ALERTS

Regulated Funds: SEC Adopts New Rule Governing the Use of Derivatives by Registered Investment Companies and BDCs

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On Oct. 28, 2020, the SEC voted to adopt new Rule 18f-4 under the Investment Company Act of 1940, as amended ("1940 Act"), to provide a modernized and comprehensive regulatory framework for the use of derivatives by regulated funds, including mutual funds (other than money market funds), exchange-traded funds ("ETFs"), registered closed-end funds and business development companies ("BDCs") (collectively, "funds").[1] Subject to various conditions, Rule 18f-4 will allow funds to enter into derivatives transactions, notwithstanding the restrictions on the issuance of "senior securities" and the use of leverage imposed by Sections 18 and 61 of the 1940 Act.[2]

In connection with the adoption of Rule 18f-4, the SEC also amended Rule 6c-11 under the 1940 Act relating to leveraged/inverse ETFs and adopted new reporting requirements and amendments to certain disclosure forms. The new rule and related amendments will become effective 60 days after publication in the Federal Register, with a compliance date of 18 months after the effective date. Hedge funds and other private investment funds are not subject to the new rule or the related amendments.

Overview of Rule 18f-4

The key requirements of Rule 18f-4 are discussed in more detail below and include:

- Adoption of a written derivatives risk management program containing risk guidelines and requiring stress testing, backtesting, internal reporting and escalation and program review;

- Imposition of an outer limit on fund leverage risk, based either on a relative or absolute value-at-risk ("VaR") test, comparing a fund's VaR to the VaR of a "designated reference portfolio" for the fund; and

- Designation of a derivatives risk manager who reports directly to the fund's board of directors.

Notably, Rule 18f-4 also provides an exception from these requirements for a fund that limits its derivatives exposure to 10% of its net assets (excluding derivatives transactions used to hedge certain currency and interest rate risks), provided that the fund establishes appropriate policies and procedures. In addition, leveraged/inverse funds, including ETFs, are subject to the Rule 18f-4 requirements, in a change from the rule as proposed.[3] In view of the significant number of comments received on the topic, the SEC did not adopt new sales practices rules that were proposed in connection with the Rule 18f-4 proposal that would have been applicable to sales of leveraged/inverse funds, but instead opted to make such funds subject to the requirements of the rule.[4] The new rule also permits a fund to enter into reverse repurchase agreements and "unfunded commitments," subject to certain conditions. In particular, the rule clarifies that unfunded commitments will not count towards a fund's asset coverage ratio under Sections 18 and 61 under the 1940 Act so long as the fund reasonably believes, at the time it enters into such a commitment, that it will have sufficient cash and cash equivalents to meet its obligations under such commitment when they come due. Lastly, funds (including money market funds) may invest in securities on a when-issued or forward-settling basis (or with a non-standard settlement cycle), subject to certain conditions.

Background

Generally, Section 18 of the 1940 Act restricts the issuance of "senior securities" by investment companies.[5] Section 18(g) defines a "senior security" as any bond, debenture, note or similar obligation constituting a security and evidencing indebtedness and any stock of a class having priority over any other class as to distribution of assets or payment of dividends (such as preferred stock). The SEC has interpreted this term broadly to include investment transactions and practices that create potential future obligations — generally, any transaction in which a fund has a potential future payment or delivery obligation, including certain derivatives transactions.

The new rule represents a departure from guidance contained in an SEC release on the application of Section 18's restrictions on certain investment practices ("Release 10666"),[6] as well as positions taken by the SEC staff in various no-action letters regarding transactions involving Section 18.[7] The SEC's release adopting the rule ("Release") notes the inconsistent industry practices that have developed in reliance on this guidance and acknowledges the need to replace the current patchwork approach to regulation of the use of derivatives in order to address investor protection concerns while also accommodating product innovation. In connection with the adoption of Rule 18f-4, the SEC is rescinding Release 10666 and the various no-action letters issued by the SEC staff.

Scope of Derivatives Transactions Covered

The rule defines a "derivatives transaction" to mean any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar 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, as well as any short sale borrowing and, if a fund chooses to rely on the rule, any reverse repurchase agreement or similar financing transaction.[8] This definition is intended to capture derivatives transactions that, in the SEC's view, involve the issuance of a senior security (i.e., transactions that create a potential future payment or delivery obligation).[9] Instruments that may commonly be referred to as derivatives, but which do not create a potential future payment or delivery obligation (e.g., purchased options and structured notes), fall outside of this definition.

Derivatives Risk Management Program and Board Oversight

Under Rule 18f-4, a fund using derivatives that does not otherwise qualify as a "limited derivatives user" will be required to implement a written derivatives risk management program ("Program") administered by a derivatives risk manager and overseen by the fund's board of directors ("Board"). The Release notes that the Program should be a part of an adviser's overall risk management and should complement other risk management activities, such as a fund's liquidity risk management program under Rule 22e-4.[10] The Program must be tailored to the fund's use of derivatives and also must include appropriate risk guidelines, along with requirements for stress testing, backtesting, internal reporting and escalation and periodic review of the Program. The risk guidelines must provide for quantitative thresholds of the fund's derivatives risks, and must specify the levels that a fund does not normally expect to exceed. Stress testing must be undertaken on at least a weekly basis, and the rule also requires backtesting of the results of the VaR calculation model used by the fund in connection with the VaR tests described in more detail below.

A Program must be administered by a derivatives risk manager, comprised of an officer or officers of the fund's investment adviser having relevant experience regarding the management of derivatives risk.[11] The derivatives risk manager may not be a portfolio manager of the fund, unless multiple individuals serve together, in which case portfolio managers may serve if they do not represent a majority of the individuals serving. The designation of the derivatives risk manager must be approved by the Board and the risk manager must periodically review the Program at least annually and provide a written report to the Board on the effectiveness of the Program also at least annually. The risk manager must also provide regular written reports to the Board at a frequency determined by the Board. However, under the rule the Board is not required to make any particular findings and the Board does not need to receive a report on every exceedance of the Program's guidelines, but instead must receive an analysis of exceedances that occurred during the period covered by the report.

VaR Limits on Fund Leverage Risk

A core component of Rule 18f-4 is the outer limit placed on fund leverage risk based on VaR, which is a statistical measurement used to calculate probable losses on an investment. As defined in the rule, VaR is an estimate of an instrument's or portfolio's potential losses over a specified time horizon and at a given confidence level.[12] VaR can help assess the impact of derivatives use on a fund's portfolio, including whether such transactions are being used to leverage the fund's portfolio or instead to hedge portfolio investments.

A fund that relies on the rule when engaging in derivatives transactions that does not otherwise qualify as a "limited derivatives user" thereunder must compare the fund's VaR to the VaR of a "designated reference portfolio" or, if that is determined not to be appropriate, must use an absolute VaR test. As adopted, the "designated reference portfolio" used in the relative VaR test either can be an index meeting certain requirements specified in the rule or the fund's own securities portfolio (excluding derivatives transactions). Under the proposed rule, only an index was permissible for VaR comparison purposes.

Under the relative test, a fund's VaR generally must not exceed 200% of the designated reference portfolio's VaR and under the absolute test it must not exceed 20%. This represents an increase from the threshold as proposed, from 150% as proposed for the relative test and from 15% as proposed for the absolute test.[13]

Limited Derivatives Users

Under the rule, a fund with derivatives exposure of no more than 10% of its net assets (excluding certain currency and interest rate hedging transactions) will not need to comply with the VaR testing requirements or the requirement to implement a derivatives risk management program. Instead, it must adopt policies and procedures reasonably designed to manage its derivatives risk. In order to qualify for exclusion from the above calculation, derivatives that hedge currency or interest rate risks must be associated with one or more specific equity or fixed-income investments held by the fund or the fund's outstanding borrowings, must be entered into and maintained for hedging purposes, and must have notional amounts that do not exceed the value, par value or principal amount, as applicable, of the hedged investment or borrowing by more than 10%.

Leveraged/Inverse Funds

As noted above, the SEC determined not to adopt the sales practices rules included in the proposed rule that would have applied to broker-dealers and investments advisers selling leveraged/inverse funds. Instead, leveraged/inverse funds using derivatives are subject to Rule 18f-4, as adopted, and are required to use an index as their designated reference portfolio. The Release notes that certain of the investor protection concerns underlying the proposed sales practices rules are addressed by the best interest standard of conduct for broker-dealers under Regulation Best Interest, and that investment advisers are subject to fiduciary obligations in the context of advisory agreements. However, the SEC states in the Release that it has directed its staff to consider any additional requirements that should apply to broker-dealers and investment advisers in order to protect investors who invest in leveraged/inverse products and other complex investment products.

In connection with leveraged/inverse ETFs, the SEC also amended Rule 6c-11 to include such ETFs within the scope of that rule, provided that they comply with Rule 18f-4, as applicable. Rule 6c-11 allows sponsors of ETFs to launch and operate ETFs without first obtaining individual exemptive orders from the SEC, subject to satisfying certain conditions.[14] Additionally, all past exemptive orders issued to leveraged/inverse ETFs are rescinded.

Reverse Repurchase Agreements

Under Rule 18f-4, a fund can engage in reverse repurchase agreements and similar financing transactions, either by meeting the asset coverage requirements of Section 18 or by electing to treat such transactions as derivatives and meeting the requirements of the rule. As a result, funds will going forward have an alternate path under the rule for utilizing reverse repurchase agreements and similar financing structures. Funds that do not otherwise engage in derivative transactions thus may have a greater ability to utilize reverse repurchase agreements in reliance on the rule than they would enjoy by treating such financing arrangements as senior securities under Section 18.

Unfunded Commitments

The rule also clarifies the previously vague treatment of unfunded commitments under Sections 18 and 61 of the 1940 Act. In particular, the rule explicitly permits a fund to enter into an unfunded commitment agreement to make certain loans or investments, notwithstanding the requirements of Sections 18 and 61, if the fund reasonably believes that it will have sufficient cash and cash equivalents to meet its obligations as they come due. As a result, funds that directly originate new portfolio investments, including most notable BDCs and other credit-focused funds, will no longer be required to consider unfunded commitments to existing portfolio companies when determining compliance with applicable leverage ratios under Sections 18 and 61, so long as they meet the requirements of the rule with respect to those commitment agreements.

Amendments to Fund Reporting Requirements

In connection with Rule 18f-4, the SEC is adopting amendments to the reporting requirements for funds relying on the rule in Forms N-PORT, N-CEN and N-LIQUID (which will be renamed N-RN). The amendments are intended to allow the SEC to oversee funds' use of derivatives and to provide information on derivatives use to the SEC, investors and other market participants.

The amendment to Form N-PORT will add new reporting items requiring information about VaR testing (specifically, information on median VaR and median VaR ratio and the number of exceptions identified during backtesting) and will require funds relying on the limited derivatives user exception to report their derivatives exposure, along with the number of business days, if any, the fund's derivatives exposure exceeded 10% of its net assets. Such information will be confidentially reported to the SEC and will not be publicly disclosed. Information about the fund's designated reference portfolio will also be required to be disclosed on the form and will be made publicly available.

As noted above, Form N-LIQUID will be renamed Form N-RN and will be amended to require that funds report information about breaches of the relative or absolute VaR tests within one business day following the fifth business day after the fund has determined its portfolio VaR has exceeded the relevant thresholds. A second report on Form N-RN will be required once the fund is back in compliance with the VaR test. While only open-end funds (excluding money market funds) are currently required to file reports on Form N-LIQUID, all funds subject to the Rule 18f-4 limits will be required to file on Form N-RN. Reporting relating to VaR made on Form N-RN will be non-public.

Form N-CEN is being amended to require funds to identify whether they relied on Rule 18f-4 during the reporting period, as well as if any exceptions under the rule were relied upon. Funds will also be required to identify whether they have entered into any reverse repurchase agreements or similar financing transactions or any unfunded commitments pursuant to Rule 18f-4.

Recordkeeping Requirements

Under the rule, a fund will be required to maintain a written record of its policies and procedures that are designed to manage the fund's derivatives risk, along with written records of the results of stress testing, backtesting, internal reporting or escalation of material risks under the derivatives risk management program and any periodic reviews of the Program. The rule also requires that a fund maintain records of written reports provided to its Board relating to the Program, as well as any reports to the Board regarding a fund's non-compliance with a VaR test. In addition, within 30 calendar days of any exceedance of a VaR test, a fund's derivatives risk manager must provide a written report to the Board with details on the exceedance. Among other things, funds will also have to maintain records documenting other relevant information regarding calculation of VaR and limited derivatives users must maintain written records of their policies and procedures that are reasonably designed to manage derivatives risk. Required records must be maintained for a period of five years.

Key Takeaways

Rule 18f-4 provides regulated funds that engage in derivatives transactions with a prescribed framework for compliance with the requirements of Section 18 (or Section 61 in the case of BDCs). However, the rule represents a significant departure from existing regulatory guidance established by Release 10666 and various SEC staff no-action letters. Investment advisers should assess how their funds will comply with the new rule and whether the funds' investment strategies must be altered to achieve compliance. In particular, for those funds that qualify as limited derivatives users, the impact of the rule will likely be far less than for those that utilize derivatives instruments more routinely. Notably, we expect the limited derivatives user exception to likely be meaningful, particularly for funds focused on credit investments or with significant offshore exposures, given the carve-out for certain currency and interest rate hedging transactions when determining availability of the exception under the rule.

Particularly for those funds that fall outside the scope of the limited derivatives user exception, operational burdens of the rule and the derivatives risk management program, including the anticipated costs of compliance should be considered. Fund boards should be engaged in this process and should assure their familiarity with their funds' practices with respect to the use of derivatives and the process for monitoring associated risks. For funds that are subject to full compliance with the requirements under the rule, boards will have new responsibilities, including appointing a derivatives risk manager and reviewing periodic reports on the risk management program. The rule may also affect to varying degrees the investment practices of funds that engage in derivatives transactions, particularly if they fail to qualify as limited derivatives users under the rule. As a result of the increased regulatory burdens imposed under the rule, we also expect some funds will seek to limit or reduce their usage of derivatives instruments to ensure they remain within the limited derivatives user exception.

We expect the treatment of both reverse repurchase agreements and unfunded commitment agreements under the rule also to have a potentially meaningful impact on a more narrow subset of funds. In particular, funds that have historically utilized reverse repurchase agreements for short-term financing purposes may seek to expand their usage by treating such instruments as derivatives instruments under the rule. In addition, BDCs and other direct-lending funds will likely benefit from the regulatory clarity provided under the rule with respect to the treatment of unfunded commitment agreements under Sections 18 and 61 under the 1940 Act.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34078 (Oct. 28, 2020), https://www.sec.gov/rules/final/2020/ic-34078.pdf. The SEC's press release No. 2020-269, https://www.sec.gov/news/press-release/2020-269. The proposed rule and request for comments, https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

[2] The rulemaking represents a re-proposal of rules that were initially proposed in 2015. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), https://www.sec.gov/rules/proposed/2015/ic-31933.pdf. In addition, in 2011,

the SEC issued a concept release soliciting comments on various issues associated with the use of derivatives by registered investment companies. *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011), https://www.sec.gov/rules/concept/2011/ic-29776.pdf.

[3] As defined by the rule, a leveraged/inverse fund is a fund that seeks 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 time. Leveraged/inverse funds in operation as of Oct. 28, 2020 are excepted from the VaR limits of the rule, subject to various conditions.

[4] The SEC received over 6,000 comment letters addressing the proposed sales practices rules.

[5] Section 61 of the 1940 Act makes Section 18 applicable to business development companies, with certain modifications.

[6] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979).

[7] *See*, e.g., *Dreyfus Strategic Income* (pub. avail. June 22, 1987), *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995) and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 1, 1996).

[8] Proposed Rule 18f-4(a). The rule allows funds to elect to treat reverse repurchase agreements and similar financing transactions as derivatives transactions subject to the rule, or to choose to be subject to the asset coverage requirements of Section 18.

[9] Release at 21.

[10] However, unlike the liquidity risk management program required by Rule 22e-4, a derivatives risk management program does not have to be approved by the Board. *See* "Registered Investment Company Update: New Guidance on Liquidity Risk Management Programs," *SRZ Alert* (Feb. 7, 2018), https://www.srz.com/resources/registered-investment-company-update-new-guidance-on-liquidity.html.

[11] The Release acknowledges that an individual who is not technically an officer of the investment adviser may have the requisite seniority and experience to carry out the role of derivatives risk manager, and if approved by the Board, such person can be treated as an officer for purposes of the rule. In addition, while the rule permits officers of a fund's sub-adviser to serve as part of the group comprising a fund's derivatives risk manager, the Release notes that certain elements of the Program may not be delegated to a sub-adviser managing only a portion of the assets of the fund, given that elements of the Program such as stress testing must be evaluated at the portfolio level.

[12] Rule 18f-4 requires that any VaR model used for purposes of compliance with the rule: (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.

[13] For closed-end funds that have outstanding shares of a senior security that is a stock, the relative and absolute VaR limits are 250% and 25%, respectively.

[14] Exchange-Traded Funds, Investment Company Release No. 33646 (Sept. 25, 2019), https://www.sec.gov/rules/final/2019/33-10695.pdf. *See* "New SEC Rule Aims to Streamline ETF Regulation," *SRZ Alert* (Oct. 17, 2019), https://www.srz.com/resources/new-sec-rule-aims-to-streamline-etf-regulation.html.

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