

Insights: Alerts

SEC Adopts Derivatives Overhaul for Funds

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On October 28, 2020, the Securities and Exchange Commission (“SEC”) finalized Rule 18f-4 under the Investment Company Act,¹ a new rule designed to provide an updated and comprehensive framework for the use of derivatives² by mutual funds, exchange-traded funds (ETFs), registered closed-end funds, and business development companies (BDCs) (collectively, “funds”).³ Under Rule 18f-4, a fund may enter into derivatives transactions, notwithstanding the restrictions on the issuance of senior securities under the Investment Company Act⁴, as long as the fund complies with the conditions set forth in the rule, which are summarized below.

Derivatives Risk Management Program and Derivatives Risk Manager. A fund that uses derivatives (other than a Limited Use Fund, as defined below) must adopt a written derivatives risk management program with risk guidelines that: (1) cover certain required elements; and (2) is otherwise tailored to address the fund's use of derivatives and the fund's specific risk profile. Requirements for the program include:

- weekly stress testing to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio;
- weekly back testing of the VaR calculation model (described below), comparing the fund's gain or loss on each day with the corresponding VaR for that day in order to identify any instance in which the fund experienced a loss exceeding the corresponding VaR calculation's estimated loss for that day;
- internal reporting and escalation (to the portfolio manager and board of directors); and
- program review on at least an annual basis.

A fund's board of directors must approve a derivatives risk manager⁵ for the fund who is responsible for administering the fund's derivatives risk management program and provides the board with periodic reports on the program's implementation and effectiveness, and the results of the fund's stress testing.⁶

Value at Risk Limits. A fund engaged in derivatives transactions (other than a Limited Use Fund) must comply with an outer limit on fund leverage risk based on “value at risk” (“VaR”). The VaR limit is generally based on a comparison of the fund's VaR to the VaR of a “designated reference portfolio” for that fund, with a fund being limited to 200% of the VaR of its designated reference portfolio (250% for closed-end

funds). The designated reference portfolio for a fund will either be an index meeting certain criteria or the fund's own securities portfolio (excluding derivatives). If a fund's derivatives risk manager reasonably determines that a designated reference portfolio is not an appropriate comparison, the fund is required to comply with an absolute VaR limit of 20% (25% for closed-end funds).

Streamlined Requirements for Limited Use Funds. A fund that limits its derivatives exposure to 10% or less of its net assets (a "Limited Use Fund") need not comply with the derivatives risk management program requirements, the VaR-based limits, or the related board oversight and reporting requirements of the rule. However, a Limited Use Fund must adopt and implement written policies and procedures that are reasonably designed to manage the Limited Use Fund's derivatives risks. In calculating derivatives exposure for the purposes of determining whether a fund is a Limited Use Fund, a fund is permitted to exclude derivatives transactions that are used to hedge certain currency and interest rate risks. In a change from the proposed rule: the final rule also makes allowance for a Limited Use Fund that temporarily exceeds the 10% threshold, requiring written reporting to the board of directors in such instances regarding whether the adviser will bring the fund into compliance with the 10% threshold within 30 days or will otherwise cease to rely on the exception.

Reporting and Record Keeping Requirements. A fund must maintain certain written records designed to allow the fund's board of directors and compliance personnel, as well as the SEC, to evaluate the fund's compliance with the rule's requirements. A fund that is out of compliance with its VaR test for five business days must file a confidential report with the SEC on Form N-RN (formerly called N-LIQUID). Forms N-PORT and N-CEN have also been amended to include information regarding a fund's compliance with Rule 18f-4.

Reverse Repurchase Agreements, Unfunded Commitments. Rule 18f-4 will permit a fund to enter into reverse repurchase agreements and similar financing transactions, as long as the fund meets the asset coverage requirements under Section 18. Alternatively, a fund may elect to treat these transactions as derivatives transactions subject to Rule 18f-4. A fund may also enter into unfunded commitment agreements if the fund reasonably believes that its assets will allow the fund to meet its obligations under these agreements.

Delayed-Settlement Securities. Rule 18f-4 will allow a fund (including, for these purposes, a money market fund) to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, subject to two conditions: (1) the fund must intend to settle the transaction physically by delivery/acceptance of the underlying/referenced security or securities; and (2) the transaction must settle within 35 days.

Related Matters

In connection with the adoption of Rule 18f-4, the SEC also took certain related actions:

Amendment to ETF Rule. Rule 6c-11, the recently adopted rule allowing ETFs to operate without an exemptive order, is being amended to allow leveraged and inverse ETFs to rely on Rule 18f-4, provided that the ETF complies with the applicable provisions of Rule 18f-4.

Rescinding Release 10666. Release 10666 and certain no-action letters and staff guidance are being rescinded as they are now moot.

Inverse/Leveraged Fund Sales Practice Rules Not Adopted. The SEC did not adopt the sales practice rules related to sales of inverse and leverage ETFs (and other leveraged/inverse investment vehicles) that were proposed in 2019 alongside the original Rule 18f-4 proposal. Instead, the SEC determined to make these inverse and leveraged products subject to Rule 18f-4, as adopted, in the same manner as non-inverse and non-leveraged funds. This effectively limits leveraged/inverse products' targeted daily return to 200% of the return (or inverse of the return) of the fund's underlying index, though the rule does contain an exception to that limitations for funds in operation as of the date of the rule's adoption that satisfy certain conditions. However, it was indicated both in the adopting release and in a joint statement by Chairman Clayton and Directors Dalia Blass, William Hinman and Brett Redfearn published in conjunction with the adoption of Rule 18f-4⁷ that the SEC remains concerned about the risks posed to retail investors by complex investment products, including inverse and leverage ETFs. SEC staff will review whether the existing regulatory framework (including Regulation Best Interest (Reg BI)) provides adequate protection for investors who invest in these types of leveraged/inverse products, especially investors with self-directed accounts (e.g., via online trading platforms) who buy and sell securities without any recommendation from, or interaction with, a registered investment adviser or registered representative of a broker-dealer subject to Reg BI.

Compliance Dates

The compliance date for Rule 18f-4 is 18 months after the effective date of the rule (*i.e.*, providing a transition period to allow funds to come into compliance with the requirements). The rescission of Release 10666 and related no-action letters and guidance will likewise become effective 18 months after the rule's effective date. The rule will be effective 60 days after it is published in the Federal Register.

If you have any questions regarding the regulation of funds, including the steps a fund will need to take to prepare for implementation of a derivatives risk management program, the mechanics of implementing a VaR model, or whether your fund will qualify as a Limited Use Fund, please feel free to contact us.

Footnotes

¹SEC, Final Rule, Use of Derivatives by Registered Investment Companies and Business Development Companies, available at <https://www.sec.gov/rules/final/2020/ic-34084.pdf>.

²Derivatives are defined as: (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) reverse repurchase agreements and similar financing transactions, for those funds that choose to treat these transactions as derivatives transactions under the rule. Note that under the first part of the definition, a derivatives instrument must involve a future payment obligation to be subject to the rule. So, for

example, if a fund purchased a standard option traded on an exchange, the purchase of that option generally would not create any subsequent obligation for the fund to deliver payment and thus would not be subject to the provisions of Rule 18f-4.

³Money market funds are excluded from the definition of a “fund” under Rule 18f-4, and therefore are excluded from the full scope of the rule.

⁴A fund using derivatives must also comply with all other applicable statutory and regulatory requirements, such as other federal securities law provisions, the Internal Revenue Code, Regulation T of the Federal Reserve Board, and the rules and regulations of the Commodity Futures Trading Commission (the “CFTC”).

⁵Note that the derivatives risk manager may not be the investment adviser itself, but rather must be one or more natural person(s), who must be sufficiently segregated from portfolio management.

⁶Unlike the recent liquidity risk management program requirements, a fund’s board of directors does not have to approve the derivatives risk management program itself. Instead, the board is responsible for appointing the derivatives risk manager to administer the program and to report to the board.

⁷Public Statement, Chairman Jay Clayton, Dalia Blass, William Hinman, & Brett Redfearn, Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2020), available at <https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28>

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