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Investment Management Alert

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SEC Adopts Rules for Use of Derivatives by Registered Investment Companies

On October 28, 2020, the Securities and Exchange Commission (SEC) voted to adopt new rules and rule and form amendments designed to provide an updated, comprehensive approach to the regulation of registered investment companies' use of derivatives and certain other transactions. Initially proposed in 2015 and reproposed in November 2019, the new exemptive rule, Rule 18f-4 under the Investment Company Act of 1940 (1940 Act), modernizes the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs), closed-end funds and business development companies (BDCs) (collectively, funds). Rule 18f-4 will permit funds (other than money market funds) to enter into derivatives transactions and certain other transactions, notwithstanding the prohibitions and restrictions under Sections 18 and 61 of the 1940 Act, provided that the funds comply with the specified conditions of the rule. The rule will also permit money market funds and other funds to invest in securities on a when-issued or forward-settling basis, or with a nonstandard settlement cycle, subject to conditions. The rule was adopted largely as proposed, although the SEC determined not to adopt the proposed sales practice rules.

Under this modernized regulatory framework, funds using derivatives generally will have to adopt a derivatives risk management program, to be administered by a derivatives risk manager overseen by the fund's board of directors, and comply with an outer limit on fund leverage risk based on value at risk (VaR). Funds that make only limited use of derivatives will not be subject to those requirements, but they will have to adopt and implement policies and procedures reasonably designed to manage derivatives risks. Additionally, funds will be subject to reporting and record-keeping requirements related to their use of derivatives.

In addition, the SEC adopted amendments to Forms N-PORT, N-LIQUID (retitled as "Form N-RN") and N-CEN to enhance the SEC's ability to oversee funds' use of and compliance with the new rules and to provide the SEC, investors and other market participants additional information regarding funds' use of derivatives.

The SEC also adopted amendments to Rule 6c-11 to allow leveraged and inverse ETFs to operate without the need for exemptive relief.

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The SEC did not adopt the proposed new sales practice rules, including new Rule 15l-2 under the Securities Exchange Act of 1934 (Exchange Act) and new Rule 211(h)-1 under the Investment Advisers Act of 1940 (Advisers Act). The sales practice rules would have required a broker, dealer or investment adviser that is registered with (or required to be registered with) the SEC to exercise due diligence in approving a retail customer's or client's account to buy or sell shares of funds or listed commodity pools that seek to provide leveraged or inverse exposure to an underlying index. The SEC believes that the enhanced standard of conduct for broker-dealers under Regulation Best Interest and the fiduciary obligations of registered investment advisers help address some of the concerns the sales practice rules were intended to address in the context of recommended transactions and transactions occurring in an advisory relationship. In the adopting release, the SEC stated that the staff has been directed to begin a review to assess the effectiveness of the existing regulatory requirements in protecting investors who invest in leveraged/inverse products and other complex investment products.

Derivatives Transactions

Rule 18f-4 will apply to "derivatives transactions," which the SEC has defined broadly to include (i) 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, (ii) any short sale borrowing and (iii) any reverse repurchase agreement or similar financing transaction, such as tender offer bond (TOB) financings, if the fund treats all such transactions as derivatives transactions subject to the final rule rather than as subject to the asset coverage requirements in Section 18 of the 1940 Act. The first prong of this definition is designed to describe those derivatives transactions that involve the issuance of a senior security, because they involve a contractual future payment obligation. Derivatives that do not impose any future payment obligation on a fund are not considered "derivatives transactions" for purposes of Rule 18f-4. For example, a standard exchange-traded option whereby a fund makes a nonrefundable premium payment to obtain the right to acquire (or sell) securities under the option but generally does not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option is not considered a "derivatives transaction" under Rule 18f-4.

Rule 18f-4 Conditions

Rule 18f-4 will permit a registered fund to enter into derivatives transactions, subject to the following conditions:

- **Derivatives Risk Management Program:** The new rule generally requires a fund to adopt and implement a written derivatives risk management program. Such a program 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 rule defines "derivatives risks" as 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 below, the fund's investment adviser) deems material.

  A fund adviser's officer or officers, or persons with a comparable degree of seniority and authority (and not a third party), must serve as the fund's derivatives risk manager and administer the program. The derivatives risk manager must have relevant experience regarding derivatives risk management and must be approved by the fund's board (including a majority of the independent board members). The rule prohibits a fund's portfolio manager from solely filling the derivatives risk manager position or constituting a majority of the officers who collectively fill the position but otherwise allows fund portfolio managers to serve in the role. The program will institute a standardized risk management framework for funds while permitting principles-based tailoring based on how a fund's use of derivatives may impact its risk profile.

  The program requirement as adopted retains the same framework and elements as the proposed program requirement. A fund's derivatives risk management program must include the following elements:

  - **Risk Identification and Assessment:** The program must identify and assess a fund's derivatives risks, including leverage, market, counterparty, liquidity, operational and legal risks.
  - **Risk Guidelines:** The program must establish and enforce guidelines that provide for measurable metrics and thresholds related to the fund's derivatives risk. The guidelines

must specify the levels of the given metric or threshold the fund does not normally expect to exceed and the measures to be taken in response to exceeding them.

- **Stress Testing:** The program must stress test derivatives risks at least weekly to assess the fund's potential losses in response to market changes that could adversely affect the fund.
- **Backtesting:** The program must backtest the VaR test used to determine the outer limit of the fund's leverage risk at least weekly and compare the fund's actual gain or loss with the VaR calculated for the fund.
- **Internal Reporting and Escalation:** The program must provide for the reporting of matters relating to the fund's use of derivatives to portfolio management and the board, including in the case of guideline exceedances.
- **Periodic Review:** A fund's derivatives risk manager must review the program at least annually to evaluate its effectiveness and update it to reflect changes in risks.

- **Board Oversight and Reporting:** The derivatives risk manager must report to the fund's board on the program's implementation and effectiveness and the results of the fund's stress testing in order to facilitate the board's oversight of derivatives risk management. These requirements were adopted substantially as proposed, with minor changes to clarify the requirements and conform to changes in other provisions of the rule.
- **Limit on Fund Leverage Risk:** A fund relying on Rule 18f-4 will generally have to comply with an outer limit on fund leverage risk based on VaR. This outer limit is based on a relative VaR test that compares the fund's VaR to that of a "designated reference portfolio," which may be either an index meeting certain requirements or the fund's own securities portfolio (excluding derivatives transactions). Under the rule, the fund's VaR generally is not permitted to exceed 200% of the VaR of its designated reference portfolio (250% for a closed-end fund that has preferred stock outstanding). If the fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio generally is not permitted to exceed 20% of the value of the fund's net assets (25% for a closed-end fund that has preferred stock outstanding). The relative and absolute VaR limits in the final rule were increased from the proposed limits of 150% and 15%, respectively.

  A 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, in a manner that is in the best interests of the fund and its shareholders. If a fund is not in compliance within five business days, the fund's derivatives risk manager must: (i) provide a written report to the fund's board explaining how, and by when, the derivatives risk manager reasonably expects the fund to come back into compliance; (ii) analyze the circumstances causing the fund to be out of compliance and update any program elements as appropriate; and (iii) provide a written report within 30 calendar days to the fund's board explaining how the fund came back into compliance, as well as the results of such analysis and any updates to program elements. As discussed below, a fund that is not in compliance within five business days also must report such event confidentially on Form N-RN to the SEC.
- **Exception for Limited Derivatives Users:** The rule provides an exception from the program requirement and the VaR-based limit on fund leverage risk for a fund that limits its derivatives exposure to 10% of its net assets, excluding certain currency and interest rate hedging transactions. Such fund must still adopt and implement written policies and procedures reasonably designed to manage the fund's derivatives risks. The exception was adopted with minor changes from the proposal, including that a fund will be permitted to exclude derivatives transactions that it uses to hedge certain currency and interest rate risks in calculating its derivatives exposure for purposes of determining eligibility for the exception. Additionally, the exception as adopted includes provisions for a fund with derivatives exposure that exceeds the 10% threshold that were not included in the proposed rule. If such fund does not reduce its derivatives exposure to an amount below the 10% threshold within five business days, the fund's adviser must provide a written report to the fund's board informing it whether the adviser intends to reduce the exposure promptly (within no more than 30 days) or put in place a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as is reasonably practicable. The SEC declined to specify in the rule specific time periods for compliance with the derivatives risk management program and VaR-based limit on fund leverage risk requirements because funds' ability to comply quickly will vary based on factors such as the complexity of a fund's use of derivatives.

- **Alternative Conditions for Certain Leveraged or Inverse Funds Not Adopted:** While the rule as proposed included a set of alternative conditions for certain leveraged or inverse funds, under the final rule as adopted such funds will generally be subject to the rule, like other funds that use derivatives. This will effectively limit leveraged or inverse funds' target daily return to 200% of the return (or inverse of the return) of the fund's underlying index. The final rule provides an exception from the VaR requirement for leveraged or inverse funds currently in operation that seek an investment return above 200% of the return (or inverse of the return) of the fund's underlying index and satisfy (i) certain conditions designed to allow such funds to continue to operate in their current form but prohibit them from changing their index or increasing the amount of their leveraged or inverse market exposure and (ii) the other requirements of Rule 18f-4.
- **Reverse Repurchase Agreements and Similar Financing Transactions:** The rule permits a fund to enter into reverse repurchase agreements and similar financing transactions, such as TOB financings, so long as the fund complies with the asset coverage requirements under Section 18 of the 1940 Act. In a change from the proposed rule, the final rule also permits a fund to elect to treat such transactions as derivatives transactions under the rule, which would permit a fund, if it so desired, to apply a consistent set of requirements to derivatives transactions and any reverse repurchase agreements or similar financing transactions. In this scenario, however, a fund's election will apply to all of its reverse repurchase agreements or similar financing transactions so that all such transactions are subject to a consistent treatment under the final rule. A fund could not, for example, elect to treat reverse repurchase agreements as derivatives transactions while at the same time electing to treat similar financing transactions, such as TOB financings, like bank borrowings under the final rule's asset coverage option.
- **When-Issued, Forward-Settling and Nonstandard Settlement Cycle Securities:** The final rule includes a provision that was not proposed that permits funds, as well as money market funds, to invest in securities on a when-issued or forward-settling basis, or with a nonstandard settlement cycle, subject to certain conditions. Provided that (i) the fund intends to settle the transaction physically and (ii) the transaction settles within 35 days, under the rule the transaction will not be deemed to involve a senior security.
- **Record-Keeping:** The rule requires that a fund comply with certain record-keeping requirements designed to provide the SEC, the fund's board of directors and compliance personnel the ability to evaluate the fund's compliance with the requirements of the rule. The record-keeping requirements were adopted largely as proposed, with conforming changes in light of alterations to other provisions of the final rule. The rule requires a fund to maintain records documenting its derivatives risk management program, any materials provided to the board of directors in connection with approving the designation of the derivatives risk manager, and any written reports provided to the board of directors relating to the program or any noncompliance with the applicable VaR test. The rule includes additional requirements for funds that are required to comply with the VaR-based limit on fund leverage risk, funds that are limited derivatives users, funds that enter into unfunded commitment agreements, and funds that enter into reverse repurchase agreements or similar financing transactions.

The rule permits a fund to enter into an unfunded commitment agreement 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. An "unfunded commitment agreement" is 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. In forming a reasonable belief that it will have sufficient cash and cash equivalents to meet its obligations with respect to unfunded commitment agreements as they come due, a fund may consider its strategy, its assets' liquidity, its borrowing capacity under existing lines of credit and the contractual provisions of its unfunded commitment agreements. A fund may not consider cash that may become available from the sale or disposition of any investment at a price significantly different than the market value of the investment or cash that may become available as a result of issuing additional equity. The SEC recognized with this approach that, while unfunded commitment agreements have the potential to raise the risk that a fund may be unable to meet its obligations under such transactions, such unfunded commitments do not generally involve the leverage and other risks associated with derivatives transactions.

Reporting Requirements

Funds will be required to confidentially report to the SEC on Form N-RN if the fund is not in compliance with the VaR-based limit on fund leverage risk for more than five consecutive business days. Funds must then report on Form N-RN when the fund comes back into compliance. Form N-PORT and Form N-CEN will also now require funds to provide certain information regarding a fund's derivatives exposure and, as applicable, information regarding the fund's VaR. This information will be publicly available and include (i) certain identifying information about the fund, including the provisions of Rule 18f-4 that the fund is relying on to engage in transactions the rule addresses; (ii) as applicable, information regarding a fund's VaR and designated reference portfolio, and VaR backtesting results; (iii) VaR test breaches, to be reported to the SEC in a nonpublic current report; and (iv) for a fund operating as a limited derivatives user, information about the fund's derivatives exposure and the number of business days that its derivative exposure exceeded 10% of its net assets. These requirements were adopted largely as proposed, with changes to streamline the VaR and exposure information certain funds are required to provide, require additional information about funds operating as limited derivatives users that exceed the 10% threshold and make certain data elements nonpublic in response to comments.

In addition, the SEC adopted a conforming amendment to Form N-2 to provide that funds relying on Rule 18f-4 will not be required to include their derivatives transactions and unfunded commitment agreements in the senior securities table on Form N-2.

Rescission of Investment Company Release 10666

The SEC is rescinding a 1979 general statement of policy (Release 10666), which provided SEC guidance on how funds may use certain derivatives and derivatives-like transactions in light of the policy objectives of Section 18 of the 1940 Act. The rescission of Release 10666 will be effective 18 months after the effective date of Rule 18f-4 and the other rule amendments. In addition, the staff in the Division of Investment Management has reviewed its no-action letters and other guidance addressing funds' use of derivatives and other transactions covered by Rule 18f-4 and has determined to withdraw some of these staff letters and guidance because some of them, or portions thereof, are moot, superseded or otherwise inconsistent with Rule 18f-4. Such withdrawal will be effective upon the rescission of Release 10666.

Rule 6c-11

In connection with the adoption of Rule 18f-4, the SEC also adopted amendments to Rule 6c-11 under the 1940 Act. Rule 6c-11 generally permits ETFs to operate without obtaining an exemptive order, subject to certain conditions. When Rule 6c-11 was adopted, it prohibited leveraged and inverse ETFs from relying on the rule. The prohibition was intended to allow the SEC to consider the Section 18 issues raised by such funds' investment strategies as part of a broader consideration of derivatives use by registered funds and BDCs. The amendments will permit leveraged and inverse ETFs to rely on Rule 6c-11 if they comply with all applicable provisions of Rule 18f-4. The SEC is also rescinding exemptive orders previously issued to sponsors of leveraged and inverse funds permitting such funds to operate as ETFs, as the orders will be superseded by amended Rule 6c-11.

Effective and Compliance Dates

The new rule and rule amendments will be effective 60 days after publication in the Federal Register. The compliance date for the new rule and rule amendments will be 18 months after the effective date.

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