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November 2, 2020

SEC Adopts Final Rule on Funds' Use of Derivatives

[32886]

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TO: ICI Members
Investment Company Directors
1940 Act Derivatives Working Group SUBJECTS: Alternative Investments
Closed-End Funds
Compliance
Derivatives
Disclosure
Exchange-Traded Funds (ETFs)
Financial Stability
Fund Governance
Recordkeeping
Risk Oversight RE: SEC Adopts Final Rule on Funds' Use of Derivatives

Last week, the Securities and Exchange Commission adopted a new rule and amendments that provide an updated approach to the regulation of derivatives and similar instruments used by mutual funds, exchange-traded funds, closed-end funds, and business development companies (collectively, "funds").[1] The rulemaking:

- Creates a new rule (Rule 18f-4) governing funds' use of derivatives and similar instruments;[2]
- Imposes related fund reporting requirements;
- Amends the ETF Rule (Rule 6-11) to allow leveraged and inverse ETFs to satisfy the ETF Rule's conditions without the need for exemptive relief;[3] and
- Rescinds certain SEC and staff guidance, exemptive relief, and no-action letters that no longer are necessary.

Under the new rule, funds using derivatives generally must adopt a derivatives risk management program that a derivatives risk manager ("DRM") administers and that the fund's board of directors oversees, and comply with an outer limit on fund leverage risk based on value at risk or "VaR".[4] Funds that use derivatives in a limited manner ("limited derivatives users") will not be subject to these requirements but must adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks. Funds also will be subject to recordkeeping and reporting requirements.

The rulemaking eliminates the Commission and staff's historical requirements that a fund "cover" its obligations in connection with various transactions, including derivatives, by maintaining "segregated accounts." The Commission does not believe that asset segregation is necessary in light of the new rule's requirements for funds to establish risk management programs and comply with the limit on fund leverage risk.

Consistent with ICI and other commenters' recommendations, the SEC made several enhancements to the proposed rule.[5] The Commission increased the VaR-based leverage limits funds are subject to under the rule and provided funds a longer remediation period for breaches of those limits. The Commission also expanded the scope of limited derivatives users that are excluded from the main requirements of the rule. In addition, while money market funds cannot rely on the new rule, the new rule will allow both funds and money market funds to continue to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, that otherwise could be deemed derivatives and restricted. Importantly, the Commission did not adopt proposed sales practices requirements requiring SEC-registered brokers-dealers and investment advisers to exercise due diligence before accepting or placing orders for leveraged and inverse investment vehicles.

The new rule and related amendments take effect 60 days after publication in the Federal Register and funds have 18 months from that date to comply. We summarize the rulemaking in four sections, below: (I) New Rule 18f-4; (II) New Reporting Requirements; (III) Leveraged/Inverse ETFs; and (IV) Rescission of Guidance and Relief/Transition Periods.

I. New Rule 18f-4

In adopting the new rule, the SEC reiterated its view that Section 18 restricts a fund's ability to invest in senior securities, including instruments that impose a contractual obligation on a fund to pay or deliver assets now or in the future to a counterparty.[6] These senior securities include derivatives,[7] reverse repurchase agreements and similar financing transactions,[8] and unfunded commitments.[9]

In response to several commenters (including ICI), the SEC recognized that money market funds, which cannot rely on the new rule, invest in securities on a when issued or forward-settling basis, or with a non-standard settlement cycle (*e.g.*, when-issued Treasury securities) that impose a future payment obligation on the money market fund and could appear to be derivatives. To address this concern, the new rule includes a targeted provision that will allow both funds and money market funds to continue to invest in these instruments without those instruments being deemed senior securities. The provision is subject to two conditions: (1) the fund must intend to settle the transaction physically; and 2) the transactions settle within 35 days.[10]

Notwithstanding the Section 18 prohibitions, new Rule 18f-4 permits a fund to enter into derivatives, reverse repurchase agreements and similar financing transactions, and unfunded commitments under certain conditions. In this section, we describe: (A) the specific conditions for funds to invest in derivatives; (B) the specific conditions for funds to invest in reverse repurchase agreements and similar financing transactions, and unfunded commitments; and (C) the common recordkeeping requirements for all funds investing in these instruments.

A. Investments in Derivatives

The new rule generally imposes two main conditions on a fund using derivatives. First, the fund must implement a derivatives risk management program that a DRM administers and that a fund's board oversees. Second, the fund must adhere to a VaR-based outer limit on fund leverage risk. Limited derivatives users and leveraged/inverse funds will be excepted from certain of these requirements.

i. Derivatives Risk Management Program and Derivatives Risk Manager

The new rule will require a fund using derivatives (other than a limited derivatives user) to adopt a written derivatives risk management program, with policies and procedures reasonably designed to manage the fund's derivatives risks. A fund adviser's officer or officers or persons with a comparable degree of seniority and authority, and not any third party, must serve as the fund's DRM and administer the program.[11] The DRM must have relevant experience regarding derivatives risk management, and the fund's board must approve the designation of the DRM.[12] Although the functions of the program must be segregated from portfolio management functions, the SEC stated that it does not intend to subject the DRM and portfolio management to a communications firewall, recognizing the important perspective portfolio management might provide to risk management.[13] Consistent with this, the new rule will prohibit a fund's portfolio manager from solely filling the DRM position or constituting a majority of the officers who compose the DRM position but otherwise will allow fund portfolio managers to serve in the position.

Under the new rule, the program must include the following elements that should be tailored to the particular types of derivatives that the fund uses and their related risks, as well as to how those derivatives impact the fund's investment portfolio and strategy:

- *Risk Identification and Assessment*. The program must identify and assess a fund's derivatives risks, considering the fund's derivatives transactions and other investments. The rule defines the derivatives risks that must be identified and managed to include leverage,[14] market,[15] counterparty,[16] liquidity,[17] operational,[18] and legal[19] risks, and other risks the DRM deems material.
- *Risk Guidelines*. The program must establish, maintain, and enforce investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds related to a fund's derivatives risks.[20] The guidelines must specify the levels of the given criterion, metric or threshold that the fund does not normally expect to exceed and the measures to be taken if they are exceeded. In developing the guidelines, the fund should consider how to implement them in view of its investment portfolio and the fund's disclosure to investors.[21]
- *Stress Testing*. The program must stress test derivatives risks at least weekly to assess a fund's potential losses in response to extreme but plausible market changes or changes in market risk factors that would significantly and adversely affect the fund.[22] It also must consider correlations of market risk factors and resulting payments to derivatives counterparties.
- *Backtesting*. The program must backtest the VaR test used to impose an outer limit on a fund's leverage risk at least weekly.[23] The requirement must provide that the fund compare its actual gain or loss with the VaR the fund had calculated for the day. A fund must identify exceptions in which it experiences a loss that exceeds the corresponding VaR calculation's estimated loss.[24]

- *Internal Reporting and Escalation*. The program must provide for the reporting of certain matters relating to a fund's derivatives use to the fund's portfolio management and board. In particular, a program must identify the circumstances under which the fund must communicate with its portfolio management about the fund's derivatives risk management, including guideline exceedances and the results of the fund's stress testing. In addition, the fund's DRM must communicate material risks to the fund's board, as appropriate.
- *Periodic Review*. A fund's DRM must periodically review the program, at least annually, to evaluate its effectiveness and to reflect changes in risk over time. The review will apply to the overall program, including each program element, the VaR model used to comply with the VaR-based limit, and any designated reference portfolio (as defined below).

Sub-advisers. In response to comments, the SEC added guidance on administrating the program in the context of sub-advisers. In this regard, it stated that the new rule provides flexibility for funds to involve sub-advisers in derivatives risk management. It noted, however, that the fund retains ultimate responsibility for complying with Rule 18f-4 and the DRM remains responsible for board reporting and administering the program. Thus, fund policies and procedures should address the oversight of any delegated activities and the oversight of the sub-adviser(s).

ii. Limit on Fund Leverage Risk

The rule generally will require funds engaging in derivatives transactions to comply with a VaR-based outer limit on fund leverage risk.[25] The limit will be based on a relative VaR test that generally restricts a fund's VaR from exceeding 200 percent of the VaR of an unlevered "designated reference portfolio" that the DRM chooses, tested at least once each business day. For its designated reference portfolio, the DRM can choose a "designated index"—an unlevered index that reflects the markets or asset classes in which the fund invests.[26] Alternatively, in a change from the proposal, the DRM can choose for an actively managed fund to use its "securities portfolio"—its own securities and other investments, excluding derivatives, that reflect the markets and asset classes in which the fund invests. In lieu of the relative VaR test, the SEC also gave more flexibility to use an absolute VaR test when a DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio, taking into account the fund's investments, investment objective, and strategy, rather than only permitting funds to use absolute VaR when a designated index is unavailable. In these situations, the fund must comply with an absolute VaR test restricting the VaR of its portfolio to no more than 20 percent of the value of the fund's net assets. In a change from the proposal and in response to comments (including from ICI), the SEC increased the relative and absolute VaR limits from 150 percent to 200 percent and 15 percent to 20 percent, respectively.

The new rule increases the relative and absolute VaR limits to 250 percent and 25 percent, respectively, for closed-end funds that have issued and have outstanding preferred stock.[27]

As proposed, the new rule provides DRMs latitude in choosing a VaR model and its parameters but requires that the model consider certain market risk factors.[28] In addition, the Commission will require the model to use a 99 percent confidence level, a time horizon of 20 trading days, and be based on at least three years of historical market data. In response to comments (including from ICI), the SEC clarified that funds may rescale calculations performed at a 95 percent confidence level VaR to a 99 percent confidence level VaR for these purposes.[29]

Remediation. If a fund determines that it is not in compliance with the VaR test, it must return to compliance promptly, in a manner that is in the best interests of the fund and its shareholders. In response to commenters (including ICI), the Commission extended its proposed three-day remediation period, such that if a fund exceeds the VaR limit for five business days, then: (1) the DRM must provide a written report to the fund's board explaining how and by when (i.e., the number of business days) the DRM reasonably expects that the fund will comply; (2) the DRM must analyze the circumstances causing the compliance issue and update any program elements appropriate to address those circumstances; and (3) the DRM must provide a written report within 30 calendar days of the exceedance to the fund's board explaining how the fund came back into compliance, the results of the DRM's analysis of the circumstances that caused the fund to be out of compliance for more than five business days, and any updates to the program elements;[30] and (4) the fund must file a report to the Commission on Form N-RN.

In another change from the proposal, the Commission eliminated the problematic restriction that ICI and others flagged upon a breach of the leverage limits, prohibiting a fund from entering into derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until it has complied with the applicable VaR test for three consecutive business days. It also eliminated the requirement for funds to return to compliance within three days.[31]

iii. Board Oversight and Reporting

As noted above, the new rule will require a fund board to approve the designation of the DRM, who will have a direct reporting line to the board and be responsible for administering the program.[32] The DRM must provide regular written reports to the board on the program's implementation and effectiveness, analyzing exceedances of the fund's guidelines and the results of the fund's stress testing. These reports must occur at least annually, and the DRM must provide regular written reports periodically as the board determines.

The DRM must provide to the board, on or before the implementation of the program and at least annually thereafter, a written report representing that the program is reasonably designed to manage the fund's derivatives risks and incorporate the required elements of the program. The report must contain the basis for the representation. In addition, the report must include such information reasonably necessary to evaluate the adequacy of the fund's program and the effectiveness of its implementation. It also must include the DRM's basis for selecting the designated reference portfolio or an explanation as to why the DRM was unable to identify one and the basis for any change in the designated reference portfolio. In addition, in response to comments (including from ICI), the rule permits the DRM to provide a summary analysis of the exceedances that occurred during the period, along with stress testing and backtesting, rather than requiring the reporting of "any" exceedances of the guidelines.

The reports and the requirements are designed to facilitate the board's oversight of the fund's derivatives risk management and compliance with the new rule. The Commission cautioned that board oversight should not be a passive activity. Rather, the board should understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program. It also should ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation. In this regard, the Commission explained that it views the board's role as one of oversight and that board members may exercise their reasonable business judgment in overseeing the program. It stated that it continues to believe that boards should view oversight as an iterative process, and explained that the use of the term "iterative" is not intended to imply that the board is responsible for day-to-day management of fund derivatives risk but to clarify that the board's oversight role requires regular engagement with the derivatives risk management program rather than a one-time assessment. Directors should take an "active" role that involves inquiry into material risks from the derivatives transactions and follow up on addressing those risks.

iv. *Limited Derivatives Users Exceptions*

The new rule will except limited derivatives users from the derivatives risk management program requirement and the limit on fund leverage risk. The exception will be available to a fund that limits its derivatives exposure to 10 percent of its net assets. In a change from the proposal (and consistent with ICI comments), a fund may exclude from the 10 percent threshold derivatives that are used to hedge certain currency and/or interest rate risks, and positions closed out with the same counterparty. A fund that relies on the exception will be required to adopt policies and procedures that are reasonably designed to manage the fund's derivatives risks that are tailored to the extent and nature of the fund's derivative use.

- *10 Percent Exception*. For purposes of the 10 percent exception, the rule defines the term "derivatives exposure" to mean the sum of the gross notional amounts of the fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short.[33] Funds may scale the notional amounts of interest rate derivatives to a 10-year bond equivalent. Funds also may delta adjust the notional amounts of options contracts.[34] Although the Commission noted that using notional amounts as a measure of market exposure is relatively blunt, the Commission stated that it is using the test to identify funds that use derivatives in a limited way.
- *Exclusions*. In a change from the proposal, the Commission modified the derivatives exposure definition to allow a fund to exclude from its derivatives exposure any closed-out positions. These positions must be closed out with the same counterparty and result in no credit or market exposure to the fund. In addition, in another change from the proposal, the rule now permits funds to exclude both currency and interest rate derivatives used to hedge the respective currency and interest rate risks associated with specific equity or fixed-income investments or fund borrowings held or made by the fund. The notional amounts of such derivatives may not exceed the value of the hedged instruments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowings) by more than 10 percent.

If a limited derivatives user exceeds the 10 percent threshold, then there are two alternatives for remediation. If the exceedance is for five business days, then the fund's investment adviser must provide a written report to the fund's board explaining whether the investment adviser intends either to: (1) promptly, but within no more than 30 calendar days of the exceedance, reduce the fund's derivatives exposure to be in compliance with the 10 percent threshold;[35] or (2) establish a derivatives risk management program, comply with the VaR-based limit on fund leverage risk, and comply with the related board oversight and reporting requirements, as soon as reasonably practicable. In either case, the fund must specify on its next Form N-PORT filing the number of business days, in excess of the five-business-day period, that the fund's derivatives exposure exceeded 10 percent of its net assets.

v. Alternative Requirements for Leveraged/Inverse Funds

The new rule generally requires that leveraged/inverse funds, except for funds that seek to provide leveraged or inverse market exposure exceeding 200 percent of the return of an index ("over-200 percent leveraged/inverse funds"), must meet all of the rule's requirements. All leveraged/inverse funds, because they provide a leveraged or inverse return of an index, must comply with the rule's relative VaR test and use the index as their designated reference portfolio.[36] Over-200 percent leveraged/inverse funds generally could not satisfy the limit on fund leverage risk in the new rule. The Commission therefore grandfathered existing over-200 percent leveraged/inverse funds into the new regime, including a provision permitting them to continue operating provided they comply with the new rule (other than the VaR-based limit on fund leverage) and meet certain other requirements.[37] Specifically, an over-200 percent leveraged/inverse fund relying on the exception may not change its underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide. In addition, the fund must disclose that it is not subject to the condition of Rule 18f-4 limiting fund leverage risk. New over-200 percent leveraged/inverse funds cannot operate without exemptive relief.

The Commission determined not to adopt the proposed sales practices rules for leveraged/inverse investment products.[38] It agreed with commenters that certain of the investor protection concerns the Commission articulated in the proposing release are addressed by the best interest standard of conduct for broker-dealers under Regulation Best Interest. For advisers, it indicated that the fiduciary obligations of investment advisers address many of the same concerns.

Nevertheless, the Commission recognized that the protections are limited.[39] Therefore, it directed its staff to review the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex investment products. Based on this review, the staff will make recommendations to the Commission for potential new rulemakings, guidance or other policy actions, if appropriate.

B. Funds' Use of Reverse Repurchase Agreements and Unfunded Commitments

The rule permits funds to invest in reverse repurchase agreements and similar financing transactions, and unfunded commitments, under specified conditions.

i. Reverse Repurchase Agreements

The Commission views reverse repurchase agreements and other similar financing transactions as allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets. Accordingly, it will allow funds to enter such transactions if funds treat them as bank borrowings or other borrowings subject to the relevant asset coverage requirements of Section 18.[40] Alternatively, in a change from the proposal, the rule allows funds the option to treat reverse repurchase agreements or similar financing transactions as derivatives transactions, rather than including them in the fund's asset coverage calculations.[41] Therefore, if treated as borrowings, reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under the limited derivatives user exception but, if treated as derivatives, they would be. 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 rule.[42]

The Commission also provided guidance on whether certain transactions are "similar financing transactions" to reverse repurchase agreements and subject to these restrictions. It confirmed its belief that tender option bond ("TOB") financings are economically similar to reverse repurchase agreements and are "similar financing transactions."[43] It also confirmed its view that securities lending arrangements are similar to reverse repurchase agreements[44] but, as stated in the proposing release, will not to treat them as "similar financing transactions" when: (1) the fund does not sell or otherwise use the non-cash collateral received for loaned securities to leverage the fund's portfolio; and (2) the fund invests cash collateral received for loaned securities solely in cash or cash equivalents.[45]

ii. Unfunded Commitment Agreements

The Commission believes that unfunded commitment agreements should be treated differently from other derivatives because they are not used to leverage a fund's portfolio or create undue speculation but could raise asset sufficiency concerns.[46] For example, if the fund is unable to meet its obligations under an unfunded commitment, it will be subjected to a counterparty's default remedies. To address this concern, the Commission will permit a fund to enter into unfunded commitment agreements if the fund reasonably believes, at the time it enters such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements, in each case as they come due. In formulating this belief, the rule will require a fund to consider its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions).[47]

C. Recordkeeping

The new rule will require a fund investing in derivatives, reverse repurchase agreements and other similar financing transactions, and unfunded commitment agreements, to adhere to recordkeeping requirements. Funds relying on Rule 18f-4 will be required to maintain for a period of at least five years, as applicable:

- Certain records documenting the fund's derivatives risk management program (*e.g.*, policies and procedures designed to manage the fund's derivatives risk, results of stress testing, results of VaR backtesting, any internal reporting or escalation of material risks under the program, and any periodic review of the program);
- Materials provided to the fund's board related to the approval and designation of the DRM and any required written reports provided to the board regarding the fund's non-compliance with the applicable VaR test (including, within 30 calendar days of an exceedance, a written report to the board explaining: how the fund came back into compliance; the results of the DRM's analysis of the circumstances that caused the fund to be out of compliance for more than five business days; any updates to the program elements; and any updates to previous reports explaining how and by when the DRM expects the fund to come back into compliance).
- For funds complying with the VaR-based limit, records documenting certain of the fund's determinations (*e.g.*, the VaR of the portfolio, the VaR of the designated

reference portfolio, the fund’s VaR ratio (value of the fund’s VaR divided by VaR of the designated reference portfolio), and, as applicable, any updates to the VaR models, and the basis for any material changes to those models);

- For limited derivatives users, records of the fund’s policies and procedures that are reasonably designed to manage its derivatives risk;
- For funds that engage in reverse repurchase agreements or similar financing transactions, records documenting whether the fund is treating the reverse repurchase agreements or similar financing transactions under: (1) an asset coverage requirements approach; or (2) a derivatives transactions treatment approach; and
- For funds that engage in unfunded commitment agreements, records documenting the fund’s basis for its reasonable belief that it has sufficient cash and cash equivalents to meet its obligations with respect to unfunded commitment agreements (made at the time the fund enters the agreements).

II. New Reporting Requirements

The Commission adopted amendments to Form N-PORT, Form N-LIQUID (which the Commission will re-title Form N-RN), and Form N-CEN to reflect new reporting requirements for funds relying on the new rule.[48]

A. Form N-PORT

The Commission amended Form N-PORT to add new items to Part B.[49] These items will be reported on Form N-PORT after the third month of a fund’s fiscal quarter, within 60 days after quarter end. While the proposal would have required all funds to publicly report their aggregate derivatives exposure, only limited derivatives users will be required to report such information and on a non-public basis.[50] A limited derivatives user also will be required to report non-publicly its: exposure from currency and interest rate derivatives that hedge related risk; and the number of business days (in excess of the five-business day remediation period) that derivatives exposures exceeded 10 percent of its net assets. These disclosures will assist the Commission in monitoring compliance with the limited derivatives user exception.

In addition, a fund will report, as applicable, the following information about the fund’s VaR tests:

- The median daily VaR for the reporting period;
- For funds subject to the relative VaR test during the reporting period, as applicable: (a) the name of the designated index; (b) the index identifier; and (c) the median VaR ratio during the reporting period; and
- Its backtesting results, showing the number of exceptions the fund identified as a result of its backtesting of its VaR model.

The Commission agreed that many investors may not have the expertise or experience to understand VaR and could misinterpret VaR figures, especially when comparing funds. Similarly, the Commission found that investors could misunderstand or ascribe inappropriate significance to the backtesting exceptions. Thus, the SEC will not make public the median VaR information (median VaR and its median VaR ratio for funds subject to the relative VaR test) and backtesting results.

B. Form N-LIQUID (to be renamed Form N-RN)

The Commission amended current reporting requirements on Form N-RN to include new reporting information about VaR breaches.[51] Specifically, if a fund's VaR under the relative VaR test were to exceed, as applicable, 200 percent or 250 percent of the VaR of its designated reference portfolio for five business days, the Commission will require such fund to report, as applicable: (1) the dates on which the fund's VaR exceeded 200 percent or 250 percent of the designated reference portfolio's VaR; (2) the VaR of its portfolio for each of these days; (3) the VaR of its designated reference portfolio for each of these days; (4) either the name of the designated index or a statement that the fund's designated reference portfolio is its securities portfolio; and (5) the index identifier for its designated index.

Similarly, if the VaR for a fund subject to the absolute VaR test were to exceed, as applicable, 20 percent or 25 percent of the value of the fund's net assets for five business days, the Commission will require such fund to report: (1) the dates on which the fund's VaR exceeded 20 percent or 25 percent 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.

Funds will have to file the Form N-RN one business day after the fifth business day of the breach. They also will have to file another Form N-RN when the fund is back in compliance with the relevant VaR test.

The Commission notes that public disclosure of real-time reporting of VaR breaches could lead to investor confusion, as investors might mistakenly assume that a fund that breaches the applicable VaR test actually suffered substantial losses or that substantial losses were imminent. Accordingly, the Commission made fund reports on Form N-RN non-public because the public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors.

C. Form N-CEN

The Commission amended Form N-CEN to require funds to identify whether:

- They relied on Rule 18f-4 during the reporting period;
- They are: (1) limited derivatives users, excepted from the program requirement and VaR-based limit on fund leverage risk; or (2) leveraged/inverse funds, excepted from the VaR-based limit on fund leverage risk;
- They entered into reverse repurchase agreements or similar financing transactions and, if so, whether they entered such transactions either: (1) in compliance with Section 18's asset coverage requirements; or (2) after determining to treat those transactions as derivatives transactions for all purposes under the rule;
- They entered into unfunded commitment agreements as provided under the rule; and
- They are relying on the rule's provisions that address investments in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle.

III. Leveraged/Inverse ETFs

The Commission amended the ETF Rule (Rule 6c-11) to allow leveraged/inverse ETFs to operate without obtaining an exemptive order from the Commission.

IV. Rescission of Guidance and Relief /Transition Periods

The Commission will rescind SEC and SEC staff guidance, exemptive relief, and no-action letters no longer necessary because of the new rulemaking. It provided a transition period to give funds sufficient time to comply. Specifically, it adopted a compliance date that is 18 months following the effective date (60 days after the rule is published in the Federal Register).

On that same compliance date, the Commission will rescind its 1979 General Statement of Policy ("Release 10666"), which states that funds could engage in reverse repurchase agreements and firm and standby commitment agreements, so long as they use "segregated accounts" to "cover" those securities to limit the fund's risk of loss.[52] In addition, on that date, the SEC will rescind the exemptive orders provided to leveraged/inverse ETFs, and the SEC's Division of Investment Management will withdraw its no-action letters and other guidance addressing transactions that Rule 18f-4 will cover, effective upon the rescission of Release 10666.

A fund may rely on the new rule immediately after its effective date but before the compliance date, provided that the fund satisfies the rule's conditions. For consistency, such a fund will not consider Release 10666, staff no-action letters or staff guidance during the period before the compliance date. In addition, such a fund may satisfy the requirement to file a report on Form N-RN by including information that Form N-RN requires in a report on Form N-LIQUID filed on the SEC's EDGAR filing system until the Commission staff updates current Form N-LIQUID on EDGAR. Similarly, a fund relying on the new rule prior to the compliance date should comply with the disclosure amendments on Forms N-PORT and N-CEN, as applicable, once those updated forms are available for filing on EDGAR. Such a fund will not need to comply with the reporting requirements until those forms are updated. Funds may contact Commission staff with any questions regarding the filing process.

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endnotes

[1] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34078 (Oct. 28, 2020), *available at* https://www.sec.gov/rules/final/2020/ic-34078.pdf.

[2] For purposes of this memo, we refer to the new rule, Rule 18f-4 under the Investment Company Act of 1940 ("1940 Act"), as the "new rule" or "rule." All references to statutory sections are to the 1940 Act, and all references to rules are to those under the 1940 Act.

[3] Rule 6c-11 permits ETFs that satisfy certain conditions to operate without the need for SEC exemptive relief. "Leveraged and inverse" investment vehicles are investment vehicles, including 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 pre-determined period of time.

[4] VaR tests are estimates of an instrument or portfolio's potential losses over a given time horizon and at a specific confidence level.

[5] *See* Letter from Paul Schott Stevens, President and CEO, ICI, to Vanessa A. Countryman, Secretary, SEC, dated Apr. 20, 2020, *available at* https://www.sec.gov/comments/s7-24-15/s72415-7098125-215777.pdf. For a summary of our comment letter, *see* ICI Memorandum No. 32398, *available at* https://www.ici.org/my_ici/memorandum/memo32398; *See also* 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, Investment Company Act Release No. 33704 (Nov. 25, 2019) ("proposing release"), *available at* https://www.sec.gov/rules/proposed/2019/34-87607.pdf. For a summary of the proposing release, *see* ICI Memorandum No. 32083, *available at* https://www.ici.org/my_ici/memorandum/memo32083.

[6] *See* Section 18 (restricting a fund's ability to issue "senior securities"). Section 18(g) defines a "senior security," in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness" (emphasis added).

[7] The rule defines a "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; (2) any short sale borrowing; and (3) [if a fund chooses to treat them as derivatives transactions (as described below),] any reverse repurchase agreement or similar financing transaction. " *See* Rule 18f-4(a). The Commission believes that the term "any similar instrument" includes firm and standby commitment agreements. The Commission views a firm commitment agreement to have the same economic characteristics as a forward contract and a standby commitment agreement to have the same economic characteristics as a put option that a fund has issued.

[8] 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.

[9] The rule defines an "unfunded commitment agreement" as "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." *See* Rule 18f-4(a).

[10] Settling transactions physically distinguishes those securities from others that permit unfunded investment exposure. Settling within 35 days distinguishes those securities from others that involve a greater potential for leverage. The Commission notes that, even though a fund or a money market fund could invest in to-be-announced transactions ("TBAs") or dollar rolls based on the provision, it will deem TBAs and dollar rolls to be

derivatives transactions because it believes those instruments are forward contracts or "similar instruments" under the definition of derivatives transaction and could be used to leverage a portfolio.

[11] Contrary to ICI's recommendation that the Commission permit the adviser entity as a whole to serve as DRM, the Commission determined that one or more natural persons will promote independence, objectivity, and accountability.

[12] The SEC noted that board approval of the designation is necessary because, unlike under the liquidity risk management rule (Rule 22e-4), the board is not required to approve the entire derivatives risk management program. The SEC also noted that the "relevant experience" requirement is designed to provide flexibility such that the person(s) serving in the role has experience in light of the derivatives unique to the fund, and, accordingly, did not take a more prescriptive approach in identifying a specific amount or type of experience that the DRM must have.

[13] The rule will require a fund to reasonably segregate the program from portfolio management to promote objective independent identification, assessment, and management of the risks associated with derivatives use.

[14] "Leverage risk" generally refers to the risk that derivatives transactions can magnify the fund's gains and losses.

[15] "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 volatility changes that adversely impact fund returns and the fund's obligations and exposures.

[16] "Counterparty risk" generally refers to the risk that a derivatives counterparty may not be willing or able to perform its obligations under the contract, and the related risks of having concentrated exposure to such counterparty.

[17] "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.

[18] "Operational risk" generally refers to risk related to potential operational issues, including documentation issues, settlement issues, system failures, inadequate controls, and human failure.

[19] "Legal risk" generally refers to insufficient documentation, insufficient capacity or authority of a counterparty, or enforceability of a contract.

[20] In the proposing release, the SEC provided examples of quantitative models and methodologies used to evaluate various risks, including for market risk (VaR, stress testing or horizon analysis), counterparty risk (concentration at various counterparties), and liquidity risk (liquidity models identifying margin requirements over a specified period under specified volatility scenarios). See proposing release, supra note 5, at 60-61.

[21] The SEC noted, for example, that a fund may wish to establish corresponding investment size controls or lists of approved transactions.

[22] The rule permits funds to stress test more frequently depending on changes in the

fund’s investment strategy, investments, and market conditions. The SEC did not accept recommendations, including from ICI, to reduce the frequency to monthly, indicating that during periods of stress, returns, correlations, and volatilities could change quickly. It noted, however, that funds could conduct more detailed scenario analyses less frequently.

[23] The Commission agreed with commenters, including ICI, that daily backtesting, as proposed, may not be necessary for funds to gather the necessary information.

[24] As described below, the VaR test must have a 99 percent confidence level. Therefore, a fund will be expected to experience a backtesting exception approximately 2.5 times a year or 1 percent of the 250 trading days in a given year.

[25] The Commission acknowledged some concerns about using a VaR test to limit leverage risk, including that it may not reflect the size of losses that occur on the trading days during which the greatest losses occur. It noted, however, that the VaR test is intended to be a complementary measure and not a stand-alone risk management tool.

[26] A designated index cannot be administered by 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 (a “prohibited index”). In response to commenters, including ICI, the Commission recognized that when funds track affiliated indexes, the index will provide the most appropriate reference portfolio for a relative VaR test. In those situations, the rule requires funds to use that index as its designated reference portfolio, regardless of whether it is a prohibited index. The Commission also clarified that indexes could include derivatives as long as the derivatives do not multiply the returns of the index or index constituents.

[27] According to the SEC, this addresses the concern that commenters, including ICI, raised that providing the same VaR limit for open-end funds and closed-end funds does not take into account that closed-end funds may have higher VaRs before entering into any derivatives transactions because they have issued preferred stock.

[28] These risks include: (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.

[29] It acknowledged that such scaling would allow a fund’s VaR calculations to consider additional observations while still appropriately complying with the rule’s VaR tests.

[30] If the fund remains out of compliance with the applicable VaR test after 30 calendar days, the DRM must update the report to explain how and by when he or she reasonably expects the fund to return to compliance, and the DRM must update the board on the fund’s progress in returning to compliance at regulatory scheduled intervals that the board determines.

[31] The Commission agreed with commenters, including ICI, that eliminating the restriction on funds entering into derivatives could negatively impact a fund’s ability to pursue its strategy and that there already are strong incentives for the fund to return to compliance. It also reasoned that its revised requirement that funds return to compliance promptly, in a manner that is in the best interests of the fund and its shareholders, requires a fund to

reduce its VaR promptly without requiring the fund to engage in transactions at potentially deep discounts.

[32] The rule will not require the board to approve the program, but the board will be responsible for overseeing compliance with Rule 38a-1. That rule requires boards to approve policies and procedures reasonably designed to prevent violation of the federal securities laws.

[33] Derivatives that do not involve future payment obligations—and therefore are not derivatives transactions under the rule—are not included in a fund's derivatives exposure. In addition, a fund choosing to treat reverse repurchase agreements and similar financings as derivatives transactions (as described below) must include the proceeds that the fund received but has not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with each such transaction.

[34] 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 will delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta.

[35] The Commission noted that, if a fund were to exceed the 10 percent threshold repeatedly, and particularly if over a long period of time excluding extreme market events, the fund would not appear to be using derivatives in a limited manner. It added that a fund's compliance policies and procedures should prevent these repeated occurrences.

[36] The Commission recognized that, for leveraged/inverse funds that seek, directly or indirectly, to provide investment returns that correspond to 200 percent of the performance or inverse performance of an index, there may be minor deviations between the VaR of the fund and 200 percent of the VaR of its designated index (e.g., attributable to financing costs embedded in the fund's derivatives and valuation differences between the fund' portfolio and the index it tracks). It noted that it would not view these de minimis deviations as exceedances of the relative VaR test because they do not reflect an increase in the fund's leveraged or inverse market exposure.

[37] Existing over-200 percent leveraged/inverse funds are those that, as of October 28, 2020: (1) are in operation; (2) have outstanding shares issued in one or more public offerings to investors; and (3) disclose in their prospectus a leverage multiple or inverse multiple that exceeds 200 percent of the performance or the inverse of the performance of the underlying index.

[38] The proposed sales practice rules would have required broker-dealers and investment advisers to exercise due diligence on retail investors before approving accounts to invest in leveraged/inverse investment products. Under those proposed rules, a firm could approve the retail investor's account to transact in leveraged/inverse investment products only if the firm had a reasonable basis to believe that the investor is capable of evaluating the risks associated with these products. In addition, the proposed rules would have, in effect, required all leveraged/inverse funds to be sold pursuant to the sales practices rules in order to rely on proposed rule 18f-4.

[39] For example, Regulation BI only applies when a broker-dealer recommends a transaction or investment strategy involving securities to a retail customer. Similarly, the new rule only addresses registered investment companies and BDCs.

[40] For example, open-end funds are permitted to borrow money from a bank, provided they have 300 percent asset coverage. Therefore, under the rule, the combination of the bank borrowings and reverse repurchase transactions would have to have 300 percent asset coverage.

[41] The Commission noted that this change is designed to provide funds flexibility to choose the approach that is best suited to its investment strategy or operational needs, while still addressing Section 18's concerns.

[42] A fund could reasonably decide to switch between options if circumstances change or it otherwise reevaluates how it should best treat such transactions. The SEC noted that, if a fund switches between options on a dynamic or frequent basis, it may indicate that the fund has not effectively evaluated the appropriate approach.

[43] In a TOB financing, a fund transfers a bond to a TOB trust that, in turn, issues floating rate securities (often called "floaters") to money market funds and other investors and transfers to the fund the residual interest to the trust (an "inverse floater") and the proceeds of the sale of the floating rate securities. The fund typically uses the cash from the sale of the floaters to purchase additional portfolio securities.

[44] The Commission stated that 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).

[45] The Commission stated that, when a fund engaged in securities lending transactions under those circumstances, it is limited in its ability to use securities lending transactions to increase portfolio leverage. The Commission reiterated its view that US generally accepted accounting principles define cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of change in interest rates. It also stated that items commonly considered to be cash equivalents include certain Treasury bills, agency securities, bank deposits, commercial paper and shares of money market funds. Contrary to commenters' suggestions, it did not expand the types of collateral in which a fund may reinvest its proceeds, because that may result in leveraging of the fund's portfolio.

[46] Any transaction that meets the rule's definition of a "derivatives transaction" will not be deemed an "unfunded commitment.

[47] A fund may not consider cash that may become available from issuing additional equity but may consider cash from the issuance of debt or other borrowings.

[48] Additionally, as proposed, the Commission amended Form N-2 for closed-end funds, so closed-end funds relying on Rule 18f-4 no longer need to include their derivatives transactions and unfunded commitment agreements in the form's senior securities table. The amendment conforms the senior securities table to provide that derivatives transactions and unfunded commitments need not be considered for computing asset coverage under Section 18(h). The Commission believes that applying Section 18's asset coverage requirements to these transactions is unnecessary in light of the new rule. Further, the Commission adopted conforming changes to Forms N-PORT and Rule 22e-4 to remove references to assets "segregated to cover" derivatives transactions. It also amended the General Instructions to Form N-PORT to amend that form's previous

description of derivatives transactions to make clear that the term has the same meaning as in the new rule solely with respect to Form N-PORT items that relate specifically to the rule.

[49] The Commission also made conforming changes to the form's General Instructions.

[50] In limiting the reporting of derivatives exposure to only limited derivatives users, the Commission agreed with commenters, including ICI, that such reporting would not have permitted investors or other market participants to determine the purposes for which a fund uses derivatives (*e.g.*, for hedging).

[51] The Commission also made conforming changes to the form's General Instructions.

[52] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.
