2016 INVESTMENT MANAGEMENT CONFERENCE

SEC Derivatives Rule

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SUMMARY OF PROPOSED RULE 18F-4

- The rule would replace the existing asset segregation regime developed over the last 35+ years
- The rule would limit the way mutual funds, closed-end funds, and ETFs use derivatives and establish required risk management measures
  - Portfolio limitations
  - Asset segregation
  - Risk management program
  - Disclosure and reporting

PORTFOLIO LIMITATIONS

- A fund must comply with one of two portfolio limitations, designed to limit leverage the fund may obtain through derivatives and financial commitment transactions
  - *Exposure-based portfolio limit*
    - Aggregate exposure cannot exceed 150% of net assets
    - Exposure is the sum of the aggregate notional amount of derivative transactions, financial commitment transactions, and other senior security transactions
  - *Risk-based portfolio limit*
    - Aggregate exposure is limited to 300% of net assets *if* the fund can satisfy a risk-based test
    - The VaR-based test is intended to determine if the *aggregate* effect of derivatives transactions decreases the market risk of the fund's portfolio
  - The exposure limits are *in addition to* exposure from the fund's securities portfolio

ASSET SEGREGATION FOR DERIVATIVES TRANSACTIONS

- A fund must segregate certain assets equal to the sum of two amounts:
  - *Mark-to-market coverage amount*. The amount the fund must pay to exit the derivative transaction
    - May be reduced by variation margin
  - *Risk-based coverage amount*. A reasonable estimate of what the fund would pay to exit the derivatives transaction under stressed conditions
    - Determined by the fund’s board of directors
    - May be reduced by initial margin
- Only cash and cash equivalents may be used to meet the segregation requirement
- *Note:* Different rules apply for financial commitment transactions

ASSET SEGREGATION FOR FINANCIAL COMMITMENT TRANSACTIONS

- A fund that enters into financial commitment transactions must segregate assets equal to the *full amount* of cash or other assets the fund is obligated to pay or deliver
- “Financial commitment transactions” include:
  - Reverse repurchase agreements
  - Short sale borrowing
  - Firm or standby commitment agreements (or similar agreements)
- Pledged collateral may be used as segregated assets
- Qualifying assets for financial commitment transactions
  - Must be convertible to cash prior to the date the obligation becomes payable

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RISK MANAGEMENT PROGRAM

- Funds that engage in complex derivatives transactions or that trade derivatives frequently (*i.e.*, notional exposure >50% of NAV) must develop a formalized derivatives risk management program
- The fund's board of directors must:
  - review and approve the program;
  - receive quarterly risk reports; and
  - appoint a derivatives risk manager;
- This requirement is *in addition* to the broader risk management requirements that apply to all funds

DISCLOSURE AND REPORTING

- The proposed amendment would require each fund with a derivatives risk management program to disclose risk metrics related to its use of certain derivatives on proposed Form N-PORT
- The proposed amendment would require a fund to disclose the portfolio limitation(s) on which it relied (*i.e.*, exposure based or risk based) during the reporting period on proposed Form N-CEN

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