includes the integrity of the VaR test. On balance, we believe the proposed approach would not materially diminish the efficacy of the proposed relative VaR test while permitting less-costly approaches for funds.

We request comment on the proposed requirements regarding a fund's choice of VaR model, and the required parameters for a VaR model that funds would use under the proposed rule.

108. Should the rule specify a particular VaR model(s) that funds must use (*i.e.*, a historical simulation, Monte Carlo simulation, or parametric methodology)? If so, which methodology (or methodologies) and why?

109. Is the proposed requirement that a fund's VaR model incorporate all significant, identifiable market risk factors associated with a fund's investments appropriate? Why or why not?

110. The proposed rule would provide a non-exhaustive list of risk factors that may be relevant in light of a fund's strategy and investments. Should the final rule include this non-exhaustive list of risk factors? Are risk factors included in the proposed list appropriate? Should we include any additional risk factors to this list? If so, which ones and why?

111. The proposed rule would require a fund to use a 99% confidence level for its VaR model. Is the proposed confidence level appropriate? Should the rule include a different confidence level? If so, which level and why, and if not, why not?

112. The proposed rule would require a fund to use a time horizon of 20 trading days for its VaR model. Is the proposed time horizon appropriate? Should the rule include a different time horizon? If so, which time horizon and why, and if not, why not?

113. The proposed rule would require a fund to use at least three years of historical market data for its VaR model. Is the historical market data requirement appropriate? Should the rule set forth a different length of time for requiring historical market data? Should the requirement be limited to funds using historical simulation? Would funds experience challenges in identifying sufficient data for particular types of investments? If so, which types of investments and how should the rule address these challenges? Please explain.

114. The proposed rule does not include any requirement for third-party validation of a fund's chosen VaR model, either at inception or upon material changes, to confirm that the model is structurally sound and adequately captures all material risks.[244]

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[244] The Global Exposure Guidelines applicable to UCITS' requires such validation. *See* CESR

Should we require third-party validation? Why or why not?

115. Should the rule require a fund's board to approve the VaR model and any material changes to the model? Why or why not?

116. Should the final rule also include a requirement that a fund that uses the relative VaR test apply the same VaR model when calculating the fund's portfolio and the VaR of the designated reference portfolio? Would the requirement to apply the same VaR model to the fund's portfolio and the designated reference portfolio address any concerns that funds could inappropriately manipulate the results of VaR testing under the proposed rule's requirements? What additional cost, if any, would such a requirement impose on funds? Are there other ways that we could prevent such manipulations? To what extent would this requirement promote additional precision in the relative VaR test and would any additional precision increase the efficacy of the test in limiting fund leverage risk? Please explain.

5. Implementation

a. Testing Frequency

The proposed rule would require a fund to determine its compliance with the applicable VaR test at least once each business day.[245] Although we believe that funds would calculate their VaRs at a consistent time each day, which would generally be either in the mornings before markets open or in the evenings after markets close, we do not propose to require one at the exclusion of the other, to allow funds to conduct their VaR tests at the time that is most efficient based on each fund's facts and circumstances. We considered proposing that funds determine

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Global Guidelines, *supra* note 94.

245 Proposed rule 18f-4(c)(2)(ii).

compliance with the proposed VaR test at the time of, or immediately after, entering into a derivatives transaction. We recognize, however, that conducting a VaR test on a trade-by-trade basis could present operational challenges for some funds and could limit the fund's choice of VaR modeling. For example, we believe that most funds would be unable to perform computationally-intensive Monte Carlo simulations so frequently based on computing resources and compliance costs. Requiring this VaR calculation each day, in contrast, would provide funds flexibility to use VaR models they believe to be appropriate while also providing for fairly frequent calculations. The 2015 proposal included a testing frequency of immediately after entering into any senior securities transactions, but many commenters raised concerns about operational complexity related to transaction-by-transaction testing, and instead generally suggested a daily testing frequency.[246]

We believe that determining compliance with the VaR test less frequently than each business day would not be consistent with the purpose of a condition to limit fund leverage risk. Section 18 sets forth certain fund leverage risk protections that are fundamental to protecting investors. If this testing requirement were less frequent than each business day, then a fund could satisfy the condition only on business days requiring a VaR test and modify its trading strategy to circumvent the purpose of the test on other business days. Additionally, we believe that testing each business day is appropriate in light of the potential for market risk factors associated with a fund's investments to change quickly.

We request comment on the proposed frequency of conducting the relative or absolute VaR test.

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246 *See, e.g.*, ICI Comment Letter I*;* Franklin Resources Comment Letter; SIFMA Comment Letter; AIMA Comment Letter; BlackRock Comment Letter.

117. Is the proposed required frequency for conducting the VaR test appropriate? Should the rule require a fund to conduct the required VaR test more frequently or less frequently, such as—respectively—either before or after each transaction, multiple times throughout the day, or on a weekly basis? Why or why not? Should the required frequency vary depending on fund type or whether the fund is conducting an absolute VaR test or relative VaR test? Please explain.

118. Should the rule require funds to conduct the test at the same time each day? If so, why? What compliance or operational challenges, if any, would funds have to conduct the test at the same time each day? Would the absence of such a requirement allow funds to "game" the test?

b. Remediation

If a fund determines that it is not in compliance with the applicable proposed VaR test, then under our proposal a fund must come back into compliance promptly and within no more than three business days after such determination.[247] If the fund is not in compliance within three business days, then: (1) the derivatives risk manager must report to the fund's board of directors and explain how and by when (*i.e.*, the number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance; (2) the derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances; and (3) the fund may not enter into derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's

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[247] *See* proposed rule 18f-4(c)(2)(ii).

VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days and satisfied the board reporting requirement and program analysis and update requirements.[248]

The proposed three-business-day remediation provision is designed to provide funds with some flexibility in coming back into compliance with the applicable proposed VaR tests. It reflects our view that it would be inappropriate for a fund to purposefully exceed the VaR-based limit on fund leverage risk, but allows funds to take reasonable steps to come back into compliance without harming fund investors. The three-business-day period is designed to provide an appropriate time period to permit remediation efforts because it balances investor protections related to fund leverage risk and potential harm to a fund if it were required to sell assets or unwind transactions even more quickly. This remediation approach is similar to the remediation approach that section 18 of the Investment Company Act provides for asset coverage compliance with respect to bank borrowings, which also includes a three-day period to come back into compliance.[249]

If the fund does not come back into compliance within three business days, the proposed rule would not require the fund to exit its derivatives transactions or make other portfolio adjustments.[250] Although a fund remaining out of compliance with the applicable VaR test raises investor protection concerns related to fund leverage risk, if the proposed rule were to force a

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[248] *See* proposed rule 18f-4(c)(2)(iii); *see also infra* section II.H.2 (discussing the proposed requirement to submit a confidential report to the Commission if the fund is out of compliance with the applicable proposed VaR test for three business days).

[249] Section 18(f)(1) of the Investment Company Act.

[250] Under the proposed rule, a fund that is not in compliance within three business days also would be required to file a report to the Commission on proposed Form N-RN. *See* proposed rule 18f-4(c)(7); *infra* section II.H.2.

fund to exit derivatives transactions immediately at the end of the three-day period, this could harm investors, for example, by requiring the fund to realize trading losses that could have been avoided under a more-flexible approach. The proposed remediation provision reflects the balancing of these multiple investor protection concerns.

Instead of requiring a fund to come back into compliance under these circumstances immediately, the fund must satisfy three requirements before it can enter into derivatives transactions other than those designed to reduce the fund's VaR. First, the derivatives risk manager must report to the fund's board of directors and explain how and by when (*i.e.*, the number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance.[251] This requirement is designed to facilitate the fund coming back into compliance promptly by requiring the derivatives risk manager to develop a specific course of action to come back into compliance and to facilitate the board's oversight by requiring the derivatives risk manager to report this information to the board.

Second, the derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances.[252] That the fund was unable to come back into compliance with the applicable VaR test within three business days may suggest there are deficiencies in the fund's program. This requires the derivatives risk manager to analyze and update any program elements as appropriate before the fund is able to enter into derivatives transactions other than those designed to reduce VaR.

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251 Proposed rule 18f-4(c)(2)(iii)(A).

252 Proposed rule 18f-4(c)(2)(iii)(B).

Finally, a fund may not enter into derivatives transactions (other than those designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for at least three consecutive business days and has satisfied the applicable board reporting and program analysis and update requirements.[253] If the proposed rule were to permit a fund that is out of compliance with the limit on fund leverage risk to comply for just one day before entering into derivatives transactions that would increase the fund's market risk, this could potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test.

We request comment on the proposed remediation requirement for a fund that is out of compliance with the applicable VaR test.

119. Is the proposed three-business-day remediation provision appropriate? Could such a limited remediation period exacerbate fund or market instability and harm investors? Should the rule require a longer or shorter period, such as one or seven days? Why or why not, and if so, what should the alternative remediation period be? In light of the balancing of investor protection concerns (fund compliance with the VaR-based limit on fund leverage risk and not forcing asset sales or unwinding transactions to comply), is there a more-effective means to structure a remediation provision that balances these concerns? If so, how?

120. Should we change the rule's remediation provision to include an escalating provision that requires longer periods of compliance based on the number of three-day (or more) periods that a fund has been out of compliance? If so, how should we structure

[253] Proposed rule 18f-4(c)(2)(iii)(C).

such a provision?

121. Should we change the rule to factor in the aggregate number of days in a trailing year that a fund has been out of compliance? What additional remediation consequences should a fund address before entering into derivatives transactions (other than those designed to reduce the fund's VaR)? Please explain.

122. Should the remediation provision provide further or different limitations for a fund that continuously goes in and out of compliance with its VaR test? For example, should the rule provide that such a fund is not permitted to rely on the proposed rule indefinitely or for a set period of time? How should a rule define "continuously going in and out of compliance"? Should such a fund be subject to a lower VaR requirement? If so, what level of VaR and why? How long should the fund remain subject to any lower VaR requirement? Should the fund be subject to limits on its derivatives exposure?

123. Should the remediation provision, as proposed, require the derivatives risk manager to report to the fund's board of directors that the fund has been out of compliance with the VaR-based limit for more than three consecutive business days? Why or why not? Should the derivatives risk manager be required to explain how the fund will come back into compliance promptly and by when? Should we change the rule to require such a fund to take certain specific actions? Should we change the rule to require fund compliance within a specific time period? If so, how should we change the rule and why?

124. Should the remediation provision, as proposed, require the derivatives risk manager to analyze the circumstances for the fund being out of compliance for more than three

business days? Should we change the rule to require specific program updates? Should we change the rule to require a complete program review and update? What challenges would such a remediation requirement impose on funds? What are the benefits of specifying program updates? Under what circumstances, if any, would a fund be out of compliance for more than three business days and not have risk management program elements to update? Please explain.

6. Other Regulatory Approaches to Limiting Fund Leverage Risk

a. Stress Testing

In addition to our proposal to require stress testing as a derivatives risk management program element, we considered a stress testing requirement as a means to limit fund leverage risk in lieu of, or in addition to, the proposed VaR tests. We understand that many funds that use derivatives transactions already conduct stress tests for purposes of risk management.[254]

For example, we considered proposing a single-factor stress test requirement that would enumerate a limited number of shocks, corresponding to different asset classes in which funds commonly invest, and specify the required shock levels for each asset class. Similar to Form PF, the rule could categorize stress testing shocks based on market factors such as equity prices, risk-free interest rates, credit spreads, currency rates, commodity prices, option implied volatilities, default rates for asset-backed securities, and default rates for corporate bonds and credit-default swaps.[255] The rule could also include an "other," general category for which the corresponding

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254 *See, e.g.*, ICI Comment Letter III. While we do not propose to require stress testing as a means for limiting a fund's leverage risk, as discussed above, one element of the proposed program requires stress testing for risk management purposes. *See supra* section II.B.3.c.

255 Question 42 on Form PF requires some private fund advisers to report the impact on the fund's portfolio from specified changes to the identified market factors.

shock level would be a specific or otherwise determinable factor based on extreme but plausible market conditions determined by the derivatives risk manager. A fund would "fail" this stress test if one of the prescribed shocks would cause the fund to experience a level of loss that we would specify.

We could, for example, specify the shock levels for each market factor based on a certain number of standard deviations from the mean of historical distributions of returns for that factor, such as three or four standard deviations, as a means of establishing standardized shock levels.[256] We could then specify that a fund fails the stress test if any such shock leads to a loss of a certain percentage of the fund's net assets over a single trading day or series of trading days, such as 20% over one trading day. We could determine these metrics based on how funds that do not engage in derivatives, but that have borrowed up to and in compliance with the requirements of section 18, would perform against the stress test. For example, the stress test outer limit could be based on a fund that is not using derivatives but has invested $150 in securities based on $100 of net assets and $50 in bank borrowings. To be consistent with section 18, a fund that uses derivatives and conducts a stress test resulting in losses greater than the stress test losses of this hypothetical bank-borrowing-leveraged fund would fail the single-factor stress test.

This approach would have the benefit of setting forth a comparatively simple-to-conduct test that a broad variety of funds could apply. The challenges of a single-factor stress testing requirement, however, include identifying an appropriate universe of market risk factors for the broad universe of derivatives in which funds invest and strategies they follow, setting the

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[256] If normally distributed, shock levels based on historical returns of a market factor that is three standard deviations from the mean of that market factor would correspond to approximately a 99.7% confidence level.

appropriate level of each shock for each factor, and determining the level of losses that would result in a fund "failing" the test. Making these determinations would be particularly challenging in a rule that would apply to all funds. Any prescribed shocks and related values could become stale over time and necessarily would not include all of the relevant risk factors for each fund. As funds continue to innovate, there could be funds for which no prescribed shock would be relevant. An approach that looks at a fund's losses in response to changes in a single market risk factor also may not effectively take into account correlations among market risk factors under stressed market conditions. Stress testing is useful as a risk management tool because it provides a framework for advisers to consider a range of potential scenarios tailored to each fund and refined over time. Its benefits as a limit of fund leverage risk may not be fully realized, however, by single-factor stress testing that includes static values that a rule specifies.[257]

We also considered requiring a multi-factor stress test based on scenario analysis. Rather than a fund applying a single-factor shock to each relevant asset class, this approach would require funds to create a stress test model that takes into account multiple asset classes simultaneously, which a fund would have to identify to tailor the stress test to its fund. The fund would then run numerous scenarios against the model, shocking the multiple asset classes identified, based on a high number of iterations and permutations akin to a Monte Carlo simulation. A multi-factor stress test would result in a matrix or range of estimated potential losses during stressed market conditions because each scenario permutation would create one estimated potential loss calculation. The benefits of multi-factor stress testing include tailoring

[257] We recognize that these concerns do not apply to all uses of single-factor stress testing. For example, money market fund stress testing does not raise similar concerns in part because of money market funds' common strategies and limited universe of investment holdings. *See* rule 2a-7(g)(8) under the Investment Company Act (requiring periodic stress testing).

the stress test to the investment and risk characteristics of a fund's portfolio, which may result in more meaningful derivatives risk management. But in considering a multi-factor stress testing requirement, we would have to consider whether such a framework, if highly particularized, would permit enough long-term flexibility as an applicable regulatory limit on fund leverage risk. For example, the multi-factor stress test could identify specific correlations and assumptions that funds should reflect in their stress tests based on their strategies and investments, or identify specific historical market events to run as scenarios against their stress test model. In addition, if we were to propose a principles-based multi-factor stress testing requirement that would rely on funds to tailor their stress tests, it would present regulatory challenges in determining whether funds were adhering to a limit on fund leverage risk consistent with section 18.

Finally, our proposed VaR-based limit on fund leverage risk, as opposed to stress testing, may better align with section 18's investor protection goals concerning the level of risk in a registered fund. This is because the limitations in section 18 apply under both normal and stressed market conditions.[258] For these reasons, as well as the regulatory design challenges of specifying the universe of asset class shocks and setting their corresponding levels, we are proposing a VaR-based limit on fund leverage risk instead of a stress testing approach to limiting fund leverage risk.

We request comment on stress testing as a means to limit funds' leverage risk.

125. In addition to our proposed stress testing requirement as part of the derivatives risk management program, should the rule require stress testing as a means to limit fund leverage risk in lieu of or in addition to the VaR-based limit on fund leverage risk?

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[258] *See supra* section I.B.1.

Why or why not? Is a stress test an effective means to limit a fund's leverage risk? Please explain. If we were to include a stress testing requirement in addition to a VaR-based limit on fund leverage risk, should we require a fund to comply with both requirements, or should we allow a fund to choose one or the other? If we were to allow funds to comply with either approach, would that result in inconsistent limits across funds and would that be appropriate if so?

126. To measure and/or limit fund leverage risk, do funds currently use VaR tests, stress tests or both? If a fund uses VaR tests but not stress tests (or vice versa), did the fund consider using the other approach as a means to measure and limit its leverage risk? Why or why not?

127. If funds use both VaR tests and stress tests to measure and/or limit fund leverage risk, why do they use both tests? Are there certain fund types or strategies that are better suited for VaR or for stress testing? If so, which ones and why?

128. Should the limit of fund leverage risk focus on normal market conditions, stressed market conditions, or both? Please explain.

129. Should the rule require a single-factor stress test as an alternative to the proposed VaR-based limit on fund leverage risk? If so, what single-factor shocks should the test require? What would the corresponding shock levels be for each factor? Are the example single-factor shocks discussed above appropriate? Please explain. How frequently and on what basis, if at all, do commenters anticipate that the Commission would need to amend a rule that incorporated the enumerated shocks and their corresponding levels?

130. What number of standard deviations from the mean of historical distributions of

returns should the single-factor shock levels for each market risk factor be? Would three standard deviations or four standard deviations be appropriate? How should the rule define a failed stress test? Would a loss expressed as a percentage of the fund's net assets over a single trading day or series of trading days be appropriate? What percentage and over what period would be appropriate? Would 20% over one trading day be appropriate? How frequently, if at all, do commenters anticipate that the Commission would need to amend the rule to revise the specified loss level?

131. Should the rule require a multi-factor stress test as an alternative to the proposed VaR-based limit on fund leverage risk? If so, how might the rule include a multi-factor stress testing requirement that permits adequate flexibility and tailoring but could also promote comparability and regulatory consistency in setting a leverage risk limit?

132. Should the single-factor or multi-factor stress testing methods be required as part of the proposed program's stress testing requirement? If so, which one and why?

b. Asset Segregation

We considered applying an asset segregation approach to derivatives transactions, similar to asset segregation under Release 10666, as a tool to limit funds' leverage-related risks.[259] Under this approach, we could require a fund engaging in derivatives transactions to segregate cash and cash equivalents equal in value to the full amount of the conditional and unconditional obligations incurred by the fund (also referred to as "notional amount segregation"). We could allow funds to segregate additional types of assets beyond cash and cash equivalents subject to

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[259] We separately discuss below our consideration of asset segregation as a complement to the proposed limitations on fund leverage risk. *See infra* section II.F.

prescribed haircuts based on the assets' volatilities. The 2016 DERA Memo, for example, analyzed different risk-based "haircuts" that could apply to a broader range of assets.[260] Allowing a broader range of segregated assets would have the effect of allowing funds to take on additional leverage because it would increase a fund's ability to obtain market exposure through a combination of cash, market securities investments, and derivatives transactions. Allowing funds to segregate a broader range of assets, even if subject to haircuts, also may not effectively address all of the section 18 concerns underlying an asset segregation requirement. For example, if a fund must raise cash to pay a derivatives counterparty by selling a segregated security with unrealized trading losses, then the fund still would realize trading losses on the sale of the security regardless of whether the fund applied haircuts to the value of the security when determining the amount of its segregated assets. The haircuts therefore could help to prevent a fund from defaulting on its derivatives transactions obligations, but may not prevent a fund from realizing trading losses to meet those obligations.

Notional amount segregation, although generally an effective way to limit leverage risk, is a non-risk-sensitive and often more restrictive approach to limiting potential leverage risk as compared to the proposed VaR tests. Notional amount segregation could limit funds' ability to engage in derivatives transactions that may not raise the concerns underlying section 18. For example, if a fund had segregated all available qualifying assets, it would not be permitted to enter into a derivatives transaction that would reduce portfolio risk. The proposed VaR tests would not constrain such a transaction because it would reduce the fund's VaR.

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[260] *See, e.g.*, 2016 DERA Memo, *supra* note 12.

We also considered proposing an approach that would require funds to segregate liquid assets in an amount equal to the fund's daily mark-to-market liability plus a "cushion amount" designed to address potential future losses. Requiring funds to segregate liquid assets would indirectly limit a fund's leverage risk because each derivatives transaction and segregation of liquid assets would limit the net assets available for segregation to support additional derivatives. This approach would require segregating a smaller amount of liquid assets than the notional amount segregation approach.[261] In light of the smaller amount of segregated assets, we could provide that only a specified percentage of a fund's assets can be segregated. We could provide, for example, that a fund's segregated amount cannot exceed one-third of its total assets or one-half of its net assets because this is the maximum amount that an open-end fund can owe a bank under section 18.

This approach, however, would raise compliance complexities and may not be as effective as the proposed VaR tests in limiting fund leverage risk. For example, under this approach we would have to define the risk-based "cushion amount" funds would segregate. We could define this amount as we proposed in 2015: a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.[262] Some commenters suggested determining these amounts could raise compliance challenges.[263] Another approach would be to use the amount of required initial margin, for

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[261] *See* 2010 ABA Derivatives Report (recommending a risk-adjusted segregated amounts approach); 2011 Concept Release, *supra* note 3, at sections II.B.2, II.C.2 (citing and requesting comment on the 2010 ABA Derivatives Report approach).

[262] *See* 2015 proposed rule 18f-4(c)(9).

[263] We discuss these challenges in more detail below in section II.F. *See also, e.g.*, AAF Comment Letter; Angel; Comment Letter of James J. Angel, Ph.D., CFA (Mar. 28, 2016).

transactions subject to regulatory initial margin requirements. Not all derivatives transactions are subject to initial margin requirements, however, and these requirements generally vary based on the type of derivatives instrument. An approach that were to allow a fund to have more leverage when trading futures as compared to swaps, for example, would not seem consistent with the concerns underlying section 18.

Requiring funds to segregate liquid assets in an amount equal to the fund's daily mark-to-market liability plus a "cushion amount" therefore could introduce unnecessary complexity and compliance costs and may not result in an effective limit on fund leverage. We believe that the proposed VaR-based tests would be a more direct and effective method of limiting fund leverage risk consistent with section 18.

We request comment on asset segregation as an alternative or complement to VaR.

133. Should the rule require asset segregation in lieu of or in addition to the proposed VaR-based limit on fund leverage risk? Is asset segregation equally effective or more effective than the proposed VaR tests in limiting a fund's leverage risk? Why or why not?

134. Are there certain fund types or strategies for which an asset segregation approach would be more effective or appropriate for limiting a fund's leverage risk? Which ones and why?

135. Should the proposed rule require notional amount segregation? What challenges, if any, would funds have with complying with notional amount segregation? Would this be an effective means to limit a fund's leverage risk? If so, how? Please describe.

136. Should the proposed rule require an asset segregation risk-based approach based on the fund's daily mark-to-market liability and "cushion amount"? Please explain why

or why not. If so, how should funds calculate the risk-based cushions? Should we use the approach in the 2015 proposal for risk-based coverage amounts? Would funds encounter challenges in determining stressed conditions for purposes of that analysis? Would that approach lead to consistent segregated amounts across funds for the same or similar investments? Why or why not? Could we provide for greater consistency by prescribing a standardized schedule for computing these amounts based on the volatility of the underlying reference assets? What values should we prescribe? Rather than the approach in the 2015 proposal, should we use the amounts posted to satisfy regulatory margin requirements? Would it be appropriate for different instruments that provide the same economic exposure (*e.g.*, futures and swaps that reference the same index) to have different segregated amounts? Under this approach, how should funds calculate risk-based cushions for transactions that are not subject to regulatory initial margin requirements?

137. Should we use the risk-based cushion amount approach to indirectly limit leverage risk? If so, should we provide that a fund's segregated amount cannot exceed one-third of its total assets, one-half of its net assets, or some other percentage of a fund's total or net assets? Would such an approach be sufficiently risk-sensitive and dynamic? If we were to use such an approach, how should we address derivatives transactions that may require little or no margin or collateral to be posted?

138. Are there other reasons that the proposed rule should include asset segregation? Should the derivatives risk management program specify asset segregation requirements? Would market practices adequately address asset coverage concerns? If not, why?

139. We included an asset segregation requirement as part of the 2015 proposal designed in part to address the asset sufficiency related concerns underlying section 18. Would an asset segregation requirement help to address fund leverage risk and complement the proposed VaR tests? If so, what type of asset sufficiency test?

c. Exposure-Based Test

We considered an exposure-based approach for limiting fund leverage risk. For example, we could design an exposure-based approach that permits a fund to enter into derivatives transactions so long as its derivatives exposure does not exceed a specified percentage of the fund's net assets, such as 50%. This would be similar to an exposure-based test under the European Union guidelines that apply to UCITS funds.[264]

A fund's "derivatives exposure" could be defined as in proposed rule 18f-4.[265] A similar approach would be to provide that the sum of a fund's derivatives exposure and the value of its other investments cannot exceed 150% of the fund's net asset value. This latter approach, and particularly if cash and cash equivalents were not included in the calculation, would allow a fund

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264 CESR (now known as the European Securities and Markets Authority ("ESMA")) issued its Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS ("Global Exposure Guidelines") in 2010, addressing the implementation of the European Commission's 2009 revised UCITS Directive ("2009 Directive"). *See* CESR Global Guidelines, *supra* note 94, at 9.

A UCITS fund may, instead of complying with the European Union's VaR-based test, satisfy a "commitment approach." The commitment approach provides that a UCITS fund is in compliance with the leverage limits under the guidelines if its derivatives notional amounts (taking into account netting and hedging) do not exceed 100% of the fund's net asset value. *See* 2009 Directive.

265 Proposed rule 18f-4(a) (defining derivatives exposure to mean the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short. In determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts).

to achieve the level of market exposure permitted for an open-end fund under section 18 using any combination of derivatives and other investments.[266]

This alternative approach would recognize that for most types of derivatives, the notional amount generally serves as a measure of the fund's economic exposure to the underlying reference asset or metric. It also would provide a simple approach because a fund would just add the relevant values rather than having to perform VaR tests.

An exposure-based test does have certain limitations. One drawback to this alternative approach is that a derivative's notional amount does not reflect the way in which the fund uses the derivative and is not a risk measurement. For this reason, an exposure-based approach may be viewed as a relatively blunt measurement. It would not differentiate between derivatives transactions having the same notional amount but different underlying reference assets with potentially very different risks.

There are adjustments to notional amounts available that may better reflect the risk associated with derivatives transactions. One way to attempt to address these drawbacks would be to define the circumstances under which funds could subtract the exposure associated with "hedging" and "netting" transactions from a fund's derivatives exposure. This would be similar to the "commitment method" applicable to UCITS funds.[267] Defining these kinds of transactions

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266 This approach would exclude cash and cash equivalents because they do not meaningfully contribute to a fund's market exposure.

267 *See, e.g.*, CESR Global Guidelines, *supra* note 94, at 13-14 (defining netting as "combinations of trades on financial derivative instruments and/or security positions which refer to the same underlying asset, irrespective—in the case of financial derivative instruments—of the contracts' due date; and where the trades on financial derivative instruments and/or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other financial derivative instruments and/or security positions" and hedging as "combinations of trades on financial derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where the trades on financial derivative instruments and/or security

can be challenging. For example, determining whether transactions are "hedges" can involve an analysis of historical correlations and predicting future price movements of related instruments or underlying reference assets, among other things. Historical correlations also can break down in times of market stress.[268]

Another potential way to modify an exposure-based test would be to adjust the notional amounts that contribute to a fund's derivatives exposure based on the volatility of their underlying reference assets. Some commenters on the 2015 proposal suggested we take this approach, and DERA staff prepared an analysis of commenters' suggestions.[269] This would make an exposure-based test more risk-sensitive, but would not provide the more-comprehensive analysis of portfolio risk that VaR provides. An exposure-based test, even with these various adjustments to notional amounts for purposes of calculating a fund's derivatives exposure, still would be a relatively blunt measurement. For example, this approach could limit certain fund

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positions are concluded with the sole aim of offsetting risks linked to positions taken through the other financial derivative instruments and/or security positions").

268 In times of extreme market stress, price correlations between asset classes frequently break down. *See* Mico Loretan & William B. English, *Evaluating "Correlation Breakdowns" During Periods of Market Volatility*, Federal Reserve System International Finance Working Paper No. 658 (Feb. 2000), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=231857 ("[I]n periods of heightened market volatility correlations between asset returns can differ substantially from those seen in quieter markets. The problem of 'correlation breakdown' during periods of greater volatility is well known."). During periods of stressed conditions, correlations between asset classes with historically weak or inverse correlations may change significantly. *See* Whitney Kisling, *Greed Beats Fear With Stock-Bond Correlation Falling,* Bloomberg (Nov. 22, 2010) (stating that the 30-day correlation between S&P 500 prices and 10-year Treasury yields showed equity and bond markets, typically inversely correlated markets, moving in lockstep after the 2008 financial crisis); *see also A Review of Financial Market Events in Autumn 1998*, Bank for International Settlements, Committee on the Global Financial System (1999), *available at* http://www.bis.org/publ/cgfs12.htm (during the Russian financial crisis in August 1998 the average correlation between five-day changes in yield spreads for 26 instruments in 10 economies rose from 11% in the first half of 1998 to 37% during the height of the crisis).

269 *See* 2016 DERA Memo, *supra* note 12.

strategies that rely on derivatives more extensively but that do not seek to take on significant leverage risk.

While we do not propose an exposure-based test element as a means for limiting all funds' leverage risk, we are proposing an exposure-based test for limited derivatives users (as discussed below).[270]

We request comment on an exposure-based test as a means to limit funds' leverage risk.

140. Should the rule incorporate an exposure-based approach in addition to, or in lieu of, the proposed VaR-based limit on fund leverage risk? If so, what derivatives exposure amount should this approach permit? For example, should we modify the proposed rule so that a fund would not be required to satisfy either VaR test if the fund limited its derivatives exposure, as defined for purposes of the limited derivatives user exception discussed below, to 50% of a fund's net assets? Should an exposure-based approach focus on a fund's overall gross market exposure and be based on the sum of the fund's derivatives exposure and the value of its other investments, less any cash and cash equivalents? If so, should a fund's gross market exposure be limited to 150% of net assets to allow a fund to achieve the level of market exposure permitted for an open-end fund under section 18 using any combination of derivatives and other investments? Would any of these approaches to implementing an exposure-based limit on fund leverage risk effectively address the potential leverage associated with a fund's derivatives transactions? If so, would funds find it more cost effective or otherwise preferable to have the option to comply with an exposure-based test in lieu

[270] *See* proposed rule 18f-4(c)(3).

of the proposed VaR tests? Please explain.

141. If the rule were to incorporate an exposure-based approach, should we permit funds to make netting and hedging adjustments when calculating their derivatives exposures? If so, why? How should we define permissible netting and hedging transactions? If we permit netting and hedging to be incorporated into the exposure calculation, should the rule include third-party verification to test whether a fund’s netting and hedging calculations were reasonable and appropriate? What other provisions could achieve these concerns with netting and hedging? Please describe.

142. If the rule were to incorporate an exposure-based approach, should we permit funds to make risk-sensitive adjustments as discussed in the 2016 DERA Memo? If so, why? How should we define the permissible risk-adjusted notional amounts? If we permit these adjustments to be incorporated into the exposure calculation, should the rule include third-party verification to test whether a fund’s adjustments were reasonable and appropriate? What other provisions could achieve these concerns with risk-adjusted notional amounts? Please describe.

143. Are there certain fund types or strategies where an exposure-based test would be more appropriate? If so, which ones and why? Would these fund types or strategies have difficulty conducting either a relative VaR test or absolute VaR test? If so, why would an exposure-based test be less challenging to conduct than a VaR-based test?

144. What challenges, if any, would funds have in conducting an exposure-based test? How could an exposure-based test rule account for these challenges?

145. Do funds currently conduct exposure-based tests as a means of measuring and limiting a fund’s leverage risk? If so, which ones and why? Are these exposure-based

tests in place of or in addition to VaR-based tests or other risk measurements? Should the rule be modified to require both, and what benefits do funds find when running an exposure-based test and VaR-based test and comparing results? Would these additional compliance burdens result in a more-accurate limit on fund leverage risk? If so, how much so, and what would the additional compliance burdens be?

146. In what ways is the proposed approach to limiting leverage risk superior or inferior to the current regulatory approach or alternative approaches, including the stress testing, asset segregation and exposure-based alternatives discussed herein?

E. Limited Derivatives Users

We are proposing an exception from the proposed rule's risk management program requirement and VaR-based limit on fund leverage risk for funds that use derivatives in a limited manner. Requiring funds that use derivatives only in a limited way to adopt a derivatives risk management program that includes all of the proposed program elements could potentially require funds (and therefore their shareholders) to incur costs and bear compliance burdens that may be disproportionate to the resulting benefits.[271] We recognize that the risks and potential impact of derivatives transactions on a fund's portfolio generally increase as the fund's level of derivatives usage increases and when funds use derivatives for speculative purposes.

The proposed exception would cover two alternative types of limited derivatives use. It would be available to a fund that either limits its derivatives exposure to 10% of its net assets, or that uses derivatives transactions solely to hedge certain currency risks.[272] A fund that relies on

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[271] The cost burden concern extends to smaller funds as well, which could experience an even more disproportionate cost than larger funds. *See infra* sections III.C.3and V.D.1.c.

[272] *See* proposed rule 18f-4(c)(3)(i)-(ii); *see also infra* sections II.E.1 and II.E.2 (discussing the

the proposed exception would also be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks.[273] We believe that the risks and potential impact of these funds' derivatives use may not be as significant, compared to those of funds that do not qualify for the exception, and that a principles-based policies and procedures requirement would appropriately address these risks. We discuss and request comment on each of the elements of this proposed exception below.

1. Exposure-Based Exception

Under one alternative set of conditions, a fund would be permitted to rely on the limited derivatives user exception if its derivatives exposure does not exceed 10% of its net assets. The proposed rule would generally define the term "derivatives exposure" to mean the sum of the notional amounts of the fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short.[274] This definition is designed to provide a measure of the market exposure associated with a fund's derivatives transactions entered into in reliance on proposed rule 18f-4.[275]

We recognize that using notional amounts as a measure of market exposure could be viewed as a relatively blunt measurement in that different derivatives transactions having the same notional amount but different underlying reference assets—for example, an interest rate swap and a credit default swap having the same notional amount—may expose a fund to very different potential investment risks and potential payment obligations. The derivatives exposure

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specific requirements for funds relying on either alternative of the proposed exception).

273 *See* proposed rule 18f-4(c)(3).

274 *See* proposed rule 18f-4(a) (defining the term "derivatives exposure").

275 *Id*.

threshold in the limited derivatives user exception, however, is not designed to provide a precise measure of a fund's market exposure or to serve as a risk measure, but rather to serve as an efficient way to identify funds that use derivatives in a limited way.

The proposed definition of "derivatives exposure" would, however, include two adjustments designed to address certain limitations associated with measures of market exposure that use derivatives' notional amounts without adjustments. Specifically, the proposed rule would permit a fund to convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts.[276] Converting interest rate derivatives to 10-year bond equivalents would provide for greater comparability of the notional amounts of different interest rate derivatives that provide similar exposure to changes in interest rates but that have different unadjusted notional amount. In addition, absent this adjustment, short-term interest rate derivatives in particular can produce large unadjusted notional amounts that may not correspond to large exposures to interest rate changes.[277] Permitting funds to convert these and other interest rate derivatives to 10-year bond equivalents is designed to result in adjusted notional amounts that better represent a fund's exposure to interest rate changes. Similarly, permitting delta adjusting of options is designed to provide for a more tailored notional amount that better reflects the exposure that an option creates to the underlying reference asset.

These adjustments are therefore designed to provide for more tailored notional amounts that better reflect the exposure that a derivative creates to the underlying reference asset.

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[276] *Id*. Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta.

[277] *Id*.

Providing these adjustments also would be efficient for funds because the adjustments are consistent with the reporting requirements in Form PF and Form ADV.[278] We do not believe additional adjustments are necessary for purposes of identifying limited derivatives users. For example, commenters on the 2015 proposal suggested an approach to adjusting notional amounts based on the volatility of the underlying reference assets, and DERA staff analyzed these suggestions.[279] We believe, however, that whether a fund is using derivatives in a limited way for purposes of the limited derivatives user exception should not depend on the volatility of the underlying reference assets, but rather on the extent to which a fund uses derivatives to implement its investment strategy.

The proposed 10% derivatives exposure condition represents a threshold that is designed to exclude funds from the program requirement and the VaR-based limit on fund leverage risk when their derivatives exposure is relatively limited. This proposed threshold is based in part on staff analysis of funds' practices regarding derivatives use. Specifically, DERA staff analyzed funds' use of derivatives based on Form N-PORT filings as of September 2019. As discussed in more detail in section III, these filings covered mutual funds, ETFs, registered closed-end funds, and variable annuity separate accounts registered as management investment companies. Based on this analysis, 59% of funds report no derivatives holdings and 14% of funds report derivatives holdings with gross notional amounts above 50% of NAV.

DERA staff also analyzed the levels of these funds' derivatives exposure after adjusting interest rate derivatives and options, as permitted under the proposed rule. Taking these

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278 *See, e.g.*, General Instruction 15 to Form PF; Item B.30 of Section 2b of Form PF; Glossary of Terms, Gross Notional Value of Form ADV; Schedule D of Part 1A of Form ADV.

279 *See* 2016 DERA Memo, *supra* note 12.

adjustments into account, DERA staff's analysis showed that 78% of funds have adjusted notional amounts below 10% of NAV; 80% of funds have adjusted notional amounts below 15% of NAV; 81% of funds have adjusted notional amounts below 20% of NAV; and 82% of funds have adjusted notional amounts below 25% of NAV. Although BDCs are not required to file reports on Form N-PORT, our staff separately analyzed a sampling of BDCs, finding that of the sampled BDCs, 54% did not report any derivatives holdings and a further 29% reported using derivatives with gross notional amounts below 10% of net assets.[280]

We recognize that not all funds are currently required to file reports on Form N-PORT.[281] It appears, however, that funds' use of derivatives reflected in the Form N-PORT data is generally consistent with that in the representative sample studied in the White Paper prepared in connection with the 2015 proposal, entitled "Use of Derivatives by Investment Companies."[282] For example, DERA staff compared the percentages of funds in both data sets that reported no derivatives and the percentage with gross notional amounts less than 50% of net assets. These figures were comparable, suggesting that the Form N-PORT data provides a representative

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280 *See infra* section III.B.2. As noted above, our staff did not have sufficient information to adjust the notional amounts of the BDCs' interest rate derivatives or options. Some of the 17% of the sampled BDCs with gross notional amounts exceeding 10% of net assets likely would have lower notional amounts after applying these adjustments.

281 Larger fund groups—funds that together with other investment companies in the same "group of related investment companies" have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund—currently are required to file reports on N-PORT. Smaller fund groups must begin to file reports on Form N-PORT by April 30, 2020. While only larger fund groups are currently required to file reports on Form N-PORT, existing filings nevertheless covered 89% of funds representing 94% of assets. *See infra* note 457 and accompanying text.

282 DERA White Paper, *supra* note 1; *see also* ICI Comment Letter III (regarding a survey related to funds' use of derivatives sent to its member firms, the Investment Company Institute stated "The survey was distributed to smaller fund complex members, yet relatively few responses were received from these smaller fund members. Based on anecdotal conversations with staff at these member complexes, the smaller fund firms described no to minimal use of derivatives.").

sample of current funds, and not just the set of funds currently required to file reports on Form N-PORT.[283] Taking these results into account, we are proposing to permit a fund to operate as a limited derivatives user if its derivatives exposure is below 10% of net assets. DERA staff analysis suggests that most funds either do not use derivatives or do so to a more limited extent, and that setting the derivatives exposure threshold for the limited user exception at 10%, 15%, 20%, or 25%, for example, would result in nearly the same percentages of funds qualifying for the exception. We therefore are proposing a lower threshold of 10% because the lower threshold would result in nearly the same percentage of funds qualifying for the exception based on current practices while potentially providing greater investor protections in the future by requiring funds that exceed the lower 10% threshold to establish a program and comply with the VaR-based limit on fund leverage risk.

The 2015 proposal also included an exception from that proposal's risk management program requirement for funds: (1) whose notional derivatives exposure does not exceed 50% of net assets; and (2) that do not enter into "complex derivatives transactions," defined in that proposal to include certain path-dependent and non-linear transactions.[284] The 2015 proposal permitted funds to use delta-adjusted notional amounts for options but did not provide an adjustment for interest rate derivatives.

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283 Specifically, the DERA White Paper observes that 68% of funds held no derivatives and 89% of funds had gross notional amounts less than 50% of net assets. *See* DERA White Paper, *supra* note 1. The respective figures from the N-PORT data were 59% and 86% of funds.

284 Specifically, the 2015 proposal defined the term "complex derivatives transaction" to mean any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (1) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (2) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price. 2015 proposed rule 18f-4(c)(1).

We are proposing a 10% derivatives exposure threshold that takes into account certain adjustments rather than a higher figure, like the 50% threshold we proposed in 2015 that did not include adjustments for interest rate derivatives, because we believe this approach would more effectively identify funds whose derivatives may be effectively managed without a fund needing to establish a derivatives risk management program that includes all of the proposed program elements. A fund with derivatives exposure equal to 50% of net assets, for example, would be at risk of substantial losses, notwithstanding that an open-end fund could borrow an amount equal to 50% of its net assets from a bank.[285] Conversely, if a fund were entering into interest rate derivatives—and especially short-term interest rate derivatives—those transactions' unadjusted notional amounts could cause a fund to exceed the threshold we proposed in 2015 even though the fund's derivatives risks could be less significant than those of other funds that would qualify for the exception. The approach the Commission proposed in 2015 therefore could have permitted some funds to rely on the exception while still taking on significant derivatives risks, while disqualifying other funds whose derivatives transactions may have posed less-significant risks but that had high unadjusted notional amounts. Here, our proposal is designed to address these concerns by proposing a lower derivatives exposure threshold while also allowing funds to adjust interest rate derivatives' notional amounts because the unadjusted values may be more likely to overstate a fund's market exposure.

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285 *See, e.g.*, CFA Comment Letter (stating that the commenter did not believe it was "appropriate that a fund with 40 or 45 percent notional exposure should be viewed as having a limited amount of exposure obviating the requirement for that fund to implement a formal risk management program" and that "Section 18's limit reflects a congressional determination on the level of exposure funds may not exceed; it does not reflect the level of exposure at which funds should begin to establish formal risk management practices").

We also are not proposing to prohibit funds relying on the exception from entering into complex derivatives transactions as we proposed in 2015 because, as discussed in more detail below, we are proposing to require that limited derivatives users manage all of the risks associated with their derivatives transactions, including any complex derivatives transactions. In addition, if these or other complex or exotic derivatives were to embed multiple forms of optionality or other non-linearities such that the fund could not reliably compute the transaction's notional amount, the fund would not be able to confirm that its derivatives exposure is below 10% of the fund's net assets and therefore would not be able to rely on the limited derivatives user exception. Finally, if these complex derivatives transactions were to cause a fund's derivatives exposure to exceed 10% of the fund's net assets—or the fund were to exceed the limit for any other reason—the fund would have to reduce its derivatives exposure promptly or establish a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable.

We also considered an alternative approach to identifying funds that use derivatives in a limited way based on a fund's disclosure. Specifically, we considered providing that a fund would be a limited derivatives user if its principal investment strategies disclosed in its prospectus do not involve the use of derivatives.[286] A fund that does not identify the use of

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[286] *See, e.g.*, ICI Comment Letter III (stating that an appropriate threshold for limited derivatives users could be whether a fund listed derivatives in its prospectus as a principal investment strategy). Form N-1A requires an open-end fund to disclose its principal investment strategies, including the particular type or types of securities in which the fund principally invests or will invest. *See* Item 9 of Form N-1A. Form N-1A also provides, in part, that "[i]n determining what is a principal investment strategy, consider, among other things, the amount of the Fund's assets expected to be committed to the strategy, the amount of the Fund's assets expected to be placed at risk by the strategy, and the likelihood of the Fund's losing some or all of those assets from implementing the strategy." *See* Instruction 2 to Item 9 of Form N-1A. Form N-2 requires a closed-end fund to concisely describe the fund's investment objectives and policies that will

derivatives in its principal investment strategies should generally be using derivatives less extensively than a fund that does include the use of derivatives as a principal investment strategy. This approach would provide some efficiencies for funds because they already are required to make this disclosure.[287]

This approach would, however, have certain drawbacks. For example, whether a fund's use of derivatives is a principal investment strategy is a facts-and-circumstances-based analysis. Funds that may appear broadly similar could provide different disclosures, leading to less consistency in the application of the derivatives risk management program requirement and in the application of the VaR-based limit on leverage risk.

Taking these considerations into account, we are proposing to look at a uniform metric of a fund's derivatives exposure, rather than at the more fact-specific question of whether a fund views the use of derivatives as a principal investment strategy. We believe the proposed approach should result in more-consistent determinations by funds and would be more appropriate in determining whether a fund should qualify for the limited derivatives user exception.

We request comment on the proposed exposure-based exception.

147. Is it appropriate to permit funds to rely on the limited derivatives user exception if their derivatives exposure does not exceed 10% of their net assets? Why or why not?

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constitute its principal portfolio emphasis, including the types of securities in which the fund invests or will invest principally. *See* Item 8 of Form N-2. The instructions to this item direct the fund to briefly describe the significant investment practices or techniques that the fund employs or intends to employ with several examples, including examples related to derivatives transactions.

[287] *See* ICI Comment Letter III (stating that 92% of the firms surveyed indicated that their firms have funds that list derivatives as a principal investment strategy in their prospectus).

Should we lower or raise the proposed derivatives exposure threshold, for example to 5% or to 15%? Why or why not? Should we lower it to a *de minimis* amount, such as 1% or 3%, and provide that a fund with derivatives exposure below these levels is not required to adopt policies and procedures designed to manage derivatives risk? Should the threshold vary based on whether a fund is an open-end fund, registered closed-end fund, or BDC? If so, why, and which levels would be appropriate for each kind of fund?

148. The derivatives exposure of certain types of transactions may be difficult to calculate or may change rapidly, which may make it difficult for a fund to consistently comply with the limited derivatives user exception. Should we provide that a fund relying on the limited derivatives user exception may not enter into complex or exotic derivatives transactions, whose risks may not be fully reflected in their notional amounts? If so, what kinds of complex or exotic transactions? For example, should we provide that a fund relying on the exception may not enter into complex derivatives transactions, as defined in the 2015 proposal? Should we only permit a fund to have a more-limited amount of derivatives exposure associated with these transactions, such as 1% or 5% of net assets? Why or why not?

149. Should we prescribe how a fund must calculate its notional amounts, or is that term in the proposed rule sufficiently clear? If we should prescribe the calculation, what should we prescribe? For example, in 2015 the Commission proposed to define a derivatives transaction's notional amount to mean, among other things: (1) the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions); or (2)

the principal amount on which payment obligations under the derivatives transaction are calculated. Should we include this definition in rule 18f-4? The 2015 proposal also included specific provisions for calculating a derivatives transaction's notional amount for: (1) derivatives that provide a return based on the leveraged performance of a reference asset; and (2) derivatives transactions for which the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity.[288] Should we include either or both of these provisions in rule 18f-4? Why or why not? Would funds calculate their notional amounts consistently with these provisions even if they were not included in the rule text because the calculations would be consistent with the way market participants determine derivatives transactions' notional amounts?

150. Would funds be able to calculate notional amounts for complex derivatives and, if so, would they reflect the market risk in the transactions? Why or why? If we permit funds to enter into complex derivatives transactions as defined in the 2015 proposal while relying on the limited derivatives user exception, should we require that funds calculate these transactions' notional amounts as the Commission proposed in 2015? That proposal would have provided that the notional amount of a complex derivatives transaction would be the aggregate notional amounts of derivatives transactions (excluding complex derivatives transactions) reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction.

[288] *See* 2015 Proposing Release, *supra* 2, at n.158 and accompanying text.

151. For purposes of determining a fund's derivatives exposure, should the proposed rule treat differently derivatives that create synthetic positions where the fund holds cash and cash equivalents with a value equal to the derivative's notional amount less any posted margin? These transactions may not leverage the fund's portfolio because of the fund's holding cash and cash equivalents equal to the notional amount of the derivatives transaction less any posted margin, rather than investing in additional securities or making other investments. Take, for example, a fund with $100 that posts $20 of initial margin to initiate a long position in a swap contract referencing a market index. If the fund posted cash and cash equivalents as initial margin and maintains the remaining $80 in cash and cash equivalents as well, the fund would have a market exposure that would be similar to having invested the fund's $100 in the stocks composing the index. Such a transaction could, however, present other risks, such as counterparty risk. Because these synthetic transactions may not leverage a fund's portfolio, should we permit a fund to exclude these transactions from its derivatives exposure? Conversely, because they can raise other risks, such as counterparty risks, should they be included in derivatives exposure as proposed?

152. Should the rule define limited derivatives users using an alternative methodology other than the proposed threshold tied to derivatives exposure (or, as discussed below, for funds that use derivatives to hedge currency risks)? Why or why not? For example, should the limited derivatives user exception be defined to include funds that do not disclose the use of derivatives as a principal investment strategy in their prospectuses? Would this disclosure-based exception threshold be over- or under-inclusive? Would it lead to less consistency in the requirement to establish a

derivatives risk management program and comply with a VaR-based limit on leverage risk and potentially create uncertainty for funds as to when they would qualify for the limited user exception? Why or why not? If this could lead to less consistency, would any additional instructions in funds' registration forms, regarding what a fund should disclose as a principal investment strategy in its prospectus, help mitigate this concern, and if so, what should those instructions be? Is it appropriate to tie an exception to the derivatives risk management program requirement and VaR-based limit on fund leverage risk to a prospectus disclosure requirement? Why or why not?

153. Should the condition that a limited derivatives user's derivatives exposure not exceed 10% of the fund's net assets address exceedances and remediation? Why or why not? For example, as noted above, if a fund's derivatives exposure were to exceed 10% of the fund's net assets, the fund would have to promptly reduce its derivatives exposure or establish a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable. Should we provide in rule 18f-4 specific time periods for these actions and, if so, which time periods would be appropriate? As an alternative way to address temporary exceedances, should the rule provide that a fund will be a limited derivatives user if it adopts a policy providing that, under normal circumstances, the fund's derivatives exposure will not exceed 10% of the fund's net assets? If so, what should be considered "normal circumstances"? Would this standard be too subjective such that funds would have substantial derivatives exposures while still qualifying as limited derivatives users? Rather than a policy referring to "normal circumstances," should we require a fund to

disclose in its prospectus that it does not expect its derivatives exposure to exceed 10% of the fund's net assets? Should this disclosure also appear in the fund's annual report?

154. Should we prohibit a fund whose derivatives exposure repeatedly exceeds 10% of net assets from relying on the exception again for a period of time? For example, if a fund were to exceed this limit more than two or three times in a year, should we provide that the fund cannot rely on the limited derivatives user exception for one or two years?

155. In calculating derivatives exposure, should we permit a fund to convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts, as proposed? Would delta adjusting options raise the concern that a fund's delta-adjusted options exposure would be small, allowing a fund to avoid establishing a program, but could quickly grow in response to large price changes in the option's reference asset? How should we address this concern? Should we permit additional adjustments? Why or why not? If so, what additional adjustments should we permit? For example, should we permit funds to adjust notional amounts based on the volatility of the underlying reference assets? Why or why not?

156. The proposed rule provides that, for a fund to operate as a limited derivatives user under the exposure-based prong, the fund's derivatives exposure must not exceed 10% of net assets. The rule does not, however, prescribe the frequency with which funds must calculate their derivatives exposure to evaluate their compliance. Should we require that a fund calculate its notional amounts daily, or at some other specified

frequency? Are there other requirements we should specify regarding a fund's calculation of its derivatives exposure? If so, what are they, and why would these other requirements more accurately address a fund's derivatives exposure?

157. Should we permit a fund to adjust its derivatives exposure for purposes of the proposed exception to account for certain netting and hedging transactions?[289] Why or why not? If so, how should we define netting and hedging transactions for this purpose? How should we prescribe in rule 18f-4 the circumstances under which different derivatives—and particularly derivatives with different reference assets—should be treated as hedged or offsetting? If the rule were to permit funds to exclude hedging or netting transactions from their derivatives exposure, should we require funds to maintain records concerning these transactions to help our staff and fund compliance personnel evaluate if the transactions reasonably could be viewed as hedging or netting? If so, what information should those records reflect? For example, the regulations under section 13 of the Bank Holding Company Act, commonly known as the Volcker Rule, require certain banking entities to maintain certain documentation relating to hedging strategies, including positions and techniques.[290] Should the proposed rule take this or a similar approach? As another example, should we require funds to identify both the asset being hedged or netted and the derivatives transaction used to hedge or net that asset? How should we consider the risk that the historical correlations underlying an adviser's view that assets will have inverse price correlations can break down in times of market stress? How could a standard in the

289 *See* paragraph accompanying *supra* notes 266-267.

290 *See* 17 CFR 255.5(c).

rule be reasonably objective such that funds and our staff could confirm a fund's compliance? Should we permit funds to account for netting but not hedging or vice versa? Why or why not? Would the compliance burden to calculate netting and hedging transactions for purposes of such adjustments justify the benefits of permitting these adjustments? Why or why not? What other challenges could funds face in accounting for netting and hedging transactions that could increase the costs associated with this exercise, or that could negatively affect a fund's ability to assess its derivatives exposure accurately? Could these challenges be mitigated in any way? If so, how?

158. Should we specify in the rule that a fund calculating its derivatives exposure may net any directly-offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms, as we proposed in 2015? Why or why not?

159. In determining a fund's derivatives exposure, or the level of derivatives exposure a fund may obtain while remaining a limited derivatives user, should we consider other types of investments, like structured notes, that have return profiles that are similar to many derivatives instruments? Take, for example, a fund with derivatives exposure exceeding the proposed 10% threshold by 2% that reallocates that 2% of its net asset value from a derivatives instrument to a structured note with a similar return profile. The fund would be a limited derivatives user on the basis that its derivatives exposure was below the threshold, but would present a similar risk profile to its prior portfolio that exceeded the threshold. Are there circumstances where we should require the fund in this example to include the value of the structured note (or similar investment)

in determining its derivatives exposure? If so, which circumstances and what kinds of instruments should be included? As another alternative, should we provide that, when funds that invest in derivatives also invest in structured notes or similar investments, they should be subject to a lower threshold of derivatives exposure to remain a limited derivatives user? If so, what lower level would be appropriate?

2. Currency Hedging Exception

Under the second alternative set of conditions, a fund could rely on the limited derivatives user exception if it limits its use of derivatives transactions to currency derivatives for hedging purposes as specified in the proposed rule.[291] Under this exception, a fund could only use currency derivatives to hedge currency risk associated with specific foreign-currency-denominated equity or fixed-income investments in the fund's portfolio. In addition, the notional amount of the currency derivatives the fund holds could not exceed the value of the instruments denominated in the foreign currency by more than a negligible amount.[292]

The proposed currency hedging exception reflects our view that using currency derivatives solely to hedge currency risk does not raise the policy concerns underlying section 18. While distinguishing most hedging transactions from leveraged or speculative transactions is challenging, we believe that the currency hedging described in the proposed rule is definable because it involves a single risk factor (currency risk) and requires that the derivatives instrument must be tied to specific hedged investments (foreign-currency-denominated securities held by the fund).[293] Although we recognize that most funds that use

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291 *See* proposed rule 18f-4(c)(3)(ii).

292 *Id*.

293 Many hedges are imperfect, which makes it difficult to distinguish purported hedges from

derivatives do not use them solely to hedge currency risks, these currency hedges are not intended to leverage the fund's portfolio, and conversely could mitigate potential losses.[294]

We also recognize that certain funds hedge all of the foreign currency risk associated with their foreign securities investments. A fund that invests all or substantially all of its assets in foreign securities and currency derivatives to hedge currency risks associated with the foreign securities necessarily would have derivatives exposure exceeding 10% of net asset value. This is because such a fund could have derivatives exposure up to approximately 100% of the fund's net assets to hedge the risks associated with all of its foreign security investments. We therefore are proposing a separate basis for the limited derivatives user exception for currency hedging because certain funds that hedge currency risks would be unable to qualify for the exposure-based limited derivatives user exception discussed above.

Rather than proposing two alternative bases to qualify for the limited derivatives user exception, we considered permitting a fund to qualify as a limited derivatives user if its derivatives exposure does not exceed 10% of net assets, excluding any currency hedges as discussed above. We are not taking this combined approach, however, to preclude a fund that is operating as a limited derivatives user from engaging in a broad range of derivatives transactions that may raise risks that we believe should be managed through a derivatives management program and subject to the proposed VaR-based limit on fund leverage risk.

We request comment on the proposed currency hedging exception.

160. Is the proposed currency risk hedging exception appropriate? Why or why not?

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leveraged or speculative exposures. *See* 2015 Proposing Release, *supra* 2, at n.238 and accompanying text.

[294] *See infra* section III.C.3 (discussing the number of funds whose current derivatives transactions practices would qualify them for the currency hedging exception).

Should we modify the proposed exception in any way? Why or why not? For example, should we limit the derivatives exposure of a fund that relies on the currency hedging exception, and if so, what should be that exposure threshold? Should we prescribe the kinds of currency derivatives that a fund may use while relying on the exception? If so, which derivatives should be permitted and which should be prohibited and why? Should the rule refer to other foreign-currency-denominated assets in addition to equity or fixed-income investments? For example, do funds hedge holdings of foreign currencies themselves in addition to foreign-currency-denominated investments?

161. Are there other types of derivatives that funds use that are less likely to raise the policy concerns underlying section 18? If so, which derivatives, and how do funds use them? For instance, we are aware that funds use interest rate derivatives to hedge interest rate risk arising from fixed income investments in their portfolios. Should we modify the proposed hedging-based exception to also include interest rate derivatives that funds use for hedging purposes? Why or why not? If so, what challenges could funds encounter in identifying interest rate derivatives that are used for hedging purposes (instead of for speculation or to accomplish leveraging)? How could we define interest rate hedging in rule 18f-4 in a way that would allow hedging transactions while not permitting transactions that simply are speculating on the direction of interest rates? How could conditions in the rule help identify interest rate derivatives that funds use for "true" hedging? For example, should we require that any interest rate derivative that is treated as a hedge be tied to specific fixed-income securities or groups of specific fixed-income securities in the fund's portfolio? This

would be analogous to the proposed nexus between a fund's currency derivatives and the fund's hedged foreign-currency-denominated investments. Should we similarly allow a fund to treat as a hedging transaction an interest rate derivative that converts a fund's fixed rate borrowings to floating rate borrowings or vice versa? To what extent do funds engage in these transactions? For funds that do engage in these transactions, how large are the notional amounts of these transactions, in ten-year bond equivalents, as a percentage of the fund's net assets?

162. Should the rule address what happens if a fund using currency derivatives exceeds the notional amount of the value of the instruments denominated in a foreign currency by more than a negligible amount? If so, how should we address exceedances? Should we provide further guidance on what a negligible amount would be? For example, should we provide guidance or provide in rule 18f-4 that exceedances of 1% or 2%, for example, would be negligible?

163. Should we permit funds that rely on the first alternative set of limited derivatives user conditions (limiting their derivatives exposure to 10% of net assets) to deduct the notional amounts of their currency derivatives used for hedging purposes when calculating their derivatives exposure for purposes of the proposed exception? Why or why not? Should we allow funds to rely on both exceptions at the same time, instead of the exceptions being alternatives? If the exceptions were combined, could that result in funds relying on the limited derivatives user exception developing larger and potentially more complex derivatives portfolios that that may raise risks more appropriately managed through a derivatives management program and subject to the proposed VaR-based limit on fund leverage risk? Why or why not?

3. Risk Management

A fund relying on the limited derivatives user exception would be required to manage the risks associated with its derivatives transactions by adopting and implementing policies and procedures that are reasonably designed to manage the fund's derivatives risks.[295] The requirement that funds relying on the exception manage their derivatives risks recognizes that even a limited use of derivatives can present risks that should be managed.

For example, a fund that uses derivatives solely to hedge currency risks would not be introducing leverage risk, but could still introduce other risks, including counterparty risk and the risk that a fund could be required to sell its investments to meet margin calls. As another example, certain derivatives, and particularly derivatives with non-linear or path-dependent returns, may pose risks that require monitoring even when the derivatives represent a small portion of net asset value. For example, because of the non-linear payout profiles associated with put and call options, changes in the value of the option's underlying reference asset can increase the option's delta, and thus the extent of the fund's derivatives exposure from the option. An options transaction that represented a small percentage of a fund's net asset value can rapidly increase to a larger percentage.

The proposed rule would require funds relying on the limited derivatives user exception to adopt and implement policies and procedures reasonably designed to manage the funds' derivatives risks. Because they would be reasonably designed to address each fund's derivatives risks, these policies and procedures would reflect the extent and nature of a fund's use of

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[295] *See* proposed rule 18f-4(c)(3); *see also* proposed rule 18f-4(a) (definition of "derivatives risks") and *supra* note 118 and accompanying text (discussing the proposed definition of "derivatives risks").

derivatives within the parameters provided in the exception. For example, a fund that uses derivatives only occasionally and for a limited purpose, such as to equitize cash, could have limited policies and procedures commensurate with this limited use. A fund that uses more complex derivatives with derivatives exposure approaching 10% of net asset value, in contrast, would need to have policies and procedures tailored to the risks these derivatives could present. These policies and procedures could be more extensive and could include elements similar to those required under the proposed derivatives risk management program.

The 2015 proposal would have required funds relying on that proposal's exception to the derivatives risk management program requirement to manage derivatives risks by determining (and maintaining certain assets to cover) a "risk-based coverage amount" associated with the fund's derivatives. This amount represented an estimate of the amount the fund would expect to pay to exit the derivatives transaction under stressed conditions.

The approach we are proposing here is designed to require a fund relying on the limited derivatives user exception to manage all of the risks associated with its derivatives transactions, and not just the risks that an asset segregation requirement could address.[296] Moreover, our proposal is designed to limit derivatives risks by limiting the extent to which a fund can use derivatives while relying on the exception. As discussed above, the 2015 proposal would have permitted funds to obtain substantially greater derivatives exposure—up to 50% of net assets—without establishing a derivatives risk management program. On balance, we believe that the proposed bases for the limited derivatives user exception, together with the requirement that a fund manage any risks its limited use of derivatives presents, would provide both important

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296 We discuss the limitations of an asset segregation requirement in section II.F below.

investor protections and flexibility for funds to use derivatives in a way that is consistent with the policy concerns underlying section 18.

We request comment on the proposed requirement that a fund relying on the limited derivatives user exception manage the risks associated with its derivatives transactions by adopting policies and procedures that are reasonably designed to manage its derivatives risks.

164. Is it appropriate to require funds relying on the limited derivatives user exception to adopt policies and procedures that are reasonably designed to manage their derivatives risks, in lieu of requiring such a fund to adopt a derivatives risk management program that includes all of the proposed program elements and comply with the proposed VaR-based limit on fund leverage risk? Would this requirement effectively address the risks entailed by the levels and types of derivatives use in which a fund that qualifies for the proposed exception might engage?

165. Alternatively, should funds eligible for the proposed limited derivatives user exception be subject to a tailored version of the proposed program requirement (*e.g.*, a program requirement that would specify only certain elements, such as risk identification and assessment, establishing risk guidelines, stress testing, etc.)? If so, if so what should this entail?

166. Either in addition to or in lieu of policies and procedures reasonably designed to manage a fund's derivatives risk, should we require funds relying on the limited derivatives user exception to comply with an asset segregation requirement? Should we use the same approach we proposed in 2015? Should we use that approach but allow funds to segregate a broader range of assets, such as the assets with corresponding haircuts analyzed in the 2016 DERA Memo?

167. Should we require limited derivatives users to publicly disclose that they are limited derivatives users in their prospectus, annual report, or on their website? If so, should we require any particular disclosure to enhance investors' understanding of, for example: (1) the risks of investing in a fund that qualifies as a limited derivatives user under the proposed rule, or (2) such a fund's derivatives risk management practices?

F. Asset Segregation

The Commission and staff have historically taken the position that a fund may appropriately manage the risks that section 18 is designed to address if the fund "covers" its obligations in connection with various transactions by maintaining "segregated accounts."[297] Funds' practices regarding the amount of "cover" they segregate, and the assets available for segregation, have evolved over time. In addition, different funds have applied those practices in varying ways to derivatives transactions with comparable economic exposures. Moreover, regulatory and contractual margin requirements have developed significantly since the adoption of Release 10666.

The 2015 proposal drew on the Commission's historical approach—and sought to primarily address the Investment Company Act's asset sufficiency concern—by including an asset segregation requirement as part of the 2015 proposed rule.[298] Under the Commission's 2015 proposed approach, a fund relying on the proposed rule, in addition to complying with one of two portfolio limitations, would have had to maintain an amount of "qualifying coverage assets" designed to enable a fund to meet its derivatives-related obligations. Under the 2015 proposed rule, a fund would not have been required to segregate a derivative's full notional

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[297] *See supra* section I.B.2.

[298] *See* 2015 Proposing Release *supra* note 2, at section III.C.

amount, but instead would have had to segregate qualifying coverage assets (generally cash and cash equivalents) equal to the sum of two amounts: (1) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination (the "mark-to-market coverage amount"), and (2) a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount").[299]

Although commenters generally supported the overarching framework of the 2015 proposed rule's asset segregation requirement, they identified several operational complexities. For example, commenters stated that additional clarity was necessary for funds to determine risk-based coverage amounts, including how funds should determine stressed conditions for this purpose.[300] Commenters also raised questions about how funds could reduce segregated amounts to account for posted initial or variation margin and, more generally, how rule provisions governing coverage amounts would apply to cleared transactions (as opposed to OTC transactions covered by netting agreements).[301] A number of commenters also expressed

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[299] *See id*. at section III.C.2 (discussing the composition of qualifying coverage assets as either: (1) cash and cash equivalents, or (2) 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).

[300] *See, e.g.,* ICI Comment Letter I; BlackRock Comment Letter; Dechert Comment Letter; FSR Comment Letter; Guggenheim Comment Letter.

[301] *See, e.g.,* SIFMA Comment Letter (stating that "[i]n practice, variation margin and initial margin are often calculated in the aggregate, on a net basis, rather than separately" and recommending that funds "be able to get credit for both initial and variation margin posted on a net basis …" rather than limiting the type of coverage amount against which initial or variation margin may be credited); BlackRock Comment Letter (stating that initial and variation margin are used for cleared and OTC derivatives transactions by the clearinghouse and counterparties, respectively, when a derivatives transaction is exited and that distinguishing between the uses of the two types of margin will introduce complexity given that both forms of margin are available to cover potential obligations under derivatives in the event of a party's default).

concerns about the proposed requirement that funds generally segregate cash and cash equivalents.[302] Commenters suggested alternatives to this proposed requirement, including allowing funds to segregate a broader range of assets subject to "haircuts" prescribed by the Commission based on the relative volatility of different asset classes.[303]

Our proposal does not include a specific asset segregation requirement because we do not believe that an asset segregation requirement is necessary in light of the proposed rule's requirements, including the requirements that funds establish risk management programs and comply with the proposed VaR-based limit on fund leverage risk. As discussed in more detail above, a fund relying on proposed rule 18f-4 would be required to adopt and implement a written derivatives risk management program that, among other things, would require the fund to: identify and assess its derivatives risks; put in place guidelines to manage these risks; stress test the fund's portfolio at least weekly; and escalate material risks to the fund's portfolio managers and, as appropriate, the board of directors.[304] These proposed requirements are designed to require a fund to manage all of the risks associated with its derivatives transactions. These include—but are not limited to—the risk that a fund may be required to sell its investments to generate cash to pay derivatives counterparties, which the 2015 proposal's asset segregation was designed to address.

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302 *See, e.g.*, AIMA Comment Letter; AQR Comment Letter; BlackRock Comment Letter; Dechert Comment Letter; Comment Letter of Eaton Vance Management (Mar. 28, 2016) ("Eaton Vance Comment Letter"); Guggenheim Comment Letter; Comment Letter of JPMorgan (Mar. 28, 2016); Oppenheimer Comment Letter; PIMCO Comment Letter.

303 *See, e.g.*, Dechert Comment Letter; Eaton Vance Comment Letter; IAA Comment Letter; SIFMA Comment Letter, Guggenheim Comment Letter.

304 Proposed rule 18f-4(c)(1). Funds that rely on the limited derivatives user exception also would be required to manage the risks associated with their more limited use of derivatives. *See supra* section II.E.

Moreover, the proposed rule would require that a fund's stress testing for purposes of its derivatives management program specifically take into account the fund's payments to derivatives counterparties that could result from losses in stressed conditions. Rather than require a fund to evaluate the amounts it would pay to exit derivatives transactions under stressed conditions on a transaction-by-transaction basis as in the 2015 proposal,[305] our proposal would require funds to conduct portfolio-wide stress tests, taking into account potential payments to counterparties. Although counterparties often require funds to post margin or collateral for individual transactions (or groups of transactions) in order to cover potential loss exposure, the proposed rule's stress testing requirement is designed to provide a portfolio-wide assessment of how the fund may respond to stressed conditions and any resulting payment obligations. This portfolio-wide assessment also would be buttressed by the other provisions in the risk management program and the proposed VaR-based limit on fund leverage risk, which are designed to limit a fund's leverage risk and therefore the potential for payments to derivatives counterparties. The 2015 proposal's derivatives risk management program, in contrast, did not include such a portfolio-wide assessment. We believe that the proposed rule's requirements, in their totality, would appropriately address the asset sufficiency risks underlying section 18.

A separate asset segregation requirement, in contrast, may be less effective. As derivatives markets evolve, questions may arise about the amount (and composition) of assets that funds must segregate for novel types of transactions. Although the Commission in 2015 sought to take a principles-based approach to the amount of assets that funds would segregate,

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[305] In the 2015 proposal, funds were required to determine qualifying coverage assets on a transaction-by-transaction basis, with the exception that funds could determine the amount of qualifying coverage assets on a net basis for derivatives transactions covered by netting agreements. *See* 2015 proposed rule 18f-4(c)(6) and (9).

many commenters asserted that additional clarity would be necessary to administer this approach. It would be difficult in this context for the Commission to specify the amount of assets that funds should segregate on a transaction-by-transaction basis and to keep any specific requirements current as markets develop. And a principles-based approach to asset segregation, if it does not provide sufficient clarity, may contribute to the kinds of divergent asset segregation practices that exist today, which in turn have led to situations in which funds are not subject to a practical limit on potential leverage that they may obtain through derivatives transactions.[306] By building on current risk management practices and techniques, including VaR and stress testing, the proposed rule is designed to provide a framework that we believe funds can apply to a broad variety of fund types and derivatives uses without our having to specify the operational details that an asset segregation requirement would entail.

We request comment on our proposal not to include a specific asset segregation requirement.

168. Do commenters believe that the proposed rule's requirements discussed above, in their totality, would appropriately address the asset sufficiency risks underlying section 18? If not and commenters believe rule 18f-4 should include an asset segregation requirement, what should that requirement entail? What added benefits would an asset segregation requirement provide that the current proposed rule requirements would not?

169. Should we require funds relying on the limited derivatives user exposure-based exception to segregate assets for purposes of the exception? Why or why not? Would

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306 *See supra* sections I.B.2 and I.B.3.

an asset segregation requirement for such limited derivatives users obviate any need for a policies and procedures requirement? Why or why not?

170. Commenters in the 2015 release requested further clarity about the Commission's 2015 proposal to require a principles-based asset segregation regime. What aspect of that proposal required further clarity and why?

G. Alternative Requirements for Certain Leveraged/Inverse Funds and Proposed Sales Practices Rules for Certain Leveraged/Inverse Investment Vehicles

1. Background on Proposed Approach to Certain Leveraged/Inverse Funds

Proposed rule 18f-4 would include an alternative approach for certain funds that seek to provide leveraged or inverse exposure to an underlying index, generally on a daily basis. This alternative approach would be available for a registered investment company that is a "leveraged/inverse investment vehicle," as that term is defined in proposed Exchange Act rule 15*l*-2 and proposed Advisers Act rule 211(h)-1 (which we refer to collectively as the proposed "sales practices rules," as noted above). As discussed below, the proposed sales practices rules would require broker-dealers and investment advisers to engage in due diligence before accepting or placing an order for a customer or client that is a natural person ("retail investor") to trade a leveraged/inverse investment vehicle, or approving a retail investor's account for such trading. The definition of the term "leveraged/inverse investment vehicle" in the proposed sales practices rules would include certain entities that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.[307] The entities included in the proposed scope of the sales practices rules would include registered investment companies and certain exchange-listed commodity- or currency-based trusts or funds. In this release, we refer to the registered investment companies covered by the proposed sales practices rules as "leveraged/inverse funds" (which in turn would be subject to the proposed alternative approach under rule 18f-4). We use the proposed sales practices rules' defined term "leveraged/inverse investment vehicle" to refer to both such leveraged/inverse funds and to the exchange-listed commodity- or currency-based trusts or funds covered by those rules.

Leveraged/inverse funds, which today are structured primarily as leveraged/inverse ETFs, seek to amplify the returns of an underlying index by a specified multiple or to profit from a decline in the value of their underlying index over a predetermined period of time using financial derivatives.[308] These funds reset periodically and are designed to hedge against or profit from short-term market movements without using margin, and, as such, are generally intended as

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[307] *See* proposed rules 15*l*-2(d) and 211(h)-1(d) (defining the term "leveraged/inverse investment vehicle"); *see also, e.g.*, ETFs Adopting Release, *supra* note 76, at section II.A.3; rule 6c-11(c)(3) under the Investment Company Act.

[308] *See infra* section III.B for baseline statistics regarding leveraged/inverse ETFs and mutual funds. Leveraged/inverse ETFs operate under Commission orders providing exemptive relief from certain provisions of the Investment Company Act. These orders, however, do not provide exemptive relief from section 18 of the Investment Company Act. Rather, like other funds that use derivative investments, leveraged/inverse ETFs rely upon Release 10666 and operate consistent with the conditions in staff no-action letters and other staff guidance on derivatives transactions. *See infra* section II.L (discussing our proposal to rescind Release 10666, and stating that staff in the Division of Investment Management is reviewing certain of its no-action letters and other guidance to determine which letters and other staff guidance should be withdrawn in connection with any adoption of this proposal).

The Commission recently adopted rule 6c-11 under the Investment Company Act to permit ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the Commission. Rule 6c-11 includes a provision excluding leveraged/inverse ETFs from the scope of that rule. *See infra* section II.G.4 (discussing proposed amendments to rule 6c-11 and proposed rescission of exemptive orders issued to leveraged/inverse ETFs).

short-term trading tools.[309] To achieve their targeted returns, leveraged/inverse funds use derivatives extensively. In contrast to other funds that use derivatives as part of their broader investment strategy, leveraged/inverse funds' strategies (and use of derivatives) are predicated on leverage. Accordingly, leveraged/inverse funds raise the issues that section 18 of the Investment Company Act is designed to address.

Leveraged/inverse funds and certain commodity pools following the same strategy also present unique considerations because they rebalance their portfolios on a daily (or other predetermined) basis in order to maintain a constant leverage ratio. This reset, and the effects of compounding, can result in performance over longer holding periods that differs significantly from the leveraged or inverse performance of the underlying reference index over those longer holding periods.[310] This effect can be more pronounced in volatile markets.[311] As a result, buy-and-hold investors in a leveraged/inverse fund who have an intermediate or long-term time horizon—and who may not evaluate their portfolios frequently—may experience large and

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309 *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)], at text preceding n.39 ("Fiduciary Interpretation").

310 For example, as a result of compounding, a leveraged/inverse fund can outperform a simple multiple of its index's returns over several days of consistently positive returns, or underperform a simple multiple of its index's returns over several days of volatile returns.

311 *See* FINRA Regulatory Notice 09-31, Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds (June 2009) ("FINRA Regulatory Notice 09-31") ("Using a two-day example, if the index goes from 100 to close at 101 on the first day and back down to close at 100 on the next day, the two-day return of an inverse ETF will be different than if the index had moved up to close at 110 the first day but then back down to close at 100 on the next day. In the first case with low volatility, the inverse ETF loses 0.02 percent; but in the more volatile scenario the inverse ETF loses 1.82 percent. The effects of mathematical compounding can grow significantly over time, leading to scenarios such as those noted above.").

unexpected losses or otherwise experience returns that are different from what they anticipated.[312]

The Commission's Office of Investor Education and Advocacy and FINRA have issued alerts in the past decade to highlight issues investors should consider when investing in leveraged/inverse funds.[313] In addition, some commenters to the 2015 proposal indicated that at least some segment of investors may hold leveraged/inverse funds for long periods of time, which can lead to significant losses under certain circumstances.[314] FINRA has sanctioned a

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312 *See id.* (reminding member firms of their sales practice obligations relating to leveraged/inverse ETFs and stating that leveraged/inverse ETFs are typically not suitable for retail investors who plan to hold these products for more than one trading session). *See also* Fiduciary Interpretation, *supra* note 308 (stating that "leveraged exchange-traded products are designed primarily as short-term trading tools for sophisticated investors … [and] require daily monitoring ...."); Securities Litigation and Consulting Group, *Leveraged ETFs, Holding Periods and Investment Shortfalls*, (2010), at 13 ("The percentage of investors that we estimate hold [leveraged/inverse ETFs] longer than a month is quite striking."); ETFs Adopting Release, *supra* note 76, at n.78 (discussing comment letters submitted by Consumer Federation of America (urging the Commission to consider additional investor protection requirements for leveraged/inverse ETFs) and by Nasdaq (stating that "there is significant investor confusion regarding existing leveraged/inverse ETFs' daily investment horizon")).

313 SEC Investor Alert and Bulletins, *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors* (Aug. 1, 2009), *available at* http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm. This investor alert, jointly issued by SEC staff and FINRA, followed FINRA's June 2009 alert, which raised concerns about retail investors holding leveraged/inverse ETFs over periods of time longer than one day. *See* FINRA Regulatory Notice 9-31, *supra* note 310.

314 *See, e.g.,* CFA Comment Letter ("There is evidence that suggests investors are incorrectly using certain alternative investments that use derivatives extensively. For example, despite the fact that double and triple leveraged ETFs are short-term trading vehicles that are not meant to be held longer than one day, a significant number of shares are held for several days, if not weeks."). *But cf.* Comment Letter of Rafferty Asset Management (Mar. 28, 2016) (asserting that there is no evidence that investors do not understand the leveraged/inverse ETF product, citing, for example, an analysis of eight of its leveraged/inverse ETFs between May 1, 2009 and July 31, 2015, and finding an average implied holding period ranging from 1.18 days to 4.03 days and suggesting, therefore, that investors understand the products are designed for active trading). We note, however, that the analysis relied upon in the Comment Letter of Rafferty Asset Management did not analyze shareholder-level trading activity or provide any information on the distribution of shareholder holding periods.

number of brokerage firms for making unsuitable sales of leveraged/inverse ETFs.[315] More recently, the Commission has brought enforcement actions against investment advisers for, among other things, soliciting advisory clients to purchase leveraged/inverse ETFs for their retirement accounts with long-term time horizons, and holding those securities in the client accounts for months or years.[316]

Most leveraged/inverse funds could not satisfy the limit on fund leverage risk in proposed rule 18f-4 because they provide leveraged or inverse market exposure exceeding 150% of the return or inverse return of the relevant index.[317] These funds therefore would fail the relative

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315 *See* FINRA News Release, *FINRA Sanctions Four Firms $9.1 Million for Sales of Leveraged and Inverse Exchange-Traded Funds* (May 1, 2012), *available at* https://www.finra.org/newsroom/2012/finra-sanctions-four-firms-91-million-sales-leveraged-and-inverse-exchange-traded; FINRA News Release, *FINRA Orders Stifel, Nicolaus and Century Securities to Pay Fines and Restitution Totaling More Than $1 Million for Unsuitable Sales of Leveraged and Inverse ETFs, and Related Supervisory Deficiencies* (Jan. 9, 2014), *available at* https://www.finra.org/newsroom/2014/finra-orders-stifel-nicolaus-and-century-securities-pay-fines-and-restitution-totaling; FINRA News Release, *FINRA Sanctions Oppenheimer & Co. $2.9 Million for Unsuitable Sales of Non-Traditional ETFs and Related Supervisory Failures* (June 8, 2016), *available at* http://www.finra.org/newsroom/2016/finra-sanctions-oppenheimer-co-29-million-unsuitable-sales-non-traditional-etfs. *See also* ProEquities, Inc., FINRA Letter of Acceptance, Waiver and Consent ("AWC") No. 2014039418801 (Aug. 8, 2016), *available at* http://disciplinaryactions.finra.org/Search/ViewDocument/66461; Citigroup Global Markets Inc., FINRA Letter of AWC No. 20090191134 (May, 1, 2012), *available at* http://disciplinaryactions.finra.org/Search/ViewDocument/31714. *See also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 FR 33318 (July 12, 2019)], at paragraph accompanying nn.593-98 ("Regulation Best Interest: The Broker-Dealer Standard of Conduct").

See also, e.g., *S.E.C. v. Hallas*, No 1:17-cv-2999 (S.D.N.Y. Sept. 27, 2017) (default judgement); *In the Matter of Demetrios Hallas*, S.E.C. Release No. 1358 (Feb. 22, 2019) (initial decision), Exchange Act Release No 85926 (May 23, 2019) (final decision) (involving a former registered representative of registered broker-dealers purchasing and selling leveraged ETFs and exchange-traded notes for customer accounts while knowingly or recklessly disregarding that they were unsuitable for these customers, in violation of section 17(a) of the Securities Act and section 10(b) and rule 10b-5 thereunder of the Exchange Act).

316 *See, e.g.*, In the Matter of Morgan Stanley Smith Barney, LLC, Investment Advisers Act Release No. 4649 (Feb. 14, 2017) (settled action).

317 *See supra* section II.D (discussing the proposed VaR-based limit on fund leverage risk).

VaR test and would not be eligible to use the absolute VaR test.[318] Requiring these funds to comply with the proposed VaR tests therefore effectively would preclude sponsors from offering the funds in their current form. Investors who are capable of evaluating these funds' characteristics and their unique risks, however, may want to use them to meet specific short-term or other investment goals. We therefore are proposing a set of alternative requirements for leveraged/inverse funds designed to address the investor protection concerns that underlie section 18 of the Investment Company Act, while preserving choice for these investors. These requirements, discussed below, are designed to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating the risks these products present. They also would limit the amount of leverage that leveraged/inverse funds subject to rule 18f-4 can obtain to their current levels.

2. Proposed Sales Practices Rules for Leveraged/Inverse Investment Vehicles

As a complement to proposed rule 18f-4, we are proposing sales practices rules under the rulemaking authority provided in Exchange Act section 15(*l*)(2) and Advisers Act section 211(h).[319] The proposed sales practices rules would require broker-dealers and investment advisers to exercise due diligence on retail investors before approving retail investor accounts to invest in leveraged/inverse investment vehicles. Specifically, proposed rule 15*l*-2 under the Exchange Act would require a broker-dealer (or any associated person of the broker-dealer) to

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318 *See supra* section II.D (discussing relative and absolute VaR tests under proposed rule 18f-4). In addition, we understand that even if leveraged/inverse funds were to apply the proposed absolute VaR test, many of those funds also would fail that test.

319 These provisions provide the Commission with authority to "where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

exercise due diligence to ascertain certain essential facts about a customer who is a retail investor before accepting the customer's order to buy or sell shares of a leveraged/inverse investment vehicle, or approving the customer's account to engage in those transactions.[320] Similarly, proposed rule 211(h)-1 under the Advisers Act would require an investment adviser (or any supervised person of the investment adviser) to exercise due diligence to ascertain the same set of essential facts about a client who is a retail investor before placing an order for that client's account to buy or sell shares of a leveraged/inverse investment vehicle, or approving the client's account to engage in those transactions.[321] Under both of the proposed sales practices rules, a firm could approve the retail investor's account to buy or sell shares of leveraged/inverse investment vehicles only if the firm had a reasonable basis to believe that the investor is capable of evaluating the risks associated with these products.

The proposed sales practices rules are designed to establish a single, uniform set of enhanced due diligence and approval requirements for broker-dealers and investment advisers with respect to retail investors that engage in leveraged/inverse investment vehicle transactions, including transactions where no recommendation or investment advice is provided by a firm. These rules therefore would apply the same due diligence requirements to both broker-dealers and investment advisers.[322] They are designed to help ensure that investors in these funds are

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320 Proposed rule 15*l*-2(a). In this release, the term "firm," which collectively refers to Commission-registered broker-dealers and investment advisers, also includes associated persons of such broker-dealers.

321 Proposed rule 211(h)-1(a). In this release, the term "firm," which collectively refers to Commission-registered broker-dealers and investment advisers, also includes supervised persons of such investment advisers.

322 Although we expect that the proposed sales practices rules would cover a significant percentage of the retail investors who invest in leveraged/inverse investment vehicles, we recognize that not every purchase or sale of a leveraged/inverse investment vehicle will involve a customer or client

limited to those who are capable of evaluating their characteristics—including that the funds would not be subject to all of the leverage-related requirements applicable to registered investment companies generally—and the unique risks they present. Compliance with the proposed rules would not supplant or by itself satisfy other broker-dealer or investment adviser obligations, such as a broker-dealer's obligations under Regulation Best Interest or an investment adviser's fiduciary duty under the Advisers Act.[323]

The approval and due diligence requirements under the proposed rules are modeled after current FINRA options account approval requirements for broker-dealers.[324] Under the FINRA rules governing options, a broker-dealer may not accept a customer's options order unless the broker-dealer has approved the customer's account for options trading.[325] Similarly, the proposed sales practices rules would require that a firm approve a retail investor's account before the retail investor may invest in leveraged/inverse investment vehicles. As such, the proposed sales practices rules, like the FINRA rule, would not require firms to evaluate retail investors' eligibility to transact in these products on a transaction-by-transaction basis. We have generally modeled the proposed rules after the FINRA options account framework in part because

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of a Commission-registered broker-dealer or investment adviser that would be subject to the proposed sales practices rules.

323 *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, *supra* note 314 (discussing broker-dealer obligations when providing a recommendation to a retail customer of any securities transaction or investment strategy involving securities based on the customer's investment profile); Fiduciary Interpretation, *supra* note 308 (discussing an investment adviser's fiduciary duty to its client, and stating that as fiduciaries, investment advisers owe their clients duties of care and loyalty).

324 *See*, *e.g.*, FINRA rule 2360(b)(16), (17) (requiring for options accounts, firm approval, diligence and recordkeeping).

325 FINRA rule 2360(b)(16). The same requirements apply for transactions in index warrants, currency index warrants, and currency warrants. *See* FINRA rules 2352 and 2353. Similar requirements apply for transactions in security futures. *See* FINRA rule 2370(b)(16) (requiring broker-dealer approval and diligence regarding the opening of accounts to trade security futures).

leveraged/inverse investment vehicles, when held over longer periods of time, may have certain similarities to options.[326] The options account approval requirements also represent a current framework that can be used in connection with complex products generally.[327] This approach may provide some efficiencies and reduced compliance costs for broker-dealers that already have compliance procedures in place for approving options accounts, although we recognize that these efficiencies and reduced compliance costs would not apply to investment advisers that are not dually registered as, or affiliated with, broker-dealers subject to FINRA rules.

a. Definition of Leveraged/Inverse Investment Vehicle

The proposed sales practices rules would define a "leveraged/inverse investment vehicle" to mean a registered investment company or an exchange-listed commodity- or currency-based trust or fund (a "listed commodity pool"), that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.[328] Although the scope of this definition extends beyond just ETFs (as defined in rule 6c-11), this definition otherwise is substantively identical to the provision in rule 6c-11 excluding leveraged/inverse ETFs from the scope of that rule. The

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326 For example, both leveraged/inverse investment vehicles and options provide exposure that is economically equivalent to a dynamically rebalanced inverse or leveraged position in an underlying asset. As a result, both have return characteristics that are more complex than those of the underlying asset, particularly as a leveraged/inverse investment vehicle's leverage multiple and/or holding period increase. *See infra* section III.B.5.

327 *See* FINRA Regulatory Notice 12-03 (providing, among other things, that FINRA members "should consider prohibiting their sales force from recommending the purchase of some complex products to retail investors whose accounts have not been approved for options trading").

328 *See* proposed rule 15*l*-2(d) and proposed rule 211(h)-1(d).

substantive requirements in the proposed definition in the sales practices rules have the same meaning as the provision in rule 6c-11.[329]

We believe it is appropriate for the scope of the proposed sales practices rules to include leveraged/inverse funds as well as listed commodity pools that follow a similar leveraged or inverse strategy. The same investor protection concerns regarding aligning firms' transaction practices with investors' capability of evaluating the risks of these trading tools apply to this broader category of leveraged/inverse investment vehicles, and not just leveraged/inverse funds specifically.[330] Indeed, we understand that leveraged/inverse funds and listed commodity pools following the same strategy can have virtually identical investment portfolios. Applying the proposed rule to all leveraged/inverse investment vehicles, as defined in the proposed rules, would avoid potential regulatory arbitrage that could result if we were to place different requirements on these products.

We request comment on the definition of the term "leveraged/inverse investment vehicle" in the proposed sales practices rules.

171. Is the scope of the proposed definition of the term "leveraged/inverse investment

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329 *See* rule 6c-11(c)(4) (providing that scope of rule 6c-11 does not include ETFs that "seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time."). *See also* ETFs Adopting Release, *supra* note 76, at section II.A.3 (discussing rule 6c-11(c)(4)).

330 The definition of commodity- or currency-based trusts or funds that we propose to include in the leveraged/inverse investment vehicle definition tracks a definition recently provided by Congress in the Fair Access to Investment Research Act of 2017, Public Law No. 115-66, 131 Stat. 1196 (2017) (the "FAIR Act"), which we understand includes the kinds of commodity pools that generally pursue leveraged or inverse investment strategies. Our proposed definition differs from the FAIR Act definition because it would not include a trust or fund that holds only commodities or currencies and does not hold derivatives. Because we believe that trusts or funds that seek to provide a leveraged or inverse return of an index generally would use derivatives to do so, we do not believe it is necessary to include trusts or funds that do not hold derivatives in the proposed definition in the sales practices rules.

vehicle" appropriate? The definition includes a fund that seeks to provide investment returns that have an inverse relationship to the performance of a market index. Do commenters agree that this is appropriate? Should the definition instead only include an inverse fund that seeks investment returns that exceed the inverse performance of a market index by a specified multiple (*e.g.*, -1.5 or lower)? Why or why not? The definition also includes a fund that seeks to provide performance results "over a predetermined period of time." Do commenters agree that this is appropriate? Generally, the extent to which a fund's performance can be expected to deviate from the multiple or inverse multiple of the performance of its index when held over longer periods is larger for funds that track a multiple or inverse multiple of the performance of an index over shorter time intervals, as those funds typically rebalance their portfolios more frequently. Should we specify a time period in the definition and, if so, what time period would be appropriate? For example, should the definition only include a fund that seeks investment returns that correspond to a multiple or inverse multiple of an index over a fixed period of time that is less than a year, a quarter, or a month? Please explain.

172. Do commenters agree with our proposal to include listed commodity pools within the definition? Are we correct that the similarities between the investment strategies and return profiles of listed commodity pools and other leveraged/inverse investment vehicles, such as leveraged/inverse ETFs, warrant including listed commodity pools within the scope of this definition?

173. Are there other types of investments or products that we should include in the leveraged/inverse investment vehicle definition? For example, should we include

exchange-traded notes within the scope of the proposed sales practices rules if they have the same or similar return profile as the leveraged/inverse funds and listed commodity pools included in the proposed definition?[331] Are there additional complex financial products, such as those discussed in FINRA Regulatory Notice 12-03 (including, among others, certain structured or asset-backed notes, unlisted REITs, securitized products, and products that offer exposure to stock market volatility), that commenters believe should be subject to the due diligence and account approval requirements that we are proposing for leveraged/inverse investment vehicles?[332]

b. Required Approval and Due Diligence in Opening Accounts

Under the proposed sales practices rules, no firm may accept an order from or place an order for a retail investor to buy or sell shares of a leveraged/inverse investment vehicle, or approve such a retail investor's account to engage in those transactions, unless the firm has complied with certain conditions. Specifically, the proposed rules would require the firm to (1) approve the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement; and (2) adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rules.

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331 The Commission also recently brought and settled an enforcement action against a dually-registered broker-dealer/investment adviser, certain of its supervisory personnel, and one of its registered representatives arising out of that representative's recommending that his customers buy and hold leveraged and inverse exchange-traded funds and exchange traded notes (including allegations that the registered representative recommended that his customers hold a triple-leveraged exchange-traded note for longer than the one-day holding period set forth in the product's prospectus). *See* In the Matter of Cadaret Grant, *et al.*, Exchange Act Release No. 84074 (Sept. 11, 2018) (alleging, among other things, a violation of section 206(4) of the Advisers Act and rule 206(4)-7 thereunder and failure to supervise) (settled action). *See* In the Matter of Cadaret Grant, *et al.*, Exchange Act Release No. 84074 (Sept. 11, 2018) (settled action).

332 *See* FINRA Regulatory Notice 12-03, *supra* note 326.

The proposed due diligence requirement provides that a firm must exercise due diligence to ascertain the essential facts relative to the retail investor, his or her financial situation, and investment objectives. A firm must seek to obtain, at a minimum, certain information about its retail investor's:

- investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon;
- employment status (name of employer, self-employed or retired);
- estimated annual income from all sources;
- estimated net worth (exclusive of family residence);
- estimated liquid net worth (cash, liquid securities, other);
- percentage of the retail investor's liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and
- investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.[333]

Based on its evaluation of this information, the firm would be required specifically to approve or disapprove the retail investor's account for buying or selling shares of leveraged/inverse investment vehicles. If the firm approves the account, the approval must be in writing.

Under the proposed rules, to provide this approval a firm must have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably

[333] *See* proposed rule 15*l*-2(b)(2). For joint accounts, the firm must seek to obtain the information for all participants in joint retail investor accounts.

expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles. We are not proposing a bright-line test for this determination. Rather, the determination would be based on all of the relevant facts and circumstances.

The information that a firm would collect includes information about the retail investor's financial status (*e.g.*, employment status, income, and net worth (including liquid net worth)); and information about his or her investment objectives generally and his or her anticipated investments in, and experience with, leveraged/inverse investment vehicles (*e.g.*, general investment objectives, percentage of liquid net worth intended for investment in leveraged/inverse investment vehicles, and investment experience and knowledge). This information is designed to provide a comprehensive picture of the retail investor to allow a firm to evaluate whether the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles.

While not required under the proposed rules, firms could consider establishing multiple levels of account approvals for a retail investor seeking to trade leveraged/inverse investment vehicles. We understand that broker-dealers set different levels of options account approval depending on the customer's trading experience and financial sophistication.[334] Similarly, a firm may determine that certain leveraged/inverse investment vehicles (*e.g.*, those with lower leverage multiples or that invest in less-volatile asset classes) are more appropriate for a lower level of account approval, while other types of leveraged/inverse investment vehicles may be more

[334] These increasing levels generally track the riskiness of the product or trading strategy; for example, the initial option account approval may permit covered call writing of equity options but higher account approvals would be needed for writing uncovered index options.

appropriate for a higher level of account approval. Any such approaches generally should be addressed in the policies and procedures that the proposed sales practices rules would require a firm to adopt and implement.[335]

The proposed rules' scope with respect to a firm's customer or client is limited to "a natural person" or "the legal representative of a natural person."[336] The rules include all natural persons—including high-net worth individuals—to provide the related investor protections to all natural persons. The proposed rules require firms to seek to obtain and to consider information related to a retail investor's net worth as part of their consideration of whether to approve the investor's account for trading in leveraged/inverse investment vehicles. We interpret "legal representative" of a natural person to mean non-professional legal representatives of a natural person.[337] This interpretation would exclude institutions and certain professional fiduciaries, but it would include certain legal entities such as trusts that represent the assets of a natural person.[338] This interpretation is designed to provide the protections of the sales practices rules where non-professional persons are acting on behalf of natural persons, but where such

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335 *See* proposed rules 15*l*-2(a) and 211(h)-1(a).

336 *See* proposed rules 15*l*-2(a) and 211(h)-1(a).

337 *See*, *e.g.*, Form CRS Relationship Summary, Exchange Act Release No. 34-86032 (June 5, 2019) [84 FR 33492 (July 12, 2019)] ("Form CRS Release"), at n.629 and accompanying text.

338 *See* Form CRS Release, *supra* note 336, at nn.645-647 and accompanying text (clarifying interpretation of "legal representative" of a natural person to cover only non-professional legal representatives (*e.g.*, a non-professional trustee that represents the assets of a natural person and similar representatives such as executors, conservators, and persons holding a power of attorney for a natural person)); Regulation Best Interest: The Broker-Dealer Standard of Conduct, *supra* note 314, at n.237 and accompanying text (defining "retail customer").

professional persons are not regulated financial services industry professionals retained by natural persons to exercise independent professional judgment.[339]

In addition, we are proposing to specify in the sales practices rules that, although the rules would apply to transactions by broker-dealers and investment advisers for retail investors—including those investors who have existing accounts before the rules' compliance date—the sales practices rules would not apply to a position in a leveraged/inverse investment vehicle established before the rules' compliance date. This provision is designed to allow existing investors in leveraged/inverse investment vehicles with open investments as of the rules' compliance date to sell their holdings (or to purchase leveraged/inverse investment vehicles to close out short positions in the leveraged/inverse investment vehicle) without the additional steps we propose to require for their broker-dealer or investment adviser to determine whether to approve the retail investor's account to trade in these products.[340] Absent this provision, the sales practices rules could prevent or delay a retail investor's ability to close or reduce a position in a leveraged/inverse investment vehicle that he or she entered into before firms were required to comply with the rules.

We also do not believe it would be appropriate to apply the sales practices rules only to retail accounts established after the rules' compliance date, because the investor protection concerns underlying the rules would apply equally to pre-existing retail investor accounts. Accordingly, the proposed rules would make clear that, even if a retail investor had already been trading leveraged/inverse investment vehicles, a firm would have to satisfy the due diligence and

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339 *See* Form CRS Release, *supra* note 336, at nn.645-647 and accompanying text.

340 This provision is designed to allow a retail investor to exit a legacy position in a leveraged/inverse investment vehicle, as discussed above, and does not reflect any view on whether any recommendation for these legacy positions was suitable when made.

account approval requirements for that investor's account before the investor could make additional investments in leveraged/inverse investment vehicles.[341]

The proposed sales practices rules also would require firms to adopt and implement written policies and procedures addressing compliance with the applicable sales practices rule.[342] We are not proposing to impose specific requirements for these policies and procedures, provided that they are reasonably designed to achieve compliance with the applicable sales practices rule, including the due diligence and account approval requirements. This requirement, together with the proposed recordkeeping requirements discussed below, is designed to provide comparable policies and procedures and recordkeeping requirements for both broker-dealers and investment advisers.

We request comment on the proposed approval and due diligence requirements for approving retail investors' accounts to trade in shares of leveraged/inverse investment vehicles.

174. Is modeling these rules on FINRA's options rule the appropriate approach? Why or why not?

175. Should the proposed sales practices rules apply to Commission-registered broker-dealers and investment advisers? Why or why not? What challenges, if any, would broker-dealers or investment advisers face complying with the proposed rules, and what compliance burdens would the proposed rules create for broker-dealers and investment advisers? Would compliance burdens be substantially different for investment advisers than for broker-dealers (for example, because of any compliance

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341 As discussed above, this evaluation would take into account, among other things, the investor's experience with leveraged/inverse investment vehicles. *See, e.g.*, proposed rules 211(h)-1(b)(2) and 15*l*-2(b)(2).

342 *See* proposed rule 15*l*-2(a); proposed rule 211(h)-1(a).

efficiencies that might result to the extent broker-dealers are already complying with FINRA's rules for approving options accounts), or vice versa? Should we apply proposed Advisers Act rule 211(h)-1 to investment advisers that are registered with one or more states but not registered with the Commission? Why or why not? Should the proposed rule for investment advisers apply equally to advisers with discretionary authority and with non-discretionary authority over client accounts? If the sales practices rule for investment advisers applies to both discretionary and non-discretionary advisory accounts, should we apply different due diligence and account approval requirements based on whether an account is discretionary or non-discretionary? Should the proposed sales practices rules apply to investment advisers, in light of their fiduciary duties to their clients? Why or why not? Should the sales practices rules apply to a broker-dealer if the broker-dealer does not effect transactions in leveraged investment vehicles for retail investors other than transactions resulting from recommendations that are subject to Regulation Best Interest? Why or why not?

176. Should the proposed rules apply to transactions in leveraged/inverse investment vehicles that are directed by a retail investor without any recommendation or advice from a broker-dealer or investment adviser? Why or why not?

177. Should the proposed rules apply on a transaction-by-transaction basis rather than requiring an initial account approval to transact in leveraged/inverse investment vehicles? Why or why not?

178. As proposed, the sales practices rules would require that a firm could provide account approval only if the firm has a reasonable basis for believing that the investor has

such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles. Is this account approval standard appropriate? Why or why not? If not, what should the account approval standard be? Should it be tied instead, for example, to an investor's ability to absorb losses, and if so how should a firm assess this?

179. Is the investor information that the proposed rules would require firms to seek to obtain under the rules' due diligence requirements appropriate, and would this information effectively assist in forming a reasonable basis for assessing the investor's knowledge and experience in financial matters as required under the proposed account approval standard? Why or why not? What modifications, if any, should we make to the information items that the proposed rules would require a firm to seek to obtain? Are there any information items that we should remove from the proposed list, or any additional information items that we should include? For example, instead of tracking generally the information elements set forth under FINRA's option rule, should the proposed rules track generally the information set forth in the definition of "retail customer investment profile" under Regulation Best Interest (*i.e.*, "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer")? As proposed, should the rules require firms to seek to obtain the percentage of the investments that the retail investor intends to invest in leveraged/inverse

investment vehicles? Why or why not?

180. Should the sales practices rules require firms to obtain the specified information, rather than to seek to obtain it? Would a firm be able to form a reasonable basis for believing that a retail investor has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles if the retail investor provides some, but not all, of the information specified in the sales practices rules?

181. What special procedures, if any, do firms currently undertake in permitting or not permitting retail investors to trade in leveraged/inverse investment vehicles? At account opening? With respect to specific transactions? With respect to concentration limits? Do firms already have approval processes in place designed to evaluate whether their retail investors are reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles? If so, do firms distinguish between types of vehicles or trading strategies? Do these practices differ between broker-dealers and investment advisers? If so, please explain the differences.

182. What special procedures, if any, do firms currently undertake in permitting or not permitting retail investors to trade in other types of complex products? Please explain in detail, including products to which such procedures apply and what the approval process entails.

183. The proposed sales practices rules would require that firms' approvals of retail investors' accounts for buying or selling shares of leveraged/inverse investment vehicles be in writing. The proposed rules would not require account disapprovals to be in writing. Should we require account disapprovals also to be in writing? Would

such a requirement raise any practical concerns, or other concerns, for firms? In other investor approval contexts, do firms currently put both their approvals and disapprovals in writing?

184. How do broker-dealers apply the options eligibility requirement with respect to clients of investment advisers, if at all, when those advisers submit orders on behalf of their clients? Do broker-dealer practices differ with respect to orders submitted by other types of intermediaries? Please explain.

185. How do broker-dealers currently analyze the information they collect under FINRA rule 2360? Which data elements do broker-dealers find most important and which elements are less important? What standards do broker-dealers apply in determining whether to approve a customer's account on the basis of the information collected?

186. Should the proposed rules require firms to provide specific disclosure as part of the approval process, similar to the options disclosure document that must be provided under FINRA rule 2360? If so, what information should it contain? Should the rules require that receipt of such disclosure be acknowledged?

187. Should the rules require firms to provide retail investors a short, plain-English disclosure generally describing the risks associated with leveraged/inverse investment vehicles as part of the proposed account approval process? For example, before a firm approves a retail investor's account for buying and selling shares of a leveraged/inverse investment vehicle, should the rules require a firm to incorporate and distill into a short disclosure the specific risk factors associated with leveraged/inverse investment vehicles (such as the risks related to compounding and other risks that leveraged/inverse funds disclose in their prospectuses)?

188. Should the rules apply to all customers or clients, and not just natural persons? Should they apply to a different subset of customers or clients and, if so, which ones and why? If the rule were to apply to all customers or clients, including institutional accounts, what changes should we make to the information that firms must collect or to the basis upon which a firm would approve or disapprove the account? Are there distinctions between institutional investors and natural persons that invest in leveraged/inverse investment vehicles that we should consider? For example, do commenters have data or information on the percentage of leveraged investment vehicles' investors who are natural persons, and how natural persons use these investment products (*e.g.*, how long do these investors hold the products)?

189. As discussed above, we understand that certain purchases or sales of leveraged/inverse investment vehicles do not involve a customer or client of a broker-dealer or investment adviser that would be subject to the proposed sales practices rules.[343] Should the proposed rules apply to these transactions? For example, should the proposed sales practices rule for broker-dealers apply to a mutual fund principal underwriter's transactions with any retail investor who is purchasing fund shares directly from the fund?

190. Should the sales practices rules include different account-approval conditions for different types of leveraged/inverse investment vehicles? For example, should the rules include different conditions for investment vehicles that seek to exceed the performance of a market index by a specified multiple, versus those that provide

[343] *See supra* note 321.

returns that have an inverse relationship to the performance of a market index? Should the rules include different levels of account approval, such as heightened requirements for investors to transact in leveraged/inverse investment vehicles with higher leverage multiples or that invest in more volatile asset classes? Similarly, should the rules include different levels of account-approval conditions based on a retail investor's trading experience and financial sophistication?

191. Do commenters agree that we should apply the sales practices rules to all retail investors, including those who have opened accounts with an investment adviser or broker-dealer before the rules' compliance date? Should the sales practices rules include exceptions from the due diligence and account approval requirements for retail investors that have already traded in leveraged/inverse investment vehicles as of the rules' compliance date? Should the sales practices rules provide exceptions for retail investors who meet established criteria, such as retail investors who are accredited investors? Why or why not?

192. The proposed rules also would not apply to, and therefore would not restrict a retail investor's ability to close or reduce, a position in a leveraged/inverse investment vehicle established before the rules' compliance date. Do commenters agree that this is appropriate? Are there modifications we should make to the rules so that they would not impede an investor's ability to close or reduce an existing position in a leveraged/inverse investment vehicle? Which modifications and why? Alternatively, should the sales practices rules apply to retail investors with positions in leveraged/inverse investment vehicles established before the rules' compliance date even if they do not seek to make additional purchases or sales of leveraged

investment vehicles? If so, how would firms comply, in practice, with the due diligence and account approval requirements for these investors?

193. Do commenters agree with the proposed policies and procedures requirement? Should the rule provide specific requirements for firms' policies and procedures relating to compliance with the sales practices rules?

c. Recordkeeping

Under the proposed sales practices rules, a firm would have to maintain a written record of the investor information that it obtained under the rules' due diligence requirements, the firm's written approval of the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles, and the versions of the firm's policies and procedures that it adopted under the proposed rules that were in place when it approved or disapproved the account. We propose that firms be required to retain these records for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the investor's account.[344] We believe that it is appropriate for the proposed rules to include a recordkeeping provision to facilitate compliance, and regulatory oversight of a firm's compliance, with the rules. Also, because an investor account that was approved to trade in leveraged/inverse investment vehicles could remain open with a firm for more than six years, we believe it is appropriate to require that records be preserved for a minimum of six years after the closing of the account, rather than six years after the creation of the records.[345] We believe that

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[344] *See* proposed rules 15*l*-2(c) and 211(h)-1(c).

[345] This is consistent with other Commission recordkeeping requirements relating to investor account documentation. *See, e.g.*, rule 17a-4(c) under the Exchange Act (requiring broker-dealers to preserve for a period of not less than six years after the closing of any customer's account any

this recordkeeping requirement would provide sufficient investor protection and, because it is generally consistent with recordkeeping requirements for broker-dealers and investment advisers, would not impose overly burdensome recordkeeping costs.[346]

We request comment on the recordkeeping requirement in the proposed sales practices rules:

194. Is the proposed recordkeeping requirement appropriate? Why or why not?

195. What changes, if any, should we make to this proposed requirement (*e.g.*, by modifying the types of records that a firm would have to keep)?

196. Does our proposal to apply the same recordkeeping requirement to both broker-dealers and investment advisers raise any specific recordkeeping concerns for either broker-dealers or investment advisers (*e.g.*, do investment advisers believe it would be particularly burdensome to comply with a six-year recordkeeping period)? Should the proposed rules include different requirements for broker-dealers and investment advisers?

197. Is the proposed duration of the recordkeeping provision, including the proposed requirement that the records be maintained for a minimum of six years after the

account cards or records relating to the terms and conditions with respect to the opening and maintenance of the account).

346 *See*, *e.g.*, *id.*; *see also* rule 204-2(e)(1) under the Investment Advisers Act (requiring investment advisers to preserve certain records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser). While we recognize that our existing recordkeeping requirements generally require broker-dealers to preserve records for six years and investment advisers for five years, we believe it would be appropriate for the recordkeeping requirements under the proposed sales practices rule to be consistent, in part because many broker-dealers and investment advisers are dual-registered, and thus are proposing a six-year period for both rules.

closing of the investor's account, appropriate? Does using the closing of the investor's account as the starting point for the recordkeeping period raise any practical difficulties for firms? Should we lengthen or shorten the required recordkeeping periods? Why or why not?

3. Alternative Provision for Leveraged/Inverse Funds Under Proposed Rule 18f-4

Under proposed rule 18f-4, a fund would not have to comply with the proposed VaR-based leverage risk limit if it: (1) meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules; (2) limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index; and (3) discloses in its prospectus that it is not subject to proposed rule 18f-4's limit on fund leverage risk. We refer to this set of proposed conditions collectively as the "alternative provision for leveraged/inverse funds." A leveraged/inverse fund that satisfies these conditions still would be required to satisfy all of the additional conditions in proposed rule 18f-4 other than the VaR tests, including the proposed conditions requiring a derivatives risk management program, board oversight and reporting, and recordkeeping.[347]

First, the alternative provision for leveraged/inverse funds requires that a leveraged/inverse fund be a "leveraged/inverse investment vehicle" as defined in the proposed sales practices rules.[348] As discussed above, the proposed sales practices rules are designed to help ensure that investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating their general characteristics and the unique risks they present.

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347 *See* proposed rule18f-4(c)(1), (5)-(6).

348 *See* proposed rule 18f-4(c)(4)(i); proposed rules 15*l*-2(d) and 211(h)-1(d) (defining the term "leveraged/inverse investment vehicle").

Second, the alternative provision for leveraged/inverse funds would limit a leveraged/inverse fund's market exposure by providing that the fund must not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index.[349] This limitation reflects the highest leverage level currently permitted by our exemptive orders for leveraged/inverse ETFs.[350] It therefore reflects the maximum amount of leverage in these funds with which investors and other market participants are familiar. To permit leveraged/inverse funds to use a higher level of leverage would heighten the investor protection concerns these funds present, notwithstanding their more limited investor base.[351] Moreover, allowing leveraged/inverse funds to increase their leverage beyond current levels would result in a non-linear increase in the extent of leveraged/inverse funds' rebalancing activity, which may have adverse effects on the markets for the constituent securities as discussed in more detail in sections III.D.1 and III.E.4. For these reasons, and because the Commission does not have experience with leveraged/inverse funds that seek returns above 300% of the return (or inverse of the return) of the underlying index, we are not proposing to permit higher levels of leveraged market exposure for leveraged/inverse funds in this rule.

Third, the alternative provision for leveraged/inverse funds would require a leveraged/inverse fund to disclose in its prospectus that it is not subject to the condition of proposed rule 18f-4 limiting fund leverage risk.[352] This requirement is designed to provide investors and the market with information to clarify that leveraged/inverse funds—which as

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349 *See* proposed rule 18f-4(c)(4)(iii).

350 *See* ETFs Adopting Release, *supra* note 76, at n.75 and accompanying text.

351 *See also* section III.C.5.

352 *See* proposed rule 18f-4(c)(4)(ii).

discussed above, use derivatives extensively—are not subject to rule 18f-4's limit on fund leverage risk.

We request comment on the proposed alternative provision for leveraged/inverse funds.

198. Should the rule include an alternative set of requirements for leveraged/inverse funds? Should leveraged/inverse funds instead be required to meet the proposed requirements for all funds that use derivatives, including the VaR-based limit on fund leverage risk? If commenters agree that we should permit leveraged/inverse ETFs to rely on rule 18f-4 based on an alternative set of requirements, are there additional conditions—either relating to these funds' derivatives risk management or otherwise—that we should consider requiring those funds to satisfy? To what extent would additional limitations or restrictions on leveraged investment vehicles' advertising or marketing materials help to address the investor protection concerns discussed above?

199. Does our proposal to include within the scope of the rule only leveraged/inverse funds that are covered by the proposed sales practices rules, along with the conditions comprising the alternative provision for leveraged/inverse funds, address the investor protection concerns related to leveraged/inverse funds?

200. If leveraged/inverse funds operate pursuant to the proposed alternative provision, should they nonetheless be subject to other requirements in the proposed rule (*e.g.*, the proposed risk management program requirement, board oversight and reporting requirement, and recordkeeping requirement)?

201. Should leveraged/inverse funds relying on the alternative provision be required to disclose in their prospectuses that the fund is not subject to the proposed VaR-based

limit on fund leverage risk, as proposed? If so, what would be the most appropriate method of disclosure? In addition to requiring this disclosure under rule 18f-4, should we also include this requirement in Form N-1A? Would it aid practitioners for a leveraged/inverse fund's registration form to specify this requirement?

202. Should a leveraged/inverse fund relying on rule 18f-4 be required to limit the investment results it seeks or obtains to 300% of the return (or inverse of the return) of the underlying index? Would some other threshold be more appropriate? Should the threshold be higher, such as 400%, or lower, such as 150% or 200%?

203. Any registered investment company that operates as a leveraged/inverse fund would be eligible to comply with the proposed alternative provision for leveraged/inverse funds in rule 18f-4. Should we limit the scope of leveraged/inverse funds eligible for this provision to open-end funds, including ETFs?

4. Proposed Amendments to Rule 6c-11 under the Investment Company Act and Proposed Rescission of Exemptive Relief for Leveraged/Inverse ETFs

Earlier this year, the Commission adopted rule 6c-11, which permits ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the Commission.[353] Rule 6c-11 includes a provision excluding leveraged/inverse ETFs from the scope of ETFs that may rely on that rule.[354] Leveraged/inverse ETFs, therefore, continue to rely on their Commission exemptive orders. In adopting rule 6c-11, the Commission stated that the particular section 18 concerns raised by leveraged/inverse ETFs' use of derivatives distinguish those funds from the other ETFs permitted to rely on that rule, and that those section 18 concerns would be

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[353] *See* ETFs Adopting Release, *supra* note 76.

[354] *See* rule 6c-11(c)(4).

more appropriately addressed in a rulemaking addressing the use of derivatives by funds more broadly.[355] The Commission further stated that leveraged/inverse ETFs are similar in structure and operation to the other types of ETFs that are within the scope of rule 6c-11.[356] The rules we are proposing, rule 18f-4 under the Investment Company Act and the sales practices rules under the Exchange Act and the Advisers Act, would create an updated and more comprehensive regulatory framework for the use of derivatives by funds, including provisions specifically applicable to leveraged/inverse ETFs. Accordingly, we propose to amend rule 6c-11 to remove the provision excluding leveraged/inverse ETFs from the scope of that rule one year following the publication of the final amendments in the Federal Register.

In addition, because the proposed amendments to rule 6c-11 would permit leveraged/inverse ETFs to rely on that rule rather than their exemptive orders, we are proposing to rescind the exemptive orders we have previously issued to leveraged/inverse ETFs. The exemptive relief granted to leveraged/inverse ETFs has resulted in an uneven playing field among market participants because the Commission has permitted only three ETF sponsors to operate leveraged/inverse ETFs and has not granted any exemptive relief for leveraged/inverse ETFs since 2009.[357] We believe that amending rule 6c-11 and rescinding these exemptive orders

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355 *See* ETFs Adopting Release, *supra* note 76, at nn.72-75 and accompanying text.

356 *See id.* at text following n.86. In addition, one sponsor of leveraged/inverse ETFs has stated that its ETFs would prefer to rely on rule 6c-11 over their exemptive orders and that leveraged/inverse ETFs would be able to comply with rule 6c-11 because they are structured and operated in the same manner as other ETFs that fall within the scope of that rule. *See id.* at n.83 and accompanying text.

357 There are currently two ETF sponsors that rely upon this exemptive relief today. *See supra* note 307 and accompanying text; *infra* note 473 and accompanying text. We also discuss below in section III.E alternative approaches for leveraged/inverse funds, including an approach under which the Commission would rescind the exemptive orders issued to leveraged/inverse ETF sponsors, permit leveraged/inverse funds to operate under rule 6c-11, but require

would promote a more level playing field and greater competition by allowing any sponsor to form and launch a leveraged/inverse ETF subject to the conditions in rules 6c-11 and proposed rule 18f-4, with transactions in the funds subject to the proposed sales practices rules. We propose to rescind these exemptive orders on the effective date of the proposed amendments to rule 6c-11 (one year following the publication of the final rule amendments in the Federal Register), to coincide with the compliance date for the sales practices rules and to allow time for broker-dealers and investment advisers to make any adjustments necessary to comply with the proposed sales practices rules. Providing a one-year period for existing leveraged/inverse ETFs also would provide time for them to prepare to comply with rule 6c-11 rather than their exemptive orders.[358]

We request comment on the proposed amendments to rule 6c-11 and rescission of leveraged/inverse ETF exemptive orders.

204. If leveraged/inverse funds are permitted to rely on rule 18f-4, should the Commission amend rule 6c-11 to permit leveraged/inverse funds to operate under that rule, as proposed? Do the requirements of proposed rule 18f-4, together with the proposed sales practices rules, adequately address the section 18 concerns relating to leveraged/inverse funds? Are there are other concerns regarding leveraged/inverse funds that we should consider in determining whether to allow such funds to rely on rule 6c-11?

205. In addition, do commenters agree with our proposal to rescind the existing

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leveraged/inverse funds to comply with rule 18f-4's VaR-based limit on fund leverage risk in lieu of adopting the proposed sales practices rules.

358 *See* ETFs Adopting Release, *supra* note 76, at text following n.451.

leveraged/inverse ETF exemptive relief in view of our proposed treatment of leveraged/inverse funds under rule 18f-4 and proposed amendments to rule 6c-11? Are there other approaches to the existing leveraged/inverse ETF exemptive relief that we should consider in view of proposed rule 18f-4 and the proposed sales practices rules?

H. Amendments to Fund Reporting Requirements

We are proposing amendments to the reporting requirements for funds that would rely on proposed rule 18f-4—in particular, amendments to Forms N-PORT, N-LIQUID (which we propose to re-title as "Form N-RN"), and N-CEN.[359] These proposed amendments are designed to enhance the Commission's ability to oversee funds' use of and compliance with the proposed rules effectively, and for the Commission and the public to have greater insight into the impact that funds' use of derivatives would have on their portfolios.[360] They would allow the

[359] 17 CFR 274.150; 17 CFR 274.223; and 17 CFR 249.330 and 17 CFR 274.101.

[360] The funds that would rely on proposed rule 18f-4 other than BDCs generally are subject to reporting requirements on Form N-PORT. All registered management investment companies, other than registered money market funds and small business investment companies, are (or will be) required to electronically file with the Commission, on a quarterly basis, monthly portfolio investment information on Form N-PORT, as of the end of each month. *See* Investment Company Reporting Modernization Adopting Release, *supra* note 178. As of April 30, 2019, larger fund groups (defined as having $1 billion or more in net assets) have begun submitting reports on Form N-PORT for the period ending March 31, 2019. Smaller fund groups (less than $1 billion in net assets) will begin submitting reports on Form N-PORT by April 30, 2020. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32936 (Dec. 8, 2017) [82 FR 58731 (Dec. 14, 2017)]. Only information reported for the third month of each fund's fiscal quarter on Form N-PORT will be publicly available (60 days after the end of the fiscal quarter). *See* Amendments to the Timing Requirements for Filing Reports on Form N-PORT, Investment Company Act Release No. 33384 (Feb. 27, 2019) [84 FR 7980 (Mar. 6, 2019)].

Currently, only open-end funds that are not regulated as money market funds under rule 2a-7 under the Investment Company Act are required to file current reports on Form N-LIQUID, under section 30(b) of the Investment Company Act and rule 30b1-10 under the Act. *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)], at section III.L.2 ("Liquidity Adopting Release").

Commission and others to identify and monitor industry trends, as well as risks associated with funds' investments in derivatives (including by requiring current, non-public reporting to the Commission when certain significant events related to a fund's leverage risk occur). The proposed amendments also would aid the Commission in evaluating the activities of investment companies in order to better carry out its regulatory functions.

1. Amendments to Form N-PORT

We are proposing to amend Form N-PORT to add new items to Part B ("Information About the Fund"), as well as to make certain amendments to the form's General Instructions.

a. Derivatives Exposure

We are proposing to amend Form N-PORT to include a new reporting item on funds' derivatives exposure.[361] A fund would be required to provide its derivatives exposure as of the end of the reporting period.[362] This information would be publicly available for the third month

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Our proposal, including proposed amendments to Form N-LIQUID, rule 30b1-10 and proposed rule 18f-4(c)(7), would add new VaR-related items to the form, and would extend the requirement to file current reports with respect to these new items to any fund (including registered open-end funds, registered closed-end funds, and BDCs) that relies on rule 18f-4 and that is subject to the rule's limit on leverage risk.

The funds that would rely on proposed rule 18f-4 other than BDCs generally are subject to reporting requirements on Form N-CEN. Specifically, all registered investment companies, including money market funds but excluding face amount certificate companies, are currently required to file annual reports on Form N-CEN. *See* Investment Company Reporting Modernization Adopting Release, *supra* note 178. Form N-CEN requires these funds to report census-type information including reports on whether a fund relied upon certain enumerated rules under the Investment Company Act during the reporting period. *See, e.g.*, Item C.7 of Form N-CEN.

361 *See* proposed Item B.9 of Form N-PORT; *see also* proposed amendments to General Instruction E to Form N-PORT (adding a new definition for "derivatives exposure," as defined in proposed rule 18f-4(a),which would permit a fund to convert the notional amounts of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts).

362 *See* proposed Item B.9 of Form N-PORT. Just as the proposed definition of "derivatives transaction" in rule 18f-4 includes derivatives instruments as well as short sale borrowings, Form

of each fund's quarter and would provide market-wide insight into the levels of funds' derivatives exposure to the Commission, its staff, and market participants.[363] It also would allow the Commission and its staff to oversee and monitor compliance with the proposed rule's exception for limited derivatives users.[364]

We seek comment on the Commission's proposed amendments to Form N-PORT requiring reporting of derivatives exposure:

206. Is the proposed requirement that funds report their derivatives exposure on Form N-PORT appropriate? Why or why not? Should we modify the proposed derivatives exposure reporting item in any way? If so, how should we modify this reporting item?

207. Our proposal would make public the information that a fund would report in response to the new derivatives exposure Form N-PORT item. Is there any reason why this information should not be publicly available?

N-PORT would require a fund to report exposure associated with derivatives instruments and short sales.

The proposed requirement to report derivatives exposure at the end of the reporting period reflects the form's requirement to report information about funds' portfolio holdings as of the last business day, or last calendar day, of each month. *See* General Instruction A to Form N-PORT. While we are proposing that funds report their highest daily VaR and median daily VaR during the reporting period (*see infra* section II.H.1.b), we are not also proposing that funds report their highest daily derivatives exposure (or median daily derivatives exposure) during the reporting period. This is because proposed rule 18f-4 requires daily calculation of a fund's VaR but does not require a fund to calculate its derivatives exposure daily.

363 We are not proposing to amend General Instruction F to Form N-PORT, which specifies the information that funds report on Form N-PORT that the Commission does not make publicly available.

While the information for the first two months of a fund's quarter would be non-public, the information for the third month of a fund's quarter would be publicly available. *See supra* note 359.

364 Under this proposal, a fund would have to indicate whether it is a limited derivatives user on Form N-CEN. *See infra* section II.H.3.

208. Should we require this reporting only from certain funds—for example, those that qualify either as limited derivatives users or leveraged/inverse funds under proposed rule 18f-4—during the reporting period?

209. Should we require funds to report metrics tied to their daily notional amount calculation on Form N-PORT (for example, a fund's highest daily derivatives exposure during the reporting period and the date of its highest exposure, and its median daily derivatives exposure during the reporting period)? Should we only require funds to report these types of metrics if we were also to modify proposed rule 18f-4 to require funds to calculate their notional amounts daily? Would this type of reporting requirement help to mitigate any potential "window dressing" concerns about funds' reporting of their derivatives exposure, and/or provide additional beneficial transparency with respect to any particular type of funds (for example, leveraged/inverse funds)? If so, would these benefits outweigh related costs?

b. VaR Information

We are also proposing to amend Form N-PORT to include a new reporting item related to the proposed VaR tests.[365] Information that a fund would report under this new reporting item would be made public for the third month of each fund's quarter.[366] The proposed item would apply to funds that were subject to the proposed VaR-based limit on fund leverage risk during the reporting period.

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365 *See* proposed Item B.10 of Form N-PORT. Proposed item B.10 would require that a fund provide the applicable VaR information in accordance with proposed rule 18f-4(c)(2)(ii), which requires a fund to determine compliance with its applicable VaR test at least once each business day.

366 *See supra* note 362. While the information for the first two months of a fund's quarter would be non-public, the information for the third month of a fund's quarter would be publicly available. *See supra* note 359.

Funds that are subject to the new VaR-related N-PORT item would have to report their highest daily VaR during the reporting period and its corresponding date, as well as their median daily VaR for the monthly reporting period.[367] Funds subject to the relative VaR test during the reporting period would report the name of the fund's designated reference index, and index identifier.[368] These funds also would have to report the fund's highest daily VaR ratio (that is, the value of the fund's portfolio VaR divided by the VaR of the designated reference index) during the reporting period and its corresponding date, as well as the fund's median daily VaR ratio for the reporting period.[369]

The proposed requirement for a fund to report highest daily VaR (and, for a fund that is subject to the relative VaR test, information about the fund's VaR ratio) is designed to help assess compliance with the proposed rule. These requirements, and the proposed requirement for a fund to report its median daily VaR (and, for a fund that is subject to the relative VaR test, the median VaR ratio) are designed to help identify changes in a fund's VaR over time, and to help identify trends involving a single fund or group of funds regarding their VaRs. The proposed requirement that a fund report information about its designated reference index is designed to help analyze whether funds are using designated reference indexes that meet the rule's requirements, and also to assess any trends in the designated reference indexes that funds select.

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367 *See* proposed Items B.10.a.-c of Form N-PORT. The proposed form amendments would require each of the reported metrics to be determined in accordance with the requirement under proposed rule 18f-4 to determine the fund's compliance with the applicable VaR test at least once each business day.

368 *See* proposed Item B.10.d.i.-ii of Form N-PORT.

369 *See* proposed Item B.10.d.iii.-v of Form N-PORT.

A fund also would have to report the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model.[370] This proposed requirement is designed to help analyze whether a fund's VaR model is effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund's investments, as required by the proposed rule.[371] This information would assist in monitoring for compliance with the proposed VaR tests and also would provide high-level information to market participants, as well as researchers and analysts, to help evaluate the extent to which funds' VaR models, used as part of the proposed VaR tests, are operating effectively. Because this information would be made publicly available on a delayed basis, and would not provide details about backtesting exceptions other than the number of exceptions, we do not believe that this proposed reporting requirement would produce adverse effects such that the reported information should be made non-public.[372]

We seek comment on the Commission's proposed amendments to Form N-PORT requiring reporting of VaR information:

210. Are the proposed requirements that funds report VaR information on Form N-PORT, and each of the elements that a fund would have to report under this requirement,

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[370] *See* proposed Item B.10.e of Form N-PORT; *see also supra* section II.B.3.d (discussing proposed backtesting requirement); ICI Comment Letter II (discussing UCITS funds being similarly required to report to their primary regulator, on a semi-annual basis, the number of VaR breaks that exceed a specified threshold (a VaR break occurs when the actual one-day loss exceeds that day's VaR), and recommending the Commission require funds to report the number of VaR breaks and the dates on which they occurred).

[371] *See supra* note 151.

[372] *See supra* notes 362, 365. *But see infra* section II.H.2 (discussing adverse effects that might arise from the real-time public reporting of a fund's VaR test breaches under the proposed amendments to Form N-LIQUID).

Information reported for the third month of each fund's fiscal quarter on Form N-PORT will be made publicly available 60 days after the end of the fiscal quarter. *See supra* note 359.

appropriate? Why or why not? Should we modify the proposed VaR information reporting item in any way? If so, how should we modify this reporting item?

211. Our proposal would make public all of the information that a fund would report in response to the new VaR information item on Form N-PORT. Is there any reason why this information should not be publicly available? For example, would making this information public lead to harm arising from investor confusion, adverse competitive effects, or for any other reason? If we require that this reported information be made public, is there additional information we should require funds to report to provide contextualization or mitigate any adverse effects that could arise from public disclosure? Should we make non-public some of these disclosures (*e.g.*, portfolio VaR or a fund's designated reference index, or information about backtesting results) but not others? If so, which ones should we make non-public and why?

212. Would any of the proposed N-PORT reporting requirements be more appropriately structured as Form N-CEN reporting requirements, or items to be reported on a current basis on Form N-RN?

213. Is there any additional information related to funds' derivatives exposure or derivatives risk management that we should require funds to report on Form N-PORT? What information and why, and should this reported information be made public?

2. Amendments to Current Reporting Requirements

We are also proposing current reporting requirements for funds that are relying on proposed rule 18f-4. We are proposing to re-title Form N-LIQUID as Form N-RN and to amend this form to include new reporting events for funds that are subject to the proposed VaR-based limit on fund leverage risk.[373] These funds would be required to determine their compliance with the applicable VaR test on at least a daily basis.[374] We are proposing to require these funds to file Form N-RN to report information about VaR test breaches under certain circumstances. Proposed rule 18f-4 would require a fund that has determined that it is not in compliance with the applicable VaR test to come back into compliance promptly and within no more than three business days after such determination.[375] We are therefore proposing that a fund that determines that it is out of compliance with the VaR test and has not come back into compliance within three business days after such determination would file a report on Form N-RN providing certain information regarding its VaR test breaches.[376]

If the portfolio VaR of a fund subject to the relative VaR test were to exceed 150% of the VaR of its designated reference index for three business days, we are proposing to require that such a fund report: (1) the dates on which the fund portfolio's VaR exceeded 150% of the VaR of its designated reference index; (2) the VaR of its portfolio for each of these days; (3) the VaR of its designated reference index for each of these days; (4) the name of the designated reference index; and (5) the index identifier.[377] A fund would have to report this information within one business day following the third business day after the fund has determined that its portfolio VaR

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373 *See* proposed Parts E-G of Form N-RN.

374 *See supra* section II.D; *see also* proposed rule 18f-4(c)(2).

375 *See supra* section II.D.5.b.

376 *See* proposed Parts E and F of Form N-RN.

377 *See* proposed Part E of Form N-RN.

exceeds 150% of its designated reference index VaR.[378] Such a fund also would have to file a report on Form N-RN when it is back in compliance with the relative VaR test.[379]

If the portfolio VaR of a fund subject to the absolute VaR test were to exceed 15% of the value of the fund's net assets for three business days, we are proposing to require that such a fund report: (1) the dates the on which the fund portfolio's VaR exceeded 15% of the value of its net assets; (2) the VaR of its portfolio for each of these days; and (3) the value of the fund's net assets for each of these days.[380] A fund would have to report this information within one business day following the third business day that the fund determined that its portfolio VaR exceeds 15% of the value of its net assets. Such a fund also would have to file a report on Form N-RN when it is back in compliance with the absolute VaR test.[381]

The data points, collectively, would aid the Commission in assessing funds' compliance with the VaR tests. In addition, the information would provide staff the ability to assess how long a fund is precluded from entering into derivatives transactions as a consequence of its lack of compliance with its VaR test.

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378 For example, if the fund were to determine, on the evening of Monday, June 1, that its portfolio VaR exceeded 150% of the fund's designated reference index VaR, and this exceedance were to persist through Tuesday (June 2), Wednesday (June 3), and Thursday (June 4), the fund would file Form N-RN on Friday, June 5 (because 3 business days following the determination on June 1 is June 4, and 1 business day following June 4 is June 5). If the exceedance were to still persist on June 5 (the date that the fund would file Form N-RN), the fund's report on Form N-RN would provide the required information elements for June 1, 2, 3, 4, and 5.

379 *See* proposed Part G of Form N-RN. The report would include the dates on which the fund was not in compliance with the VaR test, and the current VaR of the fund's portfolio on the date the fund files the report. *See also* proposed rule 18f-4(c)(2)(iii) (providing that a fund must meet specific requirements to be back in compliance).

380 *See* proposed Part F of Form N-RN.

381 *See supra* note 378.

Currently, only registered open-end funds (excluding money market funds) are required to file reports on Form N-LIQUID.[382] We are proposing to amend this form, as well as rule 30b1-10 under the Investment Company Act, to reflect the proposed 18f-4 requirement that all funds that are subject to the relative VaR test or absolute VaR test file current reports regarding VaR test breaches under the circumstances that Form N-RN specifies.[383] The scope of funds that would be subject to the new VaR test breach current reporting requirements would thus include registered open-end funds as well as registered closed-end funds and BDCs. In addition to extending the scope of funds required to respond to Form N-LIQUID, we are proposing to amend the general instructions to the form to reflect the expanded scope and application.[384]

We are proposing to require funds to provide this information in a current report because we believe that the Commission should be notified promptly when a fund is out of compliance with the proposed VaR-based limit on fund leverage risk, which in turn we believe could indicate that a fund is experiencing heightened risks as a result of the fund's use of derivatives transactions. VaR test breaches could indicate that a fund is using derivatives transactions to

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382 *See* General Instruction A.(1) to Form N-LIQUID; *see also* rule 30b1-10 [17 CFR 270.30b1-10].

383 *See* proposed Form N-RN; *see also* proposed amendments to rule 30b1-10 under the Investment Company Act, and proposed rule 18f-4(c)(7) (requiring a fund that experiences an event specified in the parts of Form N-RN titled "Relative VaR Test Breaches," "Absolute VaR Test Breaches," or "Compliance with VaR Test" to file with the Commission a report on Form N-RN within the period and according to the instructions specified in that form).

384 *See, e.g.*, proposed General Instruction A.(1) to Form N-RN (amending the defined term "registrant"); proposed General Instruction A.(2) to Form N-RN (amending the submission requirement to clarify application to the new VaR-test-breach-related items); proposed General Instruction A.(3) to Form N-RN (clarifying that only open-end funds required to comply with rule 22e-4 under the Investment Company Act would be required to respond to events occurring in Parts B – D, as applicable, while funds required to comply with the limit on fund leverage risk in proposed rule 18f-4 would be required to respond to events specified in proposed Parts E-G, as applicable); and proposed General Instruction F to Form N-RN (clarifying that the terms used in proposed Parts E-G, unless otherwise specified, would have the same meaning as the terms in proposed rule 18f-4).

leverage the fund's portfolio, magnifying its potential for losses and significant payments of fund assets to derivatives counterparties. Such breaches also could indicate market events that are drivers of potential derivatives risks or other risks across the fund industry. Either of these scenarios—increased fund-specific risks, or market events that affect funds' risks broadly—may, depending on the facts and circumstances, require attention by the Commission. The proposed current reporting requirement is designed to provide the Commission current information regarding potential increased risks and stress events (as opposed to a requirement to report the same or similar information later, for example on Form N-PORT).[385] The one-business-day time-frame for submitting a report on Form N-RN regarding a fund's VaR test breaches is designed to provide an appropriately early notification to the Commission of potential heightened risks, while at the same time providing sufficient time for a fund to compile and file its report on Form N-RN. This time-frame is also consistent with the current required timing for reporting other events on Form N-LIQUID.[386]

We are cognizant that certain adverse effects might arise from real-time public reporting of a fund's VaR test breaches. For example, publicly disclosing this information could lead to investor confusion. Investors might mistakenly assume that a fund that breached the applicable VaR test actually had suffered substantial losses or that substantial losses necessarily were imminent. Investors might also believe that a fund's failing the VaR test suggests a sudden increase in fund risk when, in some cases, a fund can fail a VaR test—and especially an absolute VaR test—due to changes in market volatility generally. Investors also might believe that a fund's real-time reporting of a VaR test breach necessarily meant that the fund was not

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[385] *See supra* section II.H.1.b.

[386] *See* General Instruction A of Form N-LIQUID.

complying with applicable regulations. Information about VaR breaches would therefore provide important information to the Commission and its staff for regulatory purposes but could confuse investors and lead them and other market participants to make incorrect assumptions about a fund's relative riskiness. This could have potential adverse effects for funds if investors redeem or sell fund shares as a result. Other market participants also could react to real-time reporting of VaR breaches in ways that could adversely affect funds. For example, if market participants knew on a real-time basis that a fund had breached the applicable VaR test, market participants might seek to anticipate the trading activity the fund might undertake to come back into compliance and engage in predatory trading that could adversely affect the fund. Accordingly, we are proposing to make funds' reports on Form N-RN regarding VaR test breaches (like their reports on this form regarding liquidity-related items) non-public, because we preliminarily believe that public disclosure of this information is neither necessary nor appropriate in the public interest or for the protection of investors.[387]

We seek comment on the Commission's proposed amendments to Form N-LIQUID requiring reporting of certain information regarding a fund's VaR test breaches:

214. Is the proposed new current reporting requirement for funds that are subject to the VaR-based limit on fund leverage risk appropriate? Why or why not? If not, how should the scope of the proposed current reporting requirement be modified? Should we require additional current reporting requirements for funds to report other derivatives-risk-related information? For example, should funds that are limited

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[387] *See* proposed General Instruction A.(1) to Form N-RN; *see also* section 45(a) of the Investment Company Act (requiring information in reports filed with the Commission pursuant to the Investment Company Act to be made available to the public, unless we find that public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors).

derivatives users pursuant to the proposed exposure-based exception be required to file current reports if their derivatives exposure were to exceed 10% of their net assets?[388] Should we require a fund to file a current report if it identifies a certain number of exceptions as a result of backtesting its VaR calculation model, and if so, what circumstances should trigger the requirement to file a current report?[389]

215. Is each of the pieces of information that we propose a fund would include in a report about a VaR test breach on proposed Form N-RN appropriate? Why or why not? Should we modify the required information in any way?

216. For a fund that is out of compliance with the VaR test, and is unable to come back into compliance within three business days after its initial determination, the proposed current reporting requirement would require that fund to file a report on Form N-RN providing certain information regarding its VaR test breaches. Is the proposed three-business-day current reporting requirement appropriate? Why or why not? Should the rule require a shorter or longer period, such as one or seven days, before prompting a current reporting requirement? Which time period would be appropriate and why?

217. We are proposing that a fund's reports regarding VaR test breaches on Form N-RN would not be made public. Would there be a benefit to publicly reporting this information, and would it be appropriate to make these disclosures public? Why or why not? Should we make public some of these disclosures but not others? If so, which ones should we make public and why?

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388 *See supra* section II.E.1.

389 *See supra* section II.B.3.d (discussing backtesting requirements in proposed rule 18f-4); *see also supra* section II.H.1.b (discussing proposed requirement to report backtesting results on Form N-PORT).

218. As an alternative or an addition to the proposed current reporting requirement, should we require funds to report information regarding VaR test breaches on Form N-PORT? Why or why not? If so, should we make public this information reported on Form N-PORT?

219. Should we modify the proposed current reporting requirement to require reporting by certain types of funds and not others? If so which types of funds, and why? For example, should we require BDCs also to report the information that we are proposing them to report on Form N-RN on Form 8-K? Why or why not?

220. As an alternative to amending Form N-LIQUID to require current reporting on VaR test breaches, should we provide a new, separate current reporting form for funds to use to report VaR test breaches (and/or any other current reporting items relating to their derivatives risk management programs under proposed rule 18f-4)? Why or why not?

3. Amendments to Form N-CEN

Form N-CEN currently includes an item that requires a fund to indicate—in a manner similar to "checking a box"—whether the fund has relied on certain Investment Company Act rules during the reporting period.[390] We are proposing amendments to this item to require a fund to identify whether it relied on proposed rule 18f-4 during the reporting period.[391] We are also proposing amendments to require a fund to identify whether it relied on any of the exceptions from various requirements under the proposed rule, specifically:

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[390] *See* Item C.7 of Form N-CEN.

[391] *See* proposed Item C.7.l of Form N-CEN.

- Whether the fund is a limited derivatives user excepted from the proposed rule's program requirement, under either the proposed exception for funds that limit their derivatives exposure to 10% of their net assets or under the exception for funds that limit their derivatives use to certain currency hedging;[392] or
- Whether the fund is a leveraged/inverse fund covered by the proposed sales practices rules that, under proposed rule 18f-4, would be excepted from the proposed limit on fund leverage risk.[393]

Finally, a fund would have to identify whether it has entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements, as provided under the proposed rule.[394] This information would assist the Commission and staff with our oversight functions by allowing us to identify which funds were excepted from certain of the proposed rule's provisions or relied on the rule's provisions regarding reverse repurchase agreements and unfunded commitment agreements.

We seek comment on the Commission's proposed amendments to Form N-CEN:

221. Should we require, as proposed, that funds identify that they relied on rule 18f-4, including whether they are limited derivatives users that are excepted from the proposed program requirement? Why or why not?

222. Should we require, as proposed, that funds identify that they are leveraged/inverse funds that are excepted from the proposed limit on fund leverage risk? Why or why not?

223. Should we require, as proposed, that funds identify that they entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements? Why or why not?

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392 *See* proposed Item C.7.l.i.-ii of Form N-CEN; *see also supra* section II.E.

393 *See* proposed Item C.7.l.iii of Form N-CEN; *see also supra* section II.G.

394 *See* proposed Item C.7.l.iv-v of Form N-CEN; *see also infra* sections II.I and II.J.

224. Are there other means that funds use to disclose or report information (*e.g.*, prospectus or annual report disclosure in addition to the other disclosure requirements in this proposal) that would be more appropriate for reporting any of the information that the proposed amendments to Form N-CEN would require? Should any of the disclosures required in the proposed amendments to Form N-PORT above be made on Form N-CEN? Why or why not?

4. BDC Reporting

BDCs do not file reports on Form N-CEN or Form N-PORT. We considered proposing to require that BDCs provide the new information that we propose registered funds report on Form N-CEN, and the new information regarding derivatives exposure and VaR that we propose to require funds to report on Form N-PORT, in their annual reports on Form 10-K. BDCs, however, generally do not enter into derivatives transactions or do so to a limited extent.[395] We therefore believe that most BDCs that enter into derivatives transactions would qualify for the limited derivatives user exception (which would make the proposed VaR reporting items on Form N-PORT inapplicable to BDCs). In addition, and as noted above, we understand that even when BDCs do use derivatives more extensively, derivatives generally do not play as significant of a role in implementing the BDC's strategy, as compared to many other types of funds that use derivatives extensively. BDCs are required under the Investment Company Act to invest at least 70% of their total assets in "eligible portfolio companies," which may limit the role that derivatives can play in a BDC's portfolio relative to other kinds of funds that would generally execute their strategies primarily through derivatives transactions (*e.g.* a managed futures fund).

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[395] *See supra* section II.D.2.b.

BDCs that would not qualify as limited derivatives users under the proposed rule also would be subject to the proposed new requirement to file current reports regarding VaR test breaches on Form N-RN.[396] Taking these factors into account, we are not proposing additional reporting requirements for BDCs because we believe that the reporting framework we are proposing for BDCs adequately addresses the Commission's ability to monitor BDCs' compliance with the proposed rules, as well as any competitive disparities that could result from disparate reporting requirements among funds that rely on proposed rule 18f-4.[397]

We seek comment on the Commission's proposal to not require BDCs to report on Forms N-PORT or N-CEN:

225. Should we require BDCs to report any of the same information on Form 10-K (or elsewhere, such as in a BDC's prospectus) that we are proposing to require registered investment companies to report on Forms N-CEN and N-PORT? Why or why not? Should we require, for example, that a BDC report its derivatives exposure, whether it is a limited derivatives user, and/or its designated reference index (if applicable)? If so, where? If a BDC uses derivatives and does not qualify as a limited derivatives user, should it have to report information about its derivatives exposure and portfolio

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396 *See supra* section II.H.2.

397 We have separately proposed to require BDCs to tag their financial statements using Inline XBRL, a structured, machine-readable format, which would provide structured data about BDCs' derivatives and other investments. *See* Securities Offering Reform Proposing Release, *supra* note 199, at section II.H.1. In addition, BDCs are currently required to disclose certain information about their exposures to market risks, including risks that may arise as a result of their derivatives-related activity. *See, e.g.*, Items 303 and 305 of Regulation S-K [17 CFR 229.303 and 229.305].

See also infra section III.D.2 (discussing, among other things, potential competitive effects resulting from BDCs not being subject to the proposed additional reporting requirements on Form N-PORT and Form N-CEN).

VaR on Form N-PORT (or elsewhere)?

226. Should we require BDCs to report on Form 10-K or elsewhere whether they have relied on the rule's provision regarding reverse repurchase agreements and similar financing transactions or unfunded commitment agreements?

I. Reverse Repurchase Agreements

Funds may engage in certain transactions that may involve senior securities primarily as a means of obtaining financing. For example, open-end funds are permitted to borrow money from a bank, provided they maintain a 300% asset coverage ratio.[398] Another common method of obtaining financing is through the use of reverse repurchase agreements. In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage of the value of the security. At an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest.[399] A reverse repurchase agreement is economically equivalent to a secured borrowing.[400]

We believe that reverse repurchase agreements and other similar financing transactions that have the effect of allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets should be treated for section 18 purposes like a bank borrowing or other borrowing, as they achieve effectively identical results. Accordingly, we are proposing that a fund may engage in reverse repurchase agreements and other similar financing

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[398] *See* section 18(f)(1) of the Investment Company Act.

[399] *See* Release 10666, *supra* note 15, at "Reverse Repurchase Agreements" discussion (stating that a reverse repurchase agreement may not have an agreed-upon repurchase date, and in that case the agreement would be treated as if it were reestablished each day).

[400] *See*, *e.g.*, Office of Financial Research, *Reference Guide to U.S. Repo and Securities Lending Markets* (Sept. 9, 2015), *available at* https://www.financialresearch.gov/working-papers/files/OFRwp-2015-17_Reference-Guide-to-U.S.-Repo-and-Securities-Lending-Markets.pdf.

transactions so long as they are subject to the relevant asset coverage requirements of section 18.[401] For example, this would have the effect of permitting an open-end fund to obtain financing by borrowing from a bank, engaging in a reverse repurchase agreement, or any combination thereof, so long as all sources of financing are included when calculating the fund's asset coverage ratio.[402]

Reverse repurchase agreements and similar financing transactions are not treated as derivatives transactions under the proposed rule because they have the economic effects of a secured borrowing, and thus more closely resemble bank borrowings with a known repayment obligation rather than the more-uncertain payment obligations of many derivatives. However, such transactions can have the effect of introducing leverage into a fund's portfolio if the fund were to use the proceeds of the financing transaction to purchase additional investments. In addition, such transactions impose a requirement to return assets at the termination of the agreement, which can raise section 18 asset sufficiency concerns to the extent the fund needs to sell less-liquid securities at a loss to obtain the necessary assets.

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401 Proposed rule 18f-4(d). Among other things, section 18 prescribes the required amount of asset coverage for a fund's senior securities and provides certain consequences for a fund that fails to maintain this amount. *See, e.g.*, section 18(a) (restrictions on dividend issuance). This provision in rule 18f-4 would not provide any exemptions from the requirements of section 61 for BDCs because that section does not limit a BDC's ability to engage in reverse repurchase or similar transactions in parity with other senior security transactions permitted under that section.

402 Section 18 states that certain borrowings that are made for temporary purposes (less than 60 days) and that do not exceed 5% of the total assets of the issuer at the time when the loan is made (temporary loans) are not senior securities for purposes of certain paragraphs in section 18. As we noted in Release 10666, reverse repurchase agreements and similar financing transactions could be designed to appear to fall within the temporary loans exception, and then could be "rolled-over," perhaps indefinitely, with such short-term transactions being entered into, closed out, and later re-entered. If substantially similar financing arrangements were being "rolled over" in any manner for a total period of 60 days or more, we would treat the later transactions as renewals of the earlier ones, and all such transactions would fall outside the exclusion for temporary loans.

Reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under the limited derivatives user provisions of the proposed rule. However, if a fund did not qualify as a limited derivatives user due to its other investment activity, any portfolio leveraging effect of reverse repurchase agreements or similar financing transactions would be included and restricted through the proposed VaR-based limit on fund leverage risk. This is because the proposed VaR tests estimate a fund's risk of loss taking into account all of its investments, including the proceeds of reverse repurchase agreements and similar investments the fund purchased with those proceeds.

Securities lending arrangements are structurally similar to reverse repurchase agreements in that, in both cases, a fund transfers a portfolio security to a counterparty in exchange for cash (or other assets). Although these arrangements are structurally similar, under our proposal we would not view a fund's obligation to return securities lending collateral as a "similar financing transaction" in the circumstances discussed below. In the 2015 Proposing Release, we sought comment on whether rule 18f-4 should address funds' compliance with section 18 in connection with securities lending.[403] Commenters stated that the staff's current guidance on securities lending forms the basis for funds' securities lending practices and effectively addresses the senior securities implications of securities lending, and thus securities lending practices need not be addressed in the final rule.[404]

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403 2015 Proposing Release, *supra* note 2, at paragraph accompanying n.149.

404 *See, e.g.*, ICI Comment Letter I; Guggenheim Comment Letter; SIFMA Comment Letter; Comment Letter of the Risk Management Association (Mar. 28, 2016). Staff guidance on Securities Lending by U.S. Open-End and Closed-End Investment Companies (Feb. 27, 2014), *available at* https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm (providing guidance on certain no-action letters that funds consider when engaging in securities lending and summarizing areas those letters address, including

Currently, funds that engage in securities lending typically reinvest cash collateral in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, and funds generally do not sell or otherwise use non-cash collateral to leverage the fund's portfolio.[405] We believe a fund that engages in securities lending under these circumstances is limited in its ability to use securities lending transactions to increase leverage in its portfolio. Accordingly, the proposed rule does not treat a fund's obligation to return securities lending collateral as a financing transaction similar to a reverse repurchase agreement, so long as the obligation relates to an agreement under which a fund engages in securities lending, the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests cash collateral solely in cash or cash equivalents. If a fund were to engage in securities lending and to invest the cash collateral in securities other than cash or cash equivalents, this may result in leveraging of the fund's portfolio, and we believe this activity would be a "similar financing transaction" and should thus be included when calculating a funds asset coverage ratio.

We believe that a fund's obligation with respect to a "tender option bond" ("TOB") financing may be similar to a reverse repurchase agreement in some circumstances. One commenter on the 2015 proposal explained that TOB financings are economically similar to

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limitations on the amount that may be lent and collateralization for such loans).

405 *See* ICI, *Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Basics* (Sept. 14, 2014), *available at* https://www.ici.org/viewpoints/view_14_sec_lending_01 ("[T]he collateral that funds can accept from borrowers must be highly liquid, such as cash, government securities, or bank letters of credit. U.S. regulated funds typically demand cash collateral. … In practice, U.S. regulated funds most often invest cash collateral in money market funds."); SIFMA, *Master Securities Lending Agreement*, section 4.2 (2000), *available at* https://www.sifma.org/wp-content/uploads/2017/08/MSLA_Master-Securities-Loan-Agreement-2000-Version.pdf (generally limiting lenders from re-hypothecating non-cash collateral).

reverse repurchase agreements because a fund employing a TOB trust has in effect used the underlying bond as collateral to secure a borrowing analogous to a fund's use of a security to secure a reverse repurchase agreement.[406] We believe that determining whether a TOB is a similar financing transaction as a reverse repurchase agreement would depend on the facts and circumstances. To the extent a fund concludes that there are economic similarities between a TOB financing and a reverse repurchase agreement, the fund should treat obligations with respect to the TOB financing as a similar financing transaction under the proposed rule.

We request comment on our proposed approach to reverse repurchase agreements and similar financing transactions under the proposed rule.

227. As proposed, should we treat reverse repurchase agreements and similar financing transactions as economically equivalent to bank borrowings under section 18, and subject them to the same asset coverage requirements? Why or why not?

228. Should we not combine reverse repurchase agreements with bank borrowing and other senior securities under the provision, and instead treat them separately but with the same limit? For example, should we allow a fund to borrow from a bank subject to the 300% asset coverage limit and also separately use reverse repurchase agreements up to a 300% asset coverage limit?

229. Should we instead treat such reverse repurchase agreements and similar financing transactions as derivatives transactions under the proposed rule? Would this have any disparate effects on certain types of funds?

230. Is there a way to distinguish reverse repurchase agreements and similar financing

[406] *See* SIFMA Comment Letter.

transactions that funds use to leverage their portfolios from instances in which funds use those transactions for other purposes? If so, should we treat such transactions engaged in for leveraging purposes differently than transactions engaged in for other purposes?

231. Should we include securities lending transactions as a similar financing transaction (regardless of how the proceeds are invested) under the proposed provision? Why or why not? Should we define in rule 18f-4 the circumstances under which securities lending would not be treated as a similar financing transaction?

232. Are there other types of transactions that we should identify and treat as similar financing transactions to reverse repurchase agreements that we have not identified above? What are they and why should they be treated accordingly?

J. Unfunded Commitment Agreements

Under unfunded commitment agreements, a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future.[407] They include capital commitments to a private fund requiring investors to fund capital contributions or to purchase shares upon delivery of a drawdown notice. The proposed rule would therefore define an unfunded commitment agreement to mean a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.[408]

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[407] We understand that the types of funds that enter into unfunded commitment agreements typically include BDCs and registered closed-end funds.

[408] Proposed rule 18f-4(a).

The Commission's 2015 proposal would have treated these agreements as "financial commitment transactions." As a result, a fund's obligations under the agreements could not exceed the fund's net asset value.[409] Commenters on the 2015 proposal identified characteristics of these agreements that they believed distinguished unfunded commitments from the derivatives transactions and financial commitment transactions covered by that proposal, which are also covered by re-proposed rule 18f-4.[410] First, commenters stated that a fund often does not expect to lend or invest up to the full amount committed. Second, commenters stated that a fund's obligation to lend is commonly subject to conditions, such as a borrower's obligation to meet certain financial metrics and performance benchmarks, which are not typically present under the types of agreements that the Commission described in Release 10666.[411] Commenters also asserted that unfunded commitment agreements do not give rise to the risks that Release 10666

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[409] *See* 2015 proposed rule 18f-4(c)(4) (defining "financial commitment transactions"); 2015 proposed rule 18f-4(b) (permitting funds to engage in financial commitment transactions if the fund maintains qualifying coverage assets with a value equal to at least the fund's aggregate financial commitment obligations); 2015 proposed rule 18f-4(c)(5) (defining a fund's "financial commitment obligations," in part, to mean "the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction).

[410] Specifically, these commenters generally compared unfunded commitment agreements to firm and standby commitment agreements (which we would in turn interpret the phrase "or any similar instrument" in proposed rule 18f-4's definition of "derivatives transaction" to include, *see supra* note 91 and accompanying paragraph). *See, e.g.*, Letter of Ares Capital Corporation (Mar. 28, 2016) ("Ares Comment Letter"); Comment Letter of the Small Business Investor Alliance (Mar. 28, 2016) ("SBIA Comment Letter"); Comment Letter of the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (Mar. 28, 2016); Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (Mar. 28, 2016) ("Skadden Comment Letter"); Dechert Comment Letter; Private Equity Growth Capital Council (Mar. 28, 2016) ("PEGCC Comment Letter").

[411] *See, e.g.*, SBIA Comment Letter; Comment Letter of Hercules Capital (Mar. 29, 2016); *see also, e.g.*, Skadden Comment Letter (contingent loan commitments typically have "funding conditions that excuse the BDC from funding if the borrower does not continue to satisfy various representations, financial and non-financial metrics and performance conditions . . . [and] cannot result in substantial risk of loss prior to funding because the BDC is not required to fund the loan if the borrower's credit or financial position degenerates meaningfully.").

identified and do not have a leveraging effect on the fund's portfolio because they do not present an opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment when the other party to the agreement calls the commitment.[412] These commenters contrasted firm and standby commitment agreements, under which a fund commits itself to purchase a security with a stated price and fixed yield without condition or upon the counterparty's demand.[413] They argued that the firm and standby commitment agreements that Release 10666 describes expose the fund to investment risk during the life of the transaction, because the value of the fund's commitment agreement will change as interest rates change.

We agree that these factors distinguish unfunded commitment agreements from the derivatives transactions covered by proposed rule 18f-4. The derivatives transactions covered by proposed rule 18f-4—including the firm and standby commitment agreements the Commission described in Release 10666—expose the fund to investment risk during the life of the transaction. Derivatives transactions therefore can be used to leverage a fund's portfolio by enabling a fund to magnify its gains and losses compared to the fund's investment, while also obligating the fund to make a payment to a counterparty. Based on the characteristics of unfunded commitment

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412 *See, e.g.*, PEGCC Comment Letter (distinguishing the agreements that Release 10666 discusses because, while the value of the fund's limited partnership interest may fluctuate based on the amount of capital it invests in the private fund, the fund has no profit or loss on the unfunded commitment); Ares Comment Letter (stating that, in general, unfunded loan commitments do not reflect a bet on interest rate movements because the yields for unfunded loan commitments are determined as a spread over a prevailing market interest rate); *see also* Altegris Comment Letter (explaining that unfunded commitment agreements do not have a potential for "pyramiding" because—in contrast to a reverse repurchase agreement—a fund "receives nothing from the underlying private equity funds in return for its capital commitments and, as a result, its gross assets remain unchanged.").

413 *See, e.g.*, SBIA Comment Letter; *see also* Altegris Comment Letter; Ares Comment Letter; Comment Letter of Dechert (Feb. 7, 2016); Skadden Comment Letter.

agreements commenters described, which we understand are typical of these agreements, we do not believe that such unfunded commitment agreements are undertaken to leverage a fund's portfolio. For example, if the yield for an unfunded loan commitment is determined as a spread over a prevailing market interest rate, the agreement creates a risk that the fund would not have liquid assets to fund the loan, but the agreement would not reflect a speculative position on the direction of interest rates.[414] We therefore do not believe that such unfunded commitment agreements generally raise the Investment Company Act's concerns regarding the risks of undue speculation.[415]

Depending on the facts and circumstances, however, an unfunded commitment agreement could raise the asset sufficiency concerns underlying the Investment Company Act.[416] A fund could be required to liquidate other assets to obtain the cash needed to satisfy its obligation under an unfunded commitment agreement if the fund did not have cash on hand to meet its obligation to provide a committed loan or make a committed equity investment. If the fund is unable to meet its obligations, the fund would be subject to default remedies available to its counterparty. For example, if a fund fails to fulfill its commitments to invest in a private fund when called to do so, the fund could be subject to the remedies specified in the limited partnership agreement (or similar document) relating to that private fund. These remedies can have the practical effect

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414 *Cf*. Release 10666, *supra* note 15, at n.12 ("Commitments to purchase securities whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in this general statement of policy. Such commitments neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage.").

415 *See supra* notes 45-47 and accompanying text.

416 *See id.*

of forfeiture of some or all of the fund's investment in the private fund.[417] In these and other circumstances a fund's investors could be harmed if the fund is unable to meet its obligations under an unfunded commitment agreement.

Because unfunded commitment agreements can raise the asset sufficiency concern underlying section 18, but generally do not raise the undue speculation concern associated with derivatives transactions (and reverse repurchase agreements and similar financing transactions), we are proposing to permit a fund to enter into unfunded commitment agreements if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.[418] While a fund should consider its unique facts and circumstances to have such a reasonable belief, the proposed rule would prescribe certain specific factors that a fund must take into account.[419]

First, the proposed rule would require a fund to take into account its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions). This is because other obligations can place competing demands on

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417 *See, e.g.*, Phyllis A. Schwartz & Stephanie R. Breslow, *Private Equity Funds: Formation and Operation* (June 2015 ed.), at 2-34 (remedies private equity funds may apply in event of investor default include, among other things, the right to charge high interest on late payments, the right to force a sale of the defaulting investor's interest, the right to continue to charge losses and expenses to defaulting investors while cutting off their interest in future profits, and the right to take any other action permitted at law or in equity).

418 *See* proposed rule 18f-4(e)(1). Because this proposed condition is designed to provide an approach tailored to unfunded commitment agreements, the proposed rule would also provide that these transactions would not be considered for purposes of computing asset coverage under section 18(h). As with our approach to derivatives transactions, applying section 18(h) asset coverage to these transactions appears unnecessary in light of the tailored requirement we are proposing. *See supra* note 66.

419 The proposed rule would also require the fund to make and maintain records documenting the basis for this belief. *See* proposed rule 18f-4(e)(2); *see also infra* section II.K.

cash a fund otherwise might intend to use to fund an unfunded commitment agreement. Second, the proposed rule would provide that a fund may not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments. This provision is designed to address the risk that a fund could suffer losses by selling assets to raise cash to fund an unfunded commitment agreement, ultimately having an adverse impact on the fund's investors. Finally, the proposed rule would provide that a fund may not consider cash that may become available from issuing additional equity. Whether a fund would be able to raise capital in the future and the amount of any additional capital would depend on a variety of factors, including future market conditions, that we believe are too speculative to support a fund's reasonable belief that it could fund an unfunded commitment with the proceeds from future sales of the fund's securities. The proposed rule would not preclude a fund from considering the issuance of debt to support a reasonable belief that it could fund an unfunded commitment, as we understand that funds often satisfy their obligations under unfunded commitments through borrowings. Moreover, such borrowings by funds would be limited by section 18's asset coverage requirements, which would limit the extent to which a fund's belief regarding its ability to borrow would allow the fund to enter into unfunded commitment agreements.

To have a reasonable belief, a fund therefore could consider, for example, its strategy, its assets' liquidity, its borrowing capacity under existing committed lines of credit, and the contractual provisions of its unfunded commitment agreements. A fund with unfunded loan commitments, for instance, could evaluate the likelihood that different potential borrowers would meet contractual "milestones" that the borrowers would have to satisfy as a condition to the obligation to fund a loan, as well as the amount of the anticipated borrowing. The fund's historical experience with comparable obligations should inform this analysis. Whether a fund has a reasonable belief also could be informed by a fund's assessment of the likeliness that subsequent developments could impair the fund's ability to have sufficient cash and cash equivalents to meet its unfunded commitment obligations.

This proposed approach for unfunded commitment agreements reflects the staff's experience in reviewing and commenting on fund registration statements, which have disclosure regarding the funds' unfunded commitments. These funds have generally represented, in substance, that they reasonably believe that their assets will provide adequate cover to allow them to satisfy all of their unfunded investment commitments, without taking into account any projected securities offerings. In their responses to staff comments, funds also have provided a general explanation as to the process by which they reached this reasonable belief.

Finally, the proposed rule would provide that an agreement that meets the rule's definition of a derivatives transaction is not an unfunded commitment.[420] This is because the proposed rule's treatment of unfunded commitments is predicated on these agreements having characteristics that distinguish them from the derivatives transactions covered by the proposed rule, as discussed above. Because the proposed definition of the term "derivatives transaction" includes any instrument that is similar to certain listed derivatives instruments, a contract that is functionally similar to a listed derivatives instrument would be a derivatives transaction and therefore would not qualify for the proposed rule's treatment of unfunded commitment agreements.[421] For example, a fund that enters into a binding commitment to make a loan or purchase a note upon demand by the borrower, with stated principal and term and a fixed interest

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[420] *See* proposed rule 18f-4(a) (defining the term "unfunded commitment agreement").

[421] *See supra* section II.A (discussing proposed definition of "derivatives transaction").

rate, would appear to have entered into an agreement that is similar to a standby commitment agreement or a written put option.[422] This transaction would expose the fund to investment risk during the life of the transaction because the value of the fund's commitment agreement will change as interest rates change. Such an agreement thus would fall within the proposed rule's definition of "derivatives transaction" and would not be an unfunded commitment agreement under the proposed rule.

We request comment on our proposed approach to unfunded commitment agreements.

233. Are unfunded commitment agreements distinguishable from derivatives transactions? Can funds use unfunded commitment agreements for speculation or to accomplish leveraging? If so, how? What types of funds enter into unfunded commitment agreements, and for what purposes?

234. Does funds' use of unfunded commitment agreements raise the undue speculation and/or the assets sufficiency concerns underlying section 18 of the Investment Company Act? Why or why not?

235. Is the proposed approach to unfunded commitment agreements appropriate? Would the proposed approach appropriately address any asset sufficiency concerns that funds' use of unfunded commitment agreements might entail? Why or why not?

236. Is the proposed requirement that a fund must have a "reasonable belief" regarding its ability to meet its unfunded commitment obligations, at the time it enters into an unfunded commitment agreement, appropriate? Should the rule instead, or also, require a fund to reassess whether this belief remains reasonable at various points

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[422] *See supra* paragraph accompanying notes 408-412 (discussing factors distinguishing unfunded commitment agreements from the derivatives transactions covered by proposed rule 18f-4).

during the period of the unfunded commitment agreement?

237. Are the rule's provisions regarding the factors that a fund must consider in determining whether it has the required "reasonable belief" appropriate? Why or why not? Are they sufficiently clear? Should we specify other factors that a fund could consider? Should the rule provide, for example, that a fund may consider potential borrowings only to the extent the fund has committed lines of credit or other committed borrowing capacity? If so, how should we define "committed" for this purpose?

238. Under the proposed rule, a fund's reasonable belief that it has sufficient cash to satisfy its unfunded commitments may not be based on cash that may become available from issuing additional equity. Do commenters agree that a fund's ability to raise capital in the future, and the amount of any such additional capital, are based on factors that are too speculative to support a fund's reasonable belief that it could use that capital to fund an unfunded commitment? Are there circumstances in which a fund can expect to raise capital in the future, such as expected inflows from retirement plan platforms, that would not raise the same concerns about supporting a reasonable belief under the proposed rule? Should the rule permit a fund to consider such additional capital as a basis for forming a reasonable belief?

239. Should the rule otherwise limit funds' use of unfunded commitment agreements? If so, how? For example, should the rule specify that funds' unfunded commitment agreements, in the aggregate, may not exceed the fund's net asset value? Or should we adopt different requirements for unfunded commitment agreements for different types of funds, based on their ability to borrow money under the Investment

Company Act?[423] Should the rule limit the agreements' counterparties or otherwise restrict the agreements' terms in any way? If so, how? Should we adopt different requirements for unfunded loan commitments, which generally will be contingent upon a borrower meeting certain "milestones," as compared to commitments to invest in a private fund due upon demand by the fund's adviser? If so, which requirements should apply to each type of transaction and why?

240. Should the rule instead treat all—or a specified subset of—unfunded commitment agreements in the same way that it treats derivatives transactions? If a subset of these agreements, should the rule specify that certain characteristics of these agreements are indicative that these agreements are "similar instruments" in the proposed rule's definition of "derivatives transaction"? Should a fund that enters into unfunded commitment agreements, but that otherwise does not use derivatives (or that limits its derivatives exposure, either as the proposed rule specifies in the limited derivative user provisions or otherwise) be subject to the proposed VaR-based limit on fund leverage risk? Should such a fund be exempt from any of the proposed rule's other requirements, and if so, which ones and why?

241. Is the proposed definition of "unfunded commitment agreement" clear and appropriate? If not, how should the Commission modify it? Should the Commission clarify any aspect of the definition (*e.g.*, should the Commission further define or provide guidance regarding agreements that involve a commitment to "make a loan to a company" or to "invest equity in a company in the future")? Would funds

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423 *See supra* notes 29-32 and accompanying text.

experience any challenges in practice differentiating between unfunded commitments, on the one hand, and firm or standby commitment agreements or other transactions included in the definition of "derivatives transaction," on the other? If so, how should the Commission provide additional clarity?

242. Are there other types of transactions that we should identify and treat as similar to unfunded commitment agreements? What are they and why should they be treated accordingly? Are there any transactions that may be viewed as firm or standby commitment agreements, but that commenters believe should be given the same treatment as unfunded commitments under the proposed rule? What kinds of transactions and why?

243. Would any adverse market effects result from the proposed treatment of unfunded commitment agreements? For example, would the proposal lead funds to restructure transactions as unfunded commitment agreements, and if so would this adversely affect investor protection? Would any modifications to the proposed rule, or additional Commission guidance, help mitigate potential adverse market effects?

K. Recordkeeping Provisions

Proposed rule 18f-4 also includes certain recordkeeping requirements. These proposed requirements are designed to provide our staff, and a fund's compliance personnel, the ability to evaluate the fund's compliance with the proposed rule's requirements.

First, the proposed rule would require the fund to maintain certain records documenting the fund's derivatives risk management program. Specifically, for a fund subject to the proposed rule's program requirements, the proposed rule would require the fund to maintain a written record of its policies and procedures that are designed to manage the fund's derivatives risks.[424] The proposed rule would also require a fund to maintain a written record of the results of any stress testing of its portfolio, results of any VaR test backtesting it conducts, records documenting any internal reporting or escalation of material risks under the program, and records documenting any periodic reviews of the program.[425] These records would allow our staff to understand a fund's derivatives risk management program and how the fund administered it.

Second, the proposed rule would require funds to keep records of any materials provided to the fund's board of directors in connection with approving the designation of the derivatives risk manager.[426] The proposed rule would also require a fund to keep records of any written reports provided to the board of directors relating to the program, and any written reports provided to the board that the rule would require regarding the fund's non-compliance with the applicable VaR test.[427] These records would help our staff to understand what was provided to the fund's board while overseeing the fund's program.

Third, for a fund that is required to comply with the proposed VaR-based limit on fund leverage risk, the fund would have to maintain records documenting the fund's determination of: the VaR of its portfolio; the VaR of the fund's designated reference index, as applicable; the fund's VaR ratio (the value of the VaR of the fund's portfolio divided by the VaR of the designated reference index), as applicable; and any updates to any VaR calculation models used

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[424] Proposed rule 18f-4(c)(6)(i)(A); *see also supra* section II.B.3.

Under proposed rule 18f-4(c)(4), leveraged/inverse funds would be subject to the proposed rule's derivatives risk management program requirement. Such funds would therefore also be subject to the program-related recordkeeping provisions of the proposed rule.

[425] Proposed rule 18f-4(c)(6)(i)(A).

[426] Proposed rule 18f-4(c)(6)(i)(B); *see also supra* section II.C.

[427] *Id.*; *see also supra* section II.D.5.b.

by the fund, as well as the basis for any material changes made to those models.[428] These records would provide information on the operation of a fund's VaR test and, for example, would allow our staff to better understand how a fund (and funds generally) implement the proposed VaR tests.

Fourth, the proposed rule would require a fund that is a limited derivatives user to maintain a written record of its policies and procedures that are reasonably designed to manage its derivatives risk.[429] These records would help our staff to understand what policies and procedures that a limited derivatives user has adopted and implemented to address the risks associated with its use of derivatives.

Fifth, the proposed rule would require a fund that enters into unfunded commitment agreements to maintain a record documenting the basis for the fund's belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements.[430] A fund must make such a record each time it enters into such an agreement.[431] These records would allow our staff to understand and evaluate funds' determinations regarding their ability to meet their obligations under their unfunded commitment agreements.

Finally, the proposed rule would require funds to maintain the required records for a period of five years.[432] In particular, a fund must retain a copy of its written policies and

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428 Proposed rule 18f-4(c)(6)(i)(C); *see also supra* section II.K.

429 Proposed rule 18f-4(c)(6)(i)(D); *see also supra* section II.K.

430 Proposed rule 18f-4(e)(2); *see also supra* section II.K.

431 *Id.*

432 Proposed rule 18f-4(c)(6)(ii); proposed rule 18f-4(e)(2).

procedures under the rule that are currently in effect, or were in effect at any time within the past five years, in an easily accessible place.[433] In addition, a fund would have to maintain all other records and materials that the rule would require the fund to keep for at least five years (the first two years in an easily accessible place).[434] The proposed five-year retention period is consistent with the period provided in rule 38a-1(d) and rule 22e-4 under the Investment Company Act. We believe consistency in these retention periods is appropriate because funds currently have compliance-program-related recordkeeping procedures in place incorporating a five-year retention period, which we believe would lessen the proposed new recordkeeping compliance burden to funds, compared to choosing a different, longer retention period.

We request comment on the proposed rule's recordkeeping requirements.

244. Are the proposed recordkeeping provisions appropriate? Are there any other records relating to a fund's derivatives transactions that a fund should be required to maintain? For example, should we also require a fund to maintain written records relating to any action the fund took after exceeding a risk guideline (or any internal reporting that occurred following the exceedance of a risk guideline)?[435] Or, as another example, should we include a provision in the proposed rule that would require a fund that enters into reverse repurchase agreements under proposed rule 18f-4(d) to maintain records documenting the fund's compliance with the applicable asset

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[433] Proposed rule 18f-4(c)(6)(ii)(A); *see also supra* notes 423 and 428 and accompanying text. The retention requirement would apply to both funds that are required to implement a derivatives risk management program and funds that are limited derivatives users under proposed rule 18f-4(c)(3).

[434] Proposed rule 18f-4(c)(6)(ii)(B); proposed rule 18f-4(e)(2).

[435] *See, e.g.*, proposed rule 18f-4(c)(1)(ii), proposed rule 18f-4(c)(1)(v)(A).

coverage requirement of section 18? Why or why not? The proposed rule would require a fund to maintain records of the VaR of its portfolio, the VaR of its designated reference index (as applicable), and its VaR ratio. To what extent would the requirement to maintain records of the fund's VaR ratio involve burdens in addition to the requirement to maintain the fund's VaR and the VaR of the designated reference index?

245. Are there feasible alternatives to the proposed recordkeeping requirements that would minimize recordkeeping burdens, including the costs of maintaining the required records, while promoting the goals of providing the Commission and its staff, and a fund's compliance personnel, sufficient information to understand: (1) a fund's derivatives risk management program and how the fund had administered it, (2) how a fund's board oversees the program, (3) the administration and effectiveness of a fund's VaR test, (4) how a limited derivatives user's policies and procedures are designed to address the risks associated with its use of derivatives, and (5) the basis for a fund's determination regarding the sufficiency of its cash to meet its obligations with respect to unfunded commitment agreements?

246. Are the record retention time periods that we have proposed appropriate? Should we require records to be maintained for a longer or shorter period? If so, for how long?

L. Transition Periods

In view of our proposal for an updated, comprehensive approach to the regulation of funds' derivatives use, we are proposing to rescind Release 10666.[436] In addition, staff in the

[436] *See supra* section I.C.

Division of Investment Management is reviewing its no-action letters and other guidance addressing derivatives transactions and other transactions covered by proposed rule 18f-4 to determine which letters and other staff guidance, or portions thereof, should be withdrawn in connection with any adoption of this proposal. Upon the adoption of any final rule, some of these letters and other staff guidance, or portions thereof, would be moot, superseded, or otherwise inconsistent with the final rule and, therefore, would be withdrawn. If interested parties believe that additional letters or other staff guidance, or portions thereof, should be withdrawn, they should identify the letter or guidance, state why it is relevant to the proposed rule, how it or any specific portion thereof should be treated, and the reason therefor. The staff review would include, but would not necessarily be limited to, all of the staff no-action letters and other staff guidance listed below, including our staff's position regarding TOBs.[437]

- Dreyfus Strategic Investing & Dreyfus Strategic Income (pub. avail. June 22, 1987)
- Merrill Lynch Asset Management, L.P. (pub. avail. July 2, 1996)
- Robertson Stephens Investment Trust (pub. avail. Aug. 24, 1995)
- Claremont Capital Corp (pub. avail. Sept. 16, 1979)
- Emerald Mgt. Co. (pub. avail. Jan. 21, 1978)
- Sanford C. Bernstein (pub. avail. June 25, 1990)
- Hutton Options Trading, L.P. (pub. avail. Feb. 2, 1989)
- Prudential-Bache IncomeVertible Plus Fund (pub. avail. Nov. 20, 1985)

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437 *See* Investment Management Staff Issues of Interest, *available at* https://www.sec.gov/divisions/investment/issues-of-interest.shtml#tobfinancing; *see also* Registered Investment Company Use of Senior Securities — Select Bibliography, *available at* https://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

- State Street Income Fund, State Street Balanced Fund (pub. avail. Oct. 21, 1985)
- New England Life Government Securities Trust (pub. avail. Sept. 26, 1985)
- Putnam Option Income Trust II (pub. avail. Sept. 23, 1985)
- Thomson McKinnon Government Securities Fund (pub. avail. Sept. 23, 1985)
- GMO Core Trust (pub. avail. Aug. 19, 1985)
- Bartlett Capital Trust (pub. avail. Aug. 19, 1985)
- Continental Option Income Plus Fund (pub. avail. Aug. 12, 1985)
- Colonial High Yield Securities Trust, Colonial Enhanced Mortgage Trust (pub. avail. July 25, 1985)
- Putnam High Income Government Trust (pub. avail. June 3, 1985)
- Bartlett Management Trust (pub. avail. May 17, 1985)
- Drexel Series Trust — Government Securities Series (pub. avail. Apr. 25, 1985)
- Koenig Tax Advantaged Liquidity Fund (pub. avail. Mar. 27, 1985)
- Colonial Tax-Managed Trust (pub. avail. Dec. 31, 1984)
- Monitrend Fund (pub. avail. Nov. 14, 1984)
- Pilot Fund (pub. avail. Sept. 14, 1984)
- Colonial Government Securities Plus Trust (pub. avail. June 15, 1984)
- Z-Seven Fund (pub. avail. May 21, 1984)
- Pension Hedge Fund (pub. avail. Jan. 20, 1984)
- Steinroe Bond Fund (pub. avail. Jan. 17, 1984)
- IDS Bond Fund (pub. avail. Apr. 11, 1983)
- Safeco Municipal Bond, Inc (pub. avail. Nov. 26, 1982)

- "Dear Chief Financial Officer" Letter, from Lawrence A. Friend, Chief Accountant, Division of Investment Management (pub. avail. Nov. 7, 1997)

Accordingly, following a one-year transition period to provide time for funds to prepare to come into compliance with the new rule, funds could only enter into derivatives transactions, reverse repurchase agreements and similar financing transactions, and unfunded commitments to the extent permitted by, and consistent with the requirements of, proposed rule 18f-4 or section 18. At that time, Release 10666 would be rescinded and, as determined appropriate in connection with the staff's review of no-action letters and other staff guidance described in this release, staff no-action letters and other staff guidance, or portions thereof, would be withdrawn.

We similarly propose to provide a one-year compliance period for the sales practices rules to provide time for broker-dealers and investment advisers to bring their operations into conformity with the new rule. We also propose a one-year delay to the effective date of the amendments to rule 6c-11, which would permit leveraged/inverse ETFs to rely on that rule, and to rescind the exemptive orders we have provided to leveraged/inverse ETF sponsors on the effective date of the amendments to rule 6c-11.

We propose that each of the transition periods discussed in this section would run from the date of the publication of any final rule in the Federal Register. Accordingly, one year after that date: (1) any fund that enters into the transactions permitted by rule 18f-4 would do so relying on that rule; (2) broker-dealers and investment advisers would be required to comply with the sales practices rules; and (3) leveraged/inverse ETFs could operate under rule 6c-11 and the current leveraged/inverse ETF sponsors' orders would be rescinded.

We request comment on these transition periods.

247. Do commenters agree that a one-year transition period to provide time for funds to

prepare to come into compliance with proposed rule 18f-4 is appropriate? Should the period be shorter or longer?

248. Should we adopt tiered transition periods for smaller entities? For example, should we provide an additional 6 months for smaller entities (or some other shorter or longer period) in any transition period that we provide? Should the transition period be the same for all funds that rely on proposed rule 18f-4 (for example 12 months after any adoption of proposed rule 18f-4, or any shorter or longer period)?

249. Is the proposed one-year compliance period for the sales practices rules appropriate? Why or why not? Is a longer or shorter compliance period necessary to allow investment advisers and broker-dealers to comply with the proposed sales practices rules? Why or why not? If we provide small and large funds a tiered transition period to comply with proposed rule 18f-4, should we similarly implement a tiered compliance period for investment advisers and broker-dealers to comply with the proposed sales practices rules? Why or why not?

250. Would our proposal to rescind the current leveraged/inverse ETF sponsors' exemptive orders on the delayed effective date of the amendments to rule 6c-11 provide sufficient time for the leveraged/inverse ETF sponsors to transition to rule 6c-11?

M. Conforming Amendments

Form N-2 requires a closed-end fund to disclose a senior securities table with certain information about any senior securities it has issued.[438] Outstanding senior securities may bear on

[438] *See* Item 4.3 of Form N-2.

the likelihood, frequency, and size of distributions from the fund to its investors because section 18 prohibits distributions when a closed-end fund does not have the asset coverage required under that section. Proposed rule 18f-4 would provide that a fund's derivatives transactions and unfunded commitments entered into under the proposed rule would not be considered for purposes of computing section 18 asset coverage.[439] These transactions therefore would not affect a fund's ability under section 18 to make distributions to investors. Registered closed-end funds are already required to disclose extensive information about their derivatives transactions on Form N-PORT. In light of this treatment under proposed rule 18f-4 and the information that is already available regarding registered closed-end funds' derivatives transactions, we are proposing to amend Form N-2 to provide that funds relying on proposed rule 18f-4 would not be required to include their derivatives transactions and unfunded commitment agreements in the senior securities table on Form N-2.[440] Commenters on the 2015 proposal that addressed this topic supported such a conforming amendment with respect to asset coverage calculations and disclosure.[441]

We request comment on the proposed conforming amendment to Form N-2, and other conforming amendments that commenters suggest would be necessary or appropriate.

251. Is the proposed conforming amendment appropriate? We have not proposed to exclude reverse repurchase agreements and similar financing transactions from the senior securities table in Form N-2 because these transactions may bear on the likelihood, frequency, and size of distributions from a fund to its investors. Do

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439 *See* proposed rule 18f-4(b).

440 *See* proposed amendment to Instruction 2 of Item 4.3 of Form N-2.

441 *See, e.g.*, Ares Comment Letter; ICI Comment Letter I.

commenters agree that this is appropriate? Why or why not? If commenters do not believe that these transactions should be included in the senior securities table, what other disclosure would be appropriate?

252. Rule 22e-4 requires funds subject to the rule, in classifying the liquidity of their portfolios and in determining whether a fund primarily holds highly liquid investments, to take into account the fund's highly liquid investments that it has "segregated" to cover certain less liquid investments.[442] Proposed rule 18f-4, however, does not include an asset segregation requirement, and would supersede Release 10666 and related staff guidance. Should we remove any references in rule 22e-4 to "segregated" assets (while retaining rule 22e-4's references to assets pledged to satisfy margin requirements)? Is there any other basis on which funds "segregate" assets that would warrant our retaining these references?

253. Are there other conforming amendments to any of our other rules or forms that we should make? If so, what rules or forms should be amended and why?

III. ECONOMIC ANALYSIS

We are mindful of the costs imposed by, and the benefits obtained from, our rules. Section 3(f) of the Exchange Act and section 2(c) of the Investment Company Act state that when the Commission is engaging in rulemaking under such titles and is required to consider or determine whether the action is necessary or appropriate in (or, with respect to the Investment Company Act, consistent with) the public interest, the Commission shall consider whether the

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[442] *See* rule 22e-4(b)(1)(ii)(C); rule 22e-4(b)(1)(iii)(B). A fund would also have to take into account the percentage of its highly liquid investments that it has pledged to satisfy margin requirements. *See id.*

action will promote efficiency, competition, and capital formation, in addition to the protection of investors. Further, section 23(a)(2) of the Exchange Act requires the Commission to consider, among other matters, the impact such rules would have on competition and states that the Commission shall not adopt any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The following analysis considers, in detail, the potential economic effects that may result from the proposed rule, including the benefits and costs to investors and other market participants as well as the broader implications of the proposal for efficiency, competition, and capital formation.

A. Introduction

Funds today use a variety of derivatives, referencing a range of assets or metrics. Funds use derivatives both to obtain investment exposure as part of their investment strategies and to manage risks. A fund may use derivatives to gain, maintain, or reduce exposure to a market, sector, or security more quickly, or to obtain exposure to a reference asset for which it may be difficult or impractical for the fund to make a direct investment. A fund may use derivatives to hedge interest rate, currency, credit, and other risks, as well as to hedge portfolio exposures.[443] As funds' strategies have become increasingly diverse, funds' use of derivatives has grown in both volume and complexity over the past several decades. At the same time, a fund's derivatives use may entail risks relating to, for example, leverage, markets, operations, liquidity, and counterparties, as well as legal risks.[444]

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[443] *See supra* section I.A.

[444] *See, e.g., supra* notes 16-17 and accompanying text.

Section 18 of the Investment Company Act is designed to limit the leverage a fund can obtain through the issuance of senior securities.[445] As discussed above, a fund's derivatives use may raise the investor protections concerns underlying section 18. In addition, funds' asset segregation practices have developed such that funds' derivatives use—and thus funds' potential leverage through derivatives transactions—does not appear to be subject to a practical limit as the Commission contemplated in Release 10666. Accordingly, we continue to be concerned that certain fund asset segregation practices may not address the concerns underlying section 18.[446]

Proposed rule 18f-4 is designed to provide an updated, comprehensive approach to the regulation of funds' use of derivatives and certain other transactions. The proposed rule would permit a fund, subject to certain conditions, to enter into derivatives or other transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18 of the Investment Company Act. We believe that the proposed rule's requirements, including the derivatives risk management program requirement and VaR-based limit on fund leverage risk, would benefit investors by mitigating derivatives-related risks, including those that may lead to unanticipated and potentially significant losses for investors.

Certain funds use derivatives in a limited manner, which we believe presents a lower degree of risk or potential impact and generally a lower degree of leverage than permitted under section 18. The proposed rule would provide an exception from the proposed derivative risk management program requirement and VaR-based limit on fund leverage risk for these limited derivatives users. Instead, the proposed rule would require a fund relying on this exception to adopt policies and procedures that are reasonably designed to manage its derivatives risks. Funds

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445 *See supra* section I.B.1.

446 *See supra* sections I.B.3.

with limited derivatives exposure and funds that use derivatives transactions solely to hedge certain currency risk would therefore not be required to incur costs and bear compliance burdens that may be disproportionate to the resulting benefits, while still being required to manage the risks their limited use of derivatives may present.[447]

The proposed rule would also provide an exception from the VaR-based limit on fund leverage risk for certain leveraged/inverse funds in light of the requirements under the proposed sales practices rules that broker-dealers and investment advisers exercise due diligence in approving the accounts of retail investors to invest in these funds, and other conditions for these funds that proposed rule 18f-4 includes.[448] This would allow these funds, which generally could not currently satisfy the proposed VaR-based limit on fund leverage risk, to continue offering their current strategies. The proposed sales practices rules' due diligence and account approval requirements also would apply to accounts of investors in certain exchange-listed commodity- or currency-based trusts or funds, which are not investment companies subject to section 18 but present similar investor protection concerns. We believe the proposed sales practices rules would enhance investor protection by helping to ensure that investors in these funds are limited to those who are capable of evaluating their characteristics—including that the funds would not be subject to all of the leverage-related requirements applicable to registered investment companies generally—and the unique risks they present.

Proposed rule 18f-4 also contains requirements for funds' use of certain senior securities that are not derivatives. Specifically, the proposed rule would permit reverse repurchase agreements and other similar financing transactions if they comply with the asset coverage

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447 *See supra* sections I.C and II.E.

448 *See supra* section II.G.

requirements of section 18; this approach would align the treatment of reverse repurchase agreements and similar financing transactions, for section 18 purposes, with the treatment of bank borrowings and other senior securities transactions subject to section 18's asset coverage requirements.[449] In addition, the proposed rule would permit a fund to enter into unfunded commitment agreements if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements.[450] This requirement is designed to address the concern that a fund may experience losses as a result of having insufficient assets to meet its obligations with respect to these transactions, and we believe that the requirement would benefit investors by mitigating such losses or other adverse effects if a fund is unable to satisfy an unfunded commitment agreement.[451]

This proposal also includes certain recordkeeping requirements and reporting requirements for funds that use derivatives.[452] We expect that the proposed recordkeeping requirements would benefit investors by facilitating fund compliance with the proposed rule and our staff's review of funds' compliance. In addition, we expect that the proposed amendments to Forms N-PORT, N-CEN, and N-RN would further benefit investors by enhancing the Commission's and the public's understanding of the impact of funds' use of derivatives on fund

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449 Similar financing transactions may include securities lending arrangements and TOBs, depending on the particular facts and circumstances of the individual transaction. *See supra* section II.I.

450 *See supra* section II.J.

451 We believe that the proposed treatment of unfunded commitment transactions is consistent with general market practices. Therefore, we believe that the proposed requirements for both types of senior securities would not have significant economic effects when measured against this baseline.

452 *See supra* sections II.C and II.H.

portfolios, and by facilitating the Commission's ability to oversee funds' use of derivatives and compliance with the proposed rules.[453]

B. Economic Baseline

1. Fund Industry Overview

The fund industry has grown and evolved substantially in past decades in response to various factors, including investor demand, technological developments, and an increase in domestic and international investment opportunities, both retail and institutional.[454] As of September 2019, there were 9,788 mutual funds (excluding money market funds) with $21,333 billion in total net assets, 1,910 ETFs organized as an open-end fund or as a share-class of an open-end fund with $3,081 billion in total net assets, 664 registered closed-end funds with 294 billion in total net assets, and 13 variable annuity separate accounts registered as management investment companies on Form N-3 with $224 billion in total net assets. There also were 413 money market funds with $3,392 billion in total net assets.[455] Finally, as of June 2019, there were 99 BDCs with $63 billion in total net assets.[456]

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453 Because leveraged/inverse funds would not be subject to the proposed VaR-based limit on fund leverage risk, these funds would not be subject to the related proposed reporting requirements on Forms N-PORT and N-RN. Leveraged/inverse funds would, however, be subject to the proposed new reporting requirements on funds' derivatives exposure on form N-PORT as well as to the proposed new requirements on Form N-CEN.

454 *See supra* note 1.

455 Estimates of the number of registered investment companies and their total net assets are based on a staff analysis of Form N-CEN filings as of September 5, 2019. For open-end funds that have mutual fund and ETF share classes, we count each type of share class as a separate fund and use data from Morningstar to determine the amount of total net assets reported on Form N-CEN attributable to the ETF share class. Money market funds are excluded from the scope of proposed rule 18f-4 but may experience economic effects as a result of being excluded from the rule's scope. We therefore report their number and net assets separately from those of other mutual funds.

456 Estimates of the number of BDCs and their net assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of June 30, 2019. Our estimate includes BDCs that may be delinquent

2. Funds' Use of Derivatives

DERA staff analyzed funds' use of derivatives based on Form N-PORT filings as of September 2019. The filings covered 9,074 mutual funds with $19,590 billion in total net assets, 1,711 ETFs with $3,317 billion in total net assets, 565 registered closed-end funds with $327 billion in net assets, and 13 variable annuity separate accounts registered as management investment companies with $219 billion in total net assets.[457] While only larger fund groups are currently required to file reports on Form N-PORT, existing filings nevertheless covered 89% of funds representing 94% of assets.[458]

Based on this analysis, 59% of funds reported no derivatives holdings, and a further 27% of funds reported using derivatives with gross notional amounts below 50% of net assets. These results are comparable to and consistent with the findings of the DERA White Paper, which studied a random sample of 10% of funds in 2014.[459]

BDCs do not file Form N-PORT. To help evaluate the extent to which BDCs use derivatives, our staff reviewed the most recent financial statements of 48 of the current 99 BDCs as of September 2019.[460] Based on this analysis, we observe that most BDCs do not use

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or have filed extensions for their filings, and it excludes 6 wholly-owned subsidiaries of other BDCs.

457 The analysis is based on each registrant's latest Form N-PORT filing as of September 23, 2019. Money market funds are excluded from the analysis; they do not file monthly reports on Form N-PORT and are excluded from the scope of proposed rule 18f-4. For open-end funds that have mutual fund and ETF share classes, we count each type of share class as a separate fund and use data from Morningstar to determine the amount of total net assets reported on Form N-PORT attributable to the ETF share class.

458 *See supra* note 280.

459 *See* DERA White Paper, *supra* note 1.

460 *See supra* note 279 and accompanying text.

derivatives extensively. Of the sampled BDCs, 54% did not report any derivatives holdings, and a further 29% reported using derivatives with gross notional amounts below 10% of net assets.

3. Current Regulatory Framework for Derivatives

Funds have developed certain general asset segregation practices to "cover" their derivatives positions, consistent with the conditions in staff no-action letters and guidance.[461] However, staff has observed that practices vary based on the type of derivatives transaction, and that funds use different practices regarding the types of assets that they segregate to cover their derivatives positions. For purposes of establishing the baseline, we assume that funds generally segregate sufficient assets to at least cover any mark-to-market liabilities on the funds' derivatives transactions, with some funds segregating more assets for certain types of derivatives transactions (sufficient to cover the full notional amount of the transaction or an amount between the transaction's full notional amount and any mark-to-market liability).[462] As the mark-to-market liability of a derivative can be much smaller than the full investment exposure associated with the position, funds' current use of the mark-to-market asset segregation approach, and funds' segregation of any liquid asset, do not appear to place a practical limit on their use of derivatives.[463]

4. Funds' Derivatives Risk Management Practices and Use of VaR Models

There is currently no requirement for funds that use derivatives to have a formalized derivatives risk management program. However, we understand that advisers to many funds

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461 *See supra* section II.B.2.b.

462 *See supra* notes 54-55 and accompanying text.

463 *See supra* section I.B.2.b.

whose investment strategies entail the use of derivatives, including leveraged/inverse funds, already assess and manage risks associated with their derivatives transactions to varying extents. In addition, we understand that funds engaging in derivatives transactions have increasingly used stress testing as a risk management tool over the past decade.[464]

We also understand that VaR calculation tools are widely available, and many advisers that enter into derivatives transactions already use risk management or portfolio management platforms that include VaR tools.[465] Advisers to funds that use derivatives more extensively may be particularly likely to currently use risk management or portfolio management platforms that include VaR capability. Moreover, advisers that manage (or that have affiliates that manage) UCITS funds may already be familiar with using VaR models in connection with European guidelines.[466] One commenter submitted the results of a survey based on responses from 24 fund complexes with $13.8 trillion in assets.[467] The results of this survey indicate that 73% of respondents used some form of both VaR and stress testing as derivatives risk management tools.

5. Leveraged/Inverse Investment Vehicles and Leveraged/Inverse Funds

Leveraged/inverse investment vehicles, as defined in the proposed sales practices rules, include leveraged/inverse funds and certain exchange-listed commodity- or currency-based trusts or funds. Currently, there are 164 leveraged/inverse ETFs with $33.9 billion in total net assets;

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464 *See also supra* note 145 and accompanying text.

465 *See also supra* note 179.

466 *See supra* note 221 and accompanying text.

467 *See* ICI Comment Letter III. The commenter also indicated that the surveyed ICI member firms accounted for 67% of mutual fund and ETF assets as of June 2019 and that survey responses were submitted by firms "whose assets under management spanned the spectrum from small to very large." However, these representations alone do not provide sufficient information about whether the surveyed firms were representative of all mutual funds and ETFs in terms of the exact distribution of specific characteristics, such as firm size or type of investment strategy.

105 leveraged/inverse mutual funds with $4.9 billion in total net assets; and 17 exchange-listed commodity- or currency-based trusts or funds with $1.2 billion in total net assets.[468]

Leveraged/inverse investment vehicles generally target a daily return (or a return over another predetermined time period) that is a multiple, inverse, or inverse multiple of the return of an underlying index; however over longer holding periods, the realized leverage multiple of the returns of an investment in a leveraged/inverse investment vehicle relative to the returns of its underlying index can vary substantially from the vehicle's daily leverage multiple.

In addition, the returns of leveraged/inverse investment vehicles over longer holding periods share certain features with the returns of holding an option.[469] For example, a call option on an index with a strike price that is much higher than the current index price (*i.e.,* the option is significantly "out of the money") is likely to expire worthless. If the option expires worthless, an investor that holds the option until expiry receives no payoff in exchange for their initial investment (the option premium) and therefore experiences a return of -100%. Holding all other factors fixed, the likelihood of this outcome increases with the strike price of the option, and the option is priced accordingly—options that are further out of the money, all else equal, will have lower premiums. At the same time, on the rare occasions when the index price exceeds the strike price at expiration, the investor will earn a high return on his or her initial investment because the

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468 Estimates of the number of leveraged/inverse mutual funds and leveraged/inverse ETFs and their total net assets are based on a staff analysis of Form N-CEN filings as of September 5, 2019. Estimates of the number of exchange-listed commodity- or currency-based trusts or funds and their total net assets are based on Bloomberg data as of September 20, 2019.

469 For a technical analysis of the similarities between the returns of leveraged/inverse ETFs over longer holding periods and the returns of holding an option, *see* Division of Economic and Risk Analysis, Economics Note: The Distribution of Leveraged ETF Returns (Nov. 2019), *available at* https://www.sec.gov/files/DERA_LETF_Economics_Note_Nov2019.pdf. The results of that analysis also apply more generally to other types of leveraged/inverse investment vehicles.

initial price paid for a call option is lower when the strike price is higher. While the payoff to holding a leveraged/inverse investment vehicle over long periods generally lacks this strict discontinuous nature (expiring either in the money or out of the money), it is nevertheless similar to that of an option in the sense that, as the vehicle's leverage multiple or investor's holding period increases, the likelihood of experiencing a loss increases (analogous to the option expiring out of the money) while gains, when they do occur, tend to be larger (analogous to the option expiring in the money).[470]

To achieve the stated leverage multiple, most leveraged/inverse investment vehicles rebalance their exposure to the underlying index daily.[471] This is also similar to options, whose payoffs can be replicated by trading dynamically in the underlying asset and a low-risk bond. For example, call options are economically equivalent to holding a long position in the underlying asset and a short position in a low-risk bond.[472] Both leveraged/inverse investment vehicles and options are therefore economically equivalent to a dynamically rebalanced leveraged/inverse or inverse leveraged/inverse position in the underlying asset or reference index.[473]

The majority of assets held in leveraged/inverse funds are held in leveraged/inverse ETFs. There are currently two ETF sponsors that rely upon exemptive relief from the

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470 In statistical terms, the option returns and returns of holding leveraged/inverse investment vehicles over longer holding periods both exhibit positive skewness.

471 Leveraged/inverse investment vehicles that track the returns of an underlying index over time periods that are longer than one day rebalance their portfolios at the end of each such period. Leveraged/inverse investment vehicles use derivatives to achieve their targeted returns.

472 Conversely, put options are economically equivalent to holding a short position in the underlying and a long position in a low-risk bond—their replicating portfolio consists of an inverse leveraged position in the underlying.

473 Option replication portfolios need to be rebalanced continuously throughout the day as the price of the underlying asset changes. While the implied rebalancing happens continuously during the trading day for options, leveraged/inverse investment vehicles perform rebalancing trades in the underlying less frequently (daily for most leveraged/inverse investment vehicles).

Commission that permits them to operate leveraged/inverse ETFs.[474] Since 2009, the Commission has not granted leveraged/inverse exemptive relief to any additional sponsors. In addition, leveraged/inverse ETFs are currently excluded from the scope of rule 6c-11, which the Commission adopted earlier this year and which allows ETFs satisfying certain conditions to operate without obtaining an exemptive order from the Commission.[475]

Retail investors predominantly purchase and sell shares of leveraged/inverse investment vehicles through broker-dealers and investment advisers.[476] To the extent that broker-dealers or investment advisers recommend leveraged/inverse investment vehicles to their customers or clients, they should have processes in place to satisfy their obligations to make only suitable recommendations or provide best interest advice, respectively.[477] For example, the basis for an investment adviser's reasonable understanding generally would include, for retail clients of investment advisers, a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals.[478] When an adviser is assessing whether complex or high-risk products—such as leveraged/inverse funds—are in a retail client's best interest, the adviser should generally apply heightened scrutiny to whether such investments

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474 *See supra* notes 307 and 356. The exemptive orders of the two sponsors that operate leveraged/inverse ETFs permit these sponsors to launch additional funds under the terms and conditions of those orders.

475 *See supra* notes 352-353 and accompanying text.

476 *See supra* note 321.

477 Following the June 30, 2020 compliance date for Regulation Best Interest, broker-dealers will have to provide recommendations in the best interest of their retail customers. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, *supra* note 308.

478 *See, e.g.*, Fiduciary Interpretation, *supra* note 308, at text preceding n.36.

fall within the retail client's risk tolerance and objectives.[479] Broker-dealers also will be required to comply with Regulation Best Interest beginning on June 30, 2020.[480] Broker-dealers complying with Regulation Best Interest will have to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer, including by understanding potential risks, rewards, and costs associated with a recommendation in light of the customer's investment profile.[481]

C. Benefits and Costs of the Proposed Rules and Amendments

The Commission is sensitive to the economic effects that may result from the proposed rules and rule and form amendments, including benefits and costs. Where possible, we have attempted to quantify the likely economic effects; however, we are unable to quantify certain economic effects because we lack the information necessary to provide reasonable estimates. In some cases, it is difficult to predict how market participants would act under the conditions of the proposed rules. For example, we are unable to predict whether the proposed derivatives risk management program requirement and VaR-based limit on fund leverage risk may make investors more or less likely to invest in funds that would be subject to these requirements or the degree to which these requirements may affect the use of derivatives by these funds. Nevertheless, as described more fully below, we are providing both a qualitative assessment and

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479 *See id.* at text preceding n.39. The Commission further stated in the Fiduciary Interpretation that leveraged/inverse funds and other complex products "may not be in the best interest of a retail client absent an identified, short-term, client-specific trading objective and, to the extent that such products are in the best interest of a retail client initially, they would require daily monitoring by the adviser." *See id.*

480 *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, *supra* note 305.

481 *See id.* at section II.C.2.

quantified estimate of the economic effects, including the initial and ongoing costs of the additional reporting requirements, where feasible.

Direct costs incurred by funds discussed below may, to some extent, be absorbed by the fund's investment adviser or be passed on to investors in the form of increased management fees. The share of these costs borne by funds, their advisers, and investors depends on multiple factors, including the nature of competition between advisers, and investors' relative sensitivity to changes in fund fees, the joint effects of which are particularly challenging to predict due to the number of assumptions that the Commission would need to make.

1. Derivatives Risk Management Program and Board Oversight and Reporting

Proposed rule 18f-4 would require funds that enter into derivatives transactions and are not limited derivatives users to adopt and implement a derivatives risk management program. The program would provide for the establishment of risk guidelines that must include certain elements, but that are otherwise tailored based on how the fund's use of derivatives may affect its investment portfolio and overall risk profile. The program also would have to include stress testing, backtesting, internal reporting and escalation, and program review elements. The proposed rule would require a fund's board of directors to approve the fund's designation of a derivatives risk manager, who would be responsible for administering the derivatives risk management program. The fund's derivatives risk manager would have to report to the fund's board on the derivatives risk management program's implementation and effectiveness and the results of the fund's stress testing and backtesting.

We understand that advisers to many funds whose investment strategies entail the use of derivatives already assess and manage risks associated with their derivatives transactions.[482] However, proposed rule 18f-4's requirement that funds establish written derivatives risk management programs would create a standardized framework for funds' derivatives risk management by requiring each fund's program to include all of the proposed program elements. To the extent that the resulting risk management activities are more comprehensive than funds' current practices, this may result in more-effective risk management across funds. While the adoption of a derivatives risk management program requirement may not eliminate all derivatives-related risks, including that investors could experience large, unexpected losses from funds' use of derivatives, we expect that investors would benefit from a decrease in leverage-related risks.

Some funds may reduce or otherwise alter their use of derivatives transactions to respond to risks identified after adopting and implementing their risk management programs. In particular, we expect that funds currently utilizing risk management practices that are not tailored to their use of derivatives may decide to make such changes to their portfolios.[483]

The proposed rule would require a fund to reasonably segregate the functions of its derivatives risk management program from those of its portfolio management.[484] This segregation requirement is designed to enhance the program's effectiveness by promoting the objective and independent identification and assessment of derivatives risk.[485] Segregating the

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482 *See supra* section III.B.4.

483 As a consequence of reducing risk, such funds may earn reduced returns.

484 *See supra* section II.B.2.

485 *See supra* note 112 and accompanying text. While some portfolio managers may find it

functions of a fund's derivatives risk management program from those of its portfolio management may also mitigate the risks of competing incentives between a fund's portfolio managers and its investors.[486]

Finally, to the extent that the periodic stress testing and backtesting requirements of the proposed derivatives risk management program result in fund managers developing a more complete understanding of the risks associated with their use of derivatives, we expect that funds and their investors will benefit from improved risk management.[487] Such benefits would be in addition to benefits derived from the proposed VaR-based limit on fund leverage risk discussed below.[488] VaR analysis, while yielding a simple yet general measure of a fund's portfolio risk, does not provide a complete picture of a fund's financial risk exposures.[489] Complementing VaR

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burdensome to collaborate with a derivatives risk manager, to the extent that portfolio managers already consider the impact of trades on the fund's portfolio risk, we believe that having the involvement of a derivatives risk manager may typically make a portfolio manager's tasks more rather than less efficient.

486 For example, portfolio managers of actively-managed funds that are underperforming competing funds may have an incentive to increase risk exposures through use of derivatives in an effort to increase returns. This behavior may result in a fund also increasing risk beyond investor expectations. (For theoretical motivation of such behaviors *see, e.g.*, Keith C. Brown, W.V. Harlow, & Laura T. Starks, *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 Journal of Finance 85 (1996), *available at* https://www.onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1996.tb05203.x; Judith Chevalier & Glenn Ellison, *Risk-Taking by Mutual Funds as a Response to Incentives*, 105 Journal of Political Economy 1167 (1997), *available at* https://www.jstor.org/stable/10.1086/516389?seq=1#metadata_info_tab_contents).

487 *See supra* sections II.B.3.c and II.B.3.d; *see also supra* section II.C.2 (discussing the proposed requirements that a fund's derivatives risk manager provide to the fund's board: (1) a written report, at least annually, providing a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program (including a review of the VaR calculation model used by the fund under proposed rule 18f-4(c)(2), and the backtesting required by proposed rule 18f-4(c)(1)(iv)); and (2) a written report, at the frequency determined by the board, regarding any exceedances of the fund's risk guidelines and the results of the fund's stress tests).

488 *See infra* section III.C.2.

489 *See id*.

analysis with stress testing would provide a more complete understanding of the fund's potential losses under different sets of market conditions. For example, simulating potential stressed market conditions not reflected in historical correlations between fund returns and asset prices observed in normal markets may provide derivatives risk managers with important information pertaining to derivatives risks in stressed environments.[490] By incorporating the potential impact of future economic outcomes and market volatility in its stress test analysis, a fund may be able to analyze future potential swings in its portfolio that may impact the fund's long-term performance. This forward-looking aspect of stress testing would supplement the proposed rule's VaR analysis requirement, which would rely on historical data.

In addition, requiring that a fund backtest the results of its VaR analysis each business day would assist funds in examining the effectiveness of the fund's VaR model. The proposed rule would require that, each business day, the fund compare its actual gain or loss for that business day with the fund's VaR calculated for that day.[491] This comparison would help identify days where the fund's portfolio losses exceed the VaR calculated for that day, as well as systematic over- or under-estimation of VaR suggesting that the fund may not be accurately measuring all significant, identifiable market risk factors.[492]

Proposed rule 18f-4 would also require that a fund's board of directors approve the designation of the fund's derivatives risk manager, taking into account the derivatives risk

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490 *See supra* section II.B.3.c (proposed rule 18f-4 would require the program to provide for stress testing to "evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors as appropriate and resulting payments to derivatives counterparties").

491 *See supra* section II.B.3.d.

492 *See supra* notes 150-151 and accompanying text.

manager's relevant experience.[493] We anticipate that this requirement, along with the derivatives risk manager's direct reporting line to the board, would result in effective communication between the board and the derivatives risk manager that would enhance oversight of the program to the benefit of the fund and its investors.

Proposed rule 18f-4 would require that the derivatives risk manager provide the fund's board a written report at least once a year on the program's effectiveness as well as regular written reports at a frequency determined by the board that analyze exceedances of the fund's risk guidelines and present the results of the fund's stress tests and backtests.[494] The proposed board reporting requirements may facilitate the board's oversight of the fund and the operation of the derivatives risk management program, to the extent the fund does not have such regular reporting mechanisms already in place. In the event the derivatives risk manager encounters material risks that need to be escalated to the fund's board, the proposed provision that the derivatives risk manager may directly inform the board of these risks in a timely manner as appropriate may help prevent delays in resolving such risks.

Funds today employ a range of different practices, with varying levels of comprehensiveness and sophistication, for managing the risks associated with their use of derivatives.[495] We expect that compliance costs associated with the proposed derivatives risk management program requirement would vary based on the fund's current risk management practices, as well as the fund's characteristics, including in particular the fund's investment strategy, and the nature and type of derivatives transactions used by the fund.

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493 *See supra* section II.C.1.

494 *See supra* section II.C.2.

495 *See supra* section III.B.4.

We understand that VaR models are widely used in the industry and that backtesting is commonly performed in conjunction with VaR analyses. As a result, we believe that many funds that would be required to establish derivatives risk management programs already have VaR models with backtesting in place. Moreover, the proposed rule's derivatives risk management program requirements, including stress testing and backtesting requirements are, generally, high-level and principles-based. As a result, it is likely that many funds' current risk management practices may already be in line with many of the proposed rule's derivatives risk management program requirements or could be readily conformed without material change. Thus, the costs of adjusting funds current' practices and procedures to comply with the parallel requirements of proposed rule 18f-4 may be minimal for such funds.

Certain costs of the proposed derivatives risk management program may be fixed, while other costs may vary with the size and complexity of the fund and its portfolio allocation. For instance, costs associated with purchasing certain third-party data used in the program's stress tests may not vary much across funds. On the other hand, certain third-party services may vary in terms of costs based on the portfolio positions to be analyzed. Further, the extent to which a cost corresponding to the program is fixed or variable may also depend on the third-party service provider.

Larger funds or funds that are part of a large fund complex may incur higher costs in absolute terms but find it less costly, per dollar managed, to establish and administer a derivatives risk management program relative to a smaller fund or a fund that is part of a smaller fund complex. For example, larger funds may have to allocate a smaller portion of existing resources for the program, and fund complexes may realize economies of scale in developing and implementing derivatives risk management programs for several funds.[496]

For funds that do not already have a derivatives risk management program in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost, we estimate that the one-time costs to establish and implement a derivatives risk management program would range from $70,000 to $500,000 per fund, depending on the particular facts and circumstances, including whether a fund is part of a larger fund complex and therefore may benefit from economies of scale. These estimated costs are attributable to the following activities: (1) developing risk guidelines and processes for stress testing, backtesting, internal reporting and escalation, and program review; (2) integrating and implementing the guidelines and processes described above; and (3) preparing training materials and administering training sessions for staff in affected areas.

For funds that do not already have a derivatives risk management program in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost, based on our understanding, we estimate that the ongoing annual program-related costs that a fund would incur range from 65% to 75% of the one-time costs to establish and implement a derivatives risk management program. Thus, a fund would incur ongoing annual costs that range

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496 Although we believe that many funds have existing risk officers whose role extends to managing derivatives risks, we note that some funds, and in particular smaller funds or those that are part of a smaller fund complex, may not have existing personnel capable of fulfilling the responsibilities of the derivatives risk manager, or may choose to hire a new employee or employees to fulfill this role, rather than assigning that responsibility to a current employee or officer of the fund or the fund's investment adviser. We expect that a fund that would hire new employees would likely incur larger costs compared to a fund that has existing employees that could serve as a fund's derivatives risk manager.

from $45,500 to $375,000.[497] These estimated costs are attributable to the following activities: (1) assessing, monitoring, and managing the risks associated with the fund's derivatives transactions; (2) periodically reviewing and updating (A) the program including any models or measurement tools (including any VaR calculation models) to evaluate the program's effectiveness and to reflect changes in risk over time, and (B) any designated reference index to evaluate its appropriateness; (3) providing written reports to the fund's board on the derivatives risk management program's implementation and effectiveness and the results of the fund's stress testing; and (4) additional staff training.

Under the proposed rule, a fund that is a limited derivatives user would not be required to establish a derivatives risk management program.[498] Based on an analysis of Form N-PORT filings, as well as financial statements filed with the Commission by BDCs, we estimate that about 22% of funds that would be subject to the proposed rule, or 2,693 funds total, would be required to implement a risk management program.[499] As many funds belong to a fund complex and are likely to experience economies of scale, we expect that the lower end of the estimated range of costs ($70,000 in one-time costs; $45,500 in annual costs) better reflects the total costs likely to be incurred by those funds.[500] In addition, we believe that many funds already have a

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497 This estimate is based on the following calculations: 0.65 x $70,000 = $45,500; 0.75 x $500,000 = $375,000.

498 The estimates of the one-time and ongoing costs described in this section include the costs associated with determining whether a fund is a limited derivatives user.

499 We estimate that about 22% of all funds that would be subject to the proposed rule hold some derivatives and would not qualify as a limited derivatives user under the proposed rule.

500 A fund that uses derivatives in a complex manner, has existing risk management practices that are not commensurate with such use of derivatives, and may have to hire additional personnel to fulfill the role of derivatives risk manager would be particularly likely to experience costs at the upper end of this range.

derivatives risk management program in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost. [501] However, as we do not have data to determine how many funds already have a program in place that would substantially satisfy the proposed rule's requirements, we over-inclusively assume that all funds would incur a cost associated with this requirement. Based on these assumptions, we provide an upper-end estimate for total industry cost in the first year of $311,041,500.[502]

2. VaR-Based Limit on Fund Leverage Risk

The proposed rule would generally impose a VaR-based limit on fund leverage risk on funds relying on the rule to engage in derivatives transactions.[503] This outer limit would be based on a relative VaR test or, if the fund's derivatives risk manager is unable to identify an appropriate designated reference index, an absolute VaR test. In either case a fund would apply the test at least once each business day. The proposed rule would include an exception from the limit on fund leverage risk for limited derivatives users and also certain funds that are "leveraged/inverse investment vehicles," as defined in the proposed sales practices rules.[504]

The proposed relative VaR test would limit a fund's VaR to 150% of the VaR of the fund's designated reference index.[505] The designated reference index would have to be

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501 One commenter indicated that implementing stress testing, which would be one of the required elements of the proposed derivatives risk management program, would be only slightly burdensome for 27% of respondents to a survey of ICI member firms and would be moderately burdensome for an additional 50% of respondents. *See* ICI Comment Letter III; *see also supra* note 466.

502 This estimate is based on the following calculation: 2,693 funds x ($70,000 + $45,500) = $311,041,500.

503 *See supra* section II.D.

504 *See supra* sections II.E and II.G.3.

505 *See supra* section II.D.2.

unleveraged and reflect the markets or asset classes in which the fund invests.[506] Therefore, the relative VaR test restricts the incremental risk associated with a fund's portfolio relative to a similar but unleveraged investment strategy. In this sense, the relative VaR test restricts the degree to which a fund can use derivatives to leverage its portfolio.

We recognize that the derivatives risk managers of some funds may not be able to identify an appropriate designated reference index.[507] As these funds would not be able to comply with the proposed relative VaR test, the proposed rule would require these funds to comply with the proposed absolute VaR test instead.[508] To comply with the absolute VaR test, the VaR of the fund's portfolio must not exceed 15% of the value of the fund's net assets. The level of loss in the proposed absolute VaR test would provide approximately comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the S&P 500 as their designated reference index during periods where the S&P 500's VaR is approximately equal to the historical mean.[509]

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[506] *See supra* section II.D.2.a. The proposed definition of "designated reference index" also includes other requirements, as discussed above. *See id.* For example, a designated reference index could not be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.

[507] *See supra* section II.D.3.

[508] Whether a fund complies with the proposed relative or absolute VaR test would depend on whether the fund's derivatives risk manager would be able to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy. *See id.* We therefore anticipate that industry norms that reflect the availability of an appropriate designated reference index would develop under which funds with similar strategies would generally comply with the same type of VaR test (that is, either the proposed relative VaR test or the proposed absolute VaR test).

[509] *See supra* section II.D.3.

One common critique of VaR is that it does not reflect the conditional distribution of losses beyond the specified confidence level.[510] In other words, the proposed VaR tests would not capture the size and relative frequency of losses in the "tail" of the distribution of losses beyond the measured confidence level.[511] As a result, two funds with the same VaR level could differ significantly in the magnitude and relative frequency of extreme losses, even though the probability of a VaR breach would be the same for the two funds. To demonstrate this limitation of VaR, we construct a simplified portfolio with an equity investment that also achieves leverage through derivatives. By varying the type of derivatives included in the portfolio, we illustrate that the tail risk varies significantly across portfolios with equal VaR.

The details of the strategy are as follows. Assume a fund has initial assets of \$100 in cash. On day t, the manager of the portfolio achieves the additional leverage by writing \$ X worth of put options, and then invests the proceeds from the sale of the options and the initial cash balance, *i.e.*, $\$(100 + X)$, into the S&P 500 index.[512] For simplicity, we further assume that the underlying asset of the shorted put options is also the S&P 500 index, so that the fund's designated reference index is the S&P 500. The maturity of the put option is assumed to be one month, and the price of the S&P on day t is normalized to \$100. On day $t + 1$, the manager buys back the put options and realizes the returns of the strategy. The one-day gross return of the fund can be described mathematically as

510 *See supra* note 181 and accompanying text.

511 The term "relative frequency" here refers to the frequency of loss outcomes in the tail of the distribution relative to other loss outcomes that are also in the tail of the distribution. This relative frequency of the loss outcomes together with the magnitude of the associated losses describe the conditional distribution of losses in the tail of the distribution.

512 This strategy could be implemented by either investing in the constituent securities of the S&P 500 directly or, for example, by investing in an ETF that tracks the S&P 500 index.

$$R_{Fund} = \frac{100+X}{100} R_M - \frac{X}{100} R_{put},$$

where R_M is the gross one-day return of the S&P 500 index, and $R_{put} = P(t+1)/P(t)$ is the gross one-day return of the put option, with the price of the put option at time *t* denoted by $P(t)$. The return of the put option depends on the return of the underlying asset, and the money-ness of the put—the lower the strike price, the more out-of-the-money is the put. In our exercise, we look at three options with three different strike prices, ranging from more out-of-the-money to at-the-money. The strike prices, denoted by K, are equal to $K = 92\%, K = 96\%$, and $K = 100\%$ of the current level of the S&P 500 index respectively.[513] Assuming the portfolio manager wants to achieve as much leverage as possible with each of the three options, while still abiding by the proposed limit set by the relative VaR level of 150% at a 99% confidence level, we calculate the amount of puts she would short, the expected returns of the three portfolios, and the relative VaR for confidence levels of 95%, 99%, and 99.9%. In our calculation, the model is calibrated to approximately match the historical return distribution of the S&P 500. Returns are assumed to be normally distributed (for simplicity) with an annualized mean return of 6% and an annual standard deviation of roughly 16%. The latter implies a daily standard deviation of 1%. For simplicity, the risk-free rate is assumed to be zero. The results are in Table 1.

TABLE 1: PORTFOLIO COMPOSITION, RETURNS AND VAR LEVELS

	K=92% Portfolio	K=96% Portfolio	K=100% Portfolio
Portfolio Weight	-0.58%	-0.93%	-1.54%
Number of Contracts	-9.92	-2.05	-0.84

513 Given the historical volatility of the S&P 500 – approximately 16% annually, or 1% daily – an 8% daily drop in the price is an 8 standard deviation event. Therefore, an option with a strike price of 92% of the current value of the S&P 500 index could be considered a deep out-of-the-money option.

Fund Expected Return	6.68%	7.00%	7.30%
Fund Relative VaR (99%)	1.49	1.49	1.49
Fund Relative VaR (99.9%)	2.14	2.07	2.03

Relative VaR levels are identical and no greater than 150% for all three portfolios at the 99% confidence level and, as expected, for each portfolio relative VaR is higher for higher confidence levels. However, this example illustrates that relative VaR varies across these portfolio for confidence levels above 99%. The fund writing the more out-of-the-money option ($K = 92\%$) is riskier in the tail of the S&P 500 return distribution (when the S&P 500 drops over the one-day period) than the fund writing the at-the-money option ($K = 100\%$), but the relative VaR level at the 99% confidence level does not reflect this difference.

Figure 1 shows the daily return profile of the three portfolios as a function of daily returns to the S&P 500 index. Along the x-axis are daily returns to the S&P 500 index, ranging from -8% to +8%. The dotted line represents the daily return profile of a portfolio that tracks 1.5 times the returns of the S&P 500 index. The figure shows that the degree of tail risk differs across portfolios. While the returns to all portfolios are equal at the 150% relative VaR limit at a 99% confidence level, returns beyond the 150% relative VaR limit are lower for portfolios that write puts that are further out-of-the-money.

FIGURE 1: DAILY PORTFOLIO RETURNS

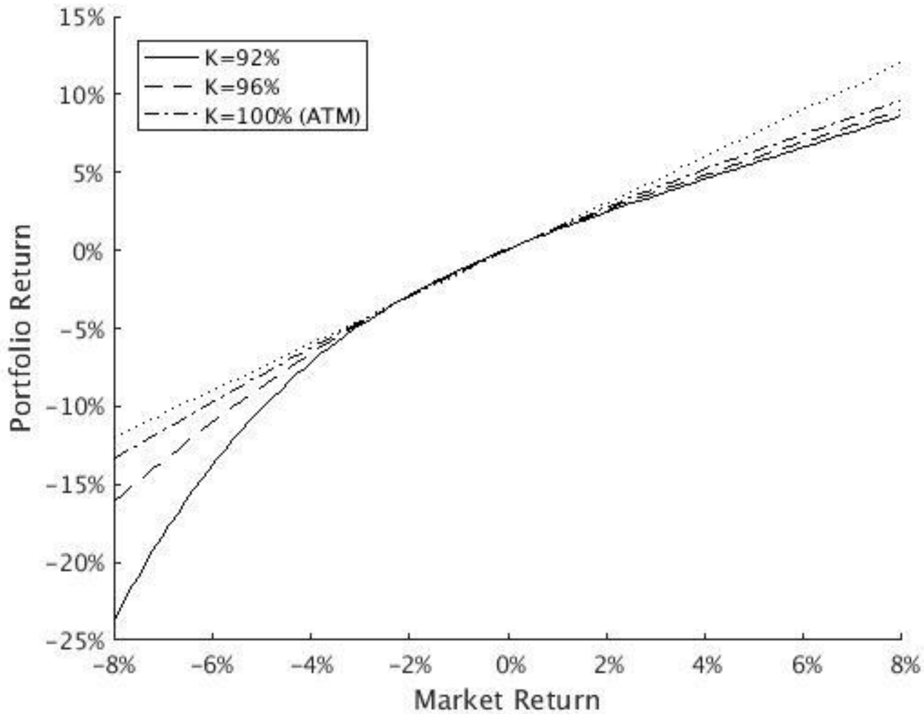
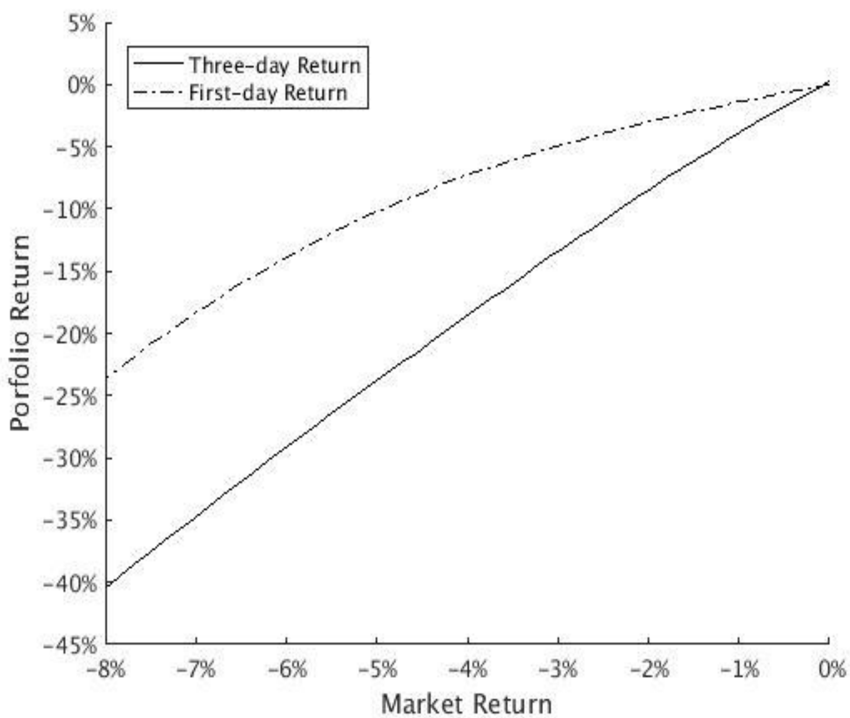


FIGURE 2: THREE-DAY RETURNS WITH DAILY REBALANCING



We also considered the effect that a decline in the S&P 500 over three consecutive days would have on the fund that is short the put options with a $K = 92\%$ strike price considered above. The proposed rule requires that a fund determine its compliance with the applicable VaR test at least once each business day. In computing three-day returns for the fund, we assume that, as the fund exceeds the relative VaR test each business day, the fund rebalances its portfolio, at the beginning of each day, to bring the fund back into compliance with the 150% relative VaR limit. The solid line in Figure 2 shows the three-day cumulative return of the fund as a function of the per-day returns of the S&P 500 on the x-axis, which is assumed to be the same for three consecutive days. The dashed curve in Figure 2 shows the corresponding first-day returns of the portfolio for comparison, which are the same as those denoted by the solid line in Figure 1. The figure shows that the three-day cumulative returns shown by the solid curve (in Figure 2) are less than three times the single-day losses shown by the dashed curve. This is a result of the daily rebalancing of the portfolio, which, in this example, reduces the incremental downside risk over time.

As discussed in more detail above, the proposed VaR tests are designed to address the concerns underlying section 18, but they are not a substitute for a fully-developed derivatives risk management program.[514] Recognizing VaR's limitations, the proposed rule also would require the fund to adopt and implement a derivatives risk management program that, among other things, would require the fund to establish risk guidelines and to stress test its portfolio in part because of concerns that VaR as a risk management tool may not adequately reflect tail risks.

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514 *See supra* note 183 and accompanying text.

DERA staff analyzed the VaR levels of the portfolios of all funds that would be subject to the proposed rule and of certain benchmark indexes as of December 2018 in order to estimate how many of the funds that would be subject to the proposed VaR-based limit on fund leverage risk currently operate in exceedance of that limit.[515] This analysis identified only six funds that would be subject to the proposed limit that DERA staff estimated may fail the relative VaR test. In the case of these six funds, DERA staff calculated the relative VaR test using the primary benchmark disclosed in the funds' prospectuses. To the extent that these funds' derivatives risk managers were to determine that a different index would be more appropriate for purposes of computing the relative VaR test or that no appropriate designated reference index were available, some or all of these funds could be compliant with the VaR-based limit on fund leverage risk either under the relative VaR test with a more appropriate index or under the absolute VaR test.[516] As a result, we estimate that there would only be a very small number of funds, if any, that would have to adjust their portfolios in order to comply with the VaR-based limit on fund leverage risk. This is consistent with the VaR-based limit on fund leverage risk functioning as an outer bound on fund leverage risk.

To the extent that there are funds that would have to adjust their portfolios to comply with the VaR-based limit on fund leverage risk, these funds would incur associated trading costs.

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515 This analysis is based on Morningstar data as of December 31, 2018. DERA staff computed the VaR of each fund and that of a reference index using historical simulation from three years of prior daily return data. Staff generally computed the relative VaR test based on a fund's primary prospectus benchmark. In cases where historical return data for the primary prospectus benchmark was not available or where the primary prospectus benchmark did not appear to capture the markets or asset classes in which a fund invests, DERA staff instead used a broad-based unleveraged index that captures a fund's markets or asset classes or a broad-based U.S. equity index.

516 Based on our analysis, we estimate that only one of the six funds that we identified may fail the proposed relative VaR test would also fail the proposed absolute VaR test.

If there were a fund that would have to adjust its portfolio so significantly that it could no longer pursue its investment strategy, such a fund may also lose investors or, if it chooses to cease operating, incur costs associated with unwinding the fund.

In addition, funds could be required to adjust their portfolios to comply in the future and, if so, would incur associated trading costs. For example, as market conditions change, a fund's VaR could exceed the proposed limits, especially if a fund relies on the absolute VaR test. The proposed VaR tests also would eliminate the flexibility that funds currently have to leverage their portfolios to a greater extent than the proposed VaR tests would permit. Although funds currently may not be exercising this flexibility, they may nevertheless value the ability to so increase leverage in the future. While, on the one hand, the proposed VaR tests impose costs on funds by restricting the strategies they may employ, the proposed limit on fund leverage risk would benefit fund investors, to the extent that it would prevent these investors from experiencing unexpected losses from a fund's increased risk exposure that are prevented by the proposed VaR-based limit on fund leverage risk.

By establishing a bright-line limit on the amount of leverage risk that a fund can take on using derivatives, the proposed rule may make some funds and their advisers more comfortable with using derivatives. As a result, some funds that currently invest in derivatives to an extent that would result in the fund's VaR being below the proposed limit may react by increasing the extent of their derivatives usage.

The proposed requirement could also indirectly result in changing the amount of investments in funds. On the one hand, the proposed rule could attract additional investment, if investors become more comfortable with funds' general level of riskiness as a result of funds' compliance with an outside limit on fund leverage risk. On the other hand, to the extent that investors currently expect funds to limit their risk to levels below those which the proposed limits would produce (which investors could observe from the required VaR reporting requirements on form N-PORT for funds other than limited derivatives users and leveraged/inverse funds), or investors see funds' general level of riskiness increasing after funds come into compliance with the proposed limits, the proposed limits may result in investors re-evaluating how much risk they are willing to take and reducing their investments in funds. Due to a lack of data regarding current investor expectations about fund risk, however, we are unable to predict which of the two effects would more likely dominate the other.

As the proposed requirements would prevent funds from offering investment strategies that exceed the proposed outer limit on fund leverage risk, those investors who prefer to invest in such funds because they value the increased potential for gains that is generally associated with riskier investment strategies may see their investment opportunities restricted by the proposed rules. As a result, such investors may instead invest in alternative investment vehicles, exchange-traded notes, or structured products, which can provide leveraged market exposure but would not be subject to the VaR-based limit on fund leverage risk of rule 18f-4.[517] Alternatively, such investors, particularly institutional ones, may instead borrow themselves or trade on margin to achieve leverage.

Funds that would be subject to the proposed VaR-based limit on fund leverage risk would incur the cost of determining their compliance with the applicable VaR test at least once each business day. Part of these costs would be associated with obtaining the necessary data required for the VaR calculation. Funds implementing the relative VaR test would likely incur larger data

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517 *See supra* section III.C.5.

costs compared to funds implementing the absolute VaR test, as the absolute VaR test would require funds to obtain data only for the VaR calculation for the fund's portfolio, whereas the relative VaR test also would require funds to obtain data for the VaR calculation for their designated reference index. In addition, some index providers may charge licensing fees to funds for including indexes in their disclosure documents or for access to information about the index's constituent securities and weightings.[518]

Funds that do not already have systems to perform the proposed VaR calculations in place would also incur the costs associated with setting up these systems or updating existing systems.[519] Both the data costs and the systems costs would likely be larger for funds that use multiple types of derivatives, use derivatives more extensively, or otherwise have more complicated derivatives portfolios, compared to funds with less complicated derivatives portfolios.

Larger funds or funds that are part of a large fund complex may incur higher costs in absolute terms but find it less costly, per dollar managed, to perform VaR tests relative to a smaller fund or a fund that is part of a smaller fund complex. For example, larger funds may have to allocate a smaller portion of existing resources for the VaR test and fund complexes may

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518 We understand that industry practices around licensing indexes for regulatory purposes vary widely, with some providers not charging any fees and others charging fees in excess of $10,000 per year.

519 One commenter indicated that implementing a UCITS VaR test would be only slightly burdensome for 45% of respondents to a survey of ICI member firms and would be moderately burdensome for an additional 34% of respondents. The commenter also indicated that respondents commonly reported that the burden would increase, in some cases very substantially, if a VaR test has different parameters or is more prescriptive than UCITS VaR. *See* ICI Comment Letter III; *see also supra* note 451. As the requirements of the proposed VaR test are generally consistent with existing market practice, including that of UCITs funds, the results of this survey therefore support our view that many funds would likely experience efficiencies in implementing the proposed VaR test.

realize economies of scale in implementing systems to compute VaR. In particular, the costs associated with implementing or updating systems to calculate VaR would likely only be incurred once at the level of a fund complex, as such systems can be used to perform VaR tests for all funds in the complex that are subject to the VaR test requirement. Similarly, larger fund complexes may incur lower costs associated with purchasing data per fund, to the extent that the VaR calculations for multiple funds in the complex partially or completely require the same data.

Under the proposed rule, a fund that holds derivatives that is either a limited derivatives user or a leveraged/inverse fund that complies with the alternative requirements for leveraged/inverse investment vehicles would not be subject to the proposed VaR-based limit on fund leverage risk. Based on an analysis of Form N-PORT filings and financial statements filed with the Commission by BDCs, we estimate that about 19% of funds that would be subject to the proposed rule, or 2,424 funds total, would be required to implement VaR tests.[520] We estimate that the incremental annual cost associated with the VaR test would range from $5,000 to $100,000 per fund, depending on the particular facts and circumstances, including whether the fund currently computes VaR; whether the fund is implementing the relative or absolute VaR test; and whether a fund that is part of a larger complex may be able to realize economies of scale. Funds that currently already compute VaR would be particularly likely to experience costs at the very low end of this range. Assuming that the midpoint of this range reflects the cost to the

[520] We estimate that about 19% of all funds that would be subject to the proposed rule hold some derivatives, would not qualify as a limited derivatives user, and are not a leveraged/inverse fund that could comply with the alternative requirements for leveraged/inverse investment vehicles.

average fund subject to the VaR requirement, we estimate a total additional annual industry cost of $127,260,000.[521]

In addition, a fund that today or in the future may operate in a manner that would result in the fund's portfolio VaR being just under the proposed limit on fund leverage risk may need to alter its portfolio during periods of increased market volatility in order to avoid falling out of compliance with the proposed limit. We would expect such a scenario to be more likely for a fund that would rely on the absolute VaR test, because the relative VaR test would allow a fund to operate with a higher portfolio VaR when the VaR of its designated reference index increases.

A fund that were to eliminate some of its leverage risk associated with derivatives in order to comply with the proposed VaR-based limit on leverage risk might do so through unwinding or hedging its derivatives transactions or through some other means. These portfolio adjustments may be costly, particularly in conditions of market stress and reduced liquidity. The proposed rule would, however, give a fund the flexibility to mitigate these potential costs by not requiring the fund to exit positions or change its portfolio if it is out of compliance with the VaR test. Instead, the rule would provide that, if a fund has been out of compliance with the applicable VaR test for more than three business days, then: (1) the derivatives risk manager must report to the fund's board of directors and explain how and by when (*i.e.*, the number of business days) the derivatives risk manager reasonably expects that the fund will come back into

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[521] This estimate is based on the following calculation: 2,424 funds x 0.5 x ($5,000 + $100,000) = $127,260,000. Some funds may find it more cost effective to restrict their use of derivatives in order to be able to rely on the proposed rule's exception for limited derivatives users compared to complying with the proposed VaR-based limit on fund leverage risk. *See supra* section II.E; *infra* section III.C.3. As we do not have data that would allow us to quantify the costs and benefits that define the tradeoff for any particular fund of changing its use of derivatives in order to qualify for the limited user exception, we are unable to quantify how many funds would make this choice.

compliance;[522] (2) the derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances; and (3) the fund may not enter into derivatives transactions other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR, until the fund has been back in compliance with the applicable VaR test for three consecutive business days and satisfied the board reporting requirement and program analysis and update requirements.[523] These provisions of the proposed rule collectively would provide some flexibility for a fund that is out of compliance with the VaR test to make any portfolio adjustments, which may allow funds to avoid some of the costs that otherwise could result from forced changes in the fund's portfolio.

3. Limited Derivatives Users

Proposed rule 18f-4 includes an exception from the proposed risk management program requirement and VaR-based limit on fund leverage risk for limited derivatives users.[524] The proposed exception would be available for a fund that either limits its derivatives exposure to 10% of its net assets or uses derivatives transactions solely to hedge certain currency risks and that also adopts and implements policies and procedures reasonably designed to manage the fund's derivative risks. We expect that the risks and potential impact of these funds' derivatives use may not be as significant, compared to those of funds that do not qualify for the exception.[525]

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522 Proposed rule 18f-4(c)(2)(iii)(A). *See also infra* section II.H.2 (discussing a report to the Commission regarding the fund being out of compliance with the applicable proposed VaR test for three business days).

523 *See* proposed rule 18f-4(c)(2)(iii).

524 *See supra* section II.E.

525 *See supra* note 270 and accompanying and immediately-following text.

Therefore, we believe that a principles-based policies and procedures requirement would appropriately address these risks.

We believe that investors in funds that use derivatives in a limited manner would benefit from the proposed requirement, which we anticipate would reduce, but not eliminate, the frequency and severity of derivatives-related losses for such funds. In addition, to the extent that the proposed framework is more comprehensive than funds' current practices, the proposed requirement may result in more effective risk management across funds and increased fund industry stability.

For funds that do not already have policies and procedures in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost, we estimate that the one-time costs would range from $1,000 to $100,000 per fund, depending on the particular facts and circumstances, including whether a fund is part of a larger fund complex; the extent to which the fund uses derivatives within the parameters of the limited user exception, including whether the fund uses more complex derivatives; and the fund's current derivatives risk management practices. These estimated costs are attributable to the following activities: (1) assessing whether a fund is a limited derivatives user; (2) developing policies and procedures reasonably designed to manage a fund's derivatives risks; (3) integrating and implementing the policies and procedures; and (4) preparing training materials and administering training sessions for staff in affected areas.

For funds that do not already have policies and procedures in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost, we estimate that the ongoing annual costs that a fund that is a limited derivatives user would incur range from 65% to 75% of the one-time costs to establish and implement the policies and procedures. Thus, a fund would incur ongoing annual costs that range from $650 to $75,000.[526] These estimated costs are attributable to the following activities: (1) assessing, monitoring, and managing the risks associated with the fund's derivatives transactions; (2) periodically reviewing and updating a fund's policies and procedures; and (3) additional staff training.

Based on an analysis of Form N-PORT filings, as well as financial statements filed with the Commission by BDCs, we estimate that about 19% of funds that would be subject to the proposed rule, or 2,398 funds total, would qualify as limited derivatives users. Almost all of these funds would be able to rely on the exposure-based exception. While some funds, about 1%, could rely on both the exposure-based exception and the currency hedging exception, only a fraction of 1% of funds would qualify as limited derivatives users solely based on the currency hedging exception.

As many funds belong to a fund complex and are likely to experience economies of scale, we expect that the lower end of the estimated range of costs ($1,000 in one-time costs; $650 in annual costs) better reflects the total costs likely to be incurred by many funds. In addition, we believe that many funds already have policies and procedures in place that could be readily adapted to meet the proposed rule's requirements without significant additional cost. However, as we do not have data to determine how many funds already have such policies and procedures in place that would substantially satisfy the proposed rule's requirements, we assume that all funds would incur a cost associated with this requirement. Based on these assumptions, we over-inclusively estimate a lower bound for the total industry cost in the first year of $751,773.[527]

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526 This estimate is based on the following calculations: 0.65 x $1,000 = $650; 0.75 x $100,000 = $75,000.

527 This estimate is based on the following calculation: 2,398 funds x 0.19 x ($1,000 + $650) =

Some funds may change how they use derivatives in order to qualify for the limited derivatives user exception and thereby avoid the potentially increased compliance cost associated with the proposed derivatives risk management program and VaR-based limit on fund leverage risk. Specifically, a fund with derivatives exposure just below 10% of its net assets may forego taking on additional derivatives positions, or a fund with derivatives exposure just above 10% of its net assets may close out some existing derivatives positions. Similarly, a fund that uses derivatives to hedge certain currency risks may forego or eliminate its use of derivatives for other purposes. As a result, the proposed exception for limited derivatives users may reduce the extent to which some funds use derivatives.[528]

4. Reverse Repurchase Agreements and Similar Financing Transactions

The proposed rule would allow funds to engage in reverse repurchase agreements and other similar financing transactions. However, as these transactions achieve economically identical results to other secured loans, the proposed rule would require that they be treated the same as bank borrowings and other borrowings under section 18. The proposal would therefore require a fund to combine any bank borrowings or other borrowings and reverse repurchase

$751,773. This cost estimate assumes that none of the funds that currently do not hold any derivatives would choose to establish and implement policies and procedures reasonably designed to manage the fund's derivatives risks in anticipation of a future limited use of derivatives. Notwithstanding this assumption, we acknowledge some funds that currently do not use derivatives may still choose to establish and implement such policies and procedures prophylactically in order to preserve the flexibility to engage in a limited use of derivatives on short notice.

[528] As we do not have data that would allow us to quantify the costs and benefits that define the tradeoff for any particular fund of changing its use of derivatives in order to qualify for the limited user exception, we are unable to quantify how many funds would make this choice.

agreements when assessing compliance with the relevant asset coverage requirements of section 18.[529]

Today, funds rely on the asset segregation approach that Release 10666 describes with respect to reverse repurchase agreements, which funds may view as separate from the limitations established on bank borrowings (and other senior securities that are evidence of indebtedness) by the asset coverage requirements of section 18.[530] As a result, the degree to which funds could engage in reverse repurchase agreements may differ under the proposed rule from the baseline. A fund that engages solely in reverse repurchase agreements, or solely in bank borrowings (for example), would be unaffected by the proposed requirement.[531] However, to the extent that a fund engages in both reverse repurchase agreements and bank borrowings (or similar transactions), because we believe these transactions are economically equivalent, they would be combined for purposes of analyzing whether a fund is in compliance with section 18's asset coverage requirement. This may have the effect of limiting the overall scale of these transactions under the proposed requirement compared to the baseline, to the extent that funds today separately analyze their asset coverage requirements with respect to reverse repurchase agreements under Release 10666 and bank borrowings and similar senior securities under section 18.

DERA staff analyzed funds' use of reverse repurchase agreements and borrowings using Form N-PORT filings as well as financial statements filed with the Commission by BDCs. Based

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[529] *See supra* section II.I.

[530] *See supra* section I.B.2.a.

[531] For example, an open-end fund with no other senior securities outstanding could borrow an amount equivalent to 50% of its net assets using reverse repurchase agreements or bank borrowings under the baseline.

on our analysis of Form N-PORT filings, we estimate that about 0.36% of funds that would be subject to the proposed rule, or 45 funds total, used these transactions in combined amounts that exceeded the asset coverage requirement.[532] These funds would have to adjust their use of reverse repurchase agreements, similar financing transactions, or borrowings in order to comply with the proposed rule and may incur associated transactions costs.

In addition, under the proposed rule, if a fund did not qualify as a limited derivatives user due to its other investment activity, any portfolio leveraging effect of reverse repurchase agreements, similar financing transactions, and borrowings would also be restricted indirectly through the VaR-based limit on fund leverage risk. As a result, a fund could be restricted through the VaR-based limit on fund leverage risk from investing the proceeds of borrowings through reverse repurchase agreements to the full extent otherwise permitted by the asset coverage requirements in section 18 if the fund did not qualify as a limited derivatives user.

5. Alternative Requirements for Certain Leveraged/Inverse Funds and Proposed Sales Practices Rules for Certain Leveraged/Inverse Investment Vehicles

The proposed sales practices rules would require a broker-dealer or investment adviser to (1) exercise due diligence in approving a retail investor's account to buy or sell shares of leveraged/inverse investment vehicles before accepting an order from, or placing an order for, such an investor to engage in these transactions; and (2) adopt and implement policies and

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532 In our review of form N-PORT filings, we observed that several of the funds that used reverse repurchase agreements and similar financing transactions (bank borrowings and similar securities) in combined amounts that exceeded 50% of net assets already exceeded the 50% limit for either repurchase agreements, similar financing transactions (bank borrowings and similar securities, or both, when considered separately. In our review of financial statements filed by the Commission by BDCs, we observed that no BDCs exceeded the asset coverage requirement.

procedures reasonably designed to achieve compliance with the proposed rules.[533] Additionally, a leveraged/inverse fund that meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules would not have to comply with the VaR-based leverage risk limit under proposed rule 18f-4, provided the fund limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index and discloses in its prospectus that it is not subject to the proposed VaR-based limit on fund leverage risk.[534]

These due diligence and approval requirements are designed to address potential investor protection concerns with respect to leveraged/inverse investment vehicles by subjecting retail investors to specific due diligence and account approval requirements by broker-dealers and investment advisers. The proposed rules also are designed to help to ensure that investors in these funds are limited to those who are capable of evaluating their characteristics—including that the funds would not be subject to all of the leverage-related requirements applicable to registered investment companies generally—and the unique risks they present. There is a body of academic literature providing empirical evidence that retail investors may not fully understand the risks inherent in their investment decisions and not fully understand the effects of compounding returns over time.[535] Retail investors could face additional burdens in investing in

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533 *See supra* section II.G.2. The proposed sales practices rules define "leveraged/inverse investment vehicle" to mean a registered investment company or an exchange-listed commodity- or currency-based trust or fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time. *See* proposed rules 15*l*-2(d) and 211(h)-1(d).

534 *See supra* section II.G.3. A leveraged/inverse fund that meets these requirements still would be required to satisfy all of the conditions in proposed rule 18f-4 other than the proposed VaR-based limit on fund leverage risk, including the proposed conditions requiring a derivatives risk management program, board oversight and reporting, and recordkeeping.

535 *See*, e.g., Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial*

leveraged/inverse investment vehicles, to the extent that they do not currently possess the requisite capability of evaluating the risks of these products to satisfy the approval requirements implemented by broker-dealers and investment advisers in connection with the proposed rules' due diligence and account approval obligations. However, we expect such retail investors would benefit from the proposed requirement, which we believe would help to ensure that investors in these funds are limited to those who are capable of evaluating the characteristics and unique risks of these products.[536] We acknowledge that these benefits may be reduced, to the extent that they overlap with the effects of investment advisers' or broker-dealers' existing requirements or practices related to a retail investors' suitability for investments in these produces as discussed in section III.B.5 above.

Since the alternative provision for leveraged/inverse funds under proposed rule 18f-4 includes a requirement that a leveraged/inverse fund disclose in its prospectus that it is not subject to the proposed limit on fund leverage risk, both investors and the market would benefit from transparency regarding which funds are exempt from rule 18f-4's limit on fund leverage

Literacy: Theory and Evidence, 52 Journal of Economic Literature 5 (2014), *available at* https://www.aeaweb.org/articles?id=10.1257/jel.52.1.5, which provides a literature review of recent survey-based work indicating that many retail investors have limited financial literacy and, for example, do not always understand the compounding of returns, which may directly apply in the context of the daily compounding feature of leveraged/inverse ETFs. The literature does not address retail investor's inattention to investment risk or the unique dynamics of compounding of daily returns in the context of leveraged/inverse ETFs or other leveraged/inverse investment vehicles specifically, but studies investor inattention to financial products more generally.

536 The sales practices rules would not apply to a position in a leveraged/inverse investment vehicle established before the rules' compliance date. *See supra* note 339 and associated text. As a result, investors with such existing positions would only be affected by the proposed sales practices rules if they seek to increase an existing or add a new position in a leveraged/inverse investment vehicle.

fund risk. Some investors may value this information to the extent that it helps them make better-informed choices between funds.

The costs that broker-dealers and investment advisers may incur as a result of the proposed sales practices rules would vary depending on the firm. For example, as the proposed requirements are generally modeled after the options account requirements, broker-dealers that already have compliance procedures in place for approving options accounts would likely have reduced compliance costs.[537] In addition, some broker-dealers and investment advisers may incur costs associated with training customer-facing personnel and supervisory review of account approval decisions. Investment advisers' and broker-dealers' existing processes, as discussed above in section III.B.5, may reduce the costs that the proposed sales practices rules otherwise would involve to the extent that investment advisers or broker-dealers can build on existing processes in complying with the proposed sales practices rules.

Broker-dealers and investment advisers would incur costs associated with the proposed sales practices rules. We estimate that one-time costs for a broker-dealer or investment adviser related to the due diligence and account approval requirements would range from $7,749 to $12,915[538] and that one-time costs related to drafting the associated policies and procedures

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537 These efficiencies and the resulting reduced compliance costs would not apply to investment advisers that are not also registered broker-dealers because they are not subject to FINRA rules.

538 This estimated range is based on the following calculations: (6 hours x $365 (compliance attorney) + 9 hours x $284 (senior systems analyst) + 12 hours x $331 (senior programmer)) = ($2,190 + $2,556 + $3,972) = $8,718 for development and implementation of online client questionnaire; (3 hours x $365 (compliance attorney) + 3 hour x $70 (compliance clerk)) = $1,305 for customer due diligence; and 1 hour x $309 (compliance manager) = $309 for evaluation of client information for account approval/disapproval for a total of $10,332. Assuming a range of +/- 25% around the average total of $10,332 gives a range for one-time costs from $10,332 x 75% = $7,749 to $10,332 x 125% = $12,915.

would range from $1,367 to $2,278.[539] Thus, we estimate total one-time costs for a broker-dealer or investment adviser would range from $9,116 to $15,193.[540]

In addition, we estimate that ongoing costs for a broker-dealer or investment adviser related to the due diligence and account approval requirements would range from $1,211 to $2,018 per year,[541] that ongoing costs related to the associated policies and procedures requirement would range from $903 to $1,505 per year,[542] and that ongoing costs related to the associated recordkeeping requirements would range from $157 to $393 per year.[543] Thus, we estimate that total ongoing costs for a broker-dealer or investment adviser would range from $2,271 to $3,915 per year.[544]

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539 This estimated range is based on the following calculations: (3 hours x $309 (senior manager) + 1 hour x $365 (compliance attorney) + 1 hour x $530 (chief compliance officer)) = ($927 + $365 + $530) = $1,822 for establishing and implementing rule 15*l*-2 policies and procedures. Assuming a range of +/- 25% around the average total of $1,822 gives a range for one-time costs from $1,822 x 75% = $1,366.50 to $1,822 x 125% = $2,277.50.

540 This estimated range is based on the following calculations: $7,749 + $1,366.50 = $9,115.50 for the minimum of the cost range and $12,915 + $2,277.50 = $15,192.50 for the maximum of the cost range.

541 This estimated range is based on the following calculations: (3 hours x $365 (compliance attorney) + 3 hour x $70 (compliance clerk)) = $1,305 per year for customer due diligence; and 1 hour x $309 (compliance manager) = $309 per year for evaluation of client information for account approval/disapproval for a total of $1,614 per year. Assuming a range of +/- 25% around the average total of $1,614 per year gives a range for ongoing costs from $1,614 x 75% = $1,210.50 per year to $1,614 x 125% = $2,017.50 per year.

542 This estimated range is based on the following calculations: (1 hour x $309 (senior manager) + 1 hour x $365 (compliance attorney) + 1 hour x $530 (chief compliance officer)) = $1,204 per year for reviewing and updating rule 15*l*-2 policies and procedures. Assuming a range of +/- 25% around the average total of $1,204 per year gives a range for ongoing costs from $1,204 x 75% = $903 per year to $1,204 x 125% = $1,505 per year.

543 This estimated range is based on the following calculations: (1 hour x $62 (general clerk) + 1 hour x $95 (senior computer operator)) = $157 per year for the minimum of the cost range and (2.5 hours x $62 (general clerk) + 2.5 hours x $95 (senior computer operator) = ($155 + $237.50)) = $392.50 per year for the maximum of the cost range.

544 This estimated range is based on the following calculations: ($1,210.50 + $903 + $157) = $2,270.50 per year for the minimum of the cost range and ($2,017.50 + $1,505 + $392.50) =

As of December 2018, there were 2,766 broker-dealers that reported some sales to retail customer investors.[545] We estimate that 700 of these broker dealers with retail customer accounts (approximately 25%) have retail customer accounts that invest in leveraged/inverse investment vehicles. Our staff further estimates that 715,000 existing customer accounts with such broker-dealers would require account approval for trading in leveraged/inverse investment vehicles and that 10,000 new customer accounts opened each year would require such approval. [546]

In addition, as of December 2018, there were 8,235 investment advisers registered with the Commission having some portion of their business dedicated to retail investors, including either individual high net worth clients or individual non-high net worth clients.[547] We estimate that 2,000 of these investment advisers with retail client accounts (approximately 25%) have retail client accounts that invest in leveraged/inverse investment vehicles. We further estimate that 715,000 existing customer accounts with such investment advisers would require account approval for trading in leveraged/inverse investment vehicles, and that 10,000 new customer accounts opened each year would require such approval.[548]

$3,915 per year for the maximum of the cost range.

545 Our estimate of the number of broker-dealers with retail customers are based on data obtained from Form BD and Form BR as of December 31, 2018.

546 The number of broker-dealers that have retail client accounts that invest in leveraged/inverse investment vehicles as well as the numbers of existing and new customer accounts with these broker-dealers that would require approval for trading in these products are based on staff experience, as we do not have data that would allow us to determine these numbers more precisely.

547 Our estimate of the number of investment advisers with retail accounts are based on data obtained from responses to Item 5.D of Form ADV as of December 31, 2018.

548 The number of investment advisors that have retail client accounts that invest in leveraged/inverse investment vehicles as well as the numbers of existing and new customer accounts with these investment advisers that would require approval for trading in these products are based on staff experience, as we do not have data that would allow us to determine these numbers more precisely.

To the extent that many broker-dealers already have compliance procedures in place for approving options accounts, which is a common industry practice, these broker-dealers would likely have reduced costs associated with the proposed requirements of the sales practices rules. Thus, we estimate that many broker-dealers would incur one-time and ongoing costs that are closer to the low end of the provided ranges, while broker-dealers that cannot take advantage of such efficiencies and many investment advisors would likely experience costs closer to the high end of the provided ranges.[549] We estimate that the total industry cost for the proposed requirements of the sales practice rule in the first year for both broker-dealers and investment advisers would equal $2,377,503,800, which is based on the midpoint of the sum of the ranges for both one-time and ongoing costs.[550] Some broker-dealers and investment advisers may decide to pass these compliance costs on to their customers. [551]

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549 *See supra* notes 514 and 518.

550 This estimate is based on the following calculations: (700 broker-dealers + 2,000 registered investment advisers having retail customer accounts that invest in leveraged/inverse investment vehicles) x ($8,718 + $1,822)) = $28,458,000 + ((2 x 715,000) existing customer accounts with broker-dealers and registered investment advisers requiring account approval for trading in leveraged/inverse investment vehicles) x ($1,305 + $309) = $2,308,020,000 for total one-time industry costs to broker-dealers and investment advisers of $2,336,478,000; and ((2 x 10,000) new customer accounts requiring account approval for trading in leveraged/inverse investment vehicles) x ($1,305 + $309) = $32,280,000 + (700 broker-dealers + 2,000 registered investment advisers having retail customer accounts that invest in leveraged/inverse investment vehicles) x $1,204) = $3,250,800 + (10,000 new customer accounts requiring account approval for trading in leveraged/inverse investment vehicles) x ($157 (broker-dealer recordkeeping costs) + $392.50 (investment adviser recordkeeping costs)) = $5,495,000 for total ongoing annual industry costs to broker-dealers and investment advisers of $41,025,800 per year. Total industry cost for proposed requirements of sales practice rule in the first year is $2,336,478,000 + $41,025,800 = $2,377,503,800, which is consistent with being the midpoint of the sum of the ranges for both one-time and ongoing costs discussed in preceding calculations.

551 The share of these costs passed on to investors by investment advisers or broker-dealers would depend on multiple factors, including the nature of competition between investment advisers and broker-dealers as well as investors' relative sensitivity to changes in fees, the joint effects of which are inherently impossible to predict. Some broker-dealers offer transactions in certain leveraged/inverse investment vehicles, such as some leveraged/inverse ETFs, without charging

In addition, some leveraged/inverse investment vehicles may lose existing or potential investors as a result of some retail investors not being approved by their broker-dealer or investment adviser to transact in leveraged/inverse investment vehicles or some retail investors being deterred by the time costs and delay introduced by the account-opening procedures. Broker-dealers or investment advisers with a larger fraction of retail customers or clients that can no longer transact in leveraged/inverse investment vehicles as a result of the proposed sales practices rules may experience larger declines in their customer or client base and associated reductions in profits.[552]

It is our understanding that no funds that would meet the definition of a "leveraged/inverse investment vehicle," and that seek returns above 300% of the return (or inverse of the return) of the underlying index, currently exist. Therefore we do not expect any costs associated with existing funds having to alter their investment strategies or business practices to comply with proposed rule 18f-4's alternative requirements for leveraged/inverse funds.

Requiring a leveraged/inverse fund covered by the proposed sales practices rules to limit its exposure to 300% of the return (or inverse of the return) of the underlying index while preventing a fund that does not qualify as a leveraged/inverse investment vehicle from offering investment strategies that exceed the proposed outer limit on fund leverage risk may also have competitive effects, which we discuss in section III.B.5 below. As an alternative to the proposed

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commissions. In these cases, broker-dealers may pass on some of the compliance costs associated with the proposed requirements by charging some amount of commission on these trades.

552 Any such reduction in a broker-dealer's or investment adviser's customer base may be offset to the extent that clients transact in other products with the same broker dealer or investment adviser instead.

exposure limit for leveraged/inverse funds, we also discuss the effects of conditioning the exemption for leveraged/inverse funds on compliance with a higher or lower exposure limit in section III.D.1 below.

6. Proposed Amendments to Rule 6c-11 under the Investment Company Act and Proposed Rescission of Exemptive Relief for Leveraged/Inverse ETFs

Existing leveraged/inverse ETFs rely on exemptive relief, which the Commission has not granted to a leveraged/inverse ETF sponsor since 2009. We are proposing to amend rule 6c-11 to remove the provision excluding leveraged/inverse ETFs from its scope, which would permit fund sponsors to operate a leveraged/inverse ETF under that rule and without obtaining an exemptive order.

The proposed amendments to rule 6c-11 would benefit any fund sponsors seeking to launch leveraged/inverse ETFs that did not obtain the required exemptive relief due to the Commission's moratorium on granting such relief as well as fund sponsors seeking to launch leveraged/inverse ETFs in the future. A fund sponsor planning to seek exemptive relief from the Commission to form and operate a leveraged/inverse ETF would also no longer incur the cost associated with applying for an exemptive order.[553] To the extent that the amendments result in new leveraged/inverse ETFs coming to market, the industry-wide assets under management of leveraged/inverse ETFs could increase and investors that would be eligible under the proposed

[553] In the ETFs Adopting Release, we estimated that the direct cost of a typical fund's application for ETF relief (associated with, for example, legal fees) is approximately $100,000. As exemptive applications for leveraged/inverse ETFs are significantly more complex than those of the average fund, we estimate that the direct costs of an application for leveraged/inverse ETF relief would amount to approximately $250,000. *See* ETFs Adopting Release, *supra* note 76, at nn.537-539 and accompanying text.

sales practices rules to invest in leveraged/inverse ETFs could benefit from an increase in investment choices.[554]

Because our proposed amendments to rule 6c-11 would permit leveraged/inverse ETFs to rely on that rule, we also are proposing to rescind the exemptive orders the Commission has previously granted to leveraged/inverse ETFs. As a result, existing and future leveraged/inverse ETFs would operate under a consistent regulatory framework. We believe that the costs to leveraged/inverse ETFs associated with rescinding their existing exemptive relief would be minimal, as we anticipate that all existing leveraged/inverse ETFs would be able to continue operating with only minor adjustments, other than being required to comply with the requirements in rule 6c-11 for additional website disclosures and basket asset policies and procedures.[555]

Additional economic considerations that the proposed treatment of leveraged/inverse ETFs presents with regards to efficiency and competition are discussed below in section III.D.

7. Unfunded Commitment Agreements

The proposed rule would permit a fund to enter into unfunded commitment agreements if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment

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554 The increase in assets under management among leveraged/inverse ETFs could be attenuated, to the extent that proposed rule 15l-2's and 211(h)-1's due diligence requirements would lead to a reduction in the number of investors that invest in these funds. *See infra* section III.C.5.

555 In this section as well as in section III.D below, we have accounted for the costs and benefits to leveraged/inverse ETFs as a result of the removal of the current exclusion of these funds from rule 6c-11. We believe that the additional considerations the Commission analyzed in the ETFs Adopting Release for ETFs other than leveraged/inverse ETFs that were included in the scope of rule 6c-11 at adoption would apply substantially similarly to leveraged/inverse ETFs. *See* ETFs Adopting Release, *supra* note 76.

agreements, in each case as they come due.[556] While a fund should consider its unique facts and circumstances, the proposed rule would prescribe certain specific factors that a fund must take into account in having such a reasonable belief. We believe that the proposed requirements are consistent with current market practices, based on the staff's experience in reviewing and commenting on fund registration statements, which have disclosure regarding their unfunded commitments, as well as representations funds have made to the staff.[557] As a result, we do not believe that the rule's treatment of unfunded commitment agreements represents a change from the baseline, although we acknowledge that there may be some variation in the specific factors that funds consider today, as well as the potential for some variation between those factors and those prescribed in the proposed rule. Because we believe that the proposed approach is consistent with general market practices and we do not have specific granular information to identify differences in funds' current practices relative to the proposed rule, we believe this proposed requirement would not lead to significant economic effects.

8. Recordkeeping

Proposed rule 18f-4 includes certain recordkeeping requirements.[558] Specifically, the proposed rule would require a fund to maintain certain records documenting its derivatives risk management program's written policies and procedures, along with its stress test results, VaR backtesting results, internal reporting or escalation of material risks under the program, and reviews of the program.[559] It would also require a fund to maintain records of any materials

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556 *See supra* section II.J.

557 *See supra* discussion in paragraph preceding note 419.

558 *See supra* section II.K.

559 *See* proposed rule 18f-4(c)(i)(A).

provided to the fund's board of directors in connection with approving the designation of the derivatives risk manager and any written reports relating to the derivatives risk management program.[560] A fund that would be required to comply with the proposed VaR test would also have to maintain records documenting the determination of: its portfolio's VaR; its designated reference index VaR, as applicable; its VaR ratio (the value of the VaR of the Fund's portfolio divided by the VaR of the designated reference index), as applicable; and any updates to any of its VaR calculation models and the basis for any material changes to its VaR models.[561] A fund that would be a limited derivatives user under the proposed rule would have to maintain a written record of its policies and procedures that are reasonably designed to manage derivatives risks.[562] Finally, a fund engaging in unfunded commitment agreements would be required to maintain records documenting the sufficiency of its funds to meet its obligations with respect to all unfunded commitment agreements.[563]

We believe that these proposed requirements would increase the effectiveness of the Commission's oversight of the fund industry, which will, in turn, benefit investors. Further, the requirement to keep records documenting the derivatives risk management program, including records documenting periodic review of the program and reports provided to the board of directors relating to the program, would help our staff evaluate a fund's compliance with the proposed derivatives risk management program requirements. We anticipate that these recordkeeping requirements would generally not impose a large additional burden on funds, as

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560 *See* proposed rule 18f-4(c)(6)(i)(B).

561 *See* proposed rule 18f-4(c)(6)(i)(C).

562 *See* proposed rule 18f-4(c)(6)(i)(D).

563 *See* proposed rule 18f-4(c)(6)(i)(E).

most funds would likely choose to keep such records, even absent the proposed requirement to do so, in order to support their ongoing administration of the proposed derivatives risk management program and their compliance with the associated requirements.

As discussed below in section IV.B.7, our estimated average one-time and ongoing annual costs associated with the recordkeeping requirements take into account the fact that certain funds can rely on the proposed rule's limited derivatives user exception and may incur less extensive recordkeeping costs relative to those funds which may not rely on this exception. Of the estimated 5,091 funds that would be subject to the recordkeeping requirements, we estimate that 2,398 funds would be limited derivatives users. Assuming that both one-time and ongoing annual recordkeeping costs for limited derivatives users are 90% of those for funds that would not qualify as limited derivatives users, we estimate that, on average, each fund that could not rely on the limited user exception would incur a one-time cost of $2,047 [564] and an ongoing cost of $330 per year[565] and each fund that could rely on the exception would incur, a one-time cost of $1,842[566] and an ongoing cost of $297 per year.[567] We thus estimate that the total industry cost for this requirement in the first year would equal $11,529,656.[568]

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564 This estimate is based on the following derivations and calculations: 1.5 hours x $62 (general clerk) / ((2,398/5,091) x 90% + ((5,091 – 2,398)/5,091)) = $97.60; and 1.5 hours x $95 (senior computer operator) / ((2,398/5,091) x 90% + ((5,091 – 2,398)/5,091)) = $149.54 for a total of $97.60 + $149.54 + ($1,800 for initial external cost burden) = $2,047.14, where (2,398/5,091) is the share of funds that are limited derivatives users and (5,091 – 2,398)/5,091) is the share of funds that are not limited derivatives users.

565 This estimate is based on the following derivations and calculations: 2 hours x $62 (general clerk) / ((2,398/5,091) x 90% + ((5,091 – 2,398)/5,091)) = $130.13; and 2 hours x $95 (senior computer operator) / ((2,398/5,091) x 90% + ((5,091 – 2,398)/5,091)) = $199.39 for a total of $130.13 + $199.39 = $329.52, where (2,398/5,091) is the share of funds that are limited derivatives users and (5,091 – 2,398)/5,091) is the share of funds that are not limited derivatives users.

566 This estimate is based on the following calculations: $2,047.14 x 90% = $1,842.43.

9. Amendments to Fund Reporting Requirements

a. Form N-PORT and Form N-CEN

We are proposing to amend Form N-PORT to include a new reporting item on funds' derivatives exposure, which would be publicly available for the third month of each fund's quarter.[569] In addition, we are proposing amendments that would require funds that are subject to the proposed VaR-based limit on fund leverage risk to report certain information related to their VaR.[570] We are also proposing to amend Form N-CEN to require a fund to identify (1) whether it is a limited derivatives user (either under the proposed exception for funds that limit their derivatives exposure to 10% of their net assets or under the exception for funds that limit their derivatives use to certain currency hedging); (2) whether it is a leveraged/inverse investment vehicle as defined in proposed sales practices rules; and (3) whether it has entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment

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567 This estimate is based on the following calculations: $329.52 x 90% = $296.57.

568 This estimate is based on the following calculations: (5,091 – 2,398 = 2,693 funds which cannot rely on the limited derivatives user exception) x ($2,047.14 + $329.52) = $6,400,347.32; and (2,398 funds which can rely on the limited derivatives user exception) x ($1,842.43 + $296.57) = $5,129,309.17 for a total of $11,529,656.48.

569 *See supra* section II.H.1.While the information for the first two months of a fund's quarter would be non-public, the information for the third month of a fund's quarter would be publicly available. *See supra* note 359.

570 Specifically, this information would include: (1) the fund's highest daily VaR during the reporting period and its corresponding date; and (2) the fund's median daily VaR for the reporting period. Funds subject to the relative VaR test during the reporting period also would have to report: (1) the name of the fund's designated reference index; (2) the index identifier; (3) the fund's highest daily VaR ratio during the reporting period and its corresponding date; and (4) the fund's median daily VaR ratio for the reporting period. Finally, all funds that are subject to the proposed limit on fund leverage risk also would have to report the number of exceptions that the fund identified as a result of the backtesting of its VaR calculation model. *See id*.

agreements.[571] These additional reporting requirements would not apply to BDCs, which do not file reports on Form N-CEN or Form N-PORT.[572]

To the extent that measures of derivatives exposure, and the other information that we would require funds to report on Forms N-PORT and N-CEN, are not currently available, the proposed requirements that funds make such information available periodically on these forms would improve the ability of the Commission to oversee reporting funds. It also would allow the Commission and its staff to oversee and monitor reporting funds' compliance with the proposed rule and help identify trends in reporting funds' use of derivatives, portfolio VaRs, and their choice of designated reference indexes. The expanded reporting also would increase the ability of the Commission staff to identify trends in investment strategies and fund products in reporting funds as well as industry outliers.[573]

Investors, third-party information providers, and other potential users would also experience benefits from the proposed amendments to Forms N-PORT and N-CEN. Investors and other potential users would have disclosure of additional information that is not currently available in any filings. We believe that the structured data format of this information in Forms N-PORT and N-CEN would allow investors and other potential users to more efficiently analyze portfolio investment information. The additional information, as well as the structure of that

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571 We believe that many of these proposed new reporting items would be inapplicable to most BDCs. *See supra* section II.H.3.

572 *See supra* section II.H.4.

573 The structuring of the information in Form N-PORT would improve the ability of Commission staff to compile and aggregate information across all reporting funds, and to analyze individual funds or a group of funds, and would increase the overall efficiency of staff in analyzing the information.

information, would increase the transparency of a fund's investment strategies and allow more efficient assessment of reporting funds' potential leverage-related risks.

The amendments to Forms N-PORT and N-CEN would also benefit investors, to the extent that they use the information, to better differentiate funds that are not limited derivatives users or leveraged/inverse funds based on their derivatives usage. For example, investors would be able to more efficiently identify the extent to which such funds use derivatives as part of their investment strategies. Investors, and in particular individual investors, could also indirectly benefit from the additional information in amended Forms N-PORT and N-CEN to the extent that third-party information providers and other interested parties obtain, aggregate, provide, analyze and report on the information. Investors could also indirectly benefit from the additional information in amended Forms N-PORT and N-CEN to the extent that other entities, including investment advisers and broker-dealers, utilize the information to help investors make more informed investment decisions related to funds that provide this information.

As discussed below in section IV.F, our estimated average one-time and ongoing annual costs associated with the amendments to Forms N-PORT take into account the fact that certain funds that are not subject to the proposed VaR-based limit on fund leverage risk in proposed rule 18f-4 would not have to report certain VaR-related information and may incur less extensive reporting costs relative to those funds subject to the limit, which are required to report such VaR-related disclosure information. Of the estimated 5,091 funds that would be subject to the exposure-related disclosure requirement, we estimate that 2,424 funds would also be subject to the VaR-related disclosure requirements. We estimate that, on average, each fund that is not subject to the VaR-related disclosure requirement would incur a one-time cost of $6,982 [574] and an ongoing cost of $2,088 per year[575] and each fund that is subject to the VaR-related disclosure requirement would incur a one-time cost of $8,374[576] and an ongoing cost of $4,176 per year. [577] We thus estimate that the total industry cost for this reporting requirement in the first year would equal $54,610,890.[578]

As discussed below in section IV.H, we estimate that the average ongoing annual cost for a registered fund to prepare amendments to Form N-CEN is $6.96 per year. [579] We thus estimate that the total industry cost for all registered funds associated with this reporting requirement in the first year is $86,130.[580]

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574 This estimate is based on the following derivations and calculations: (2 hours x $365 (compliance attorney) + 2 hours x $331 (senior programmer) + ($5,590 for initial external cost burden)) = $6,982 to comply with the new N-PORT requirements of derivatives exposure information in the first reporting quarter of the fiscal year.

575 This estimate is based on the following derivations and calculations: (3 hours x $365 (compliance attorney) + 3 hours x $331 (senior programmer)) = $2,088 per year to comply with the new N-PORT requirements of derivatives exposure information in the final three reporting quarters of the fiscal year.

576 This estimate is based on the following derivations and calculations: (4 hours x $365 (compliance attorney) + 4 hours x $331 (senior programmer) + ($5,590 for initial external cost burden)) = $8,374 to comply with the new N-PORT requirements of derivatives exposure and VaR-related information in the first reporting quarter of the fiscal year.

577 This estimate is based on the following derivations and calculations: (6 hours x $365 (compliance attorney) + 6 hours x $331 (senior programmer)) = $4,176 to comply with the new N-PORT requirements of derivatives exposure and VaR-related information in the final three reporting quarters of the fiscal year.

578 This estimate is based on the following calculations: (5,091 – 2,424 = 2,667 funds which are not subject to the VaR-related disclosure agreements) x ($6,982 + $2,088) = $24,189,690; and (2,424 funds which are subject to the VaR-related disclosure agreements) x ($8,374 + $4,176) = $30,421,200 for a total of ($24,189,690 + $30,421,200) = $54,610,890.

579 This estimate is based on the following derivations and calculations: 0.01 hour x $365 (compliance attorney) + 0.01 hour x $331 (senior programmer) = $3.65 + $3.31 = $6.96 per year

580 This estimate is based on the following derivations and calculations: (12,375 registered funds required to prepare a report on Form N-CEN as amended) x $6.96 = $86,130.

b. Amendments to Current Reporting Requirements

We are also proposing current reporting requirements for funds that are relying on proposed rule 18f-4 and subject to the proposed VaR-based limit on fund leverage risk. Specifically, a fund that is out of compliance with the VaR test for more than three business days would be required to file a non-public report on Form N-RN providing certain information regarding its VaR test breaches and a fund will also be required to file a report when it is back in compliance with its applicable VaR test.[581]

We anticipate that the enhanced current reporting requirements could produce significant benefits. For example, when a fund is out of compliance with the proposed VaR-based limit on fund leverage risk, this may indicate that a fund is experiencing heightened risks as a result of a fund's use of derivatives transactions. Such breaches also could indicate market events that are drivers of potential derivatives risks across the fund industry and therefore complement other sources of information related to such market events for the Commission. As a result, we believe that the proposed current reporting requirement would increase the effectiveness of the Commission's oversight of the fund industry by providing the Commission and staff with current information regarding potential increased risks and stress events, which in turn would benefit investors.

As discussed below in section IV.G, our estimated average cost burdens associated with the amendments to form N-RN are based on the assumption that, of the estimated 2,424 funds that would be required to comply with either of the VaR tests, the Commission would receive approximately 30 filings per year in response to each of the new VaR-related items proposed to

[581] *See supra* section II.H.2.

be included in Form N-RN, as amended. We estimate such funds would incur an average cost of $3.49 per year on a per-fund basis[582] to prepare amended Form N-RN. Thus, the estimated total industry cost for this reporting requirement in the first year for funds required to comply with either of the VaR tests is $8,460.[583]

We do not believe there would be any potential indirect costs associated with filing Form N-RN, such as spillover effects or the potential for investor flight due to a VaR test breach (to the extent that investors would leave a fund if they believed a fund's VaR test breaches indicate that a fund has a risk profile that is inconsistent with their investment goals and risk tolerance), because Form N-RN filings would not be publicly disclosed. Because the Form N-RN filing requirements would be triggered by events that are part of a fund's proposed requirement to determine compliance with the applicable VaR test at least daily, any monitoring costs associated with Form N-RN are included in our estimates of the compliance costs for rule 18f-4 above.

10. Money Market Funds

Money market funds are excluded from the scope of proposed rule 18f-4. As we are proposing to rescind Release 10666, however, money market funds would not be able to enter into transactions covered by proposed rule 18f-4, including derivatives transactions and reverse repurchase agreements. As discussed above in section II.A.1, we believe that money market funds currently do not typically engage in derivatives transactions or the other transactions

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582 This estimate is based on the following derivations and calculations: 0.005 hour x $365 (compliance attorney) + 0.005 hour x $331 (senior programmer) = $1.83 + $1.66 = $3.49 per year on a per-fund basis.

583 This estimate is based on the following derivations and calculations: (30 filings per year fractionalized across the 2,424 funds per year required to comply with either of the VaR tests) x $3.49 = $8,460.

permitted by rule 18f-4.[584] However, to the extent that there are money market funds that do engage in such transactions to increase the efficiency of their portfolio management, these funds would bear the costs associated with losing any such efficiencies.

However, we believe any costs to money market funds that may currently enter into transactions covered by proposed rule 18f-4 would likely be small. Specifically, as discussed above in section II.A.1, we believe that these transactions would generally be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, and especially if used to leverage the fund's portfolio. Therefore, we do not believe that any fund that may currently engage in these transactions would use them as an integral part of its investment strategy.

D. Effects on Efficiency, Competition, and Capital Formation

This section evaluates the impact of the proposed rules and amendments on efficiency, competition, and capital formation. However, we are unable to quantify the effects on efficiency, competition, and capital formation because we lack the information necessary to provide a reasonable estimate. For example, we are unable to predict how the proposed rules, amendments, and form amendments would change investors' propensity to invest in funds and ultimately affect capital formation. Therefore, much of the discussion below is qualitative in nature, although where possible we attempt to describe the direction of the economic effects.

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[584] Money market funds file monthly reports on Form N-MFP and disclose schedules of portfolio securities held on the form. For each security held, Form N-MFP requires money market funds to disclose the investment category most closely identifying the instrument held from a list of investment categories. *See* Item C.6 of Form N-MFP. However, the form does not contemplate nor include data element categories for transactions covered by proposed rule 18f-4, including derivatives transactions and reverse repurchase agreements. We therefore do not estimate the extent to which money market funds currently rely on these transactions.

1. Efficiency

Proposed rule 18f-4 in conjunction with the proposed rescission of Release 10666 may make derivatives use more efficient for certain funds, particularly for those funds that would qualify as limited derivatives users. Specifically, funds' current asset segregation practices may provide a disincentive to use derivatives for which notional amount segregation is the practice, even if such derivatives would otherwise provide a lower-cost method of achieving desired exposures than purchasing the underlying reference asset directly. For example, a fund seeking to sell credit default swaps to take a position in an issuer's credit risk may currently choose not to do so because of the large notional amounts that the fund would segregate for that specific derivatives position. The proposed rule therefore could increase efficiency by mitigating current incentives for funds to avoid use of certain derivatives (even if foregoing the use of those derivatives would entail cost and operational efficiencies).

In addition, the proposed rules and amendments may change the degree to which some funds choose to use derivatives generally or the degree to which funds use certain derivatives over others.[585] Changes in the degree to which certain derivatives are used by funds could affect the liquidity and price efficiency of these derivatives. Although unaddressed in the academic literature, we expect an increase in the use of derivatives to correspond to an increase in

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585 Specifically, (1) as discussed in the previous paragraph, funds may transact in more notional-value based derivatives as a result of removing the incentive distortion of notional- vs. market-value asset segregation under funds' current asset segregation practices; (2) new potential funds may reduce their use of derivatives transactions to satisfy the proposed VaR-based limit on fund leverage risk (*see supra* section III.C.2); (3) existing funds may change their use of derivatives transactions to respond to risks identified after adopting and implementing their risk management programs (*see supra* section III.C.1); and (4) both existing and new potential funds may increase their use of derivatives transactions as a result of the exemptive rule's bright-line limits on leverage risk (*see supra* section III.C.2). Overall, the effect of the proposed rules and amendments on funds use of derivatives transactions is ambiguous and depends on the type of derivatives transaction.

derivatives market liquidity as more derivatives contracts may be easily bought or sold in markets in a given period, as well as an increase in price efficiency since information regarding underlying securities (and other factors that affect derivatives prices) may be better reflected in the prices of derivative contracts.

Changes in the degree to which certain derivatives are used could also affect the pricing efficiency and liquidity of securities underlying these derivatives and those of related securities. For example, one paper provides evidence that the introduction of credit default swap contracts decreases the liquidity and price efficiency of the equity security of the issuer referenced in the swap.[586] Conversely, the paper also observes that the introduction of exchange-traded stock option contracts improves the liquidity and price efficiency of the underlying stocks.

The proposed VaR-based limit on fund leverage risk would also establish a bright-line limit on the amount of leverage that a fund can take on using derivatives.[587] To the extent that funds are more comfortable with managing their derivatives exposures to a clear outside limit, the proposed rule could improve the efficiency of fund's portfolio risk management practices.

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586 This paper analyzed NYSE-listed firms and observed that, all else equal, equity markets become less liquid and equity prices become less efficient when single-name credit default swap contracts are introduced, while the opposite results hold when equity options are listed on exchanges. Ekkehart Boehmer, Sudheer Chava, & Heather E. Tookes, *Related Securities and Equity Market Quality: The Case of CDS*, 50 Journal of Financial and Quantitative Analysis 509 (2015), *available at* https://www.cambridge.org/core/journals/journal-of-financial-and-quantitative-analysis/article/related-securities-and-equity-market-quality-the-case-of-cds/08DE66A250F9950FA486AE818D5E0341. The latter result, that traded equity options are associated with more liquid and efficient equity prices, is consistent with several other academic papers. *See, e.g.*, Charles Cao, Zhiwu Chen, & John M. Griffin, *Informational Content of Option Volume Prior to Takeovers*, 78 Journal of Business 1073 (2005), as well as Jun Pan & Allen M. Poteshman, *The Information in Option Volume for Future Stock Prices*, 19 Review of Financial Studies 871 (2006). The effects described in the literature are based on studies of the introduction of derivative securities and may therefore apply differently to changes in the trading volume of derivatives securities that may occur as a result of the proposed rule.

587 *See supra* section III.C.2.

In addition, the recordkeeping elements of proposed rule 18f-4 would facilitate more efficient evaluation of compliance with the rule while also providing the Commission with information that may be useful in assessing market risks associated with derivative products. Moreover, the proposed amendments to fund's current reporting requirements could facilitate the Commission's oversight of funds subject to proposed rule 18f-4 with fewer resources, thus making its supervision more efficient. [588]

The amendments to Forms N-PORT and N-CEN would allow investors, to the extent that they use the information, to better differentiate funds that are not limited derivatives users or leveraged/inverse funds based on their derivatives usage.[589] As a result, investors would be able to more efficiently identify the extent to which such funds use derivatives as part of their investment strategies, allowing them to make better-informed investment decisions.

The proposed sales practices rules could also reduce investments in leveraged/inverse investment vehicles, to the extent that some retail investors would not be approved by their broker-dealer or investment adviser to transact in leveraged/inverse investment vehicles or to the extent that some retail investors would be deterred by the time costs and delay introduced by the account-opening procedures.[590] The proposed amendments to rule 6c-11, however, would likely outweigh these effects in the case of leveraged/inverse ETFs and lead to an overall increase in the number and assets under management for these types of funds.

To the extent that the proposed rules would lead to a reduction in investment in leveraged/inverse commodity- or currency-based trusts or funds, the liquidity of these products

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[588] *See supra* section III.C.8.

[589] *See supra* section III.C.9.a.

[590] *See supra* section III.B.5.

may decline as a result. Conversely, to the extent that the proposed rules would lead to an overall increase in investments in leveraged/inverse ETFs, the liquidity of these funds may increase as a result. The likely increase in the number, and assets under management, of leveraged/inverse ETFs as a result of the proposed amendments to rule 6c-11 may affect the quality of the markets for underlying securities and derivatives. Specifically, the academic literature to date provides some evidence, albeit inconclusive, that leveraged/inverse ETFs' rebalancing activity may have an impact on the price and volatility of the constituent assets that make up the ETFs. For example, one paper empirically tests whether the rebalancing activity of leveraged/inverse ETFs impacts the price and price volatility of underlying stocks.[591] The authors find a positive association, suggesting that rebalancing demand may affect the price and price volatility of component stocks, and may reduce the degree to which prices reflect fundamental value of the component stocks. As leveraged/inverse ETFs commonly use derivatives to rebalance their portfolios, similar effects could also extend to underlying derivatives, although we are not aware of any academic literature that has examined the effects of leveraged/inverse ETFs' rebalancing activity on derivatives markets. Conversely, another paper argues that the existing literature that studies the effect of leveraged/inverse ETFs' rebalancing activity on the constituent asset prices does not control for the effect of the creation and redemption transactions (*i.e.*, fund flows) by authorized participants.[592] The paper presents evidence that positively leveraged/inverse ETFs tend to have capital flows in the opposite direction of the underlying index, and inverse leveraged/inverse ETFs tend to have capital flows in the same direction as the underlying index,

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591 *See* Qing Bai, Shaun A. Bond & Brian Hatch, *The Impact of Leveraged and Inverse ETFs on Underlying Real Estate Returns*, 43 Real Estate Economics 37 (2015).

592 *See* Ivan T. Ivanov & Stephen Lenkey, *Are Concerns About Leveraged ETFs Overblown?*, FEDS Working Paper No. 2014-106 (2014).

suggesting that investor behavior may attenuate the effect of leveraged/inverse ETFs' rebalancing activity on the prices of underlying securities and derivatives.[593]

2. Competition

Certain aspects of the proposed rules and amendments may have an impact on competition. Certain of these potential competitive effects result from the proposed rule imposing differential costs on different funds. Specifically, (1) large fund complexes may find it less costly to comply per fund with the new requirements of proposed rule 18f-4;[594] (2) funds that would qualify as limited derivatives users would generally incur lower compliance costs associated with the rule than funds that would not qualify for this exception;[595] (3) funds that would comply with the relative VaR test would generally incur higher compliance costs than those that would comply with the absolute VaR test; (4) BDCs are not subject to the additional reporting requirements on Forms N-CEN or N-PORT and would therefore not incur the increased compliance costs that would be imposed on filers of these forms; and (5) leveraged/inverse funds are not subject to several of the additional reporting requirements on forms N-CEN or N-PORT and would therefore incur a reduced additional burden compared to other funds that are not limited users of derivatives.[596] To the extent that investors believe that the funds that would incur lower compliance burdens and the funds that would incur a higher compliance burden under the

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593 The literature we are aware of focuses on leveraged/inverse ETFs and does not study similar effects of leveraged/inverse mutual funds, although both types of funds generally engage in similar rebalancing activity. To the extent that similar effects may be attributable to leveraged/inverse mutual funds and that any increase in leveraged/inverse ETF assets would be (at least partially) offset by a decrease in leveraged/inverse mutual fund assets, this may ameliorate the overall effect on the price and volatility of constituent assets.

594 *See supra* section III.C.2.

595 *See supra* section III.C.3.

596 *See supra* section III.C.2.

rule are substitutes, the rule would result in a competitive advantage for funds with the lower compliance burden to the extent that a lower burden makes such funds materially less costly to operate.

To the extent that the proposed sales practices rules' due diligence and account approval requirements limit certain customers or clients from buying or selling shares of certain leveraged/inverse investment vehicles, such investors may instead opt to invest in another product with a similar risk profile that is not subject to those requirements.[597] Thus, the proposed sales practices rules may generate substitution spillover effects that increase competition between leveraged/inverse investment vehicles within the scope of the rule and other products outside the scope of the rule that provide similar exposures.

Similarly, broker-dealers and investment advisers with a larger fraction of retail customers or clients that can no longer transact in leveraged/inverse investment vehicles as a result of the proposed sales practices rules' due diligence and account approval requirements may experience larger declines in their customer or client base.[598] As a result, broker-dealers and investment advisers that would see a larger reduction in customers or clients may be at a competitive disadvantage compared to broker-dealers and investment advisers that would see only a smaller reduction in customers or clients or no reduction at all.

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[597] Some investors that are not approved to buy or sell leveraged/inverse investment vehicles may opt to move their capital into exchange-traded notes or other products with a similar risk profile. Conversely, some investors may transact in leveraged/inverse investment vehicles without involving a broker-dealer or investment adviser that would be subject to the proposed sales practices rules, although this is uncommon. *See supra* note 321.

[598] Any such reduction in a broker-dealer's or investment adviser's customer base may be offset to the extent that clients transact in other products with the same broker dealer or investment adviser instead. *See supra* section III.C.5.

The Commission has not provided exemptive relief to new prospective sponsors of leveraged/inverse ETFs since 2009.[599] The proposed amendments to rule 6c-11 would allow other leveraged/inverse ETFs to enter the leveraged/inverse ETF market, likely leading to more competition among leveraged/inverse ETFs and between leveraged/inverse ETFs and other products that investors may perceive as substitutes, such as leveraged/inverse mutual funds. This increase in competition could be significant, as the leveraged/inverse ETF market is very concentrated; currently, only two fund sponsors operate leveraged/inverse ETFs.[600] In addition, fees for leveraged/inverse ETFs and substitute products, such as leveraged/inverse mutual funds, could fall as a result of any such increase in competition.

3. Capital Formation

Certain aspects of the proposed rules and amendments may have an impact on capital formation. Certain of these effects may arise from a change in investors' propensity to invest in funds. On the one hand, investors may be more inclined to invest in funds as a result of increased investor protection arising from any decrease in leverage-related risks. On the other hand, some investors may reduce their investments in certain funds that may increase their use of derivatives in light of the bright-line VaR-based limit on fund leverage risk.[601] Additionally, some investors may re-evaluate their desire to invest in funds generally as a result of the increased disclosure requirements, with some investors deciding to invest more and other investors deciding to invest less. While we are unable to determine whether the proposed rules and amendments would lead

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599 *See supra* text following note 473.

600 The increase in competition among leveraged/inverse ETFs could be attenuated, to the extent that proposed rule 15*l*-2's and 211(h)-1's due diligence requirements would limit the number of investors that invest in these funds. *See supra* section III.C.5.

601 *See supra* section III.C.2.

to an overall increase or decrease in fund assets, to the extent the overall fund assets change, this may have an effect on capital formation.

The proposed rule may also decrease the use of reverse repurchase agreements, similar financing transactions, or borrowings by some funds, or reduce some funds' ability to invest the borrowings obtained through reverse repurchase agreements.[602] To the extent that this restricts a fund's ability to obtain financing to invest in debt or equity securities, capital formation may be reduced.

In addition, the proposed sales practices rules may reduce capital formation in asset markets directly connected with covered leveraged/inverse investment vehicles. By restricting the accounts of customers or clients seeking to buy or sell shares of a leveraged/inverse investment vehicle, the proposed rules may produce net capital outflows from retail investors. However, the size of this effect would depend on the number of retail investors that would no longer be approved to buy or sell shares of leveraged/inverse investment vehicles and any other investments these retail investors would make in lieu of investing in leveraged/inverse investment vehicles.

E. Reasonable Alternatives

1. Alternative Implementations of the VaR Tests

a. Different Confidence Level or Time Horizon

Proposed rule 18f-4 would require that a fund's VaR model use a 99% confidence level and a time horizon of 20 trading days.[603] We could alternatively require a different confidence level and/or a different time horizon for the VaR test.

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[602] *See supra* section III.C.4.

[603] *See supra* section II.D.4.

As discussed above in section II.D.4, market participants calculating VaR most commonly use 95% or 99% confidence levels and often use time horizons of 10 or 20 days. The proposed VaR parameters therefore represent a confidence level and time horizon at the high end of what is commonly used. Compared to requiring a lower confidence level and a shorter time horizon, the proposed parameters result in a VaR test that is designed to measure, and therefore limit the severity of, less frequent but larger losses. The cost of calculating VaR does not vary based on how the model is parametrized, meaning the proposed confidence level and time horizon would not lead to larger compliance costs for funds compared to the alternatives we considered. A lower confidence level or shorter time horizon may be less effective at placing a VaR-based outer limit on fund leverage risk associated with larger losses and would not result in cost savings for funds.

b. Absolute VaR Test Only

To establish an outer limit for a fund's leverage risk, the proposed rule would generally require a fund engaging in derivatives transactions to comply with a relative VaR test; the fund could instead comply with an absolute VaR test only if the derivatives risk manager is unable to identify an appropriate designated reference index for the fund. As an alternative, we could require all funds that would be subject to the proposed VaR-based limit on fund leverage risk to comply with an absolute VaR test.

Use of an absolute VaR test would be less costly for some funds that would be required to comply with the relative VaR test under the proposed rule, including because the relative VaR test may require some funds to pay licensing costs associated with the use of the reference index.[604] In addition, use of an absolute VaR test would reduce the compliance challenge for fund risk managers who have difficulty identifying a designated reference index; however, this benefit would be limited for funds that have an existing or easy-to-identify benchmark.

On the other hand, the absolute VaR test is a static measure of fund risk in the sense that the implied limit on a fund's VaR will not change with the VaR of its designated reference index. The absolute VaR test is therefore less suited for measuring leverage risk and limiting the degree to which a fund can use derivatives to leverage its portfolio, as measuring leverage inherently requires comparing a fund's risk exposure to that of an unleveraged point of reference.[605] An additional implication of this aspect of an absolute VaR test is that a fund may fall out of compliance with an absolute VaR test just because the market it invest in becomes more volatile even though the degree of leverage in the fund's portfolio may not have changed. Overall, we believe that permitting funds to rely on an absolute VaR test only in those instances when a designated reference index is unavailable is justified.

c. Choice of Absolute or Relative VaR Tests

As another alternative, we could allow derivatives risk managers to choose between an absolute and a relative VaR limit, depending on their preferences and without regard to whether a designated reference index is available. Such an alternative would offer derivatives risk managers more flexibility than the proposed rule and could reduce compliance costs for funds, to the extent that derivatives risk managers would choose the VaR test that is cheaper to implement for their particular fund. However, this alternative may result in less uniformity in the outer limit on funds' leverage risk across the industry, as individual derivatives risk managers would have

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604 *See supra* section III.C.2.

605 *Id.*

the ability to choose between VaR-based tests that could provide for different limits on fund leverage risk. Funds that invest in assets with a low VaR, for example, could obtain significantly more leverage under an absolute VaR test because the VaR of the fund's designated reference index would be low; as a result, investors in these funds would be less protected from leverage-related risks compared to the proposed rule.

d. Optional Relative VaR Test Using a Fund's "Securities VaR"

As another alternative, we could allow funds relying on the relative VaR test to compare the fund's VaR to its "securities VaR" (*i.e.*, the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions), rather than the VaR of the fund's designated reference index, depending on the derivatives risk manager's preferences and without regard to whether a designated reference index is available.[606]

While such an alternative would offer derivatives risk managers more flexibility than the proposed rule, we believe that it would not be easier to implement or lead to cost savings for a significant number of funds. Conversely, the alternative VaR test based on a fund's "securities VaR" would provide an incentive for some funds to invest in volatile, riskier securities that would increase the fund's "securities VaR," thereby reducing the test's effectiveness at limiting fund leverage risk. As a result, investors in these funds would be less protected from leverage-related risks compared to the proposed rule.

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[606] The 2015 Proposing Release also included a risk-based portfolio limit based on VaR, which provided that a fund would satisfy its risk-based portfolio limit condition if a fund's full portfolio VaR was less than the fund's "securities VaR." *See* 2015 Proposing Release, *supra* note 2, at section III.B.2.

e. Third-Party Validation of a Fund's VaR Model

The proposed rule does not require third-party validation of a fund's chosen VaR model. As an alternative, we could require that a fund obtain third-party validation of its VaR model, either at inception or in connection with any material changes to the model, to independently confirm that the model is structurally sound and adequately captures all material risks.[607] While such a requirement could help ensure funds' compliance with the proposed VaR-based limit on fund leverage risk, this incremental benefit may not justify the potentially significant additional costs to funds associated with third-party validation of the fund's VaR model.[608]

2. Alternatives to the VaR Tests

a. Stress Testing

As an alternative to the proposed VaR-based limit on fund leverage risk, we could require a stress testing approach. As discussed above in section II.D.6.a, we understand that many funds that use derivatives transactions already conduct stress testing for purposes of risk management. However, we do not believe that a stress testing approach would impose significantly lower costs on funds compared to a VaR-based approach, with the exception of those funds that already conduct stress testing but not VaR testing.[609]

In addition, as also discussed in section II.D.6.a above, it would be challenging for the Commission to specify a set of asset class shocks, their corresponding shock levels, and, in the

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607 *See also supra* note 243.

608 We note that the UCITS regime requires third-party validation of funds' VaR models; as a result, these additional costs could be mitigated for fund that are part of a complex that also includes UCITS funds. *See supra* note 243.

609 *See also* ICI Comment Letter III (stating that, "depending on the type of fund managed and whether the fund currently employs the test for risk management purposes, some respondents viewed a stress loss test as being more burdensome to implement, while others viewed a VaR test as being more burdensome to implement.").

case of multi-factor stress testing, assumptions about the correlations of the shocks, in a manner that applies to all funds and does not become stale over time. While we could also prescribe a principles-based stress testing requirement, we believe that the flexibility such an approach would give to individual funds over how to implement the test would render it less effective than the proposed VaR test at establishing an outer limit on fund leverage risk.

Finally, stress testing generally focuses on a narrower and more remote range of extreme loss events compared to VaR analysis. As a result, a limit on fund leverage risk based on stress testing would likely be less effective at limiting fund leverage risk during more normal conditions and protecting investors from unexpected losses resulting from less extreme scenarios.

b. Asset Segregation

As another alternative, we could require an asset segregation approach in lieu of the proposed VaR-based limit on fund leverage risk. For example, we could consider an approach similar to the Commission's position in Release 10666, under which a fund engaging in derivatives transactions would segregate cash and cash equivalents equal in value to the full amount of the conditional and unconditional obligations incurred by the fund (also referred to as "notional amount segregation"). Such an approach could also permit a fund to segregate a broader range of assets, subject to haircuts.[610] Alternatively, we could require funds to segregate liquid assets in an amount equal to the fund's daily mark-to-market liability plus a "cushion amount" designed to address potential future losses.

As discussed above in section II.D.6.b, we believe that asset segregation approaches have several drawbacks as a means for limiting fund leverage risk, compared to the proposed VaR

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[610] The 2016 DERA Memo, for example, analyzed different risk-based "haircuts" that could apply to a broader range of assets. *See, e.g.*, 2016 DERA Memo, *supra* note 12.

tests. For example, notional amount segregation is not risk-sensitive and could restrict derivatives transactions that would reduce portfolio risk. Similarly, segregation of liquid assets in an amount equal to the fund's daily mark-to-market liability plus a "cushion amount" would be difficult to implement in a manner that is applied uniformly across all funds and types of derivatives. In addition, asset segregation approaches raise certain compliance complexities that may not make them significantly less costly to implement for funds than the proposed VaR tests.[611]

In conjunction with the proposed VaR-based limit, we could also require a fund relying on the proposed rule to maintain an amount of "qualifying coverage assets" designed to enable a fund to meet its derivatives-related obligations. As discussed above, we believe that the proposed rule's requirements, including the requirements that funds establish risk management programs and comply with the proposed VaR-based limit on fund leverage risk, would address the risk that a fund may be required to realize trading losses by selling its investments to generate cash to pay derivatives counterparties.

c. Exposure-Based Test

We alternatively considered proposing an exposure-based approach for limiting fund leverage risk in lieu of the proposed VaR test. An exposure-based test could limit a fund's derivatives exposure, as defined in the proposed rule, to a specified percentage of the fund's net assets. For example, we considered proposing that a fund limit its derivatives exposure to 50% of net assets. This would allow a fund to add to its portfolio an amount of derivatives exposure equal to the amount that an open-end fund could borrow from a bank. A similar approach would

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611 *See supra* section II.D.6.b.

be to provide that the sum of a fund's derivatives exposure and the value of its other investments cannot exceed 150% of its net asset value. This latter approach, and particularly if cash and cash equivalents were not included in the calculation, would allow a fund to achieve the level of market exposure permitted for an open-end fund under section 18 using any combination of derivatives and other investments.

While an exposure-based test may be simpler and therefore less costly to implement for the typical fund than the proposed VaR tests, an exposure-based test has certain limitations compared to VaR tests, as discussed in detail in section above. One limitation is that measuring derivatives exposure based on notional amounts would not reflect how derivatives are used in a portfolio, whether to hedge or gain leverage, nor would it differentiate derivatives with different risk profiles. Various adjustments to the notional amount are available that may better reflect the risk associated with the derivatives transactions, although even with these adjustments the measure would remain relatively blunt. For example, an exposure-based limit could significantly limit certain strategies that rely on derivatives more extensively but that do not seek to take on significant leverage risk.

Some of the limitations of an exposure-based approach could be addressed, however, if rule 18f-4 were to provide an exposure-based test as an optional alternative to the proposed VaR tests, rather than as the sole means of limiting fund leverage risk. Under this second alternative, funds with less complex portfolios might choose to rely on an exposure-based test because it would be simpler and impose lower compliance costs than the proposed VaR tests. Furthermore, if we provided that the sum of a fund's derivatives exposure and the value of its other investments cannot exceed 150% of its net asset value, funds below this threshold would generally also pass the proposed relative VaR test.[612] Conversely, funds with more complex portfolios that rely on derivatives more extensively but that do not seek to take on significant leverage risk might choose to rely on the proposed VaR test. As the proposed rule would already except limited derivatives users from the VaR-based limit on fund leverage risk, however, we do not believe that also giving funds the option of relying on an exposure-based limit on fund leverage risk would be necessary or that it would significantly reduce the compliance burden associated with the rule.

3. Stress Testing Frequency

Proposed rule 18f-4 would require funds that enter into derivatives transactions and are not limited derivatives users to adopt and implement a derivatives risk management program that includes stress testing, among other elements. The proposed rule would permit a fund to determine the frequency of stress tests, provided that the fund must conduct stress testing at least weekly.

As an alternative to the weekly requirement, we considered both shorter and longer minimum stress testing frequencies. On the one hand, more frequent stress testing would reflect changes in risk for fund strategies that involve frequent and significant portfolio turnover. In addition, more frequent stress testing may reflect increases in market stress in a timelier manner. On the other hand, given the forward-looking nature of stress testing, we expect that most funds would take foreseeable changes in market conditions and portfolio composition into account when conducting stress testing. In addition, more frequent stress testing may impose an increased

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612 A fund that limited the sum of its derivatives exposure and the value of its other investments to 150% of its net asset value would generally also pass the proposed relative VaR test, provided that derivatives notionals are either not adjusted or only adjusted for delta in the case of options.

cost burden on funds, although we would expect any additional cost burden to be small, to the extent that funds perform stress testing in an automated manner. Overall, we preliminarily believe that the proposed minimum weekly stress testing appropriately balances the anticipated benefits of relatively frequent stress testing against the burdens of administering stress testing.

Another alternative would be to permit a fund to determine its own stress testing frequency without the proposed rule prescribing a minimum stress testing frequency. This approach would provide maximum flexibility to funds regarding the frequency of their stress tests, and would reduce compliance costs for funds that determine that stress testing less frequently than weekly is warranted in light of their own particular facts and circumstances. However, allowing funds to individually determine the frequency with which stress tests are conducted could result in some funds stress testing their portfolios too infrequently to provide timely information to the fund's derivatives risk manager and board. Taking these considerations into account, we are proposing to require weekly stress tests, rather than less frequent testing, to provide for consistent and reasonably frequent stress testing by all funds that would be required to establish a derivatives risk management program.

4. Alternative Exposure Limits for Leveraged/Inverse Funds

A fund that meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules would not have to comply with the VaR-based leverage risk limit under proposed rule 18f-4, provided the fund limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index and discloses in its prospectus that it is not subject to the proposed limit on fund leverage risk.[613] Alternatively, we could condition the

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[613] *See supra* section II.G.3.

exemption on compliance with a higher or lower exposure limit.

Over longer holding periods, the realized leverage multiple of the returns of an investment in a leveraged/inverse fund relative to the returns of its underlying index can vary substantially from the fund's daily leverage multiple.[614] All else equal, this effect becomes stronger as the fund's leverage multiple increases. The extent of a leveraged/inverse fund's rebalancing activity likewise increases as the fund's leverage multiple increases.[615] Therefore, the effects of leveraged/inverse funds' rebalancing activity on the constituent asset prices may be heightened if a significant number of leveraged/inverse funds were to increase their leverage beyond the levels currently observed in markets and, conversely, could be diminished if a significant number of leveraged/inverse funds were to reduce their leverage below current levels.

While permitting a higher exposure limit may benefit fund sponsors to the extent that some sponsors would bring funds with higher leverage multiples to market, we are concerned that a higher exposure limit would heighten the investor protection concerns these funds present. Conversely, limiting leveraged/inverse funds' exposure could reduce the concerns these funds present, but could reduce investor choice relative to the baseline given that leveraged/inverse funds today operate with levels of leverage up to the exposure limit we propose. Allowing funds to continue to obtain this level of leverage, subject to the additional requirements in proposed rule 18f-4 and in light of the proposed sales practices rules, is designed to address the investor

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614 *See supra* section III.B.5.

615 The rebalancing demand of a leveraged/inverse fund is a function of the fund's assets, the realized return of its reference index, and is proportional to the term $(x^2 - x)$, where x denotes the fund's leverage multiple. (*See, e.g.*, Minder Cheng & Ananth Madhavan, *The dynamics of leveraged/inverse and inverse exchange-traded funds*, 7 Journal of Investment Management 4 (2009).) As a result, increasing a fund's leverage multiple increases its rebalancing demand more than linearly.

protection concerns that underlie section 18, while preserving choice for retail investors who are capable of evaluating their characteristics and unique risks. For these reasons, and because the Commission does not have experience with leveraged/inverse funds that seek returns above 300% of the return (or inverse of the return) of the underlying index, we are not proposing to permit higher levels of leveraged/inverse market exposure for leveraged/inverse funds in this rule. We also are not proposing a lower exposure limit for these funds in light of the investor protections that we believe proposed rule 18f-4 and the sales practices rules would provide.[616]

5. No Sales Practices Rules and No Separate Exposure Limit for Leveraged/Inverse Funds

The proposed rules would require a leveraged/inverse fund that meets the definition of a "leveraged/inverse investment vehicle" to limit its investment results to 300% of the return (or inverse of the return) of the underlying index and would require a broker-dealer or investment adviser to exercise due diligence in approving a retail investor's account to buy or sell shares of leveraged/inverse investment vehicles, as well as implement policies and procedures reasonably designed to achieve compliance with the proposed rules.[617] In lieu of the proposed sales practices rules and associated exception from the VaR-based limit on fund leverage risk, we could alternatively require leveraged/inverse funds to comply with the proposed relative VaR test.

Existing leveraged/inverse ETFs and mutual funds generally could comply with the proposed relative VaR test only if they restricted the investment results they seek to 150% of the return (or inverse of the return) of the underlying index. Therefore, under this alternative, leveraged/inverse funds that seek investment results in excess of this limit would either have to

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616 *See supra* section II.G.3.

617 *See supra* sections II.G.3 and II.G.2.

significantly change their investment strategy or liquidate. Given that existing fund sponsors frequently offer leveraged/inverse funds with various target multiples referencing the same index, we would expect that this alternative would reduce the number of leveraged/inverse funds.

Compared to the proposal, this alternative would also restrict choice for investors that prefer to invest in leveraged/inverse funds that pursue investment results in excess of 150% of the return (or inverse of the return) of the underlying index and who would satisfy the due diligence and approval requirements adopted by their broker-dealer or investment adviser in connection with the proposed rule.

At the same time, the alternative could result in increased investor protection for investors in these funds compared to the proposal. While investors' access to leveraged/inverse funds would not be subject to the proposed sales practice rules under this alternative (and investment advisers and broker-dealers would not incur the associated compliance costs), these funds would be required to limit their exposure to 150% of the return (or inverse of the return) of the underlying index, thereby reducing the potential consequences for leveraged/inverse fund investors who are not capable of evaluating their return characteristics and ameliorating the associated investor protection concerns. Conversely, the alternative would reduce protection for investors in leveraged/inverse commodity- and currency-based trusts or funds, as those funds would be subject to neither the 150% exposure limit nor the proposed sales practices rules.

Finally, because leveraged/inverse funds would no longer be able to offer exposures above 150% of the return (or inverse of the return) of the underlying index, the alternative may ameliorate the concerns associated with the rebalancing activity of leveraged/inverse ETFs, which decreases with the targeted leverage multiple of these funds.[618] As discussed above in section D.1, however, while the literature observes that leveraged/inverse ETFs' rebalancing activity may have an adverse impact on the prices and volatility of the constituent assets that make up leveraged/inverse ETFs, the literature, overall, is not definitive.

Overall, we believe that preserving investor choice justifies providing leveraged/inverse funds an exemption from the proposed VaR-based limit on fund leverage risk, particularly in light of the proposed sales practices rules, which we believe would help to ensure that investors in these funds are limited to those who are capable of evaluating the characteristics and risks of these products.[619]

6. Enhanced Disclosure

As an alternative to the requirements in rule 18f-4, such as the proposed derivatives risk management program and the VaR-based limit on fund leverage risk, we could consider addressing the risks associated with funds' use of derivatives through enhanced disclosures to investors with respect to a fund's use of derivatives and the resulting derivatives-related risks.[620] While an approach focused on enhanced disclosures could result in greater fund investment flexibility, such an approach may be less effective than the proposed rule in addressing the purposes and concerns underlying section 18 of the Investment Company Act. Section 18 itself imposes a specific limit on the amount of senior securities that a fund may issue, regardless of

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[618] *See supra* sections III.D.1 and III.E.4. While the literature focuses on leveraged/inverse ETFs, the results may apply similarly to leveraged/inverse mutual funds.

[619] *See also supra* note 535.

[620] *See, e.g.*, Comment Letter of the Fixed Income Market Structure Advisory Committee on proposed rule 6c-11 under the Investment Company Act (Oct. 29, 2018) (recommending that the Commission consider future rulemaking regarding "leveraged ETP" investor disclosure requirements).

the level of risk introduced or the disclosure that a fund provides regarding those risks. Absent additional requirements to limit leverage or potential leverage, requiring enhancement to derivatives disclosure alone would not appear to provide any limit on the amount of leverage a fund may obtain. Indeed, the degree to which funds use derivatives varies widely between funds. As a result, an approach focused solely on enhanced disclosure requirements may not provide a sufficient basis for an exemption from the requirements of section 18 of the Investment Company Act.

F. Request for Comments

The Commission requests comment on all aspects of this initial economic analysis, including whether the analysis has: (1) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (2) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (3) identified and considered reasonable alternatives to the proposed new rules and rule amendments. We request and encourage any interested person to submit comments regarding the proposed rules, our analysis of the potential effects of the proposed rules and proposed amendments, and other matters that may have an effect on the proposed rules. We request that commenters identify sources of data and information as well as provide data and information to assist us in analyzing the economic consequences of the proposed rules and proposed amendments. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may have overlooked. In addition to our general request for comments on the economic analysis associated with the proposed rules and proposed amendments, we request specific comment on certain aspects of the proposal:

254. Are we correct that many funds already have a derivatives risk management program in place that could be readily adapted to meet the proposed rule’s requirements

without significant additional cost? If so, for how many funds would this be true?

255. The proposed rule does not include any requirement for third-party validation of a fund's chosen VaR model, either at inception or upon material changes, to confirm that the model is structurally sound and adequately captures all material risks.[621] How costly would such a requirement be to funds? What would the benefits of such a requirement be?

256. Are we correct that many funds that use derivatives in a limited manner already have in place policies and procedures that are reasonably designed to address their derivatives that could be readily adapted to meet the proposed rule's requirements without significant additional cost? If so, for how many funds would this be true?

257. How many broker-dealers provide customers the ability to buy or sell interests in leveraged/inverse investment vehicles? How many investment advisers place orders to buy or sell leveraged/inverse investment vehicles for their advisory clients? How many retail investor accounts with broker-dealers and investment advisers trade leveraged/inverse investment vehicles?

258. How many current investors in leveraged/inverse investment vehicles would likely not be approved to buy or sell these products under the proposed sales practices rules' due diligence and account approval requirements?

259. If we provided that the sum of a fund's derivatives exposure and the value of its other investments cannot exceed 150% of its net asset value, funds below this threshold would generally also pass the proposed relative VaR test. How many funds would be

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621 *See also supra* note 243.

likely to rely on such an exposure-based test if exempted funds that satisfied this limit from the proposed VaR tests?

IV. PAPERWORK REDUCTION ACT ANALYSIS

A. Introduction

Proposed rule 18f-4, proposed rule 15*l*-2, and proposed rule 211(h)-1 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[622] In addition, the proposed amendments to rule 6c-11 under the Investment Company Act, as well as to Forms N-PORT, Form N-LIQUID (which would be renamed Form N-RN), and N-CEN would affect the collection of information burden under those rules and forms.[623]

The titles for the existing collections of information are: "Form N-PORT" (OMB Control No. 3235-0731); "Form N-LIQUID" (OMB Control No. 3235-0754); "Form N-CEN" (OMB Control No. 3235-0730); and "Rule 6c-11 under the Investment Company Act of 1940, Exchange-traded funds" (OMB Control No. xxxx-xxxx). The titles for the new collections of information would be: "Rule 18f-4 under the Investment Company Act of 1940, Use of Derivatives by Registered Investment Companies and Business Development Companies," "Rule 15*l*-2 under the Securities Exchange Act of 1934, Broker and Dealer Sales Practices for Leveraged/Inverse Investment Vehicles," and "Rule 211(h)-1 under the Investment Advisers Act

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[622] 44 U.S.C. 3501-3520.

[623] We do not believe that the proposed conforming amendment to Form N-2, to reflect a clarification that funds do not have to disclose in their senior securities table the derivatives transactions and unfunded commitment agreements entered into in reliance on proposed rule 18f-4, makes any new substantive recordkeeping or information collection within the meaning of the PRA. Accordingly, we do not revise any burden and cost estimates in connection with this proposed amendment.

of 1940, Investment Adviser Sales Practices for Leveraged/Inverse Investment Vehicles." The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently-valid control number.

The Commission published notice soliciting comments on the collection of information requirements in the 2015 Proposing Release and submitted the proposed collections of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.[624] The Commission received comments on the 2015 proposal's collection of information burden regarding the 2015 proposal's trade-by-trade determination of compliance with portfolio limits.[625] These comments were considered but did not form the basis of our burden estimates because we do not propose a trade-by-trade determination of compliance with the proposed VaR-based tests.

We discuss below the collection of information burdens associated with proposed rule 18f-4, proposed rule 15*l*-2, proposed rule 211(h)-1, as well as proposed amendments to rule 6c-11 and Forms N-PORT, N-LIQUID, and N-CEN.

B. Proposed Rule 18f-4

Proposed rule 18f-4 would permit a fund to enter into derivatives transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18 of the Investment Company Act.

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624 *See* 2015 Proposing Release, *supra* note 2.

625 *See, e.g.*, Vanguard Comment Letter; Invesco Comment Letter; *see also supra* note 245 and accompanying text.

Proposed rule 18f-4 would generally require a fund that relies on the rule to enter into derivatives transactions to: adopt a derivatives risk management program; have its board of directors approve the fund's designation of a derivatives risk manager and receive direct reports from the derivatives risk manager about the derivatives risk management program; and require a fund to comply with a VaR-based test designed to limit a fund's leverage risk consistent with the investor protection purposes underlying section 18. Proposed rule 18f-4 includes an exception from the risk management program requirement and limit on fund leverage risk if a fund is a "limited derivatives user" that either limits its derivatives exposure to 10% of its net assets or it uses derivatives transactions solely to hedge certain currency risks. A fund relying on the proposed exception would be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks. Proposed rule 18f-4 also includes alternative requirements for a leveraged/inverse fund not subject to the proposed VaR-based leverage risk limit, if such a fund: (1) meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules; (2) limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index; and (3) discloses in its prospectus that it is not subject to proposed rule 18f-4's limit on fund leverage risk.[626] Proposed rule 18f-4 also would require a fund to adhere to certain recordkeeping requirements that are designed to provide the Commission's staff, and the fund's board of directors and compliance personnel, the ability to evaluate the fund's compliance with the proposed rule's requirements.

[626] *See* proposed rule 18f-4(c)(4); *supra* section II.G.3.

The respondents to proposed rule 18f-4 would be registered open- and closed-end management investment companies and BDCs.[627] We estimate that 5,091 funds would likely rely on rule 18f-4.[628] Compliance with proposed rule 18f-4 would be mandatory for all funds that seek to engage in derivatives transactions in reliance on the rule, which would otherwise be subject to the restrictions of section 18. To the extent that records required to be created and maintained by funds under the rule are provided to the Commission in connection with examinations or investigations, such information would be kept confidential subject to the provisions of applicable law.

1. Derivatives Risk Management Program

Proposed rule 18f-4 would require certain funds relying on the rule to adopt and implement a written derivatives risk management program, which would include policies and procedures reasonably designed to manage the fund's derivatives risks. The proposal would require a fund's program to include the following elements: (1) risk identification and assessment; (2) risk guidelines; (3) stress testing; (4) backtesting; (5) internal reporting and escalation; and (6) periodic review of the program.[629] Under the proposed rule, the derivatives

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[627] *See* proposed rule 18f-4(a) (defining "fund").

[628] *See supra* notes 467, 498 and accompanying text, and paragraph following note 525 (2,693 funds that would be subject to the proposed derivatives risk management program and limit on fund leverage risk requirements + 2,398 funds relying on the limited derivatives user exception and complying with the related limited derivatives user requirements).

The Commission's estimates of the relevant wage rates in the tables below are based on salary information for the securities industry compiled by the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2013. The estimated wage figures are modified by Commission staff to account for an 1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits, overhead, and adjusted to account for the effects of inflation. *See* Securities Industry and Financial Markets Association, Report on Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Report").

[629] *See* proposed rule 18f-4(c)(1)(i)-(vi); *supra* section II.A.2 (discussing the proposed derivatives

risk manager is responsible for administering the derivatives risk management program and its policies and procedures. Certain funds relying on the proposed rule would not be subject to the program requirement.[630] We estimate that 2,693 funds would likely be subject to the program requirement.[631] Below we estimate the initial and annual ongoing burdens associated with initial documentation of the program, and any revision (and related documentation) of the derivatives risk management program arising from the periodic review of the program. In addition to the initial burden to document the program, including policies and procedures reasonably designed to manage the fund's derivatives risks, we estimate that a fund relying on the proposed rule would have an ongoing burden associated with the proposed periodic review requirements to evaluate the program's effectiveness and to reflect changes in the fund's derivatives risks over time. Below we estimate the initial and annual ongoing burdens associated with documentation and any review and revision of funds' programs including their policies and procedures.

Table 2 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with the derivatives risk management program requirement under proposed rule 18f-4. We do not estimate that there will be any initial or ongoing external costs associated with the derivatives risk management program requirement.

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risk management program requirement).

630 A fund that is a limited derivatives user would not be required to comply with the proposed program requirement. Funds that are limited derivatives users would be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks. *See* proposed rule 18f-4(c)(3); *infra* section IV.B.6 (discussing limited derivatives users).

631 *See supra* notes 498, 627 and accompanying text.

Table 2: Derivatives Risk Management Program PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Written derivatives risk management program development	12 hours	4 hours	×	$357 (derivatives risk manager)	$1,428
	12 hours	4 hours	×	$466 (assistant general counsel)	$1,864
	12 hours	4 hours	×	$365 (compliance attorney)	$1,460
Periodic review and revisions of the program	0 hours	2 hours	×	$357 (derivatives risk manager)	$714
	0 hours	2 hours	×	$466 (assistant general counsel)	$932
	0 hours	2 hours	×	$365 (compliance attorney)	$730
Total annual burden per fund		18 hours			$7,128
Number of funds		× 2,693			× 2,693
Total annual burden		48,474 hours			$19,195,704

Notes:
1. For "Written Derivatives Risk Management Program Development," these estimates include initial burden estimates annualized over a three-year period.
2. *See supra* note 627.

2. Board Oversight and Reporting

The proposed rule would require: (1) a fund's board of directors to approve the designation of the fund's derivatives risk manager,[632] (2) the derivatives risk manager to provide written reports to the board regarding the program's implementation and effectiveness,[633] and (3) the derivatives risk manager to provide written reports describing any exceedances of the fund's guidelines and the results of the fund's stress testing and backtesting.[634] We estimate that 2,693 funds would be subject to these requirements.[635]

Table 3 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with the board oversight and reporting requirements under proposed rule 18f-4. We do not estimate that there will be any initial or ongoing external costs associated with the board oversight and reporting requirements.

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632 *See* proposed rule 18f-4(c)(5)(i); *supra* section II.C (discussing the proposed board oversight and reporting requirements).

633 *See* proposed rule 18f-4(c)(5)(ii); *supra* section II.C.

634 *See* proposed rule 18f-4(c)(5)(iii); *supra* section II.C. Burdens associated with reports to the fund's board of directors of material risks arising from the fund's derivatives transactions, as described in proposed rule 18f-4(c)(1)(v), are discussed above in *supra* section IV.B.1.

635 *See supra* notes 498, 627 and accompanying text.

Table 3: Board Oversight and Reporting PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Approving the designation of the derivatives risk manager	3 hours	1 hour	×	$17,860 (combined rate for 4 directors)[2]	$17,860
Derivatives risk manager written reports[3]		8 hours	×	$357 (derivatives risk manager)	$2,856
		1 hour	×	$17,860 (combined rate for 4 directors)	$17,860
Total annual burden per fund		10 hours			$11,786
Number of funds		× 2,693			× 2,693
Total annual burden		26,930 hours			$31,739,698

Notes:
1. For "Approving the Designation of the Derivatives Risk Manager," this estimate includes initial burden estimates annualized over a three-year period.
2. *See supra* notes 627.
3. *See supra* notes 631-632 and accompanying text.

3. Disclosure Requirement Associated with Limit on Fund Leverage Risk

The proposed rule would also generally require funds relying on the rule to comply with an outer limit on fund leverage risk based on VaR. This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index." If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test.[636] Under the proposed rule, a fund must disclose its designated reference index in its annual report.[637] We estimate that 2,424 funds would be subject to this disclosure requirement.[638]

Table 4 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with the disclosure requirement associated with the proposed limit on fund leverage risk. We do not estimate that there will be any paperwork-related initial or ongoing external costs associated with this proposed disclosure requirement.

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636 The collections of information burdens for disclosure requirements associated with the proposed limit on fund leverage risk are reflected in the PRA for proposed rule 18f-4 and not in the funds' applicable disclosure forms because the burden arises from the proposed rule. The Paperwork Reduction Act analysis for the funds' applicable disclosure forms will not reflect the collections of information burdens for disclosure requirements associated with the proposed limit on fund leverage risk.

A fund that is a leveraged/inverse investment vehicle, as defined in the proposed sales practices rules, would not be required to comply with the proposed VaR-based limit on fund leverage risk. Broker-dealers and investment advisers would be required to approve retail investors' accounts to purchase or sell shares in these funds. *See infra* sections IV.C and IV.D (discussing leveraged/inverse investment vehicles and leveraged/inverse funds covered by the sales practices rules). The proposed rule also would provide an exception from the proposed VaR tests for funds that use derivatives to a limited extent or only to hedge currency risks. *See infra* sections IV.B.5 (discussing the proposed rule's provisions regarding limited derivatives users).

VaR test burdens related to recordkeeping and reporting are reflected in the recordkeeping section below, and also in the Forms N-PORT, N-CURRENT, and N-CEN burdens discussed below. *See infra* sections IV.F, IV.G, and IV.H.

637 *See* proposed rule 18f-4(c)(2)(iv).

638 *See supra* notes 519-520 and accompanying text.

Table 4: Disclosure Requirement Associated with Limit on Fund Leverage Risk PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Disclosure of designated reference index	0 hours	.5 hours	×	$309 (compliance manager)	$154.50
	0 hours	.5 hours	×	$365 (compliance attorney)	$182.50
Total annual burden per fund		1 hour			$337
Number of funds		× 2,424			× 2,424
Total annual burden		2,424 hours			$816,888

Notes:
1. *See supra* note 627.

4. Disclosure Requirement for Leveraged/Inverse Funds

Under the proposed rule, a fund would not have to comply with the proposed VaR-based leverage risk limit if it: (1) meets the definition of a "leveraged/inverse investment vehicle" in the proposed sales practices rules; (2) limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index; and (3) discloses in its prospectus that it is not subject to proposed rule 18f-4's limit on fund leverage risk.[639] We estimate that 269 funds would be subject to the proposed prospectus disclosure requirement for leveraged/inverse funds.[640]

Table 5 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with the disclosure requirement in the proposed rule's alternative provision for leveraged/inverse funds. We do not estimate that there will be any initial or ongoing external costs associated with this proposed disclosure requirement.

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639 *See* proposed rule 18f-4(c)(4); *supra* section II.G (discussing the alternative requirements for leveraged/inverse funds).

640 *See supra* note 467 and accompanying text (164 leveraged/inverse ETFs + 105 leveraged mutual funds).

Table 5: Disclosure Requirement Associated with Leveraged/Inverse Funds PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Leveraged/inverse fund prospectus disclosure	0 hours	.25 hours	×	$309 (compliance manager)	$77
	0 hours	.25 hours	×	$365 (compliance attorney)	$91
Total annual burden per fund		1 hour			$168
Number of funds		× 269			× 269
Total annual burden		269 hours			$45,192

Notes:
1. *See supra* note 627.

5. Disclosure Changes for Money Market Funds

Money market funds are excluded from the scope of the rule and could not rely on proposed rule 18f-4 to enter into derivatives transactions or other transactions addressed in the proposed rule.[641] To the extent a money market fund currently discloses in its prospectus that it may use any of these transactions—even if it is not currently entering into these transactions—money market funds would be subject to the burdens associated with making disclosure changes to their prospectuses. We estimate that 413 funds could be subject to such disclosure changes on account of money market funds' exclusion from the proposed rule.[642]

Table 6 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with disclosure changes that money market funds could make because of their exclusion from proposed rule 18f-4.[643] We do not estimate that there will be any initial or ongoing external costs associated with this disclosure change requirement.

641 *See* proposed rule 18f-4(a) (defining the term "Fund" to "…not include a registered open-end company that is regulated as a money market fund"); *supra* section II.A.1 (discussing the exclusion of money market funds from the scope of the proposed rule).

642 *See supra* note 454 and accompanying text. This likely overestimates the total number of funds subject to these disclosure changes, because we believe that money market funds currently do not typically engage in derivatives transactions or the other transactions addressed by proposed rule 18f-4. *See supra* section II.A.1.

643 These per-fund burden estimates likely overestimate the total burden associated with these disclosure changes. *See supra* note 641.

Table 6: Disclosure Changes for Money Market Funds PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Money market prospectus disclosure changes	.75 hours	.25 hours	×	$309 (compliance manager)	$77
	.75 hours	.25 hours	×	$365 (compliance attorney)	$91
Total annual burden per fund		.5 hour			$168
Number of funds		× 413			× 413
Total annual burden		207 hours			$69,384

Notes:
1. *See supra* note 627.

6. Policies and Procedures for Limited Derivatives Users

Proposed rule 18f-4 would require funds relying on the limited derivatives user provisions to adopt and implement written policies and procedures reasonably designed to manage the fund's derivatives risks.[644] Only funds that limit their derivatives exposure to 10% of their net assets or that use derivatives transactions solely to hedge certain currency risks would be permitted to rely on these provisions. We estimate that 2,398 funds would be subject to the limited derivatives users requirements.[645] In addition to the initial burden to document the policies and procedures, we estimate that limited derivatives users would have an ongoing burden associated with any review and revisions to its policies and procedures to ensure that they are "reasonably designed" to manage the fund's derivatives risks. Below we estimate the initial and annual ongoing burdens associated with documentation and any review and revision of the limited derivatives users' policies and procedures.

Table 7 below summarizes the proposed PRA initial and ongoing annual burden estimates associated with the policies and procedures requirement for limited derivatives users under proposed rule 18f-4. We do not estimate that there will be any initial or ongoing external costs associated with the policies and procedures requirement for limited derivatives users.

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644 *See* proposed rule 18f-4(c)(3); *supra* section II.E (discussing the proposed policies and procedures requirement for limited derivatives users).

645 *See supra* paragraph following note 525.

Table 7: Policies and Procedures for Limited Derivatives Users PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Written policies and procedures	3 hours	1 hour	×	$329 (senior manager)[4]	$329
	3 hours	1 hour	×	$365 (compliance attorney)[4]	$365
Review of policies and procedures	0 hours	.25 hours		$329 (senior manager)[4]	$82.25
	0 hours	.25 hours		$365 (compliance attorney)[4]	$91.25
Total annual burden per fund		2.5 hours			$867.50
Number of funds		× 2,398			× 2,398
Total annual burden		5,995 hours			$2,080,265

Notes:
1. For "Written Policies and Procedures," these estimates include initial burden estimates annualized over a three-year period.
2. *See supra* note 627.

7. Recordkeeping Requirements

Proposed rule 18f-4 would require a fund to maintain certain records documenting its derivatives risk management program's written policies and procedures, along with its stress test results, VaR backtesting results, internal reporting or escalation of material risks under the program, and reviews of the program.[646] The proposed rule would also require a fund to maintain records of any materials provided to the fund's board of directors in connection with approving the designation of the derivatives risk manager and any written reports relating to the derivatives risk management program.[647] A fund that is required to comply with the proposed VaR test would also have to maintain records documenting the determination of: its portfolio VaR; the VaR of its designated reference indexes, as applicable; its VaR ratio (the value of the VaR of the Fund's portfolio divided by the VaR of the designated reference index), as applicable; and any updates to any of its VaR calculation model and the basis for any material changes to its VaR model.[648] A fund that is a limited derivatives users under the proposed rule would have to maintain a written record of its policies and procedures that are reasonably designed to manage derivatives risks.[649] A fund engaging in unfunded commitment agreements would be required to maintain records documenting the sufficiency of its funds to meet its obligations with respect to all unfunded commitment agreements.[650]

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646 *See* proposed rule 18f-4(c)(6)(i)(A); *supra* section II.K (discussing the proposed recordkeeping requirements).

647 *See* proposed rule 18f-4(c)(6)(i)(B).

648 *See* proposed rule 18f-4(c)(6)(i)(C).

649 *See* proposed rule 18f-4(c)(6)(i)(D).

650 *See* proposed rule 18f-4(e)(2).

We estimate that 5,091 funds would be subject to the recordkeeping requirements.[651] Below we estimate the average initial and ongoing annual burdens associated with the recordkeeping requirements. This average takes into account that some funds such as limited derivatives users may have less extensive recordkeeping burdens than other funds that use derivatives more substantially.

Table 8 below summarizes the proposed PRA estimates associated with the recordkeeping requirements in rule 18f-4.

[651] *See supra* notes 467, 498 and accompanying text, and paragraph following note 525 (2,693 funds that would be subject to the proposed derivatives risk management program and limit on fund leverage risk requirements + 2,398 funds relying on the limited derivatives user exception and complying with the related limited derivatives user requirements).

Table 8: Recordkeeping PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
Establishing recordkeeping policies and procedures	1.5	.5		$62 (general clerk)	$31	$1,800	$600
	1.5	.5		$95 (senior computer operator)	$47.50		
Recordkeeping	0 hours	2 hours	×	$62 (general clerk)	$31	$0	$0
	0 hours	2 hours	×	$95 (senior computer operator)	$47.50		
Total annual burden per fund		5 hours			$157		$600
Number of funds		× 5,091			× 5,091		5,091
Total annual burden		25,455 hours			$799,287		$3,054,600

Notes:
1. For "Establishing Recordkeeping Policies and Procedures," these estimates include initial burden estimates annualized over a three-year period.
2. *See supra* note 627.

8. Proposed Rule 18f-4 Total Estimated Burden

As summarized in Table 9 below, we estimate that the total hour burdens and time costs associated with proposed rule 18f-4, including the burden associated with documenting the derivatives risk management program, board oversight and reporting, disclosure requirements associated with the proposed VaR tests, disclosure requirements associated with the alternative requirements for leveraged/inverse funds, policies and procedures development for limited derivatives users, and recordkeeping, amortized over three years, would result in an average aggregate annual burden of 109,754 hours and an average aggregate annual monetized time cost of $54,761,797. We also estimate that, amortized over three years, there would be external costs of $3,054,600 associated with this collection of information. Therefore, each fund that relies on the rule would incur an average annual burden of approximately 20.56 hours, at an average annual monetized time cost of approximately $10,757, and an external cost of $600 to comply with proposed rule 18f-4.[652]

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[652] These per-fund burden estimates likely overestimate the total burden of proposed rule 18f-4 because not all funds (*e.g.*, limited derivatives users) would incur the various burdens set forth in the table.

Table 9: Proposed Rule 18f-4 Total PRA Estimates

	Internal hour burden	Internal burden time cost	External cost burden
Derivatives risk management program	48,474 hours	$19,195,704	$0
Board oversight and reporting	26,930 hours	$31,739,698	$0
Disclosure requirement associated with limit on fund leverage risk	2,424 hours	$816,888	$0
Disclosure requirement associated with alternative requirements for leveraged/inverse funds	269 hours	$45,192	$0
Disclosure changes for money market funds	207 hours	$69,384	$0
Policies and procedures for limited derivatives users	5,995 hours	$2,080,265	$0
Recordkeeping requirements	25,455 hours	$799,287	$3,054,600
Total annual burden	109,754	$54,746,418	$3,054,600
Number of funds	÷ 5,091	÷ 5,091	÷ 5,091
Average annual burden per fund	20.56 hours	$10,754	$600

C. Proposed Rule 15*l*-2: Sales Practices Rule for Broker-Dealers

Proposed rule 15*l*-2 would impose burdens on registered broker-dealers relating to investments in leveraged/inverse investment vehicles by their retail customers.[653] The proposed rule is designed to address investor protection concerns relating to leveraged/inverse investment vehicles by helping to ensure that retail investors in these products are capable of evaluating their characteristics and the unique risks they present. The collections of information under proposed rule 15*l*-2, discussed below, would assist the Commission with its accounting, auditing and oversight functions. The respondents to the proposed rule would be broker-dealers registered under the Exchange Act with retail customers that transact in leveraged/inverse investment

[653] Specifically, the proposed sales practices rules (proposed rule 15*l*-2, as well as proposed rule 211(h)-1 under the Advisers Act), would require broker-dealers and investment advisers to engage in due diligence before accepting or placing an order for a retail investor to trade a leveraged/inverse investment vehicle or approving an investor's account for such trading. *See supra* section II.G.2.

vehicles. Compliance with proposed rule 15*l*-2 would be mandatory for all such broker-dealers. To the extent that records required to be created and maintained by broker-dealers under the proposed rule are provided to the Commission in connection with examinations or investigations, such information would be kept confidential subject to the provisions of applicable law.

We estimate that, as of December 31, 2018, there were approximately 2,766 broker-dealers registered with the Commission that reported some sales to retail customer investors.[654] We further estimate that 700 of those broker dealers with retail customer accounts (approximately 25%) have retail customer accounts that invest in leveraged/inverse investment vehicles.

1. Due Diligence and Account Approval

Under proposed rule 15*l*-2, before accepting an order from a customer that is a natural person (or the legal representative of a natural person) to buy or sell shares of a leveraged/inverse investment vehicle, or approve such a customer's account to engage in those transactions, the broker-dealer must approve the customer's account to engage in those transactions in accordance with the proposed rule.[655] To make this determination, the broker-dealer must exercise due diligence to ascertain certain facts about the customer, his or her financial situation, and investment objectives. To comply with this due diligence requirement, the broker-dealer must seek to obtain certain information described in the proposed rule. This proposed rule is modeled, in large part, after the FINRA rule requiring due diligence and account approval for retail investors to trade in options. Based on our understanding of how broker-dealers comply with the

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[654] Our estimates relating to retail sales by broker-dealers are based on data obtained from Form BD and Form BR. *See also supra* note 543 and accompanying text.

[655] *See supra* section II.G.2.b.

FINRA options account requirements, we believe that a common way for broker-dealers to comply with this due diligence obligation would be to utilize in-house legal and compliance counsel, as well as in-house computer and website specialists, to create an online form for customers to provide the required information for approval of their accounts to trade in leveraged/inverse investment vehicles. We also believe that a portion of the due diligence would be performed by individuals associated with a broker-dealer or by telephone or in-person meetings with investors. Based on our understanding of current broker-dealer practices, we do not believe there would be any initial or ongoing external costs associated with the proposed broker-dealer due diligence requirement.

Currently, there are 105 leveraged/inverse mutual funds, 164 leveraged/inverse ETFs, and 17 exchange-listed commodity- or currency-based trusts or funds that meet the definition of "leveraged/inverse investment vehicle" under the proposed rule.[656] Accordingly, there are 286 leveraged/inverse investment vehicles in total for which a broker-dealer would be required to approve a retail customer's account before the customer could transact in the shares of those vehicles. Based on our experience with broker-dealers and leveraged/inverse investment vehicles, we estimate that each of these leveraged/inverse investment vehicles is held by approximately 2,500 separate retail investor accounts held by registered broker dealers, for a total of 715,000 existing accounts requiring approval to trade in leveraged/inverse investment vehicles. We further estimate that approximately 10,000 new retail accounts will be opened each year requiring approval to trade in leveraged/inverse investment vehicles.[657]

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[656] *See supra* note 467 and accompanying text.

[657] *See supra* note 545 and accompanying text.

Table 10 below summarizes our initial and ongoing PRA burden estimates associated with the due diligence and account approval requirements in proposed rule 15*l*-2. Based on our understanding of current broker-dealer practices, we do not estimate that there will be any initial or ongoing external costs associated with the proposed due diligence and account approval requirements.

Table 10: Proposed Rule 15*l*-2 Due Diligence and Account Approval PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
Development and implementation of customer due diligence	6 hours	2 hours	×	\$365 (compliance attorney)	\$730		
	9 hours	3 hours	×	\$284 (senior systems analyst)	\$852		
	12 hours	4 hours	×	\$331 (senior programmer)	\$1324		
Annual burden per broker-dealer		9 hours			\$2906		
Estimated number of affected broker- dealers		700			700		
Total burden (I)		6300 hours			\$2,034,200		
Customer due diligence	3 hours	1 hour	×	\$365 (compliance attorney)	\$365		
	3 hours	1 hour	×	\$70 (compliance clerk)	\$70		
Evaluation of customer information for account approval/disapproval	1 hour	.33 hours	×	\$309 (compliance manager)	\$101.97		
Total annual burden per customer account	7 hours	2.33 hours			\$536.97		
Estimated number of affected customer accounts		× 248,333.33[3]			× 248,333.33	× 248,333.33	× 248,333.33
Total burden (II)		578,616.66 hours			\$133,347,548		
Total annual burden (I+II)		584,916.66 hours			\$135,381,748	\$0	\$0

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See supra* note 627.
3. We estimate that 715,000 existing customer accounts with broker-dealers would require the proposed rule 15*l*-2 account approval for trading in leveraged/inverse investment vehicles, and that 10,000 new customer accounts opened each year would require such approval. Accordingly, we believe that over a three-year period, a total of 745,000 accounts will require approval, which when annualized over a three-year period, equals 248,333.33 accounts per year.

2. Policies and Procedures

Proposed rule 15*l*-2 requires broker-dealers to adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rule's provisions.[658] We believe that broker-dealers likely would establish these policies and procedures by adjusting their current systems for implementing and enforcing compliance policies and procedures. While broker-dealers already have policies and procedures in place to address compliance with other Commission rules (among other obligations), they would need to update their existing policies and procedures to account for rule 15*l*-2. To comply with this obligation, we believe that broker-dealers would use in-house legal and compliance counsel to update their existing policies and procedures to account for the requirements of rule 15*l*-2. For purposes of these PRA estimates, we assume that broker-dealers would review the policies and procedures that they would adopt under proposed rule 15*l*-2 annually (for example, to assess whether the policies and procedures continue to be "reasonably designed" to achieve compliance with the proposed rule). We therefore have estimated initial and ongoing burdens associated with the proposed policies and procedures requirement. As discussed above, we estimate that approximately 700 broker dealers have retail customer accounts that invest in leveraged/inverse investment vehicles. We do not estimate that there will be any initial or ongoing external costs associated with the proposed policies and procedures requirement.

Table 11 below summarizes our initial and ongoing annual PRA burden estimates associated with the policies and procedures requirement in proposed rule 15*l*-2.

658 *See supra* section II.G.2.b.

Table 11: Proposed Rule 15*l*-2 Policies and Procedures PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Establishing and implementing rule 15*l*-2 policies and procedures	3 hours	1 hour	×	$309 (compliance manager)	$309.00
	1 hours	0.33 hours	×	$365 (compliance attorney)	$120.45
	1 hour	0.33 hours	×	$530 (chief compliance officer)	$174.90
Reviewing and updating rule 15*l*-2 policies and procedures		1 hour	×	$309 (compliance manager)	$309.00
		1 hour	×	$365 (compliance attorney)	$365.00
		1 hour	×	$530 (chief compliance officer)	$530.00
Total annual burden per broker-dealer		4.66 hours			$1,808.35
Number of affected broker-dealers		× 700			× 700
Total annual burden		3,262 hours			$1,265,845

Notes:

1. Includes initial burden estimates annualized over a three-year period.

2. *See supra* note 627.

3. Recordkeeping

Under proposed rule 15*l*-2, a broker-dealer would have to maintain a written record of the information that it obtained under the rule 15*l*-2 due diligence requirement and its written approval of the customer's account, as well as the firm's policies and procedures, for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the client's account.[659] To comply with this obligation, we believe that broker-dealers would use in-house personnel to compile and maintain the relevant records. We do not estimate that there will be any initial or ongoing external costs associated with this requirement.

Table 12 below summarizes our PRA initial and ongoing annual burden estimates associated with the recordkeeping requirement in proposed rule 15*l*-2.

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659 *See supra* section II.G.2.c.

Table 12: Proposed Rule 15*l*-2 Recordkeeping PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Recordkeeping	0 hours	1 hour	×	\$62 (general clerk)	\$62
	0 hours	1 hour	×	\$95 (senior computer operator)	\$95
Total annual burden per broker-dealer	0 hours	2 hours			\$157
Number of affected broker-dealers	× 700	× 700			× 700
Total annual burden	0 hours	1,400 hours			\$109,900

Notes:
1. *See supra* note 627.

4. Proposed Rule 15*l*-2 Total Estimated Burden

As summarized in Table 13 below, we estimate that the total hour burdens and time costs associated with proposed rule 15*l*-2, including the burden associated with the due diligence and account approval requirement, the policies and procedures requirement, and the recordkeeping requirement, would result in an average aggregate annual burden of 589,578.66 hours and an average aggregate time cost of $136,757,493. Therefore, each broker-dealer would incur an annual burden of approximately 842.26 hours, at an average time cost of approximately $195,367.85, to comply with proposed rule 15*l*-2.

Table 13: Proposed Rule 15*l*-2 Total PRA Estimates

	Internal initial burden hours	Internal burden time cost	External cost burden
Due diligence and account approval	584,916.66 hours	$135,381,748	$0
Policies and procedures	3,262 hours	$1,265,845	$0
Recordkeeping	1,400 hours	$109,900	$0
Total annual burden	589,578.66 hours	$136,757,493	$0
Number of affected broker-dealers	÷ 700	÷ 700	÷ 700
Average annual burden per affected broker-dealer	842.26 hours	$195,367.85	$0

D. Proposed Rule 211(h)-1: Sales Practices for Registered Investment Advisers

Proposed 211(h)-1 would impose burdens on registered investment advisers relating to investments in leveraged/inverse investment vehicles by their retail clients.[660] Proposed rule 211(h)-1 is designed to address investor protection concerns relating to leveraged/inverse investment vehicles by helping to ensure that retail investors in these products are capable of evaluating their characteristics and the unique risks they present. The Commission also believes that the collections of information under proposed rule 211(h)-1, discussed below, would assist the Commission with its accounting, auditing and oversight functions.

660 *See supra* note 652.

The respondents to the proposed rule would be investment advisers registered under the Advisers Act that place orders for retail clients to invest in leveraged/inverse investment vehicles. Compliance with proposed rule 211(h)-1 would be mandatory for all such investment advisers. To the extent that records required to be created and maintained by investment advisers under the proposed rule are provided to the Commission in connection with examinations or investigations, such information would be kept confidential subject to the provisions of applicable law.

We estimate that, as of December 31, 2018, approximately 8,235 investment advisers registered with the Commission have some portion of their business dedicated to retail investors, including either individual high net worth clients or individual non-high net worth clients.[661] Based on our experience with registered investment advisers, we further estimate that 2,000 of these investment advisers with retail client accounts (approximately 25%) have retail client accounts that invest in leveraged/inverse investment vehicles. As such, the investment advisers for those client accounts would be subject to the requirements of proposed rule 211(h)-1.[662]

1. Due Diligence and Account Approval

Under proposed rule 211(h)-1, before placing an order for the account of a client that is a natural person (or the legal representative of a natural person) to buy or sell shares of a leveraged/inverse investment vehicle, or approving such a client's account to engage in those transactions, the investment adviser must approve the client's account to engage in those transactions in accordance with the proposed rule.[663] To make this determination, the adviser

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661 Based on responses to Item 5.D of Form ADV.

662 *See supra* note 547 and accompanying paragraph.

663 *See* proposed rule 211(h)-1; *supra* section II.G.2.

must exercise due diligence to ascertain certain facts about the client, his or her financial situation, and investment objectives. To comply with this due diligence requirement, the investment adviser must seek to obtain certain information described in the proposed rule. Based on our understanding of how broker-dealers comply with the FINRA options account requirements, as discussed above (which we assume, for purposes of this PRA estimate, that investment advisers could model their compliance programs after), we believe that investment advisers likely would comply with this due diligence obligation by utilizing in-house legal and compliance counsel, as well as in-house computer and website specialists, to create an online form for clients to complete with the required information for approval of their accounts to trade in leveraged/inverse investment vehicles.[664] We also believe that a portion of the due diligence would be performed by individuals associated with an investment adviser by telephone or in-person meetings with investors.

Currently, there are 105 leveraged/inverse mutual funds, 164 leveraged/inverse ETFs, and 17 exchange-listed commodity- or currency-based trusts or funds that meet the definition of "leveraged/inverse investment vehicle" under the proposed rule.[665] Accordingly, there are 286 leveraged/inverse investment vehicles in total for which an investment adviser would be required to approve a retail client's account before the client could transact in the shares those vehicles. Based on our experience with registered investment advisers, we estimate that each of these leveraged/inverse investment vehicles is held by approximately 2,500 separate retail investor accounts held by investment advisers, for a total of 715,000 existing accounts requiring approval to trade in leveraged/inverse investment vehicles. Based on our experience, we further estimate

[664] *See supra* paragraph accompanying note 654.

[665] *See supra* note 467 and accompanying text.

that approximately 10,000 new retail accounts will be opened each year requiring approval to trade in leveraged/inverse investment vehicles.[666]

Table 14 below summarizes our initial and ongoing PRA burden estimates associated with the due diligence requirement in proposed rule 211(h)-1. We do not estimate that there will be any initial or ongoing external costs associated with the proposed due diligence and approval requirements.

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[666] *See supra* note 547 and accompanying text.

Table 14: Proposed Rule 211(h)-1 Due Diligence and Account Approval PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
Development and implementation of client due diligence	6 hours	2 hours	×	$365 (compliance attorney)	$730		
	9 hours	3 hours	×	$284 (senior systems analyst)	$852	$0	$0
	12 hours	4 hours	×	$331 (senior programmer)	$1324		
Annual burden per investment adviser		9 hours			$2906		
Estimated number of affected investment advisers		2000			2000		
Total burden (I)		18,000 hours			$5,812,000		
Client due diligence	3 hours	1 hour	×	$365 (compliance attorney)	$365		
	3 hours	1 hour	×	$70 (compliance clerk)	$70		
Evaluation of client information for account approval/disapproval	1 hour	.33 hours		$309 (compliance manager)	$101.97		
Total annual burden per client account	7 hours	2.33 hours			$536.97		
Estimated number of affected client accounts		× 248,333.33[3]			× 248,333.33		
Total burden (II)		578,616.66 hours			$133,347,548		
Total annual burden (I+II)		596,616.66 hours			$139,159,548	$0	$0

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See supra* note 627.
3. We estimate that 715,000 existing client accounts with registered investment advisers would require the proposed rule 211(h)-1 account approval for trading in leveraged/inverse investment vehicles, and that 10,000 new client accounts opened each year would require such approval. Accordingly, we believe that over a three-year period, a total of 745,000 client accounts would require approval, which when annualized over a three-year period, is 248,333.33 accounts per year.

2. Policies and Procedures

Proposed rule 211(h)-1 requires investment advisers to adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rule's provisions.[667] We believe that investment advisers likely would establish these policies and procedures by adjusting their current systems for implementing and enforcing compliance policies and procedures. While investment advisers already have policies and procedures in place to address compliance with other Commission rules (among other obligations), they would need to update their existing policies and procedures to account for rule 211(h)-1. To comply with this obligation, we believe that investment advisers would use in-house legal and compliance counsel to update their existing policies and procedures to account for the requirements of rule 211(h)-1. For purposes of these PRA estimates, we assume that investment advisers would review the policies and procedures that they would adopt under proposed rule 211(h)-1 annually (for example, to assess whether the policies and procedures continue to be "reasonably designed" to achieve compliance with the proposed rule, and in compliance with Advisers Act rule 206(4)-7(b)). We therefore have estimated initial and ongoing burdens associated with the proposed policies and procedures requirement. We do not estimate that there will be any initial or ongoing external costs associated with the proposed policies and procedures requirement.

Table 15 below summarizes our PRA estimates associated with the policies and procedures requirement in proposed rule 211(h)-1.

667 *See supra* section II.G.2.b.

Table 15: Proposed Rule 211(h)-1 Policies and Procedures PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Establishing and implementing rule 211(h)-1 policies and procedures	3 hours	1 hour	x	$309 (compliance manager)	$309
	1 hours	0.33 hours	x	$365 (compliance attorney)	$120.45
	1 hour	0.33 hours	x	$530 (chief compliance officer)	$174.90
Reviewing and updating rule 211(h)-1 policies and procedures		1 hour		$309 (compliance manager)	$309
		1 hour		$365 (compliance attorney)	$365
		1 hour		$530 (chief compliance officer)	$530
Total annual burden per investment adviser		4.66 hours			$1808.35
Number of affected investment advisers		× 2,000			× 2,000
Total annual burden		9,320 hours			$3,616,700

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See supra* note 627.

3. Recordkeeping

Under the proposed rule, a registered investment adviser would have to maintain a written record of the information that it obtained under the rule 211(h)-1 due diligence requirement and its written approval of the client's account for buying or selling shares of leveraged/inverse investment vehicles, as well as the firm's policies and procedures, for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the client's account.[668] To comply with this obligation, we believe that investment advisers would use in-house personnel to compile and maintain the relevant records. We do not estimate that there will be any initial or ongoing external costs associated with this requirement.

Table 16 below summarizes our PRA estimates associated with the recordkeeping requirement in proposed rule 211(h)-1.

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668 *See supra* section II.G.2.c.

Table 16: Proposed Rule 211(h)-1 Recordkeeping PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs
PROPOSED ESTIMATES					
Recordkeeping	0 hours	2.5 hours	×	$62 (general clerk)	$155
	0 hours	2.5 hours	×	$95 (senior computer operator)	$237.50
Total annual burden per investment adviser	0 hours	5 hours			$392.50
Number of affected investment advisers	× 2000	× 2000			× 2000
Total annual burden	0 hours	10,000			$785,000

Notes:

1. Includes initial burden estimates annualized over a three-year period.
2. *See supra* note 627.

4. Proposed Rule 211(h)-1 Total Estimated Burden

As summarized in Table 17 below, we estimate that the total hour burdens and time costs associated with proposed rule 211(h)-1, including the burden associated with the due diligence and account approval requirement, the policies and procedures requirement, and the recordkeeping requirement, would result in an average aggregate annual burden of 615,936.66 hours and an average aggregate time cost of $143,561,248. Therefore, each investment adviser would incur an annual burden of approximately 307.97 hours, at an average time cost of approximately $71,780.62 to comply with proposed rule 211(h)-1.

Table 17: Proposed Rule 211(h)-1 Total Estimated PRA Burden

	Internal initial burden hours	Internal burden time cost	External cost burden
Due diligence and account approval	596,616.66	$139,159,548	$0
Policies and procedures	9,320	$3,616,700	$0
Recordkeeping	10,000	$785,000	$0
Total annual burden	615,936.66	$143,561,248	$0
Number of affected investment advisers	÷ 2000	÷ 2000	÷ 2000
Average annual burden per investment adviser	307.97	$71,780.62	$0

E. Rule 6c-11

We recently adopted rule 6c-11, which permits ETFs that satisfy certain conditions to operate without first obtaining an exemptive order from the Commission.[669] The rule is designed to create a consistent, transparent, and efficient regulatory framework for such ETFs and facilitate greater competition and innovation among ETFs. Rule 6c-11 includes a provision excluding leveraged/inverse ETFs from the scope of ETFs that may rely on that rule. To promote a level playing field among ETFs, and in view of the other conditions we are proposing to place on leveraged/inverse ETFs under proposed rule 18f-4 and on transactions in leveraged/inverse

669 *See supra* notes 352-355 and accompanying text.

ETFs' securities under proposed rule 15*l*-2 and 211(h)-1, we are proposing to amend rule 6c-11 to permit leveraged/inverse ETFs to rely on that rule. Because we believe this proposed amendment would increase the number of funds relying on rule 6c-11, we are updating the PRA analysis for rule 6c-11 to account for any burden increases that would result from this increase in respondents to that rule. We are not updating the rule 6c-11 PRA analysis in any other respect.

Rule 6c-11 requires an ETF to disclose certain information on its website, to maintain certain records, and to adopt and implement certain written policies and procedures. The purpose of these collections of information is to provide useful information to investors who purchase and sell ETF shares in secondary markets and to allow the Commission to better monitor reliance on rule 6c-11 and will assist the Commission with its accounting, auditing and oversight functions.

The respondents to rule 6c-11 will be ETFs registered as open-end management investment companies other than share class ETFs and non-transparent ETFs. This collection will not be mandatory, but will be necessary for those ETFs seeking to operate without individual exemptive orders, including all ETFs whose existing exemptive orders will be rescinded. Information provided to the Commission in connection with staff examinations or investigations will be kept confidential subject to the provisions of applicable law.

Under current PRA estimates, 1,735 ETFs would be subject to these requirements. The current PRA estimates for rule 6c-11 include 74,466.2 total internal burden hours, $24,771,740.10 in internal time costs, and $1,735,000 in external time costs.

We continue to believe that the current annual burden and cost estimates for rule 6c-11 are appropriate, but estimate that the proposed amendment to rule 6c-11 would result in an increase in the number of respondents. Specifically, we estimate that an additional 164 ETFs (all leveraged/inverse ETFs) would rely on rule 6c-11, resulting in an increase in the number of respondents to 1,899 ETFs.[670] Table 18 below summarizes these revisions to the estimated annual responses, burden hours, and burden-hour costs based on the proposed amendment to rule 6c-11.

[670] *See supra* note 467 and accompanying text.

Table 18: Rule 6c-11 PRA Estimates

	Previously estimated annual internal hour burden[1]	Updated estimated annual internal hour burden[2]	Previously estimated annual internal burden time cost	Updated estimated annual internal time burden cost	Previously estimated annual external cost burden	Updated estimated annual external cost burden
Website disclosure	33,398.75 hours	36,555.75 hours	$10,717,945.15	$11,731,053.51	$1,735,000	$1,899,000
Recordkeeping	8,675 hours	9,495 hours	$680,987.50	$745,357.50	$0	$0
Policies and procedures	32,392.45 hours	35,454.33 hours	$13,372,807.45	$14,636,865.33	$0	$0
Total annual burden	74,466.2 hours	81,505.08 hours	$24,771,740.10	$27,113,276.34	$1,735,000	$1,899,000
Number of affected ETFs	÷ 1,735	÷ 1,899	÷ 1,735	÷ 1,899	÷ 1,735	÷ 1,899
Average annual burden per ETF	42.92 hours	42.92 hours	$14,277.66	$14,277.66	$1,000	$1,000

Notes:

1. The previously estimated burdens and costs in this table are based on an estimate of 1,735 ETFs relying on rule 6c-11.
2. The updated estimated burdens and costs in this table are based on an estimate of 164 leveraged/inverse ETFs that would rely on rule 6c-11 pursuant to the proposed amendment to that rule, for a total estimate of 1,899 ETFs that would rely on rule 6c-11.

F. Form N-PORT

We are proposing to amend Form N-PORT to add new items to Part B ("Information About the Fund"), as well as to make certain amendments to the form's General Instructions.

Form N-PORT, as amended, would require funds to provide information about their derivatives exposure.[671] We estimate that 5,091 funds would be subject to this exposure-related disclosure requirement.[672]

In addition, funds that are subject to the limit on fund leverage risk in proposed rule 18f-4 would have to report certain VaR-related information, including: (1) the fund's highest daily VaR during the reporting period and its corresponding date; and (2) the fund's median daily VaR for the reporting period. Funds subject to the relative VaR test during the reporting period also would have to report: (1) the name of the fund's designated reference index, (2) the index identifier, (3) the fund's highest daily VaR ratio during the reporting period and its corresponding date; and (4) the fund's median daily VaR ratio for the reporting period.[673] Finally, all funds that are subject to the proposed limit on fund leverage risk also would have to report the number of exceptions that the fund identified as a result of the backtesting of its VaR calculation model.[674] We estimate that 2,424 funds would be subject to these VaR-related disclosure requirements.[675]

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671 *See* proposed Item B.9 of Form N-PORT; *supra* section II.H.1.a.

672 *See supra* notes 467, 498 and accompanying text, and paragraph following note 525 (2,693 funds that would be subject to the proposed derivatives risk management program and limit on fund leverage risk requirements + 2,398 funds relying on the limited derivatives user exception and complying with the related limited derivatives user requirements).

673 *See* proposed Item B.10 of Form N-PORT; *supra* section II.H.1.b.

674 *See id.*

675 *See supra* paragraph following note 525.

Preparing reports on Form N-PORT is mandatory for all management investment companies (other than money market funds and small business investment companies) and UITs that operate as ETFs and is a collection of information under the PRA. The information required by Form N-PORT must be data-tagged in XML format. Responses to the reporting requirements will be kept confidential, subject to the provisions of applicable law, for reports filed with respect to the first two months of each quarter; the third month of the quarter will not be kept confidential, but made public sixty days after the quarter end. Form N-PORT is designed to assist the Commission its regulatory, disclosure review, inspection, and policymaking roles, and to help investors and other market participants better assess different fund products.[676]

Based on current PRA estimates, we estimate that funds prepare and file their reports on Form N-PORT either by (1) licensing a software solution and preparing and filing the reports in house, or (2) retaining a service provider to provide data aggregation, validation and/or filing services as part of the preparation and filing of reports on behalf of the fund. We estimate that 35% of funds subject to the proposed N-PORT filing requirements would license a software solution and file reports on Form N-PORT in house, and the remainder would retain a service provider to file reports on behalf of the fund.

Table 19 below summarizes our PRA initial and ongoing annual burden estimates associated with the proposed amendments to Form N-PORT.

[676] The specific purposes for each of the new proposed reporting items are discussed in section II.H.1 *supra*.

Table 19: Form N-PORT PRA Estimates

	Internal initial burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
Report derivatives exposure information	2 hours	4.33 hours[3]	×	$365 (compliance attorney)	$1,580	$5,590	$4,210
	2 hours	4.33 hours	×	$331 (senior programmer)	$1,433		
Total new burden for derivatives exposure information		8.66 hours			$3,013		
Number of funds for derivatives exposure information		× 5,091			× 5,091		
Total new annual burden for derivatives exposure information (I)		44,088 hours			$15,339,183		
Report VaR-related information	2 hours	4.33 hours	×	$365 (compliance attorney)	$1,580		
	2 hours	4.33 hours	×	$331 (senior programmer)	$1,433		
Total new burden for VaR-related information		8.66 hours			$3,013		
Number of funds for VaR-related information		× 2,424			× 2,424		
Total new annual burden for VaR-related information (II)		20,992 hours			$7,303,512		
Total new annual burden (I + II)		65,080 hours			$22,642,695		$21,433,110[4]
Current burden estimates		1,803,826 hours					$103,776,240
Revised burden estimates		1,868,906 hours					$125,209,350

Notes:
1. Includes initial burden estimates annualized over a three-year period.
2. *See supra* note 627. These PRA estimates assume that the same types of professionals would be involved in the proposed reporting requirements that we believe otherwise would be involved in preparing and filing reports on Form N-PORT.
3. This estimate assumes that, annually after the initial 2 hours to comply with the new N-PORT requirements, each of a compliance attorney and a senior programmer would incur 1 burden hours per filing associated with the new reporting requirements. The estimate of 4.33 hours is based on the following calculation: ((2 hours for the first filing x 1 = 2) + (3 additional filings in year 1 x 1 hour for each of the additional 3 filings in year 1 = 3) + (4 filings in years 2 and 3 x 1 hour per filing x 2 years) = 8) / 3 = 4.33.
4. This estimate is based on the following calculation: $4,210 (average costs for funds reporting the proposed information on Form N-PORT) * 5,091 funds (which includes funds reporting derivative exposure information and VaR-related information).

G. Form N-RN

We are proposing to amend Form N-LIQUID (which we propose to re-title as "Form N-RN") to add new current reporting requirements for funds subject to the proposed VaR-based limit on fund leverage risk pursuant to proposed rule 18f-4.[677] Specifically, a fund that determines that it is out of compliance with the VaR test and has not come back into compliance within three business days after such determination would have to file a non-public report on Form N-RN providing certain information regarding its VaR test breaches.[678] If the portfolio VaR of a fund subject to the relative VaR test were to exceed 150% of the VaR of its designated reference index for three business days, a fund would have to report: (1) the dates on which the fund portfolio's VaR exceeded 150% of the VaR of its designated reference index; (2) the VaR of its portfolio for each of these days; (3) the VaR of its designated reference index for each of these days; (4) the name of the designated reference index; and (5) the index identifier. If the portfolio VaR of a fund subject to the absolute VaR test were to exceed 10% of the value of the fund's net assets for three business days, a fund would have to report: (1) the dates on which the fund portfolio's VaR exceeded 10% of the value of its net assets; (2) the VaR of its portfolio for each of these days; and (3) the value of the fund's net assets for each of these days.

In addition, if a fund that has filed Part E or Part F of Form N-RN to report it has breached its applicable VaR test, has come back into compliance with either the relative VaR test

[677] *See supra* section II.H.2.

[678] This requirement would be implemented through the proposed amendments to rule 30b1-10 under the Investment Company Act, and proposed rule 18f-4(c)(7). For purposes of this PRA analysis, the burden associated with the proposed amendments to rule 30b1-10 and proposed rule 18f-4(c)(7) is included in the collection of information requirements for Form N-RN.

or the absolute VaR test, as applicable, it must file a report on Form N-RN to indicate that.[679] Specifically, a fund must report the dates on which its portfolio VaR exceeded, as applicable, 150% of the VaR of its designated reference index (if the fund is subject to the relative VaR test under proposed rule 18f-4(c)(2)(i)) or exceeded 15% of the value of its net assets (if the fund is subject to the absolute VaR test under proposed rule 18f-4(c)(2)(ii)).[680] Furthermore, a fund must also report the current VaR of its portfolio.[681]

A fund would have to report information for either VaR test breach, within one business day following the third business day after the fund has determined that its portfolio VaR exceeds either of the VaR test thresholds, as applicable. Similarly, a fund that has come back into compliance with its applicable VaR test would have to file such a report within one business day. We estimate that 2,424 funds per year would be required to comply with either of the VaR tests, and the Commission would receive approximately 30 filing(s) per year in response to each of the new VaR-related items that we proposed to include on Form N-RN, as amended.[682]

Under the proposed amendments to Form N-RN, preparing a report on this form would be mandatory for any fund that is out of compliance with its applicable VaR test for more than three business days, as described above, and for any fund that has come back into compliance with its applicable VaR test. A report on Form N-RN is a collection of information under the PRA. The VaR test breach information provided on Form N-RN, as well as the information a

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679 *See* proposed Part G of Form N-RN.

680 *Id*.

681 *Id*.

682 This estimate is similar to the Commission's estimates of the number of reports that funds, in the aggregate, would submit annually in response to the liquidity-related items of Form N-LIQUID. *See* Liquidity Adopting Release, *supra* note 359, at nn.1281-1283 and accompanying paragraph. *See also supra* paragraph following note 525.

fund provides when it has come back into compliance, would enable the Commission to receive information on events that could impact funds' leverage-related risk more uniformly and efficiently and would enhance the Commission's oversight of funds when significant fund and/or market events occur. The Commission would be able to use the newly required information that funds would provide on Form N-RN in its regulatory, disclosure review, inspection, and policymaking roles. Responses to the reporting requirements and this collection of information would be kept confidential, subject to provisions of applicable law.

Table 20 below summarizes our PRA initial and ongoing annual burden estimates associated with the proposed amendments to funds' current reporting requirement. Staff estimates there will be no external costs associated with this collection of information. We further assume similar hourly and cost burdens, as well as similar response rates, for responses to either a breach of the absolute VaR test or the relative VaR test.

Table 20: Form N-RN PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Relative or absolute VaR test breach reports	0 hour	0.005 hours[2]	×	$365 (compliance attorney)	$1.83
	0 hour	0.005 hours	×	$331 (senior programmer)	$1.66
Total new annual burden per fund		0.01 hours			$3.49
Number of funds		× 2,424			× 2,424
Total new annual burden		24 hours			$8,460
Current burden estimates		941 hours			
Revised burden estimates		965 hours			

Notes:
1. *See supra* note 627. These PRA estimates assume that the same types of professionals would be involved in the proposed reporting requirements that we believe otherwise would be involved in preparing and filing reports on Form N-LIQUID.
2. This estimate is based on the assumption that, of the 2,424 funds that would be required to comply with either of the VaR tests, on average the Commission would receive 30 reports regarding a relative or absolute VaR test breach and that compliance attorney and senior programmer would each spend 30 minutes as part of preparing and submitting this report.

H. Form N-CEN

We are proposing to amend Form N-CEN to require a fund to identify whether it relied on proposed rule 18f-4 during the reporting period.[683] Form N-CEN is a structured form that requires registered funds to provide census-type information to the Commission on an annual basis. The proposed amendments also would require a fund to identify whether it relied on any of the exemptions from various requirements under the proposed rule, specifically: (1) whether the fund is a limited derivatives user excepted from the proposed rule's program requirement, under either of the proposed exception's alternatives (either a funds that limits its derivatives exposure to 10% of its net assets, or a fund that uses derivatives transactions solely to hedge certain currency risks); or (2) whether it is a leveraged/inverse investment fund covered by the proposed sales practices rules that, under proposed rule 18f-4, would be excepted from the proposed limit on fund leverage risk. Finally, a fund would have to identify whether it has entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements, as provided under the proposed rule.

Preparing a report on Form N-CEN, as amended, would be mandatory for all registered funds. Responses would not be kept confidential. We estimate that 12,375 funds would be subject to these disclosure requirements.[684]

The purpose of Form N-CEN is to satisfy the filing and disclosure requirements of section 30 of the Investment Company Act, and of amended rule 30a-1 thereunder. The information required to be filed with the Commission assures the public availability of the

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683 *See supra* section II.H.3.

684 *See supra* section III.B.1 (9,788 mutual funds + 1,910 ETFs organized as an open-end fund or as a share-class of an open-end fund + 664 registered closed-end funds + 13 variable annuity separate accounts registered as management investment companies on Form N-3).

information and is designed to facilitate the Commission's oversight of registered funds and its ability to monitor trends and risks.

Table 21 below summarizes our PRA initial and ongoing annual burden estimates associated with the proposed amendments to Form N-CEN based on current Form N-CEN practices and burdens associated with minor amendments to the form. Staff estimates there will be no external costs associated with this collection of information.

Table 21: Form N-CEN PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs
PROPOSED ESTIMATES					
Reporting derivatives-related fund census information	0 hour	0.01 hours	×	$365 (compliance attorney)	$3.7
	0 hour	0.01 hours	×	$331 (senior programmer)	$3.3
Total new annual burden per fund		0.02 hours			$7
Number of funds		× 12,375			× 12,375
Total new annual burden		248 hours			$86,625
Current burden estimates		74,425 hours			
Revised burden estimates		74,673 hours			

Notes:
1. *See supra* note 627. These PRA estimates assume that the same types of professionals would be involved in the proposed reporting requirements that we believe otherwise would be involved in preparing and filing reports on Form N-CEN.
2. This estimate assumes each fund reporting on Form N-CEN would spend 1 to 2 minutes reporting these new data elements.

I. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules and amendments should direct them to the OMB, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to, Vanessa Countryman, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-24-15. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-24-15, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street, NE, Washington, DC 20549- 2736.

V. INITIAL REGULATORY FLEXBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis has been prepared in accordance with section 3 of the Regulatory Flexibility Act.[685] It relates to proposed rules 18f-4, 15*l*-2, 211(h)-1, and proposed amendments to Forms N-PORT, N-LIQUID (which we propose to re-title as "Form N-RN"), and N-CEN.[686]

A. Reasons for and Objectives of the Proposed Actions

The Commission is proposing new rules 18f-4, 211(h)-1, and 15*l*-2, amendments to rule 6c-11, as well as amendments to Forms N-PORT, N-LIQUID, and N-CEN. These proposed rules, and proposed rule and form amendments, are designed to address the investor protection purposes and concerns underlying section 18 of the Investment Company Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives and the other transactions covered by proposed rule 18f-4.[687]

Proposed rule 18f-4 is designed to provide an updated, comprehensive approach to the regulation of funds' use of derivatives and certain other transactions, generally through the implementation of a derivatives risk management program, limits on fund leverage risk, board oversight and reporting, and related recordkeeping requirements.[688] The proposed sales practices rules are designed to address certain specific considerations raised by certain leveraged/inverse investment vehicles by requiring registered broker-dealers and investment advisers to satisfy due

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[685] 5 U.S.C. 603.

[686] As discussed above, the proposed conforming amendment to Form N-2 does not change the Form N-2 collection of information. *See supra* note 622. We also do not believe there to be any reporting, recordkeeping, or compliance burden associated with this proposed conforming amendment.

[687] *See supra* section I.B (discussing the requirements of section 18, and as well as Congress' concerns underlying the limits of section 18).

[688] *See supra* section II.A.2.

diligence and account approval requirements.[689] Finally, the proposed amendments to Forms N-PORT, N-LIQUID, and N-CEN are designed to enhance the Commission's ability to effectively oversee the use by funds, broker-dealers and investment advisers of the proposed rules and to provide the Commission and the public with greater insight into the impact that funds' use of derivatives may have on their portfolios.[690]

All of these requirements are discussed in detail in section II of this release. The costs and burdens of these requirements on small funds, investment advisers, and broker-dealers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the applicable costs and burdens on all funds, investment advisers, and broker-dealers.[691]

B. Legal Basis

The Commission is proposing new rule 18f-4 under the authority set forth in sections 6(c), 12(a), 18, 31(a), 38(a), and 61 of the Investment Company Act of 1940 [15 U.S.C. 80a-6(c), 80a-12(a), 80a-18, 80a-30(a), 80a-37(a), and 80a-60]. The Commission is proposing amendments to rule 6c-11 under the authority set forth in sections 6(c), 22(c), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 22(c), and 80a-37(a)]. The Commission is proposing new rule 15*l*-2 under the authority set forth in sections 3, 3(b), 3E, 10, 15(l), 15F, 17, 23(a), and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78c, 78c(b), 78c-5, 78j, 78o(l), 78o-10, 78q, 78w(a), and 78mm]. The Commission is proposing new rule 211(h)-1 under the authority set

689 *See supra* section II.G.

690 *See supra* section II.H.

691 *See supra* sections III and IV. These sections also discuss the professional skills that we believe compliance with the proposed rules, and proposed rule and form amendments would entail.

forth in sections 206, 206A, 208, 211(a), and 211(h), and of the Investment Advisers Act of 1940 [15 U.S.C. 80b-6, 80b-6a, 80b-8, 80b-11(a), and 80b-11(h)]. The Commission is proposing amendments to Form N-PORT, Form N-LIQUID (which we propose to re-title as "Form N-RN"), Form N-CEN, and Form N-2 under the authority set forth in sections 8, 18, 30, and 38 of the Investment Company Act of 1940 [15 U.S.C. 80a-8, 80a-18, 80a-29, 80a-37, 80a-63], sections 6, 7(a), 10 and 19(a) of the Securities Act of 1933 [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 10, 13, 15, 23, and 35A of the Exchange Act [15 U.S.C. 78j, 78m, 78o, 78w, and 78ll].

C. Small Entities Subject to Proposed Rules

For purposes of Commission rulemaking in connection with the Regulatory Flexibility Act, an investment company is a small entity if, together with other investment companies in the same group of related investment companies, it has net assets of $50 million or less as of the end of its most recent fiscal year (a "small fund").[692] Commission staff estimates that, as of June 2019, approximately 42 registered open-end mutual funds, 8 registered ETFs, 33 registered closed-end funds, and 16 BDCs (collectively, 99 funds) are small entities.[693]

For purposes of Commission rulemaking in connection with the Regulatory Flexibility Act, a broker-dealer is a small entity if it: (1) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to rule 17a-5(d) under the Exchange Act, or, if not required to file such statements, had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been

[692] *See* rule 0-10(a) under the Investment Company Act [17 CFR 270.0-10(a)].

[693] This estimate is derived an analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending June 2019.

in business, if shorter); and (2) it is not affiliated with any person (other than a natural person) that is not a small business or small organization.[694] Commission staff estimates that, as of June 30, 2019, there are approximately 942 broker-dealers that may be considered small entities.[695]

Under Commission rules, and for the purposes of the Advisers Act and the Regulatory Flexibility Act, a registered investment adviser generally is a small entity if it: (1) has assets under management having a total value of less than $25 million; (2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[696] We believe that proposed rule 211(h)-1 would not affect most investment advisers that are small entities ("small advisers"). Many small advisers would not be affected because they are registered with one or more state securities authorities and not with the Commission. Under section 203A of the Advisers Act, many small advisers are prohibited from registering with the Commission and are regulated by state regulators.[697] Of those advisers that are registered with the Commission, we estimate based on IARD data that as of June 30, 2019, approximately 470 SEC-registered investment advisers are small entities under the RFA.[698] Of these, we estimate that 171 registered

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694 *See* rule 0-10(c)(1)-(2) under the Exchange Act [17 CFR 240.0-10(c)(1)(2)].

695 This estimate is derived from an analysis of data for the period ending June 30, 2019 obtained from Financial and Operational Combined Uniform Single (FOCUS) Reports that broker-dealers generally are required to file with the Commission and/or SROs pursuant to rule 17a-5 under the Exchange Act [17 CFR 240.17a-5].

696 *See* rule 0-7(a) under the Advisers Act [17 CFR 275.0-7(a)].

697 15 U.S.C. 80b-3a.

698 Based on SEC registered investment adviser responses to Item 12 of Form ADV.

investment advisers are small entities that provide advice to individual clients.[699]

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

1. Proposed Rule 18f-4

a. Derivatives Risk Management Program, and Board Oversight and Reporting

Proposed rule 18f-4 would generally require a fund relying on the rule—including small entities, but not including funds that are limited derivatives users—to adopt and implement a derivatives risk management program.[700] This risk management program would include policies and procedures reasonably designed to assess and manage the risks of the fund's derivatives transactions.[701] The program requirement is designed to permit a fund to tailor the program's elements to the particular types of derivatives that the fund uses and related risks, as well as how those derivatives impact the fund's investment portfolio and strategy. The proposal would require a fund's program to include the following elements: (1) risk identification and assessment; (2) risk guidelines; (3) stress testing; (4) backtesting; (5) internal reporting and escalation; and (6) periodic review of the program. The proposed rule also would require: (1) a fund's board of directors to approve the designation of the fund's derivatives risk manager and

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[699] Based on SEC-registered investment adviser responses to Items 5.D.(1)(a)-(b), 5.D.(3)(a)-(b), 5.F and 12 of Form ADV. These responses indicate that: the investment adviser has clients that are high net worth individuals and/or individuals other than high net worth individuals; the investment adviser has regulatory assets under management attributable to clients that are high net worth individuals and/or individuals other than high net worth individuals; and that the investment adviser is a small entity. Firms that are registered as a broker-dealer and an investment adviser are counted in both the total number of small investment advisers and small broker-dealers that would be subject to the new requirements. We believe that counting these firms twice is appropriate because of any additional burdens of complying with the rules with respect to both their advisory and brokerage businesses.

[700] *See supra* section II.A.2; proposed rule 18f-4(c)(1).

[701] *See* proposed rule 18f-4(a).

(2) the derivatives risk manager to provide written reports to the board regarding the program's implementation and effectiveness, including describing any exceedances of the fund's guidelines and the results of the fund's stress testing and backtesting.[702]

As discussed above, we estimate that the one-time operational costs necessary to establish and implement a derivatives risk management program would range from $70,000 to $500,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[703] We also estimate that each fund would incur ongoing program-related costs that range from 65% to 75% of the one-time costs necessary to establish and implement a derivatives risk management program.[704] Thus, we estimate that a fund would incur ongoing annual costs associated with proposed rule 18f-4 that would range from $45,500 to $375,000.[705] We estimate that approximately 22% of funds would be required to implement a derivatives risk management program, including board oversight.[706] We similarly estimate—applying to small funds the same estimated percentage of funds that would implement a derivatives risk management program—that approximately 22% of small funds (approximately 22 small funds) would establish a derivatives risk management program.[707]

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[702] *See supra* sections II.C and III.C.1.

[703] *See supra* section III.C.1. This section, along with sections IV.B.1 and IV.B.2, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

[704] *Id*.

[705] *Id*.

[706] These are funds that would not be considered limited derivatives users under the proposed rule. *See supra* sections II.E, III.C.1, IV.B.1 and IV.B.2; *infra* section V.D.1.c.

[707] *See supra* sections III.C.1 and V.C. We estimate that there are 99 small funds that meet the small entity definition. *See supra* note 692 and accompanying text. 99 small funds x 22% = approximately 22 funds that are small entities.

There are different factors that would affect whether a smaller fund incurs program-related costs that are on the higher or lower end of the estimated range. For example, we would expect that smaller funds—and more specifically, smaller funds that are not part of a fund complex—may not have existing personnel capable of fulfilling the responsibilities of the proposed derivatives risk manager, or may choose to hire a derivatives risk manager rather than assigning that responsibility to a current officer (or officers) of the fund's investment adviser who is not a portfolio manager. Also, while we would expect larger funds or funds that are part of a large fund complex to incur higher program-related costs in absolute terms relative to a smaller fund or a fund that is part of a smaller fund complex, we would expect a smaller fund to find it more costly, per dollar managed, to comply with the proposed program requirement because it would not be able to benefit from a larger fund complex's economies of scale.[708]

b. Limit on Fund Leverage Risk

Proposed rule 18f-4 would also generally require a fund relying on the rule—including small entities, but not including funds that are limited derivatives users or that are certain leveraged/inverse funds that the rule describes—to comply with an outer limit on fund leverage risk based on VaR.[709] This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test.[710] Under the proposed rule, a fund must disclose its

708 *See supra* section III.C.1.

709 *See supra* sections II.D, II.E, and II.G.

710 *See supra* sections II.D.2, II.D.3.

designated reference index in its annual report.[711] This proposed requirement is designed to limit fund leverage risk consistent with the investor protection purposes underlying section 18.

As discussed above, we estimate that the one-time operational costs necessary to establish and implement a VaR calculation model consistent with the proposed limit on fund leverage risk would range from $5,000 to $100,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[712] We estimate that approximately 19% of funds would be required to comply with the proposed limit on fund leverage risk.[713] We similarly estimate—applying to small funds the same estimated percentage of funds overall that would comply with this requirement—that approximately 19% of small funds (approximately 19 small funds) would be required to comply with the proposed limit on fund leverage risk.[714]

There are multiple factors that could affect whether the costs that smaller funds would incur in complying with the proposed limit on fund leverage risk would be on the lower versus higher end of this estimated range. To the extent that funds (including smaller funds) have already established and implemented portfolio VaR testing practices and procedures, these funds would incur fewer costs relative to those funds that have not already established and implemented VaR-based analysis in their risk management. If as a result of fewer resources, a

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711 Proposed rule 18f-4(c)(2)(iv).

712 *See supra* section III.C.2. This section, along with section IV.B.3, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

713 *See supra* section III.C.2. This estimate excludes both: (1) limited derivatives users, and (2) funds that are leveraged/inverse investment vehicles under the proposed sales practices rules. *Id.*; *see also supra* sections II.E, II.G, III.C.2, III.C.3, III.C.5, and IV.B.3; *infra* section V.D.1.c.

714 *See supra* sections III.C.2 and V.C. We estimate that there are 99 small funds that meet the small entity definition. *See supra* note 692 and accompanying text. 99 small entities x 19% = approximately 19 funds that are small entities.

smaller fund, and more specifically a smaller fund not part of a fund complex, hired a third-party vendor to comply with the VaR-based limit on fund leverage risk, this could increase costs of complying with the proposed limit for those funds. Finally, costs would vary based on factors such as whether the fund uses multiple types of derivatives or uses derivatives more extensively, whether the fund would be implementing the absolute VaR test versus the relative VaR test, and whether (for a fund that uses the relative VaR test) the fund uses a designated reference index for which the index provider charges a licensing fee.[715]

c. Requirements for Limited Derivatives Users

Proposed rule 18f-4 includes an exception from the proposed rule's risk management program requirement and limit on fund leverage risk for "limited derivatives users."[716] The proposed exception would be available to a fund that either limits its derivatives exposure to 10% of its net assets, or that uses derivatives transactions solely to hedge certain currency risks. Any fund that relies on the proposed exception—small funds as well as large funds—would also be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks. We expect that the risks and potential impact of these funds' derivatives use may not be as significant, compared to those of funds that do not qualify for the exception, and that a principles-based policies and procedures requirement would appropriately address these risks. These "reasonably designed" policies and procedures would have a scope that that reflects the extent and nature of a fund's use of derivatives within the parameters that the proposed exception provides.

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715 *See supra* note 202 and accompanying paragraph; note 517 and accompanying sentence.

716 *See supra* section II.E; proposed rule 18f-4(c)(3)(i)-(ii).

As discussed above, we estimate that the one-time costs to establish and implement policies and procedures reasonably designed to manage a fund's derivative risks would range from $1,000 to $100,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[717] We also estimate that the ongoing annual costs that a fund that is a limited derivatives user would incur range from 65% to 75% of the one-time costs to establish and implement the policies and procedures. Thus, we estimate that a fund would incur ongoing annual costs associated with the proposed limited derivatives user exception that would range from $650 to $75,000.[718] We anticipate that larger funds that are limited derivatives users—or limited derivatives user funds that are part of a large fund complex—would likely experience economies of scale in complying with the proposed requirements for limited derivatives users that smaller funds would not necessarily experience.[719] Thus, smaller funds that are limited derivatives users could incur costs on the higher end of the estimated range. However, a smaller fund whose derivatives use is limited could benefit from the proposed limited derivatives user exception, because it would not be required to adopt a derivatives risk management program (including all of the proposed program elements), and therefore such a fund could potentially avoid incurring costs and bearing compliance burdens that may be disproportionate to any benefits.[720]

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717 *See supra* section III.C.3 (discussing the one-time range of costs for implementing the limited derivatives user requirements under proposed rule18f-4 and the variables impacting a fund incurring costs at the lower or higher end of the estimated cost range). This section, along with section IV.B.6, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

718 *Id*.

719 *See supra* note 707 and accompanying text.

720 *See supra* section II.E.

We estimate that approximately 19% of funds that use derivatives would qualify for the limited derivatives user exception.[721] We would expect some small funds to fall within the proposed limited derivatives user exception.[722] However, not all small funds that use derivatives would necessarily qualify as limited derivatives users. We estimate—applying to small funds the same estimated percentage of funds overall that would qualify as limited derivatives users—that approximately 19% of small funds that use derivatives (approximately 19 small funds) would comply with the proposed requirements for limited derivatives users under the proposed rule.[723]

d. Reverse Repurchase Agreements and Unfunded Commitment Agreements

Proposed rule 18f-4 would permit a fund to engage in reverse repurchase agreements and other similar financing transactions so long as they are subject to the relevant asset coverage requirements of section 18.[724] Because funds are required to rely on the asset segregation approach in Release 10666, the degree to which funds could engage in reverse repurchase agreements under the proposal would generally be the same as under current practice. Therefore we do not estimate a significant compliance burden—either for small funds that engage in reverse repurchase agreements or for larger funds—associated with the proposed provisions

721 *Id*. This estimate excludes both: (1) funds that would comply with the derivatives risk management program, and (2) funds that would be leveraged/inverse investment vehicles under proposed rule 15*l*-2. *See also supra* sections II.A.2, II.E, II.G, III.C.1, III.C.3, III.C.5, IV.B.4, and V.D.1.a.

722 *Id.*; *see also supra* section III.C.3.

723 *Id.*; *see also supra* sections III.C.3 and V.C. We estimate that there are 99 small funds that meet the small entity definition. *See supra* note 692 and accompanying text. 99 small entities x 19% = approximately 19 funds that are small entities.

724 *See supra* section II.I.

regarding reverse repurchase agreements in rule 18f-4.[725] For large and small funds subject to the proposed limit on fund leverage risk, any portfolio leveraging effect of reverse repurchase agreements or similar financing transactions would be included and restricted through the proposed VaR-based limits, and therefore would incrementally affect the costs associated with complying with these limits.[726]

The proposed rule also includes a provision that codifies an approach for funds' participation in unfunded commitment agreements in light of the concerns underlying section 18.[727] Proposed rule 18f-4 would permit a fund to enter into unfunded commitment agreements if it reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due. The proposed rule would prescribe factors that a fund must consider in forming such a reasonable belief. If a fund enters into unfunded comment agreements in compliance with this requirement, the proposed rule specifies that unfunded commitment agreements will not be considered for purposes of computing asset coverage, as defined in section 18(h) of the Investment Company Act. This proposed approach for unfunded commitment agreements reflects the staff's experience in reviewing and commenting on fund registration statements, as discussed above.[728] We therefore do not expect that the proposed approach would result in significant costs to small or large funds because we believe the

[725] *See supra* section III.C.4.

[726] *See supra* section II.I.

[727] *See supra* section II.J.

[728] *See id.*

proposed approach is generally consistent with the current practices of funds that enter into unfunded commitment agreements.

e. Recordkeeping

Proposed rule 18f-4 includes certain recordkeeping provisions that are designed to provide the Commission's staff, and the fund's board of directors and compliance personnel, the ability to evaluate the fund's compliance with the proposed rule's requirements.[729] The proposed rule would require a fund to maintain certain records documenting its derivatives risk management program, including a written record of: (1) its policies and procedures designed to manage the fund's derivatives risks, (2) the results of any stress testing of its portfolio, (3) the results of any VaR test backtesting it conducts, (4) records documenting any internal reporting or escalation of material risks under the program, and (5) records documenting any periodic reviews of the program.[730]

Second, the proposed rule would also require a fund to maintain a written record of any materials provided to the fund's board of directors in connection with approving the designation of the derivatives risk manager. The proposed rule would also require a fund to keep records of any written reports provided to the board of directors relating to the program, and any written reports provided to the board that the rule would require regarding the fund's non-compliance with the applicable VaR test.[731]

Third, a fund that is required to comply with the proposed VaR test would also have to maintain written records documenting the determination of: its portfolio VaR; the VaR of its

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729 *See supra* section II.K.

730 *See* proposed rule 18f-4(c)(6)(i)(A).

731 *See* proposed rule 18f-4(c)(6)(i)(B).

designated reference index, as applicable; its VaR ratio (the value of the VaR of the Fund's portfolio divided by the VaR of the designated reference index), as applicable; and any updates to the VaR calculation models used by the fund, as well as the basis for any material changes made to those models.[732]

Fourth, the proposed rule would require a fund that is a limited derivatives user to maintain a written record of its policies and procedures that are reasonably designed to manage its derivatives risks.[733]

Finally, a fund that enters into unfunded commitment agreements would be required to maintain a records documenting the basis for the fund's belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements.[734] A record must be made each time a fund enters into such an agreement.[735]

As discussed above, we estimate that the average one-time recordkeeping costs for funds that would not qualify as limited derivatives users would be $2,047 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[736] We also estimate that such a fund would incur an average ongoing annual recordkeeping costs of $330.[737] We further estimate that the one-time and ongoing annual recordkeeping costs for a limited derivatives user to be 90% of those for funds that do not qualify as limited

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732 *See* proposed rule 18f-4(c)(6)(i)(C).

733 *See* proposed rule 18f-4(c)(6)(i)(D).

734 *See* proposed rule 18f-4e)(2); *see also supra* note 429 and accompanying text.

735 *Id.*; *see also supra* note 430 and accompanying text.

736 *See supra* section III.C.8. This section, along with section IV.B.7, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

737 *Id.*

derivatives users.[738] Thus, for each fund that could rely on the limited derivatives user exception, we estimate a one-time cost of $1,842 and an ongoing cost of $297 per year.[739] To the extent that we estimate that small funds would be subject to the various provisions of the proposed rule that would necessitate recordkeeping requirements, as discussed above, these small funds also would be subject to the associated proposed recordkeeping requirements. Therefore, we estimate that: 22% of small funds (approximately 22 small funds) would have to comply with the program-related recordkeeping requirements and requirements regarding materials provided to the fund's board; 19% of small funds (approximately 19 small funds) would have to comply with requirements to maintain records of compliance with the proposed VaR test; and 19% of small funds (approximately 19 funds) would have to comply with the recordkeeping requirements for limited derivatives users.[740]

A fund's recordkeeping-related costs will vary, depending on the provisions of proposed rule 18f-4 that the fund relies on. For example, funds that are required to adopt derivatives risk management programs, versus funds that are limited derivatives users under the proposed rule, would be subject to different recordkeeping requirements. However, while small funds' recordkeeping burdens would vary based on the provisions of the proposed rule that a fund relies on, their recordkeeping burdens would not vary solely because they are small funds. We do not anticipate that larger funds, or funds that are part of a large fund complex, would experience any significant economies of scale related to the proposed recordkeeping requirements.

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738 *Id*.

739 *Id*.

740 *See supra* sections III.C.1, III.C.2, III.C.3, V.D.1.a, V.D.1.b, and V.D.1.c.

2. Proposed Amendments to Forms N-PORT, N-LIQUID, and N-CEN

a. Proposed Amendments to Form N-PORT

The proposed amendments to Form N-PORT would require funds to report information about their derivatives exposure, and also—as applicable for funds that are subject to the proposed rule 18f-4 VaR-based limit on fund leverage risk—to report certain VaR-related information.[741] These proposed amendments would provide market-wide insight into the levels of reporting funds' derivatives exposure to the Commission, its staff, and market participants at the specific points in time covered by the reporting. They also would help the Commission and its staff assess compliance with proposed rule 18f-4.

All funds that file Form N-PORT would have to provide information regarding their derivatives exposure on this form. We estimate that 41% of small funds that file Form N-PORT (approximately 34 small funds) use derivatives, and thus only these funds would have substantive information to report in response to this new exposure-related disclosure requirement.[742]

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741 *See supra* section II.H.1; *see also* proposed Items B.9 and B.10 of Form N-PORT.

742 *See supra* sections V.C, V.D.1.a, and V.D.1.c. Because BDCs do not file reports on Form N-PORT, we deduct the number of BDCs from the total number of small funds that we estimate (99 small funds – 16 BDCs that are small entities = 83 small funds that file reports on Form N-PORT). *See supra* note 692 and accompanying text.

We estimate that approximately 22% of funds would be subject to the proposed rule's derivatives risk management program requirements and approximately 19% of funds would be subject to either of the limited derivatives user exceptions, with funds from both groups subject to reporting requirements on Form N-PORT. *See supra* notes 706, 720, and accompanying text. Although both of these estimated percentages include BDCs, we note that the total number of BDCs relative to the number of registered open- and closed-end funds is small, and therefore our estimates do not adjust these percentages to reflect the fact that BDCs do not file Forms N-PORT. *See supra* section III.B.1. Therefore, we estimate the total number of small funds subject to the proposed Form N-PORT requirements as follows: 83 small funds that file reports on Form N-PORT x (22% + 19% = 41%) = 34 small funds.

In addition, funds that are subject to the proposed limit on fund leverage risk would have to report: (1) the fund's highest daily VaR during the reporting period and its corresponding date; and (2) the fund's median daily VaR for the reporting period. Funds subject to the relative VaR test during the reporting period also would have to report: (1) the name of the fund's designated reference index, (2) the index identifier, (3) the fund's highest daily VaR ratio during the reporting period and its corresponding date; and (4) the fund's median daily VaR ratio for the reporting period. A fund would be required to determine its compliance with its applicable VaR test once each business day.[743]

All funds that are subject to the proposed limit on fund leverage risk also would have to report the number of exceptions that the fund identified as a result of the backtesting of its VaR calculation model. We estimate that 19% of small funds (approximately 16 small funds) would be subject to these VaR-related disclosure requirements.[744]

We estimate that each fund that reports information in response to the proposed VaR-related disclosure requirements on Form N-PORT would incur a one-time cost of $2,784 and an ongoing cost of $4,176 per year, and each fund that is not subject to the VaR-related disclosure

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743 *See supra* note 364.

744 We estimate 83 small funds that file reports on Form N-PORT. *See supra* note 741.

We estimate that approximately 19% of funds would be subject to the proposed limit on fund leverage risk. *See supra* note 712 and accompanying text. Although this estimated percentage include BDCs, we note that the total number of BDCs relative to the number of registered open- and closed-end funds is small, and therefore our estimate does not adjust this percentage to reflect the fact that BDCs do not file Forms N-PORT. *See supra* section III.B.1. Therefore, we estimate the total number of small funds that would make VaR-related disclosures on Form N-PORT as follows: 83 small funds that file reports on Form N-PORT x 19% = approximately 16 small funds.

requirement would incur a one-time cost of $1,392 and an ongoing cost of $2,088 per year.[745] Notwithstanding the economies of scale experienced by large versus small funds, we would not expect the costs of compliance associated with the new Form N-PORT requirements to be meaningfully different for small versus large funds. The costs of compliance would vary only based on fund characteristics tied to their derivatives use. For example, a fund that uses derivatives extensively would incur more costs to calculate its derivatives exposure than a fund that does not use derivatives extensively.[746] And a fund that is a limited derivatives user, or that otherwise is not subject to the proposed VaR test, would not incur any costs to comply with the proposed new VaR-related N-PORT items.[747]

b. Proposed Amendments to Form N-LIQUID

We are proposing to re-title Form N-LIQUID as Form N-RN, and amend this form to include new reporting events for funds that are subject to proposed rule 18f-4's limit on fund leverage risk.[748] The proposed amendments would require funds subject to the limit on fund leverage risk to report information about VaR test breaches under certain circumstances. These proposed current reporting requirements are designed to aid the Commission in assessing funds' compliance with the VaR tests, and to provide staff the ability to assess how long a fund is precluded from entering into derivatives transactions as a consequence of its lack of compliance with its VaR test. We are proposing to require funds to provide this information in a current report because we believe that the Commission should be notified promptly when a fund is out of

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745 *See supra* section III.C.9.a.; *see also supra* section IV.F (discussing the professional skills that we believe compliance with this aspect of the proposal would entail).

746 *See supra* note 714.

747 *See* proposed Item B.10 to Form N-PORT.

748 *See supra* section II.H.2.

compliance with the proposed VaR-based limit on fund leverage risk (and also when it has come back into compliance with its applicable VaR test). We believe this information could indicate that a fund is experiencing heightened risks as a result of a fund's use of derivatives transactions, as well as provide the Commission insight about the duration and severity of those risks, and whether those heightened risks are fund-specific or industry-wide.

As discussed above, we estimate that each fund subject to the proposed new current reporting requirements would incur an average cost of $10 per year to prepare amended Form N-RN.[749] We estimate that approximately 19 registered open- and closed-end funds, and BDCs, are small entities that would be required to report VaR test related information on Form N-RN.[750] Because the proposed amendments to Form N-RN would require both large and small funds to report VaR test breaches, the burden to report is not associated with fund size, and consequently, we would not expect the costs of compliance with the new Form N-RN requirements to be meaningfully different for small versus large funds.

c. Proposed Amendments to Form N-CEN

The proposed amendments to Form N-CEN would require a fund to identify whether it relied on proposed rule 18f-4 during the reporting period.[751] The proposed amendments also would require a fund to identify whether it relied on any of the exemptions from various

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[749] *See supra* section III.C.9.b; *see also supra* section IV.G (discussing the professional skills that we believe compliance with this aspect of the proposal would entail).

[750] This estimate is based on an estimate that 16 small registered open- and closed-end funds would make VaR-related disclosures on Form N-PORT (*see supra* note 743 and accompanying text), plus 3 BDCs (16 total small BDCs (*see supra* note 692 and accompanying text) x 19% (our estimate of the percentage of funds subject to a VaR-based limit on fund leverage risk, *see supra* note 712 and accompanying text) = approximately 3 BDCs). Thus, 16 small registered open- and closed-end funds + 3 BDCs = 19 funds.

[751] *See supra* section II.H.3.

requirements under the proposed rule, specifically: (1) whether the fund is a limited derivatives user excepted from the proposed rule's program requirement, under either of the proposed exception's alternatives (either a funds that limits its derivatives exposure to 10% of its net assets, or a fund that uses derivatives transactions solely to hedge certain currency risks); or (2) whether it is a leveraged/inverse fund covered by the proposed sales practices rules that, under proposed rule 18f-4, would be excepted from the proposed limit on fund leverage risk. Finally, a fund would have to identify whether it has entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements, as provided under the proposed rule.[752] The proposed amendments to Form N-CEN are designed to assist the Commission and staff with our oversight functions by allowing us to identify which funds were excepted from certain of the proposed rule's provisions or relied on the rule's provisions regarding reverse repurchase agreements and unfunded commitment agreements.

As discussed above, we estimate that each fund subject to the proposed new Form N-CEN reporting requirements would incur on average an ongoing annual cost of $6.96 per year.[753] We estimate that approximately 34 registered open- and closed-end funds are small entities that would be subject to the proposed new Form N-CEN reporting requirements.[754] Notwithstanding

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752 *See* proposed Item C.7.l.iv-v of Form N-CEN; *see also supra* section II.I and II.J; proposed rule 18f-4(d); and proposed rule 18f-4(e).

753 *See supra* section III.C.9.a; *see also supra* section IV.H (discussing the professional skills that we believe compliance with this aspect of the proposal would entail).

754 Because BDCs do not file reports on Form N-CEN, we deduct the number of BDCs from the total number of small funds that we estimate (99 small funds – 16 BDCs that are small entities = 83 small funds that file reports on Form N-CEN). *See supra* note 692 and accompanying text.

The estimate of 34 funds is based on the percentage of funds we believe would be subject to the proposed derivatives risk management program requirement (22% of funds, *see supra* note 498 and accompanying text) plus the percentage of funds we believe would qualify as limited derivatives users (19% of funds, *see supra* note 720 and accompanying text). We estimate that 83 any economies of scale experienced by large versus small funds, we would not expect the costs of compliance with the new Form N-CEN requirements to be meaningfully different for small versus large funds.

3. Proposed Sales Practices Rules

The proposed sales practices rules under the Exchange Act and the Advisers Act would require a firm to exercise due diligence in determining whether to approve the account of a retail investor to buy or sell shares of a leveraged/inverse investment vehicle before accepting an order from, or placing an order for, the retail investor to engage in these transactions.[755] Under the proposed sales practices rules, no firm may accept an order from or place an order for a retail investor to buy or sell shares of a leveraged/inverse investment vehicle, or approve such an investor's account to engage in those transactions, unless the firm has complied with certain conditions.

Specifically, the proposed sales practices rules would require the firm to: (1) approve the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement; and (2) adopt and implement policies and procedures reasonably designed to achieve compliance with the proposed rules.[756] The proposed sales practices rules' due diligence requirements provide that a firm must exercise due diligence to

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small funds that file reports on Form N-CEN (99 total small funds less 16 small BDCs) x 41% (22% + 19%) = 34 small funds subject to the proposed Form N-CEN reporting requirements. To the extent that there are funds that either (1) would not adopt a derivatives risk management program or (2) would not qualify as limited derivatives user, but that would rely on the rule's provisions with respect to reverse repurchase agreements or unfunded commitment agreements, this analysis might underestimate the number of funds that would be subject to the new Form N-CEN reporting requirements.

755 *See supra* section II.G.1.

756 *See supra* section II.G.2.b.

ascertain the essential facts relative to the retail investor, his or her financial situation, and investment objectives. A firm must seek to obtain, at a minimum, certain specified information about the retail investor. The proposed sales practices rules also include recordkeeping requirements relating to the information that the firm obtained through its due diligence, the firm's approval or disapproval of the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles (account approvals must be in writing), and the firm's policies and procedures that it adopted pursuant to those rules.[757]

The proposed sales practices rules are designed to establish a uniform set of enhanced due diligence and account approval requirements for all leveraged/inverse investment vehicle transactions, including transactions where no recommendation or investment advice is provided by a firm. They also are designed in part to help to ensure that investors in these funds are limited to those who understand their characteristics—including that these funds would not be subject to all of the leverage-related requirements applicable to registered investment companies generally—and the unique risks they present.

As discussed above, we estimate that each broker-dealer subject to proposed rule 15*l*-2, and each investment adviser subject to proposed rule 211(h)-1, would incur total one-time costs that would range from $9,115.50 to $15,192.50 to comply with the proposed rules, and total ongoing costs that would range from $2,270.50 to $3,915 per year to comply with the proposed

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757 *See supra* section II.G.2.c.

rules.[758] We estimate that approximately 236 broker-dealers and 43 registered investment advisers are small entities that would be subject to the proposed sales practices rules.[759]

The costs that broker-dealers and investment advisers may incur as a result of the proposed sales practices rules would vary depending on the firm and the due diligence requirements that the firm adopts as a result of the proposed rules' requirements.[760] We expect that economies of scale among larger firms could result in cost reductions for larger firms. Compliance costs could, however, be different across firms with relatively smaller or larger numbers of retail investors as customers or clients.[761]

4. Proposed Amendments to Rule 6c-11

We are proposing to amend rule 6c-11 to remove the provision excluding

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758 *See supra* notes 539 and 543 and accompanying text. This discussion, along with sections IV.C and IV.D *supra*, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

759 We estimate there are currently 942 small broker-dealers. *See supra* note 694 and accompanying text. We further estimate that 700 broker-dealers (or 25% of all 2,766 broker-dealers registered with the Commission) have retail customer accounts that invest in leveraged/inverse investment vehicles. *See supra* section III.C.5. Our estimate of 236 broker-dealers is based on the following calculation: 942 small broker dealers x 25% = approximately 236 small broker-dealers that have retail customer accounts that invest in leveraged/inverse investment vehicles.

We estimate that there are currently 470 SEC-registered investment advisers that are small entities. *See supra* note 697 and accompanying text. Of these, we estimate that 171 provide advice to individual clients, and could therefore be subject to the proposed new sales practices rules under the Advisers Act. *See supra note* 698 and accompanying text. We further estimate that 2,000 investment advisers (or approximately 25% of the 8,235 investment advisers that are registered with the Commission and offer some part of their business to retail investors) have retail client accounts that invest in leveraged/inverse investment vehicles. *See supra* sections III.C.5 and IV.D. Our estimate of 43 investment advisers is based on the following calculation: 171 small investment advisers that provide advice to individual clients x 25% = approximately 43 small investment advisers that have retail client accounts that invest in leveraged/inverse investment vehicles.

760 *See supra* section III.C.5 (discussing costs and benefits of proposed sales practices rules).

761 *See supra* section II.G.2.b (discussing required approval and due diligence for retail investors' accounts to trade shares of leveraged/inverse investment vehicles under the proposed sales practices rules).

leveraged/inverse ETFs from the scope of that rule and to newly permit leveraged/inverse ETFs to rely on that rule.[762] Rule 6c-11 permits ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the Commission.[763] The rule is designed to create a consistent, transparent, and efficient regulatory framework for such ETFs and facilitate greater competition and innovation among ETFs. As a consequence of our proposed amendment to rule 6c-11, and proposal to rescind the exemptive orders we have previously issued to leveraged/inverse ETFs, these proposed amendments would newly permit leveraged/inverse ETFs to come within scope of the rule's exemptive relief.

Currently, there are 73 leveraged/inverse ETFs.[764] As a result of the proposed amendments, we would expect the number of funds relying on rule 6c-11 to increase, and we estimate that all 73 leveraged/inverse ETFs would newly seek to use rule 6c-11. We also estimate, for purposes of this Regulatory Flexibility Act analysis, that approximately 1 of these leveraged/inverse ETFs would be a small leveraged/inverse ETF that would seek to rely on rule 6c-11.[765] We do not estimate our amendments to rule 6c-11 would change the estimated per-fund cost burden associated with rule 6c-11, but we do believe the number of funds using the rule, as a result of our amendment, would now increase.[766] The costs associated with complying with rule 6c-11 are discussed in the ETFs Adopting Release.[767]

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762 *See supra* section II.G.4.

763 *Id*.

764 *See supra* note 467.

765 This estimate is based on the following calculation: 8 small ETFs / 1,190 total ETFs = approximately 0.67% of ETFs that are small ETFs. *See supra* sections III.B.1 and V.C. 0.67% of 73 leveraged/inverse ETFs = approximately 1 leveraged/inverse ETF.

766 *See supra* section IV.E.

767 *See* ETFs Adopting Release, *supra* note 76, at section IV.

E. Duplicative, Overlapping, or Conflicting Federal Rules

Commission staff has not identified any federal rules that duplicate, overlap, or conflict with proposed Investment Company Act rule 18f-4, proposed Exchange Act rule 15*l*-2, proposed Advisers Act rule 211(h)-1, or the proposed amendments to Form N-PORT, Form N-LIQUID, and Form N-CEN.

We recognize that other broker-dealer or investment adviser obligations require these entities to engage in due diligence with respect to transactions they recommend to customers or clients. The proposed sales practices rules, in contrast, would apply regardless of whether a broker-dealer or investment adviser recommends that a customer or client buy or sell leveraged/inverse investment vehicles. We therefore do not believe that the sales practices rules would conflict with existing broker-dealer or investment adviser obligations, and believe that any overlap or duplication should be limited because a broker-dealer or investment adviser could consider the information it collects in connection with the sales practices rules in connection with the due diligence the broker-dealer or investment adviser conducts in connection with other, existing obligations for recommended transactions.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant economic impact on small entities. We considered the following alternatives for small entities in relation to our proposal: (1) exempting funds, broker-dealers, and registered investment advisers that are small entities from the proposed reporting, recordkeeping, and other compliance requirements, to account for resources available to small entities; (2) establishing different reporting, recordkeeping, and other compliance requirements or frequency, to account for resources available to small entities; (3) clarifying, consolidating, or simplifying the compliance requirements under the proposal for small entities; and (4) using performance rather than design standards.

1. Proposed Rule 18f-4

We do not believe that exempting small funds from the provisions in proposed rule 18f-4 would permit us to achieve our stated objectives. Because proposed rule 18f-4 is an exemptive rule, it would require funds to comply with new requirements only if they wish to enter into derivatives or certain other transactions.[768] Therefore, if a small entity does not enter into derivatives or such other transactions as part of its investment strategy, then the small entity would not be subject to the provisions of proposed rule 18f-4. In addition, a small fund whose derivatives use is limited could benefit from the proposed limited derivatives user exception, because it would not be required to adopt a derivatives risk management program (including all of the proposed program elements).

We estimate that 59% of all funds do not have any exposure to derivatives or such other transactions.[769] This estimate indicates that many funds, including many small funds, would be unaffected by the proposed rule. However, for small funds that would be affected by our proposed rule, providing an exemption for them could subject investors in small funds that invest in derivatives or engage in such other transactions to a higher degree of risk than investors to large funds that would be required to comply with the proposed elements of the rule.

The undue speculation concern expressed in section 1(b)(7) of the Investment Company Act, and the asset sufficiency concern reflected in section 1(b)(8) of the Act—both of which the proposed rule is designed to address—apply to both small as well as large funds. As discussed

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768 *See supra* sections II.D.6 and III.E.

769 *See supra* note 458 and accompanying paragraph.

throughout this release, we believe that the proposed rule would result in investor protection benefits, and these benefits should apply to investors in smaller funds as well as investors in larger funds. We therefore do not believe it would be appropriate to exempt small funds from the proposed rule's program requirement or VaR-based limit on fund leverage risk, or to establish different requirements applicable to funds of different sizes under these provisions to account for resources available to small entities. We believe that all of the proposed elements of rule 18f-4 should work together to produce the anticipated investor protection benefits, and therefore do not believe it is appropriate to except smaller funds because we believe this would limit the benefits to investors in such funds.

We also do not believe that it would be appropriate to subject small funds to different reporting, recordkeeping, and other compliance requirements or frequency. Similar to the concerns discussed above, if the proposal included different requirements for small funds, it could raise investor protection concerns for investors in small funds including subjecting small fund investors to a higher degree of risk if the small fund uses derivatives transactions. We also believe that all fund investors will benefit from enhanced Commission monitoring and oversight of the fund industry, which we anticipate will result from the disclosure and reporting requirements.

We do not believe that clarifying, consolidating, or simplifying the compliance requirements under the proposal for small funds would permit us to achieve our stated objectives. Again, this approach would raise investor protection concerns for investors in small funds using derivatives transactions. However, as discussed above, the proposed rule contains an exception for limited derivatives users that we anticipate would subject funds that qualify for this exception to fewer compliance burdens. We recognize that the risks and potential impact of derivatives transactions on a fund's portfolio generally increase as the fund's level of derivatives usage increases and when funds use derivatives for speculative purposes. Therefore the proposed rule would entail a less significant compliance burden for funds—including small funds—that choose to limit their derivatives usage in the manner that the proposed exception specifies. The proposal, therefore, does include provisions designed to consider the requirement burdens based on the fund's use of derivatives (rather than the size of the fund).

The costs associated with proposed rule 18f-4 would vary depending on the fund's particular circumstances, and thus the proposed rule could result in different burdens on funds' resources. In particular, we expect that a fund that pursues an investment strategy that involves greater derivatives risk may have greater costs associated with its derivatives risk management program. For example, a fund that qualifies as a limited derivatives user under the proposed rule would be exempt from the proposed requirements to adopt and implement a derivatives risk management program, and to adhere to the proposed rule's VaR-based limit on fund leverage risk. The costs of compliance with the proposed rule would vary even for limited derivatives users, as these funds would be required to adopt policies and procedures that are "reasonably designed" to manage their derivatives risks. Thus, to the extent a fund that is a small entity faces relatively little derivatives risk, we believe it would incur relatively low costs to comply with the proposed rule. However, we believe that it is appropriate to correlate the costs associated with the proposed rule with the level of derivatives risk facing a fund, and not necessarily with the fund's size in light of our investor protection objectives.

Finally, with respect to the use of performance rather than design standards, the proposed rule generally uses performance standards for all funds relying on the proposed rule, regardless of size. We believe that providing funds with the flexibility with respect to investment strategies and use of derivatives transactions is appropriate, as well as the derivatives risk management program design. However, the proposed rule also uses design standards with respect to certain requirements such as complying with the VaR-based limit on fund leverage risk and the specified program elements in the derivatives risk management program. For the reasons discussed above, we believe that this use of design standards is appropriate to address investor protection concerns, particularly the concerns expressed in sections 1(b)(7), 1(b)(8), and 18 of the Investment Company Act.

2. Proposed Sales Practices Rules

Similarly, we do not believe that exempting any subset of broker-dealers or registered investment advisers, including those firms that are small entities, from the provisions in the proposed sales practices rules would permit us to achieve our stated investor protection objectives. We also do not believe that it would be desirable to establish different requirements applicable to firms of different sizes under the proposed sales practices rules to account for resources available to small entities, to consolidate or simplify the compliance requirements under the proposal for small entities, or to use performance standards rather than design standards for small entities.

We do not believe exempting small broker-dealers and investment advisers from the proposed sales practices rules would serve the interest of investors. As we discussed above, leveraged/inverse investment vehicles present unique considerations, and the proposed sales practices rules are designed in part to address the investor protection concerns leveraged/inverse funds present.[770] The proposed sales practices rules would permit broker-dealers and investment

[770] *See supra* section II.G.

advisers to accept or place orders to buy or sell shares of a “leveraged/inverse investment vehicle” only for investors that they have approved for those transactions, based on certain required criteria.[771] Exempting smaller broker-dealer and investment adviser firms would create a regulatory gap, whereby larger funds would be required to comply with the proposed sales practices rules’ due diligence requirements to determine whether to approve the account of retail investor to buy or sell shares of a leveraged/inverse investment vehicle, and small entities would not need to conduct this same diligence.

As discussed above, we believe that this limitation on leveraged/inverse investment vehicles’ investor base would help provide that investors in these vehicles understand the characteristics of these vehicles and the unique risks they present.[772] Providing different requirements or simplifying the requirements for small entities would dilute these investor protection benefits for customers or clients of small entities. We do not believe that the investor protection benefits of the proposed sales practices rules should depend on whether an investor is transacting through a small or a large firm. Furthermore, a broker-dealer or investment adviser would have to comply with the applicable proposed rule’s requirements only if it transacts with retail investors in the shares of leveraged/inverse investment vehicles.[773]

Finally, we are not proposing performance standards rather than design standards for

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771 *See* proposed rule 15*l*-2(b).

772 *See supra* section II.G.

773 We estimate that approximately 236 broker-dealers and 43 registered investment advisers are small entities that would be subject to the proposed sales practices rules. *See supra* note 758 and accompanying text.

Broker-dealers and investment advisers that would have to comply with the proposed sales practices rules also might currently have processes in place that would provide efficiencies in complying with the proposed rules. *See supra* note 536 and accompanying text.

smaller entities. We believe that subjecting smaller entities to different standards under the proposed rules could lead to inconsistency in how investors would transact in leveraged/inverse investment vehicles, depending on whether the investor has a relationship with a large or small broker-dealer or investment adviser. This would be inconsistent with the regulatory and investor protections purposes of the proposed rules and could subject investors who interact with small firms to a higher degree of risk than investors who interact with larger firms. It could also circumvent the proposed rules' ability to establish a uniform set of enhanced due diligence and approval requirements for all leveraged/inverse investment vehicle transactions, and to address the investor protection concerns underlying section 18 for leveraged/inverse funds by limiting their investor base.

3. Proposed Amendments to Forms N-PORT, N-LIQUID, and N-CEN

We do not believe that the interests of investors would be served by exempting funds that are small entities from the proposed disclosure and reporting requirements. We believe that the form amendments are necessary to help identify and provide the Commission, staff, investors, and other market participants timely information about funds that comply with proposed rule 18f-4, and to realize the anticipated benefits of the proposed reporting requirements.[774] Exempting small funds from coverage under all or any part of the proposed form amendments could compromise the effectiveness of the required disclosures, which the Commission believes would not be consistent with its goals of industry oversight and investor protection. We believe that all fund investors, including investors in small funds, would benefit from disclosure and reporting requirements that would permit them to make investment choices that better match

[774] *See supra* section III.C.9.

their risk tolerances. We also believe that all fund investors would benefit from enhanced Commission monitoring and oversight of the fund industry, which we anticipate would result from the proposed disclosure and reporting requirements.

For similar reasons, we do not believe that the interests of investors would be served by establishing different reporting, recordkeeping, or other compliance requirements for small funds. We considered providing small funds simplified compliance or disclosure requirements. However, we believe this too would subject investors in small funds that invest in derivatives to a higher degree of risk and information asymmetry than investors to large funds that would be required to comply with the proposed disclosure requirements. We also note that registered open- and closed-end management investment companies, including those that are small entities, have already updated their systems and have established internal processes to prepare, validate, and file reports on Forms N-PORT and N-CEN (or will do so shortly).[775] For funds that will be required to file reports on Form N-RN, the vast majority of them are open-end funds, which already are required to submit the form upon specified events. With respect to the additional registered closed-end funds and BDCs newly required to file reports on Form N-RN, we do not believe they would need more time to comply with the new reporting requirements, given the limited set of reporting requirements they would be subject to and the relatively low burden we estimate of filing reports on Form N-RN.

We also do not believe that the interests of investors would be served by clarifying, consolidating, or simplifying the compliance requirements under the proposal for small funds.

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[775] *See supra* note 359 (discussing, among other things, Form N-PORT compliance dates and noting that the funds that would rely on proposed rule 18f-4 (if adopted) other than BDCs generally are subject to reporting requirements on Form N-CEN); *see also* Investment Report Modernization Adopting Release *supra* note 178, at section II.H.

Small funds are as vulnerable to the same potential risks associated with their derivatives use as larger funds are, and therefore we believe that simplifying or consolidating the proposed reporting requirements for small funds would not allow us to meet our stated objectives. Moreover, we believe many of the proposed disclosure requirements involve minimal burden. For example, the Form N-CEN "checking a box" reporting requirement is completed on an annual basis.

Finally, we did not prescribe performance standards rather than design standards for small funds because we believe this too could diminish the ability of the proposed rules to achieve their intended regulatory purpose by creating inconsistent reporting requirements between small and large funds, and weakening the benefits of the proposed reporting requirement for investors in small funds.

4. Rule 6c-11

Rule 6c-11 is designed to modernize the regulatory framework for ETFs and to create a consistent, transparent, and efficient regulatory framework.[776] The Commission's full Regulatory Flexibility Act Analysis regarding rule 6c-11, including analysis of significant alternatives, appears in the 2019 ETFs Adopting Release and the 2018 ETFs Proposing Release.[777] Our analysis of alternatives for small leveraged/inverse ETFs here is consistent with the Commission's analysis of alternatives for small ETFs in those releases.

We do not believe that permitting or requiring different treatment for any subset of leveraged/inverse ETFs, including small leveraged/inverse ETFs, under the proposed

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[776] *See* ETFs Adopting Release, *supra* note 76, at section I.

[777] *See id.* at section VI; *see also* Exchange-Traded Funds, Investment Company Act Release No. 10515 (June 28, 2018) [83 FR 37332 (July 31, 2018)] ("ETFs Proposing Release"), at section V.

amendments to rule 6c-11, and the rule's related recordkeeping, disclosure and reporting requirements, would permit us to achieve our stated objectives. Similarly, we do not believe that we can establish simplified or consolidated compliance requirements for small leveraged/inverse ETFs under the proposed amendments to rule 6c-11 without compromising our objectives. The Commission discussed the bases for this determination (with respect to ETFs other than leveraged/inverse ETFs) in more detail in the ETFs Proposing Release and the ETFs Adopting Release, and we are extending that analysis to leveraged/inverse ETFs in this Initial Regulatory Flexibility Act Analysis. In addition, we do not believe it would be appropriate to exempt small leveraged/inverse ETFs from the proposed amendments to rule 6c-11 (or to establish different disclosure, reporting, or recordkeeping requirements, or simplified or consolidated compliance requirements under rule 6c-11 for these entities) because of the particular risks that leveraged/inverse ETFs may present.[778] We also do not think it would be appropriate to establish different requirements under rule 6c-11 for small leveraged/inverse ETFs, which could produce a competitive advantage for these funds compared to larger leveraged/inverse ETFs (and compared to other ETFs that rely on the rule). This would conflict with our goals of creating a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs.

G. Request for Comment

The Commission requests comments regarding this analysis. We request comment on the number of small entities that would be subject to our proposal and whether our proposal would have any effects that have not been discussed. We request that commenters describe the nature of

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[778] *See supra* section II.G.1.

any effects on small entities subject to our proposal and provide empirical data to support the nature and extent of such effects. We also request comment on the estimated compliance burdens of our proposal and how they would affect small entities.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), the Commission must advise OMB whether a proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results in or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a “major rule” for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. STATUTORY AUTHORITY

The Commission is proposing new rule 18f-4 under the authority set forth in sections 6(c), 12(a), 18, 31(a), 38(a), and 61 of the Investment Company Act of 1940 [15 U.S.C. 80a-6(c), 80a-12(a), 80a-18, 80a-30(a), 80a-37(a), and 80a-60]. The Commission is proposing amendments to rule 6c-11 under the authority set forth in sections 6(c), 22(c), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 22(c), and 80a-37(a)]. The Commission is proposing new rule 15*l*-2 under the authority set forth in sections 3, 3(b), 3E, 10, 15(l), 15F, 17, 23(a), and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78c, 78c(b), 78c-5, 78j, 78o(l), 78o-10, 78q, 78w(a), and 78mm]. The Commission is proposing new rule 211(h)-1 under the authority set forth in sections 206, 206A, 208, 211(a), and 211(h), and of the Investment Advisers Act of 1940 [15 U.S.C. 80b-6, 80b-6a, 80b-8, 80b-11(a), and 80b-11(h)]. The Commission is proposing amendments to Form N-PORT, Form N-LIQUID (which we propose to re-title as "Form N-RN"), Form N-CEN, and Form N-2 under the authority set forth in sections 8, 18, 30, and 38 of the Investment Company Act of 1940 [15 U.S.C. 80a-8, 80a-18, 80a-29, 80a-37, 80a-63], sections 6, 7(a), 10 and 19(a) of the Securities Act of 1933 [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 10, 13, 15, 23, and 35A of the Exchange Act [15 U.S.C. 78j, 78m, 78o, 78w, and 78ll].

TEXT OF RULES AND FORMS

List of Subjects

17 CFR Parts 240 and 249

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

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PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is amended by adding a subauthority for Section 240.15*l*-2 to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1376 (2010); and Pub. L. 112-106, sec. 503 and 602, 126 Stat. 326 (2012), unless otherwise noted.

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Section 240.15*l*-2 is also issued under Pub. L. 111-203, sec. 913, 124 Stat. 1376, 1827 (2010).

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2. Section 240-15*l*-2 is added to read as follows:

§ 240.15*l*-2 Broker and dealer sales practices for leveraged/inverse investment vehicles.

(a) *Required approval of customer account*. No broker or dealer registered or required to be registered under the Securities Exchange Act of 1934, or any associated person of the broker or dealer, may accept an order from a customer that is a natural person (or the legal representative of a natural person) to buy or sell shares of a leveraged/inverse investment vehicle unless the broker or dealer has approved such a customer's account to engage in those transactions and has adopted and implemented policies and procedures reasonably designed to achieve compliance with this section. Any approval of a customer's account for buying or selling leveraged/inverse investment vehicles must be effected as provided in paragraph (b).

(b) *Diligence in approving accounts*. (1) In determining whether to approve a customer's account to buy or sell leveraged/inverse investment vehicles, the broker or dealer must exercise due diligence to ascertain the essential facts relative to the customer, his or her financial situation, and investment objectives, including, at a minimum, the information specified in paragraph (b)(2) of this section (and must seek to obtain information for all participants in a joint account). Based upon this information, the broker or dealer must specifically approve or disapprove the customer's account for buying and selling shares of leveraged/inverse investment vehicles. An approval of a customer account must be in writing. A broker or dealer may provide this approval if the broker or dealer has a reasonable basis for believing that the customer has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles.

(2) A broker or dealer must seek to obtain the following information at a minimum regarding the customer:

(i) Investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon;

(ii) Employment status (name of employer, self-employed or retired);

(iii) Estimated annual income from all sources;

(iv) Estimated net worth (exclusive of family residence);

(v) Estimated liquid net worth (cash, liquid securities, other);

(vi) Percentage of the customer's estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and

(vii) Investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.

(c) *Recordkeeping*. A broker or dealer must maintain a written record of the information that it obtained under paragraph (b) of this section and, if applicable, its written approval of the customer's account, as well as the versions of the firm's policies and procedures required under paragraph (a) that were in place when it approved or disapproved the customer's account, for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the customer's account.

(d) *Definitions*. For purposes of this section:

Associated person of the broker dealer means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of the Exchange Act (other than paragraph (6) thereof).

Commodity- or Currency-Based Trust or Fund means a trust or other person:

(1) Issuing securities in an offering registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and which class of securities is listed for trading on a national securities exchange;

(2) The assets of which consist primarily of derivative instruments that reference commodities or currencies, or interests in the foregoing; and

(3) That provides in its registration statement under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) that a class of its securities are purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets.

Leveraged/inverse investment vehicle means a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.

(e) *Transition*. This section applies to all customers of the broker or dealer, including customers who have opened accounts with the broker or dealer before the compliance date for this section, provided that this section does not apply to, and therefore will not restrict a customer's ability to close or reduce, a position in a leveraged/inverse investment vehicle that a customer established before the compliance date of this section.

PART 270 - RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

3. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

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Section 270.6c-11 is also issued under 15 U.S.C. 80a-6(c) and 80a-37(a).

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270.6c-11 [Amended]

4. Amend §270.6c-11 by removing paragraph (c)(4).

5. Section 270.18f-4 is added to read as follows:

§ 270.18f-4 Exemption from the requirements of section 18 and section 61 for certain senior securities transactions.

(a) *Definitions*. For purposes of this section:

Absolute VaR test means that the VaR of the fund's portfolio does not exceed 15% of the value of the fund's net assets.

Derivatives exposure means the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short. In determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts.

Derivatives risks means the risks associated with a fund's derivatives transactions or its use of derivatives transactions, including leverage, market, counterparty, liquidity, operational, and legal risks and any other risks the derivatives risk manager (or, in the case of a fund that is a limited derivatives user as described in paragraph (c)(3) of this section, the fund's investment adviser) deems material.

Derivatives risk manager means an officer or officers of the fund's investment adviser responsible for administering the program and policies and procedures required by paragraph (c)(1) of this section, provided that the derivatives risk manager:

(1) May not be a portfolio manager of the fund, or if multiple officers serve as derivatives risk manager, may not have a majority composed of portfolio managers of the fund; and

(2) Must have relevant experience regarding the management of derivatives risk.

Derivatives transaction means:

(1) Any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives 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 margin or settlement payment or otherwise; and

(2) Any short sale borrowing.

Designated reference index means an unleveraged index that: (1) is selected by the derivatives risk manager and that reflects the markets or asset classes in which the fund invests; (2) is not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used; and (3) is an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N-1A [17 CFR 274.11A]. In the case of a blended index, none of the indexes that compose the blended index may be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.

Fund means a registered open-end or closed-end company or a business development company, including any separate series thereof, but does not include a registered open-end company that is regulated as a money market fund under § 270.2a-7.

Relative VaR test means that the VaR of the fund's portfolio does not exceed 150% of the VaR of the designated reference index.

Unfunded commitment agreement means a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.

Value-at-risk or *VaR* means an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level, provided that any VaR model used by a fund for purposes of determining the fund's compliance with the relative VaR test or the absolute VaR test must:

(1) Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable:

(i) Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;

(ii) Material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and

(iii) The sensitivity of the market value of the fund's investments to changes in volatility;

(2) Use a 99% confidence level and a time horizon of 20 trading days; and

(3) Be based on at least three years of historical market data.

(b) *Derivatives transactions*. If a fund satisfies the conditions of paragraph (c) of this section, the fund may enter into derivatives transactions, notwithstanding the requirements of sections 18(a)(1), 18(c), 18(f)(1), and 61 of the Investment Company Act (15 U.S.C. 80a-18(a)(1), 80a-18(c), 80a-18(f)(1), and 80a-60), and derivatives transactions entered into by the fund in compliance with this section will not be considered for purposes of computing asset coverage, as defined in section 18(h) of the Investment Company Act (15 U.S.C. 80a-18(h)).

(c) *Conditions*. (1) *Derivatives risk management program*. The fund adopts and implements a written derivatives risk management program ("program"), which must include policies and procedures that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund. The program must include the following elements:

(i) *Risk identification and assessment*. The program must provide for the identification and assessment of the fund’s derivatives risks. This assessment must take into account the fund’s derivatives transactions and other investments.

(ii) *Risk guidelines*. The program must provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund’s derivatives risks. These guidelines must specify levels of the given criterion, metric, or threshold that the fund does not normally expect to exceed, and measures to be taken if they are exceeded.

(iii) *Stress testing*. The program must provide for stress testing to evaluate potential losses to the fund’s portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund’s portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties. The frequency with which the stress testing under this paragraph is conducted must take into account the fund’s strategy and investments and current market conditions, provided that these stress tests must be conducted no less frequently than weekly.

(iv) *Backtesting*. The program must provide for backtesting of the results of the VaR calculation model used by the fund in connection with the relative VaR test or the absolute VaR test by, each business day, comparing the fund’s gain or loss with the corresponding VaR calculation for that day, estimated over a one-trading day time horizon, and identifying as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation’s estimated loss.

(v) *Internal reporting and escalation*. (A) *Internal reporting*. The program must identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the program, including exceedances of the guidelines specified in paragraph (c)(1)(ii) of this section and the results of the stress tests specified in paragraph (c)(1)(iii) of this section.

(B) *Escalation of material risks*. The derivatives risk manager must inform in a timely manner persons responsible for portfolio management of the fund, and also directly inform the fund's board of directors as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified by the fund's exceedance of a criterion, metric, or threshold provided for in the fund's risk guidelines established under paragraph (c)(1)(ii) of this section or by the stress testing described in paragraph (c)(1)(iii) of this section.

(vi) *Periodic review of the program*. The derivatives risk manager must review the program at least annually to evaluate the program's effectiveness and to reflect changes in risk over time. The periodic review must include a review of the VaR calculation model used by the fund under paragraph (c)(2) of this section (including the backtesting required by paragraph (c)(1)(iv) of this section) and any designated reference index to evaluate whether it remains appropriate.

(2) *Limit on fund leverage risk*. (i) The fund must comply with the relative VaR test or, if the derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy, the absolute VaR test.

(ii) The fund must determine its compliance with the applicable VaR test at least once each business day. If the fund determines that it is not in compliance with the applicable VaR test, the fund must come back into compliance promptly and within no more than three business days after such determination.

(iii) If the fund is not in compliance with the applicable VaR test within three business days:

(A) The derivatives risk manager must report to the fund's board of directors and explain how and by when (*i.e.*, number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance;

(B) The derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than three business days and update any program elements as appropriate to address those circumstances; and

(C) The fund may not enter into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance with the applicable VaR test for three consecutive business days and has satisfied the requirements set forth in paragraphs (c)(2)(iii)(A) and (B) of this section.

(iv) If the fund is complying with the relative VaR test, an open-end fund must disclose in its annual report the fund's designated reference index as the fund's "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N-1A [17 CFR 274.11A], and a registered closed-end fund or business development company must disclose its designated reference index in the annual report, together with a presentation of the fund's performance relative to the designated reference index. A fund is not required to include this disclosure in an annual report if the fund is a "New Fund," as defined in Form N-1A [17 CFR 274.11A], or would meet that definition if it were filing on Form N-1A [17 CFR 274.11A], at the time the fund files the annual report.

(3) *Limited derivatives users*. A fund is not required to adopt a program as prescribed in paragraph (c)(1) of this section, or comply with the limit on fund leverage risk in paragraph (c)(2) of this section, if the fund adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks and:

(i) The fund's derivatives exposure does not exceed 10 percent of the fund's net assets; or

(ii) The fund limits its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held by the fund, provided that the currency derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount.

(4) *Leveraged/inverse funds*. A fund is not required to comply with the limit on fund leverage risk in paragraph (c)(2) of this section if:

(i) The fund is a leveraged/inverse investment vehicle as defined in § 240.15*l*-2 and § 275.211(h)-1;

(ii) The fund discloses in its prospectus that it is not subject to the limit on fund leverage risk in paragraph (c)(2) of this section; and

(iii) The fund does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index.

(5) *Board oversight and reporting*. (i) *Approval of the derivatives risk manager*. A fund's board of directors, including a majority of directors who are not interested persons of the

fund, must approve the designation of the derivatives risk manager, taking into account the derivatives risk manager's relevant experience regarding the management of derivatives risk.

(ii) *Reporting on program implementation and effectiveness*. On or before the implementation of the program, and at least annually thereafter, the derivatives risk manager must provide to the board of directors a written report providing a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the elements provided in paragraphs (c)(1)(i) through (vi) of this section. The representation may be based on the derivatives risk manager's reasonable belief after due inquiry. The written report must include the basis for the representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program and, for reports following the program's initial implementation, the effectiveness of its implementation. The written report also must include the derivatives risk manager's basis for the selection of the designated reference index or, if applicable, an explanation of why the derivatives risk manager was unable to identify a designated reference index appropriate for the fund.

(iii) *Regular board reporting*. The derivatives risk manager must provide to the board of directors, at a frequency determined by the board, a written report regarding the derivatives risk manager's analysis of any exceedances described in paragraph (c)(1)(ii) of this section, the results of the stress testing conducted under paragraph (c)(1)(iii) of this section, and the results of the backtesting conducted under paragraph (c)(1)(iv) of this section since the last report to the board. Each report under this paragraph must include such information as may be reasonably necessary for the board of directors to evaluate the fund's response to any exceedances and the results of the fund's stress testing.

(6) *Recordkeeping*. (i) *Records to be maintained*. A fund must maintain a written record documenting, as applicable:

(A) The fund's written policies and procedures required by paragraph (c)(1) of this section, along with:

(1) The results of the fund's stress tests under paragraph (c)(1)(iii) of this section;

(2) The results of the backtesting conducted under paragraph (c)(1)(iv) of this section;

(3) Records documenting any internal reporting or escalation of material risks under paragraph (c)(1)(v)(B) of this section; and

(4) Records documenting the reviews conducted under paragraph (c)(1)(vi) of this section.

(B) Copies of any materials provided to the board of directors in connection with its approval of the designation of the derivatives risk manager, any written reports provided to the board of directors relating to the program, and any written reports provided to the board of directors under paragraph (c)(2)(iii)(A) of this section.

(C) Any determination and/or action the fund made under paragraphs (c)(2)(i)-(ii) of this section, including a fund's determination of: the VaR of its portfolio; the VaR of the fund's designated reference index, as applicable; the fund's VaR ratio (the value of the VaR of the Fund's portfolio divided by the VaR of the designated reference index), as applicable; and any updates to any VaR calculation models used by the fund and the basis for any material changes thereto.

(D) If applicable, the fund's written policies and procedures required by paragraph (c)(3) of this section.

(ii) *Retention periods*. (A) A fund must maintain a copy of the written policies and procedures that the fund adopted under paragraphs (c)(1) or (c)(3) of this section that are in effect, or at any time within the past five years were in effect, in an easily accessible place.

(B) A fund must maintain all records and materials that paragraphs (c)(6)(i)(A)*(1)-(4)* and (c)(6)(i)(B)-(D) of this section describe for a period of not less than five years (the first two years in an easily accessible place) following each determination, action, or review that these paragraphs describe.

(7) *Current reports*. A fund that experiences an event specified in the parts of Form N-RN [referenced in 17 CFR 274.223] titled "Relative VaR Test Breaches," "Absolute VaR Test Breaches," or "Compliance with VaR Test" must file with the Commission a report on Form N-RN within the period and according to the instructions specified in that form.

(d) *Reverse repurchase agreements*. A fund may enter into reverse repurchase agreements or similar financing transactions, notwithstanding the requirements of sections 18(c), and 18(f)(1) of the Investment Company Act, if the fund complies with the asset coverage requirements of section 18 and combines the aggregate amount of indebtedness associated with the reverse repurchase agreement or similar financing transaction with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.

(e) *Unfunded commitment agreements*.(1) A fund may enter into an unfunded commitment agreement, notwithstanding the requirements of sections 18(a), 18(c), 18(f)(1), and 61 of the Investment Company Act, if the fund reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due. In forming a reasonable belief, the fund must take into account its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions), and may not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments, or from issuing additional equity. Unfunded commitment agreements entered into by the fund in compliance with this section will not be considered for purposes of computing asset coverage, as defined in section 18(h) of the Investment Company Act (15 U.S.C. 80a-18(h)).

(2) For each unfunded commitment agreement that a fund enters into under paragraph (e)(1) of this section, a fund must document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its unfunded commitment agreement obligations, and maintain a record of this documentation for a period of not less than five years (the first two years in an easily accessible place) following the date that the fund entered into the agreement.

6. Revise §270.30b1-10 to read as follows:

§270.30b1-10 Current report for open-end and closed-end management investment companies.

Every registered open-end management investment company, or series thereof, and every registered closed-end management investment company, but not a fund that is regulated as a money market fund under §270.2a-7, that experiences an event specified on Form N-RN, must file with the Commission a current report on Form N-RN within the period and according to the instructions specified in that form.

PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

7. The general authority for part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

8. Amend Form N-2 (referenced in §§ 239.14 and 274.11a-1) by revising instruction 2. to sub-item "3. *Senior Securities*" of "Item 4. Financial Highlights" to read as follows:

Note: The text of Form N-2 does not, and this amendment will not, appear in the *Code of Federal Regulations*.

Form N-2

* * * * *

Item 4. Financial Highlights

* * * * *

3. *Senior Securities*

* * * * *

Instructions

* * * * *

2. Use the method described in section 18(h) of the 1940 Act [15 U.S.C. 80a-18(h)] to calculate the asset coverage to be set forth in column (3). However, in lieu of expressing asset coverage in terms of a ratio, as described in section 18(h), express it for each class of senior securities in terms of dollar amounts per share (in the case of preferred stock) or per $1,000 of indebtedness

(in the case of senior indebtedness). A fund should not consider any derivatives transactions, or any unfunded commitment agreements, that it enters into in compliance with rule 18f-4 under the Investment Company Act [17 CFR 270.18f-4] for purposes of computing asset coverage.

* * * * *

9. Amend Form N-CEN (referenced in §§249.330 and 274.101) by adding new Item C.7.l. to read as follows:

Note: The text of Form N-CEN does not, and this amendment will not, appear in the *Code of Federal Regulations*.

FORM N-CEN

ANNUAL REPORT FOR REGISTERED INVESTMENT COMPANIES

* * * * *

Item C.7. * * *

l. Rule 18f-4 (17 CFR 270.18f-4): _____
   i. Is the Fund excepted from the rule 18f-4 (17 CFR 270.18f-4) program requirement under rule 18f-4(c)(3)(i) (17 CFR 270.18f-4(c)(3)(i))? _____
   ii. Is the Fund excepted from the rule 18f-4 (17 CFR 270.18f-4) program requirement under rule 18f-4(c)(3)(ii) (17 CFR 270.18f-4(c)(3)(ii))? _____
   iii. Is the Fund a leveraged/inverse fund covered by rule 15l-2 under the Exchange Act (17 CFR 240.15l-2) or rule 211(h)-1 under the Investment Advisers Act of 1940 (17 CFR 275.211(h)-1) that, under rule 18f-4(c)(4) (17 CFR 270.18f-4(c)(4)), is excepted from the requirement to comply with the limit on leverage risk described in rule 18f-4(c)(2) (17 CFR 270.18f-4(c)(2))? ____
   iv. Has the Fund entered into any reverse repurchase agreements or similar financing transactions under rule 18f-4(d) (17 CFR 270.18f-4(d))? ____
   v. Has the Fund entered into any unfunded commitment agreements under rule 18f-4(e) (17 CFR 270.18f-4(e))? ____

* * * * *

10. Amend Form N-PORT (referenced in §274.150) by:

a. Adding to General Instruction E. "Definitions" in alphabetical order, the following definitions:
   i. "Absolute VaR Test";
   ii. "Designated Reference Index";
   iii. "Derivatives Exposure";
   iv. "Relative VaR Test";
   v. "Value-at-risk";
   vi. "VaR Ratio"; and
b. Adding Items B.9 and B.10.

The additions read as follows:

Note: The text of Form N-PORT does not, and this amendment will not, appear in the *Code of Federal Regulations*.

Form N-PORT

MONTHLY PORTFOLIO INVESTMENTS REPORT

* * * * *

GENERAL INSTRUCTIONS

* * * * *

E. Definitions

* * * * *

"Absolute VaR Test" has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

* * * * *

"Derivatives Exposure" has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

* * * * *

"Designated Reference Index" has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

* * * * *

"Relative VaR Test" has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

* * * * *

"Value-at-risk" or VaR has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

* * * * *

"VaR Ratio" means the value of the Fund's portfolio VaR divided by the VaR of the Designated Reference Index.

* * * * *

PART B. * * *

Item B.9 Derivatives Exposure. Report as a percentage of the Fund's net asset value:

a. Derivatives Exposure.

   i. Exposure from derivatives instruments.

   ii. Exposure from short sales.

Item B.10 VaR Information. For Funds subject to the limit on fund leverage risk in rule 18f-4(c)(2) [17 CFR 270.18f-4(c)(2)], provide the following information, as determined in accordance with the requirement under rule 18f-4(c)(2)(ii) to determine the fund's compliance with the applicable VaR test at least once each business day:

a. Highest daily VaR during the reporting period.

b. Date of highest daily VaR during the reporting period.

c. Median daily VaR during the reporting period.

d. For Funds that were subject to the Relative VaR Test during the reporting period, provide:

   i. Name of the Fund's Designated Reference Index.

   ii. Index Identifier for the Fund's Designated Reference Index.

   iii. Highest VaR Ratio during the reporting period.

   iv. Date of highest VaR Ratio during the reporting period.

   v. Median VaR Ratio during the reporting period.

e. Backtesting Results. Number of exceptions that the Fund identified as a result of its backtesting of its VaR calculation model (as described in rule 18f-4(c)(1)(iv) [17 CFR 270.18f-4(c)(1)(iv)] during the reporting period.

* * * * *

11. Revise §274.223, its sectional heading, and Form N-LIQUID (referenced in §274.223) and its title to read as follows:

§274.223 Form N-RN, Current report, open- and closed-end investment company reporting.

This form shall be used by registered open-end management investment companies, or series thereof, and closed-end management investment companies, or series thereof, to file reports pursuant to §270.18f-4(c)(7) and §270.30b1-10 of this chapter.

Note: The text of Form N-RN does not, and this amendment will not, appear in the *Code of Federal Regulations*.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM N-RN
CURRENT REPORT FOR REGISTERED MANAGEMENT INVESTMENT COMPANIES AND BUSINESS DEVELOPMENT COMPANIES

Form N-RN is to be used by a registered open-end management investment company or series thereof, but not including a fund that is regulated as a money market fund under rule 2a-7 under the Act (17 CFR 270.2A-7) (a “registered open-end fund”), a registered closed-end management investment company (a “registered closed-end fund”), or a closed-end management investment company that has elected to be regulated as a business development company (a “business development company”), to file current reports with the Commission pursuant to rule 18f-4 and rule 30b1-10 under the Investment Company of 1940 Act [15 U.S.C. 80a] (“Act”) (17 CFR 270.18f-4; 17 CFR 270.30b1-10). The Commission may use the information provided on Form N-RN in its regulatory, disclosure review, inspection, and policymaking roles.

GENERAL INSTRUCTIONS

A. Rules as to Use of Form N-RN.

(1) Form N-RN is the reporting form that is to be used for current reports of registered open-end funds (not including funds that are regulated as money market funds under rule 2a-7 under the Act), registered closed-end funds, and business development companies (together, “registrants”) required by, as applicable, section 30(b) of the Act and rule 30b1-10 under the Act, as well as rule 18f-4 under the Act. The Commission does not intend to make public information reported on Form N-RN that is identifiable to any particular registrant, although the Commission may use Form N-RN information in an enforcement action.

(2) Unless otherwise specified, a report on this Form N-RN is required to be filed, as applicable, within one business day of the occurrence of the event specified in Parts B – G of this form. If the event occurs on a Saturday, Sunday, or holiday on which the Commission is not open for business, then the one business day period shall begin to run on, and include, the first business day thereafter.

(3) For registered open-end funds required to comply with rule 22e-4 under the Investment Company Act [17 CFR 270.22e-4], complete Parts B – D of this form, as applicable. For registrants that rely on rule 18f-4 of the Act [17 CFR 270.18f-4], complete Parts E – G of this form, as applicable.

B. Application of General Rules and Regulations

The General Rules and Regulations under the Act contain certain general requirements that are applicable to reporting on any form under the Act. These general requirements should be carefully read and observed in the preparation and filing of reports on this form, except that any provision in the form or in these instructions shall be controlling.

C. Information to Be Included in Report Filed on Form N-RN

Upon the occurrence of the event specified in Parts B – G of Form N-RN, as applicable, a registrant must file a report on Form N-RN that includes information in response to each of the items in Part A of the form, as well as each of the items in the applicable Parts B – G of the Form.

D. Filing of Form N-RN

A registrant must file Form N-RN in accordance with rule 232.13 of Regulation S-T (17 CFR Part 232). Form N-RN must be filed electronically using the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR").

E. Paperwork Reduction Act Information

A registrant is not required to respond to the collection of information contained in Form N-RN unless the form displays a currently valid Office of Management and Budget ("OMB") control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. 3507.

F. Definitions

(1) References to sections and rules in this Form N-RN are to the Investment Company Act (15 U.S.C 80a), unless otherwise indicated. Terms used in this Form N-RN have the same meaning as in the Investment Company Act, rule 22e-4 under the Investment Company Act (for Parts B-D of the Form), or rule 18f-4 under the Investment Company Act (for Part E – G of the Form), unless otherwise indicated. In addition, as used in this Form N-RN, the term registrant means the registrant or a separate series of the registrant, as applicable.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM N-RN
CURRENT REPORT FOR REGISTERED MANAGEMENT INVESTMENT COMPANIES AND BUSINESS DEVELOPMENT COMPANIES

PART A. General Information

Item A.1. Report for [mm/dd/yyyy].

Item A.2. CIK Number of registrant.

Item A.3. EDGAR Series Identifier.

Item A.4. Securities Act File Number, if applicable.

Item A.5. Provide the name, e-mail address, and telephone number of the person authorized to receive information and respond to questions about this Form N-RN.

PART B. Above 15% Illiquid Investments

If more than 15 percent of the registrant's net assets are, or become, illiquid investments that are assets as defined in rule 22e-4, then report the following information:

Item B.1. Date(s) on which the registrant's illiquid investments that are assets exceeded 15 percent of its net assets.

Item B.2. The current percentage of the registrant's net assets that are illiquid investments that are assets.

Item B.3. Identification of illiquid investments. For each investment that is an asset that is held by the registrant that is considered illiquid, disclose (1) the name of the issuer, the title of the issue or description of the investment, the CUSIP (if any), and at least one other identifier, if available (*e.g.*, ISIN, Ticker, or other unique identifier (if ticker and ISIN are not available)) (indicate the type of identifier used), and (2) the percentage of the fund's net assets attributable to that investment.

PART C. At or Below 15% Illiquid Investments

If a registrant that has filed Part B of Form N-RN determines that its holdings in illiquid investments that are assets have changed to be less than or equal to 15 percent of the registrant's net assets, then report the following information:

Item C.1. Date(s) on which the registrant's illiquid investments that are assets fell to or below 15 percent of net assets.

Item C.2. The current percentage of the registrant's net assets that are illiquid investments that are assets.

PART D. Assets that are Highly Liquid Investments Below the Highly Liquid Investment Minimum

If a registrant's holdings in assets that are highly liquid investments fall below its highly liquid investment minimum for more than 7 consecutive calendar days, then report the following information:

Item D.1. Date(s) on which the registrant's holdings of assets that are highly liquid investments fell below the fund's highly liquid investment minimum.

PART E. Relative VaR Test Breaches

If a registrant is subject to the relative VaR test under rule 18f-4(c)(2)(i) [17 CFR 270.18f-4(c)(2)(i)], and the fund determines that it is not in compliance with the relative VaR test and has not come back into compliance within 3 business days after such determination, provide:

Item E.1. The dates on which the VaR of the registrant's portfolio exceeded 150% of the VaR of its designated reference index.

Item E.2. The VaR of the registrant's portfolio on the dates each exceedance occurred.

Item E.3. The VaR of the registrant's designated reference index on the dates each exceedance occurred.

Item E.4. The name of the registrant's designated reference index.

Item E.5. The index identifier for the registrant's designated reference index.

PART F. Absolute VaR Test Breaches

If a registrant is subject to the absolute VaR test under rule 18f-4(c)(2)(i) [17 CFR 270.18f-4(c)(2)(i)], and the fund determines that it is not in compliance with the absolute VaR test and has not come back into compliance within 3 business days after such determination, provide:

Item F.1. The dates on which the VaR of the registrant's portfolio exceeded 15% of the value of the registrant's net assets.

Item F.2. The VaR of the registrant's portfolio on the dates each exceedance occurred.

Item F.3. The value of the registrant's net assets on the dates each exceedance occurred.

PART G. Compliance with VaR Test

If a registrant that has filed Part E or Part F of Form N-RN has come back into compliance with either the relative VaR test or the absolute VaR test, as applicable, then report the following information:

Item G.1. Dates on which the VaR of the registrant's portfolio exceeded, as applicable, 150% of the VaR of its designated reference index (if the registrant is subject to the relative VaR test under rule 18f-4(c)(2)(i) [17 CFR 270.18f-4(c)(2)(i)]) or 15% of the value of the registrant's net assets (if the registrant is subject to the absolute VaR test under rule 18f-4(c)(2)(i) [17 CFR 270.18f-4(c)(2)(i)]).

Item G.2. The current VaR of the registrant's portfolio.

PART H. Explanatory Notes (if any)

A registrant may provide any information it believes would be helpful in understanding the information reported in response to any Item of this Form.

SIGNATURES

Pursuant to the requirements of the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

____
(Registrant)

Date ______________________________

____
(Signature)*

*Print name and title of the signing officer under his/her signature.

* * * * *

PART 275 - RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

12. The authority citation for part 275 continues to read, in part, and the subauthority for Section 275.211h-1 is added to read as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

* * * * *

Section 275.211(h)-1 is also issued under sec. 913, Pub. L. 111-203, 124 Stat. 1827-28 (2010).

* * * * *

13. Section 275.211(h)-1 is added to read as follows:

§ 275.211(h)-1 Investment adviser sales practices for leveraged/inverse investment vehicles.

(a) *Required approval of client account*. No investment adviser registered or required to be registered under the Advisers Act, or any supervised person of the investment adviser, may place an order for the account of an advisory client that is a natural person (or the legal representative of a natural person) to buy or sell shares of a leveraged/inverse investment vehicle unless the investment adviser has approved such a client's account to engage in those transactions and has adopted and implemented policies and procedures reasonably designed to achieve compliance with this section. Any approval of a client's account for buying or selling leveraged/inverse investment vehicles must be effected as provided in paragraph (b).

(b) *Diligence in approving accounts*. (1) In determining whether to approve a client's account to buy or sell leveraged/inverse investment vehicles, the investment adviser must exercise due diligence to ascertain the essential facts relative to the client, his or her financial situation, and investment objectives, including, at a minimum, the information specified in paragraph (b)(2) of this section (and must seek to obtain information for all participants in a joint account). Based upon this information, the investment adviser must specifically approve or disapprove the client's account for buying and selling shares of leveraged/inverse investment vehicles. An approval of a client account must be in writing. An investment adviser may provide this approval if the investment adviser has a reasonable basis for believing that the client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles.

(2) An investment adviser must seek to obtain the following information at a minimum regarding the client:

(i) Investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon;

(ii) Employment status (name of employer, self-employed or retired);

(iii) Estimated annual income from all sources;

(iv) Estimated net worth (exclusive of family residence);

(v) Estimated liquid net worth (cash, liquid securities, other);

(vi) Percentage of the client's estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and

(vii) Investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.

(c) *Recordkeeping*. An investment adviser must maintain a written record of the information that it obtained under paragraph (b) of this section and, if applicable, its written approval of the client's account, as well as the versions of the firm's policies and procedures required under paragraph (a) that were in place when it approved or disapproved the client's account, for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the client's account.

(d) *Definitions*. For purposes of this section:

Commodity- or currency-based trust or fund means a trust or other person:

(1) Issuing securities in an offering registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and which class of securities is listed for trading on a national securities exchange;

(2) The assets of which consist primarily of derivative instruments that reference commodities or currencies, or interests in the foregoing; and

(3) That provides in its registration statement under the Securities Act of 1933 (15 U.S.C. 77a et seq.) that a class of its securities are purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets.

Leveraged/inverse investment vehicle means a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.

Supervised person means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser.

(e) *Transition*. This section applies to all clients of the investment adviser, including clients who have opened accounts with the investment adviser before the compliance date for this section, provided that this section does not apply to, and therefore will not restrict the ability to close or reduce, a client's position in a leveraged/inverse investment vehicle that a client established before the compliance date of this section.

By the Commission.

Dated: November 25, 2019

Eduardo A. Aleman
Deputy Secretary

VIII. APPENDIX A

Note: Appendix A will not appear in the Code of Federal Regulations.

Feedback Flier: Funds' Use of Derivatives

We are proposing a new regulatory approach for funds' use of derivatives. This includes proposed rule 18f-4 under the Investment Company Act of 1940, a new exemptive rule designed to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives. The proposal also includes certain new proposed reporting requirements relating to funds' derivatives use. More information about our proposal is available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

We are particularly interested in learning what small funds think about the requirements of proposed new rule 18f-4 and the proposed new reporting requirements. Hearing from small funds could help us learn how the proposed rule and new reporting requirements would affect these entities, and evaluate how we could address any unintended consequences resulting from the cost and effort of regulatory compliance while still promoting investor protection. We would appreciate your feedback on any or all of the following questions.

All of the following questions are optional, including any questions that ask about identifying information. ***Please note that responses to these questions – including any other general identifying information you provide – will be made public.***

Item 1: General Identifying Information

Instructions: At your option, you may include general identifying information that would help us contextualize your other feedback on the proposal. This information could include responses to the following questions, as well as any other general identifying information you would like to provide. Responses to these items—like responses to the other items on this Feedback Flier—will be made public.

a. How big is the fund in terms of net asset value? (This may be expressed in a range, for example, $40 million - $50 million.)

b. What is/are the principal investment strategy/strategies of the fund?

c. Does the fund use derivatives transactions (as defined in the proposed rule) to pursue the fund's principal investment strategy/strategies? [Y/N]

d. Is the fund part of a fund complex? [Y/N]

e. Please include any additional general identifying information that you wish to provide, that could add context for your other feedback on the proposal.

Item 2: Derivatives Risk Management Program

<u>Instructions</u>: If you believe the fund would be required to adopt and implement a derivatives risk management program under the proposed rules, please answer the following questions. If you do not believe so, please proceed to Item 4.

a. The proposed derivatives risk management program requirement would include the following seven elements. In the following chart, please indicate which of the proposed program elements you think would be the most expensive for the fund to implement and which would be least expensive to implement, by ranking the following elements from one (1) – most expensive – through seven (7) – least expensive – using each number only once. If you have any comments about the factors informing your analysis, please include.

Derivatives Risk Management Program Elements		Rank by Cost (1 – most expensive; 7 – least expensive) Use each number once	Comments
a)	Risk identification and assessment		
b)	Risk guidelines		
c)	Stress testing		
d)	Backtesting		
e)	Internal reporting and escalation		
f)	Periodic review of the program		
g)	Board reporting and oversight		

b. Implementation timing.

1.) How many months do you think it would take the fund to adopt and implement a derivatives risk management program (check one box)?

6 months – 12 months	12 months – 18 months	18 months – 24 months	> 24 months
[ ]	[ ]	[ ]	[ ]

2.) If the response above is more than 12 months, what would help to shorten that time period?

3.) Please provide any explanatory notes that you would like to include.

c. Implementation cost.

1.) Approximately how much do you think it would cost the fund to implement a derivatives risk management program (in terms of combined internal and external costs) (check one box)?

Estimated cost ($)			
$0 - $150,000	$150,001 - $350,000	$350,001 - $500,000	> $500,000
[ ]	[ ]	[ ]	[ ]

2.) Please include any explanatory notes that you would like to provide. These could describe, for example, how a fund that is part of a fund complex might share these costs, any particular cost considerations for a fund that uses sub-advisers, or the extent to which the estimated costs would arise from internal versus external costs (such as those associated with third-party service providers).

d. To the extent that the fund is a sub-advised fund, would any of the proposed program elements present any particular challenges for the fund to implement in light of its advisory structure? If so please explain.

Item 3: Limit on Fund Leverage Risk

Instructions: The proposed rule would require certain funds to comply with a limit on fund leverage risk based on value at risk ("VaR"). The following questions relate to this proposed requirement.

a. Does the fund currently use VaR testing? [Y/N]

b. Implementation cost.

1.) If you anticipate that, if the proposed rules were adopted, the fund would have to comply with the VaR testing requirement, approximately how much do you think it would cost the fund to implement the proposed VaR test requirements (in terms of combined internal and external costs) (check one box)?

Estimated cost ($)			
$0 - $25,000	$25,001 - $50,000	$50,001 - $75,000	> $75,000

[ ]	[ ]	[ ]	[ ]

2.) Please include any explanatory notes that you would like to provide. These could describe, for example, how a fund that is part of a fund complex might share these costs, any particular cost considerations for a fund that uses sub-advisers, or the extent to which the estimated costs would arise from internal versus external costs (such as those associated with third-party service providers).

c. Use of relative VaR test and absolute VaR test.

1.) Would the fund anticipate that it would use the proposed relative VaR test or the proposed absolute VaR test (check one box)?

Relative VaR test	Absolute VaR test
[ ]	[ ]

2.) If you anticipate that you would use the proposed relative VaR test, and you already disclose a benchmark index for performance disclosure, do you anticipate that the index would also qualify as a designated reference index under the proposed rule? [Y/N]

d. To the extent that the fund is a sub-advised fund, would the proposed limit on fund leverage risk present any particular challenges for the fund to implement in light of its advisory structure? If so please explain.

Item 4: Limited Derivatives Users

Instructions: If you believe the fund would qualify as a limited derivatives user under the proposed rule, please answer the following questions. If you do not believe so, please proceed to question 5.

a. Please state which basis for the proposed limited derivatives user exception you think the fund would seek to rely on (check one box):

Exposure-based test (The fund's derivatives exposure does not exceed 10% of the fund's net asset value)	**Currency hedging exception** (The fund only uses derivatives for currency hedging purposes as specified in the proposed rule)
[ ]	[ ]

b. Should the rule include any other bases for a fund to qualify as a limited derivatives user? What alternative approach and why?

c. Implementation cost.

1.) Approximately how much do you think it would cost the fund to adopt and implement policies and procedures reasonably designed to manage its derivatives risks (in terms of combined internal and external costs) (check one box)?

Estimated cost ($)				
$0 - $25,000	$25,001 - $50,000	$50,001 - $75,000	$75,001 - $100,000	> $100,000
[ ]	[ ]	[ ]	[ ]	[ ]

2.) Please include any explanatory notes that you would like to provide.

Item 5: Recordkeeping

a. Approximately how much would it cost the fund to comply with the proposed recordkeeping requirements associated with rule 18f-4 (in terms of combined internal and external costs)?

b. Should we modify any of the proposed recordkeeping requirements, and if so, how?

Item 6: Reporting Requirements

a. Approximately how much would it cost the fund to comply with the proposed new requirements for reporting on Form N-PORT, Form N-CEN, and Form N-RN (in terms of combined internal and external costs)?

b. Should we modify any of the proposed reporting requirements, and if so, how?

Item 7: Other Feedback on Proposed Rule 18f-4 and Proposed New Reporting Requirements

Instructions: Please include any other additional suggestions or comments about proposed rule 18f-4, and/or the proposed new reporting requirements, that you would like to provide.

We will post your feedback on our website. Your submission will be posted without change; we do not redact or edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly.

If you are interested in more information on the proposal, or want to provide feedback on additional questions, click here. Comments should be received on or before [insert date 60 days after publication in the Federal Register].

Thank You!

Other Ways to Submit Your Feedback

You also can send us feedback in the following ways (include the file number S7-24-15 in your response):

Print Your Responses and Mail

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Print a PDF of Your Responses and Email
Use the printer friendly page and select a PDF printer to create a file you can email to: rule-comments@sec.gov

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Print a Blank Copy of This Flier, Fill it Out, and Mail
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

IX. APPENDIX B

Note: Appendix B will not appear in the Code of Federal Regulations.

Feedback Flier: Sales Practices Rules for Transacting in Shares of Leveraged/Inverse Investment Vehicles

We are proposing two new sales practices rules—rule 15*l*-2 under the Securities Exchange Act of 1934, and Rule 211(h)-1 under the Investment Advisers Act of 1940—that would require a broker, dealer, or registered investment adviser to exercise due diligence in approving a retail customer's or client's account to buy or sell shares of certain "leveraged/inverse investment vehicles." More information about our proposal is available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

We are particularly interested in learning what small broker-dealers and investment advisers think about the proposed new sales practices rules' requirements. Hearing from these smaller firms could help us learn how our proposed rules would affect them, and evaluate how we could address any unintended consequences resulting from the cost and effort of regulatory compliance while still promoting investor protection. We would appreciate your feedback on any or all of the following questions.

All of the following questions are optional, including any questions that ask about identifying information. ***Please note that responses to these questions – including any other general identifying information you provide – will be made public.***

Item 1: General Identifying Information

Instructions: At your option, you may include general identifying information that would help us contextualize your other feedback on the proposal. This information could include responses to the following questions, as well as any other general identifying information you would like to provide. Responses to these items—like responses to the other items on this Feedback Flier—will be made public.

a. Is the firm a Commission-registered investment adviser or a broker-dealer?

b. What is the size of the firm in terms of:
   1.) The number of retail investors (as defined in the release)?
   2.) For Investment Advisers, regulatory assets under management?
   3.) For broker-dealers, regulatory net capital?
   4.) Other (please specify)?

c. Please include any additional general identifying information that you wish to provide, that could add context to your other feedback on the proposal.

d. Does the firm accept orders from or place orders for the accounts of retail investors to buy or sell shares of leveraged/inverse investment vehicles (as defined in the proposed sales practices rules)?

Item 2: Cost to Comply with the Proposed Due Diligence and Account Approval Requirements

a. What do you expect the cost to your firm would be in order to comply with these proposed requirements (in terms of combined internal and external costs)?
   1.) For an investment adviser (check one box):

Estimated cost ($)		
$0 - $5,000	$5,001 - $10,000	> $10,000
[ ]	[ ]	[ ]

   2.) For a broker-dealer (check one box):

Estimated cost ($)		
$0 - $25,000	$25,001 - $50,000	> $50,000
[ ]	[ ]	[ ]

b. Are there any less expensive alternatives to the proposed requirements you can suggest that would still preserve the proposed rules' intended investor protection safeguards?

Item 3: Other Feedback on Proposed Sales Practices Rules

Instructions: Please include any other additional suggestions or comments about the proposed sales practices rules that you would like to provide.

We will post your feedback on our website. Your submission will be posted without change; we do not redact or edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly.

If you are interested in more information on the proposal, or want to provide feedback on additional questions, click here. Comments should be received on or before [insert date 60 days after publication in the Federal Register].

Thank You!

Other Ways to Submit Your Feedback

You also can send us feedback in the following ways (include the file number S7-24-15 in your response):

Print Your Responses and Mail
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Print a PDF of Your Responses and Email
Use the printer friendly page and select a PDF printer to create a file you can email to: rule-comments@sec.gov

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Print a Blank Copy of This Flier, Fill it Out, and Mail
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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