THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 54 No. 19 November 10, 2021

A DIVIDED SEC (FINALLY) ADOPTS SWEEPING RULE GOVERNING FUND USE OF DERIVATIVES

The SEC's new rule requires mutual funds (with some exceptions) that use more than a limited amount of derivatives to adopt a comprehensive derivatives management program, designate a board-approved derivatives risk manager, and not exceed a designated maximum outer limit on leverage based on value at risk. The author discusses the background and provisions of the new rule in detail. He notes that the Commission did not adopt its proposed and controversial sales practice rules for leveraged/inverse funds.

By Jay G. Baris *

The U.S. Securities and Exchange Commission, on October 28, 2020, adopted a new rule under the Investment Company Act of 1940, as amended (the "1940 Act") and amended related forms, governing how investment companies use derivatives (the "New Rule" or "Rule 18f-4"). The New Rule caps a decades-long effort to clarify and streamline a patchwork of confusing and often conflicting guidance and interpretations by the SEC and its staff that struggled to keep up with rapidly evolving investment techniques and markets.[1]

In a nutshell, Rule 18f-4 requires mutual funds (other than money market funds), exchange-traded funds ("ETFs"), and registered closed-end funds (including business development companies, or "BDCs") that use derivatives in more than a limited amount to adopt a comprehensive derivatives risk management program, and designate a board-approved derivatives risk manager. The New Rule sets a maximum outer limit on leverage, based on value at risk, or VaR, pegged to a designated benchmark index (generally 200% for mutual funds and ETFs, and 250% for closed-end funds) or, alternatively, an absolute VaR limit (generally 20% of the net assets of a mutual fund or 25% of the net assets of a closed-end fund). Funds that use derivatives in a more limited manner are subject to slimmed-down requirements ("Derivatives Lite" regulation).

Notably, the SEC pulled back from proposed rules that would have introduced significant speed bumps for

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, 1940 Act Release No. IC-34084 (Oct. 28, 2020), 85 Fed. Reg. 83126 (Dec. 21, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-12-21/pdf/2020-24781.pdf [hereinafter the Adopting Release].

* *JAY G. BARIS is a partner in the investment funds group of Sidley Austin LLP in New York. His email address is jbaris@sidley.com. The author gratefully acknowledges the contributions and insights of ANDREW J. DONOHUE, who served at the Securities and Exchange Commission as Director of the Division of Investment Management from 2006-2010 and as Chief of Staff from 2015-2017.*

FORTHCOMING

● ***KEY GOVERNANCE CONSIDERATIONS IN INITIAL PUBLIC OFFERINGS***

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb.

investors in "leveraged/inverse investment vehicles."[2] As proposed, the SEC would have subjected these funds to restrictive "sales practices rules" under the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940, which would have required broker-dealers and investment advisers to pre-screen potential investors and determine that they understand the risks before allowing them to invest.[3]

The SEC's New Rule is not without controversy. Approved by a divided Commission by a 3-2 vote just days before the 2020 presidential election, the New Rule pulled back from some of the more contentious features of the 2019 Proposing Release,[4] which drew more than 6,000 public comments, maybe a record in the annals of SEC rulemaking history.[5] The 2019 Proposing Release, in turn, represented a significant departure from the SEC's ill-fated 2015 proposal.[6]

In this article, we begin with the definitions of a derivative and derivatives transactions, briefly chart the colorful history, including some dramatic twists and turns of the SEC's path to Rule 18f-4, and summarize Rule 18f-4 and how it will affect investment companies and their investors.

WHAT IS A DERIVATIVE AND WHAT IS A DERIVATIVES TRANSACTION?

A derivative is simply a financial instrument that derives its value by reference to another asset or metric. For example, the value of a derivative can be linked to the value of a stock, bond, currency, interest rate, market index, or currency exchange. Typical examples of derivatives include options, futures, swaps, and forward contracts.[7]

Most derivatives involve some form of leverage or potential for leverage. Leverage exists "when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return."[8]

It is important to distinguish between the types of leverage that derivatives involve. The first type of leverage, known as "indebtedness leverage," allows a

[2] "Leveraged/inverse investment vehicles" refers to registered investment companies and certain exchange-listed commodity or currency-based trusts or funds 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 predetermined period of time. 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, 1940 Act Release No. IC-33704 (Nov. 25, 2019), 85 Fed. Reg. 4446, 4567 n.13 (Jan. 24, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf [hereinafter the 2019 Proposing Release]. The New Rule refers to these funds as "leveraged/inverse funds."

[3] The sales practices rules would have applied not only to mutual funds, ETFs, registered closed-end funds, and BDCs, but also to certain exchange products (ETPs) and commodity pools, the shares of which are registered under the Securities Act of 1933. These entities themselves, however, are not registered under the Investment Company Act of 1940, as amended.

[4] 2019 Proposing Release, *supra* note 2.

[5] For a more in-depth discussion of the SEC's 2019 Proposing Release and Its historical origins, see Jay G. Baris, *Derivatives Redux: A Historical Perspective as the SEC Proposes Rules Governing Investment Company Use of Derivatives*, 53 REV. SECS. & COMMODITIES REG. 6 (Mar. 25, 2020) [hereinafter *Derivatives Redux*].

[6] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-28/pdf/2015-31704.pdf [hereinafter the 2015 Proposing Release].

[7] Adopting Release, *supra* note 1, at 83164.

[8] Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25128, 25129 n.5 (Apr. 27, 1979), https/www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf [hereinafter Release 10666].

fund to magnify gains and losses compared to the actual amount of money invested and may require the fund to pay or deliver additional assets under specified conditions. Derivatives that create indebtedness leverage include futures contracts, swaps, and "written" options. By investing a small amount of money up front ("initial margin"), a fund obtains the economic exposure to the reference asset that it would have as if it had invested a much larger amount of money. The fund's initial margin is at risk, and if the value of the reference asset moves in the "wrong" direction, the fund will be obligated to pay additional amounts, which can far exceed the amount of the initial margin. This obligation to pay money in the future is an example of a "senior security," because it is an obligation that is senior to the rights of the fund's shareholders to the fund's assets.

The second kind of leverage, known as "economic leverage," allows an investor to obtain the economic equivalent of leverage because the investment magnifies the exposure beyond initial investment, but does not require the investor to pay any money beyond her initial investment. Derivatives that create economic leverage include purchased call options and purchased put options. The investor pays a premium for the economic leverage, but is not required to make any other payments in the future above the initial amount of the premium.

The New Rule regulates those "derivatives transactions" that involve an obligation to pay money in the future, effectively resulting in a senior security, and thus leverage. Rule 18f-4(a) 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) reverse repurchase agreements or similar financing transactions.[9]

The SEC-designated Rule 18f-4 to limit the issuance of senior securities, of which derivative transactions are a primary example. The genesis of this rule lies within Section 18 of the 1940 Act.

SECTION 18 OF THE 1940 ACT: CONGRESSIONAL INTENT TO LIMIT FUND LEVERAGE

To understand the origins of the regulation of derivatives, we start at the beginning — Section 1 of the 1940 Act. When it enacted the 1940 Act, Congress declared that the national public interest and the interest of investors are adversely affected, among other reasons, "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities."[10] In 1992, the SEC's Division of Investment Management published a study that observed, among other things, leverage by investment companies, primarily through excessive borrowing and the issuance of "excessive amounts of senior securities," was one of many concerns that led to the enactment of the 1940 Act.[11]

In response to concerns about excessive borrowing and leverage, funds operating without adequate assets and reserves, and other perceived abuses, Congress adopted Section 18 of the 1940 Act and other related protective measures.[12] Section 18 limits the ability of registered investment companies (mutual funds and closed-end funds) to use leverage by restricting leveraged capital structures, primarily by restricting the ability of funds to issue "senior securities."

Section 18(g) defines "senior security" generally to include "any bond, debenture, note, or similar obligation or instrument 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."[13] A senior security representing indebtedness means any senior security other than stock.

To address these concerns, Section 18 generally prohibits a mutual fund from issuing or selling any

[9] Adopting Release, *supra* note 1, at 83172.

[10] Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(7).

[11] SEC DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, 430 (May 1992), *available at* https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

[12] Adopting Release, *supra* note 1, at 83167. For a summary of the market and regulatory conditions during the heyday of the stock market leading to the 1929 crash and the enactment of the 1940 Act, *see* Jay Baris and Andrew Donohue, *Still Spry at 75: Reflections on the Investment Company Act and the Investment Advisers Act*, 22 INV. LAW. 7 (July 2015).

[13] 15 U.S.C. § 80a-1(g).

"senior security" of which it is the issuer, except that it may borrow from a bank (provided that immediately after the borrowing, there is asset coverage of at least 300% of all borrowings). Closed-end funds may borrow from banks and other sources, and may issue one class of senior debt, subject to a 300% asset coverage requirement, and may issue one class of preferred stock, subject to a 200% asset coverage requirement.[14]

While a mutual fund must maintain asset coverage of at least 300% of all borrowings, Section 18(a)(1) provides, among other things, that a leveraged, closed-end fund may not pay dividends or other distributions or purchase any of its capital stock unless it satisfies asset coverage requirements, and senior security holders have certain rights if asset coverage falls below the required levels.

REGULATORY DEVELOPMENTS – 1979-2019[15]

In 1979, the SEC published Release 10666, which created a regulatory framework to address investments in reverse repurchase agreements, firm commitment agreements, and standby commitment agreements, which it said could result in the issuance of a senior security that could violate Section 18.[16] The SEC stated that it would not raise issues under Section 18 with respect to the types of transactions addressed in the release, provided that funds segregated highly liquid assets in the amount of their potential obligations under the relevant transactions to ensure that they had sufficient assets to cover their obligations. Release 10666 was the precursor of modern-day regulation by the SEC of investment company use of derivatives. In the 30 years that followed, the SEC's Division of Investment Management issued more than 30 no-action letters that expanded the scope of Release 10666 to a growing number of other investment practices, including use of derivatives.

In April 2009, Andrew J. Donohue, then the director of the Division of Investment Management, revived the debate around regulatory issues that investment companies faced when using derivatives and leverage. He explored whether the patchwork of guidance and interpretations concerning derivatives allowed funds to technically comply with the law but achieve outcomes that strayed from public policy concerns.[17]

Meanwhile, SEC concerns about the dangers of investment company leverage continued unabated. In August 2011, an SEC Concept Release requested comments on a wide range of issues relating to investment company use of derivatives and leverage.[18] The Concept Release addressed, among other things, the various asset segregation practices that evolved after Release 10666 and its regulatory progeny. The Concept Release floated the idea of using a "Value at Risk" approach as an alternative for the notional and mark-to-market standards for assessing fund risk to derivatives and addressed other legal issues related to fund use of derivatives, including how funds should treat derivatives in measuring compliance with standards relating to asset diversification, portfolio concentration, and exposure to securities-related issuers.[19]

In December 2015, the SEC proposed an ill-fated first round of Rule 18f-4, designed to replace decades of guidance and staff no-action letters.[20] As proposed in 2015, Rule 18f-4 would require funds to comply with

[14] Section 61 of the 1940 Act subjects BDCs to the same restrictions that apply to closed-end funds, except the applicable amount for any senior security representing indebtedness is 200%, which can be decreased to 150% under certain circumstances.

[15] For a more comprehensive discussion of SEC regulatory guidance after 1979 through 2010, see *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010), *available at* https://www.americanbar.org/content/dam/aba/publications/blt/2010/08/inside-buslaw-derivative-leverage-201008.pdf [hereinafter 2010 ABA Derivatives Report].

[16] Release 10666, *supra* note 8, at 25129.

[17] Andrew J. Donohue, Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality? Remarks Before the Subcommittee on Investment Companies and Investment Advisers of the Committee on Federal Regulation of Securities at the Spring Meeting of the Section of Business Law of the American Bar Association, (Apr. 17, 2009) [hereinafter Donohue Speech], *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm.

[18] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 Fed. Reg. 55237 (Sept. 7, 2011), *available at* https://www.govinfo.gov/content/pkg/FR-2011-09-07/pdf/2011-22724.pdf [hereinafter the Concept Release]. For a more complete summary and analysis of the Concept Release, *see* Jay Baris & Andrew Donohue, *SEC Concept Release Tackles Investment Company Use of Derivatives*, 45 REV. SECS. & COMMODITIES REG. NO. 3 (Feb. 8, 2012).

[19] Concept Release, *supra* note 18, at 55239.

[20] 2015 Proposing Release, *supra* note 6, at 80884.

one of two alternative substantive limitations on senior securities transactions: an exposure-based portfolio limit or a risk-based portfolio limit.

The exposure-based limit would have required a fund to limit its exposure to "senior securities transactions" to 150% of the fund's net assets. The proposed rule defined a fund's "exposure" to senior securities transactions as the sum of (1) transactions (subject to certain adjustments); (2) the aggregate obligations of the fund under its financial commitment transactions; and (3) the aggregate indebtedness (or in the case of closed-end funds and BDCs, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the fund pursuant to Sections 18 or 61 of the 1940 Act.[21]

The alternative risk-based limit would have required a fund to limit its "risk-based portfolio limit" to 300% of net assets and comply with a VaR test.

The 2015 Proposal proved to be controversial, generating more than 200 public comments. The SEC never finalized a rule based on the 2015 Proposing Release, which faded into oblivion upon the resignation of Chair Mary Jo White on January 20, 2017.[22]

2019 REBOOT PROPOSAL

In November 2019, the SEC revamped its thinking on investment company use of derivatives and proposed a new set of rules. The 2019 Proposing Release combined a principles-based approach while maintaining rules-based requirements, centering on the VaR concept. The 2019 Proposing Release proposed to regulate any "derivatives transaction" that involved the issuance of a "senior security;" that is, one that contractually obligates a fund to make a future payment under certain conditions.

The 2019 Proposing Release took aim at leveraged/inverse funds.[23] As a quid pro quo for allowing leveraged/inverse funds to operate, financial intermediaries and advisers would have been required to comply with the sales practices rules, which would have required broker-dealers and investment advisers to exercise due diligence on retail investors before approving retail investor accounts to invest in leveraged funds.[24]

2020 – THE NEW RULE

The SEC adopted the New Rule on November 25, 2020, in the midst of the COVID-19 pandemic. The SEC recognized both that (1) the market volatility that the pandemic introduced underscored the need for robust derivatives risk management and (2) derivatives can play an important role in a fund's ability to hedge risk and respond to quickly changing market demands.[25]

Against this background, by a 3-2 vote, the SEC adopted Rule 18f-4 and other amendments with the goal of modernizing and clarifying a decades-old patchwork of rules, guidance, statements, and interpretations, some of which may have been inconsistent and thus frequently created uncertainty among lawyers, advisers, and fund directors.

Scope of the New Rule. Rule 18f-4 is an exemptive rule that would permit an investment company to enter into "derivatives transactions," as defined in the New Rule, notwithstanding the restrictions contained in Section 18 or Section 61 of the 1940 Act, subject to certain conditions.[26] Rule 18f-4 applies to mutual funds (other than money market funds), ETFs organized as open-end investment companies, registered closed-end funds, and companies that have elected to be treated as BDCs. It does not apply to unit investment trusts (or to ETFs organized as unit investment trusts). In a departure from the 2019 Proposing Release, the Rule also allows funds, including money market funds, to invest in securities on a when-issued or forward-settling basis, subject to certain conditions.

---

[21] Section 61 of the 1940 Act applies Section 18 to BDCs, with certain modifications. Generally, references here (and in the Adopting Release to Section 18) generally refer to Section 61 with respect to BDCs.

[22] For a discussion of the circumstances of the death of the 2015 Proposal, see *Derivatives Redux*, *supra* note 5, at n.35.

[23] Rule 18f-4(a) defines a "leveraged/inverse fund" to mean "a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple ('leverage multiple'), or to provide investment returns that have an inverse relationship to the

footnote continued from previous column…

performance of a market index ('inverse multiple'), over a predetermined period of time."

[24] For a more comprehensive discussion about the 2019 Proposing Release, *see Derivatives Redux*, *supra* note 5, at 63–67.

[25] Adopting Release, *supra* note 1, at 83165.

[26] Section 61 of the 1940 Act applies Section 18 to BDCs, with certain modifications. Generally, references here (and in the Adopting Release to Section 18) generally refer to Section 61 with respect to BDCs.

Derivatives transactions. As discussed above, for decades, investment companies complied with Section 18's limitations on the ability of funds to issue "senior securities" by segregating liquid assets on its books to "cover" their derivatives positions on the theory that segregated accounts, if properly maintained, would limit the fund's risk of loss by ensuring that the fund had adequate resources to meet its obligations resulting from its derivatives activities.[27] These practices varied among fund groups and types of derivatives being covered.

The New Rule takes a materially different approach. Rather than view each derivatives transaction individually, funds must establish a derivatives risk management program, evaluate and manage risks, and establish maximum VaR limits.

Below we summarize these conditions and how they operate.

Derivatives risk management program. A fund that uses derivatives in more than a limited manner must adopt a derivatives risk management program ("DRMP") "reasonably designed to manage the fund's derivatives risks" and to reasonably segregate the DRMP's functions from the portfolio management of the fund.[28] The DRMP must contain risk guidelines that cover specific elements, but can be otherwise tailored to address the types of derivatives that the fund uses and their related risks.

Rule 18f-4 does not specifically require a fund's board to approve the DRMP; rather, the board will engage with the DRMP "through its appointment of the derivatives risk manager, who is responsible for administering the program and reporting to the board on the program's implementation and effectiveness."[29] Among other things, Rule 18f-4 provides the following:

- *Program administration.* Rule 18f-4 requires one or more officers of the fund's adviser to serve as the derivatives risk manager. The officer may not be a portfolio manager of the fund and must have "relevant experience" regarding management of derivatives risk. If multiple officers serve as the derivatives risk manager, a majority of those persons cannot be portfolios managers. The derivatives risk manager may delegate specific activities to a sub-adviser, subject to appropriate oversight. The fund's board of directors, including a majority of the directors who are not "interested persons" of the fund, must approve the derivatives risk manager.

- *Elements of a DRMP*. A fund's DRMP must include these six elements:

  — *Risk identification and assessment.*[30] A DRMP requires a fund to identify and assess its derivatives risks, taking into account the fund's derivatives risks and transactions. The DRMP requires the fund to identify and manage risks including leverage, market, counterparty, liquidity, operational, and legal risks, and any other risks that the derivatives risk manager deems material. The potential risks are not limited only to those specified in Rule 18f-4.

  — *Risk guidelines.*[31] Each DRMP requires a fund to establish, maintain, and enforce investment, risk management, or related guidelines that provide for "quantitative or otherwise measurable criteria," or thresholds related to derivatives risks. While the Rule does not impose specific risk limits for the guidelines, it requires a fund to establish its own quantitative thresholds tailored to the fund.

  — *Stress testing.*[32] Each DRMP requires funds to stress test derivatives risks at least weekly, in a way that is analogous to the stress testing requirements that apply to money market funds and liquidity risk management procedures. Specifically, a stress test "must evaluate potential losses 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."[33]

  — *Backtesting*.[34] The DRMP must provide for backtesting, designed to confirm the effectiveness of the fund's VaR model. A fund must backtest at least weekly (as compared to a daily requirement, as originally proposed) the results of the fund's VaR calculation model used in connection with the relative VaR test or the

[27] Adopting Release, *supra* note 1, at 83235.

[28] Rule 18f-4(c).

[29] Adopting Release, *supra* note 1, at 83177.

[30] Rule 18f-4(c)(1)(i).

[31] Rule 18f-4(c)(1)(ii).

[32] Rule 18f-4(c)(1)(iii).

[33] Adopting Release, *supra* note 1, at 83180.

[34] Rule 18f-4(c)(1)(iv).

absolute VaR test (discussed below). The test must compare the fund's gain or loss that occurred on each business day during the backtesting period with the corresponding VaR calculation for that day, estimated over a one-trading-day time horizon, and identify any exceptions.

— *Internal reporting and escalation.*[35] The DRMP must identify when and how portfolio managers will be informed about the DRMP's operation, including when the fund exceeds its guidelines, and the results of any stress tests. Also, the DRMP must provide for timely escalation of material risks to portfolio managers. It must also provide for the derivatives risk manager to directly inform the fund's board of material risks arising from the fund's use of derivatives transactions, including those resulting when the fund exceeds its guidelines.

— *Periodic review of the DRMP*.[36] Rule 18f-4 requires a fund's derivatives risk manager to review the program at least annually to evaluate the program's effectiveness and to reflect changes to the fund's derivatives risks over time. The periodic review must include a review of the fund's VaR calculation model.

What is VaR? Generally, "value at risk" attempts to quantify the amount an investor can lose over a period of time, based on historical probability levels.[37] The SEC described VaR in the Adopting Release:

> VaR is an estimate of an instrument's or portfolio's potential losses over a given time horizon and at a specified confidence level. VaR will not provide, and is not intended to provide, an estimate of an instrument's or portfolio's maximum loss amount. For example, if a fund's VaR calculated at a 99% confidence level was $100, this means the fund's VaR model estimates that, 99% of the time, the fund would not be expected to lose more than $100. However, 1% of the time, the fund would be expected to lose more than $100, and VaR does not estimate the extent of this loss.[38]

The SEC acknowledged that by itself, VaR does not measure actual portfolio leverage. Rather, the SEC believes that a VaR test that compares a fund's VaR to an "unleveraged reference portfolio" that reflects the markets or asset classes in which the fund invests is a way to analyze whether the fund is using derivatives to leverage its portfolio.[39] The test reflects an understanding that a fund's use of derivatives may actually reduce risks to the portfolio, rather than increase them. When the fund uses derivatives extensively but its VaR did not exceed the VaR of an appropriate benchmark, the SEC reasons, its derivatives use would indicate that the fund was not substantially leveraging its portfolio and thus does not raise concerns under Section 18.

Rule 18f-4 requires a fund's VaR model to take into account and incorporate certain market risk factors associated with the fund's investments and provide parameters for the VaR calculation's confidence level, time horizon, and historical market data. Funds need not use the same VaR model for calculating its portfolio's VaR and the VaR of its designated reference portfolio.[40] The Rule identifies a non-exhaustive list of common market risk factors that a fund must account for in its VaR model to the extent they apply. These market risk factors include: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk, and commodity price risk; (2) material risks arising from the non-linear 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. Moreover, the VaR tests must apply a 99% confidence level and a time horizon of 20 trading days and be based on at least three years of historical market data.

VaR limits. Rule 18f-4 generally establishes an outer limit on risk under VaR-based tests. Funds must comply with a "relative VaR test," unless the derivatives risk manager "reasonably determines" that this test would not provide an appropriate reference, taking into account the fund's investment objectives and strategy. A fund that does not apply the relative VaR test must comply

[35] Rule 18f-4(c)(1)(v).

[36] Rule 18f-4(c)(1)(vi).

[37] 2010 ABA Derivatives Report, *supra* note 13, at 18 n.28. For a discussion of how the financial industry and the SEC have used the value at risk concept, *see* Henry T. C. Hu, *The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model*, 60 BUS. LAW. 1303 (2005).

[38] Adopting Release, *supra* note 1, at 83187–88.

[39] *Id.* at 83188.

[40] *Id.* at 83200.

with the "absolute VaR test."[41] In effect, Rule 18f-4 limits a fund's use of derivatives indirectly, based on the amount of the fund's risk exposure compared to a benchmark. The VaR tests replace the decades-old requirement to segregate assets to "cover" potential obligations in connection with derivatives transactions by maintaining "segregated accounts."

Rule 18f-4 provides two exceptions to this requirement. The first applies to "limited derivatives users," and the second applies to "leveraged/inverse funds." We discuss these exceptions in detail below. Rule 18f-4 does provide exceptions for funds that are limited to investors who are "qualified clients" (as defined in Rule 205-3 under the Advisers Act), "accredited investors" (as defined in rules 215 and 501(a) under the Securities Act of 1933), or "qualified purchasers" (as defined in section 2(a)(51) of the 1940 Act).

What is the Relative VaR Test? The Relative VaR test requires a fund to calculate the VaR of the fund's portfolio and measure it against the VaR of a "designated reference portfolio."[42] The reference portfolio is designed to create a baseline VaR that functions as the VaR of the fund's unleveraged portfolio.

A designated reference portfolio can be either (1) a "designated index," which is an unleveraged index approved by the derivatives risk manager that reflects the markets or asset classes in which the fund invests[43] or (2) the fund's own securities portfolio, excluding derivatives transactions (a "securities portfolio").

A designated index cannot be one that is administered by an organization that is an "affiliated person" of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or investment adviser (a "prohibited index"), unless the index is widely recognized and used.

The "designated reference portfolio" concept departs from the 2019 Proposing Release in some significant ways. First, the 2019 Proposing Release would have required the designated index to be an "appropriate broad-based securities market index" or an "additional index," which is a narrower requirement.[44] Second, the Rule provides that, if a fund's investment objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its designated reference portfolio, even if the index otherwise would be a prohibited index that would not be permitted under the New Rule.[45] Third, the 2019 Proposing Release would not have allowed an actively managed fund to use its own securities portfolio as the reference portfolio for the relative VaR test. Fourth, consistent with the SEC's desire to encourage concise fund disclosures, the Rule does not require a fund to publicly disclose its designated index in the fund's annual report, as originally proposed.[46]

To comply with the Relative VaR Test, a fund's VaR cannot exceed 200% of the VaR of the fund's designated reference portfolio. Closed-end funds that have outstanding shares of a preferred stock issued cannot exceed 250% of the VaR of the funds' designated reference portfolio. The 2019 Proposing Release would have set the threshold at 150% of the fund's designated index.

If a fund's derivatives risk manager believes that the relative VaR test potentially understates or overstates a particular fund's leverage risk, the Rule provides an alternate means of estimating and limiting its leverage risk: the absolute VaR test.

What is the Absolute VaR Test? Generally, a fund satisfies the Absolute VaR test if its VaR does not exceed 20% of the value of the fund's net assets. A closed-end fund with outstanding preferred stock, however, satisfies the Absolute VaR test if its VaR does not exceed 25% of the value of the fund's net assets. The 2019 Proposing Release would have limited a fund's VaR to 15% of the value of its net assets. The SEC said that it settled on the higher Absolute VaR test limits because they are consistent with the Relative VaR Test, and they reflect similar risk profiles.[47]

Frequency of testing; remediation. The Rule provides that a fund must determine its compliance with the applicable VaR test at least once each business day. If the fund determines that it does not comply with its test, it must comply promptly after it determines non-

[41] Rule 18f-4(c)(2).

[42] Rule 18f-4(a).

[43] A designated index cannot be one that is administered by an "affiliated person" of the fund, including its investment adviser, or principal underwriter, or created at the request of the fund or investment adviser, unless the index is widely recognized and used (a "prohibited index").

[44] Adopting Release, *supra* note 1, at 83192.

[45] *Id.* at 83193.

[46] *Id.*

[47] *Id.* at 83199.

compliance "in a manner that is in the best interests of the fund and its shareholders."[48]

If the fund does not comply with its VaR test within five business days, then the derivatives risk manager must:

> (1) provide a written report to the fund's board of directors explaining how and by when the derivatives risk manager reasonably expects the fund to return to compliance;
>
> (2) analyze the circumstances that caused the fund to be out of compliance for more than five business days and update any program elements as appropriate; and
>
> (3) provide a written report within 30 days of the "exceedance" to the fund's board of directors explaining how the fund came back into compliance and the results of the analysis. If the fund continues to be out of compliance at that time, it must update its report "at regularly scheduled intervals" determined by the board.

Board oversight and reporting. As noted above, the board of directors must approve the fund's derivatives risk manager. Then, the derivatives risk manager must provide the board, *on or before the implementation of the program and then at least annually*, a written report that represents that the DRMP is "reasonably designed to manage the fund's derivatives risk" and includes the required elements. The derivatives risk manager can base the representations on "reasonable belief after due inquiry" and must include the basis for the representations and any other information that is "reasonably necessary to evaluate the adequacy of the fund's program" and its effectiveness.[49]

Exception for Limited Derivatives Users

Rule 18f-4 excepts "limited derivatives users" from the VaR-based limits on fund leverage risk and the DRMP requirement. For purposes of the Rule, a "limited derivatives user" means a fund that limits its derivatives exposure to 10% of its net assets, *excluding* derivatives transactions that are used to hedge certain currency and/or interest rate risks, and positions closed out with the same counterparty.[50] A fund that relies on this exception must adopt unspecified policies and procedures that are reasonably designed to manage its derivatives risk.

For purposes of this exception, "derivatives exposure" means the sum of (1) the gross notional amount of a fund's derivatives transactions, such as futures, swaps, and options and (2) in the case of short sale borrowings, the value of any asset sold short.

The 2019 Proposing Release included a proposal to except limited derivatives users from the derivatives risk management program requirement and the VaR-based limit on leverage risk. The proposed exception would have been available to a fund that either limited its derivatives exposure to less than 10% of its net assets or limited its derivatives transactions solely to certain currency hedging transactions.[51]

Unlike the 2019 Proposing Release, the New Rule 18f-4 clarifies that derivatives instruments that do not involve future payment obligations (e.g., purchased call options) are not included in the fund's derivatives exposure.[52] This calculation is based on "gross" notional amounts, which means that a fund cannot net long and short positions to determine whether it can rely on this exception. The Rule allows funds to make two adjustments designed to address limitations associated with notional measures of market exposure.[53]

When a fund that relies on the limited derivatives user exception exceeds the 10% derivatives threshold for more than five business days, the fund's adviser must provide a written report to the fund's board of directors stating that the adviser intends to pursue one of two alternative remedies. The first is that the adviser must promptly, but within no more than 30 days of the exceedance, reduce the fund's derivatives exposure to comply with the 10% threshold. The second is that the adviser must establish a DRMP and comply with the VaR-based limits on fund leverage risk and comply with the Rule's other requirements. In either case, the fund must report on its next Form N-PORT filing the number of business days in excess of the five-business-day

[48] Rule 18f-4 (c)(2)(ii).

[49] Rule 18f-4(c)(3)(ii).

[50] Rule 18f-4(c)(4).

[51] Adopting Release, *supra* note 1, at 83206.

[52] Rule 18f-4(a).

[53] "Specifically, the first adjustment permits a fund to convert the notional amount of interest rate derivatives to 10-year bond equivalents, and the second adjustment permits a fund to delta adjust the notional amounts of options contracts." Adopting Release, *supra* note 1, at 83207.

period that the fund's derivatives investments exceeded the 10% limit.

Leveraged/Inverse Funds

As noted above, the SEC did not adopt the sales practices rules that effectively would have discouraged public investments in leveraged/inverse funds. The 2019 Proposing Release would have exempted a leveraged/inverse fund from the VaR-based leverage requirements if (1) the fund limited its investment results it seeks to 300% of the return (or inverse return) of the benchmark index and (2) any broker-dealer or investment adviser recommending transactions in shares of that fund would have to assess the ability of an investor to understand the risks of investing in those funds (the "sales practices rules"). As noted, the sales practices rules drew more than 6,000 public comments to the 2019 Proposing Release.

Leveraged/inverse funds that seek to provide market exposure to no more than 200% of the return or inverse return of the underlying index can operate under Rule 18f-4 and are not subject to the sales practices rules. Leveraged/inverse funds that seek exposure to greater than 200% of the return or inverse return of the underlying index, however, cannot satisfy the VaR-based limits of Rule 18f-4. The SEC recognized that some of these funds, including some that seek to provide exposure to 300% of the return or inverse return of the underlying index, have operated for years under the prior regulatory environment. Accordingly, the SEC grandfathered these "over 200% leveraged/inverse funds" existing as of October 28, 2020, provided that they comply with all the other provisions of the Rule and other conditions. Among other things, over 200% leveraged/inverse funds cannot change the underlying index or increase, directly or indirectly, the amount of leveraged return they seek and must disclose that they are not subject to the VaR limits.[54]

The SEC, however, left the door to further regulation open a crack; it published a separate joint statement by the SEC's Chairman and several staff members addressing leveraged/inverse funds that staff would further study complex derivatives products, including over 200% leveraged/index funds.[55]

Finally, the SEC amended Rule 6c-11 under the 1940 Act to include leveraged/inverse ETFs to rely on that rule rather than individual exemptive orders, provided that those ETFs comply with Rule 18f-4.

Reverse Repurchase Agreements and Similar Financing Transactions

Reverse repurchase agreements and other similar financing transactions (e.g., tender option bonds) allow a fund effectively to obtain additional cash that it can use for investment purposes or to finance acquisition of fund assets.[56] The New Rule gives funds the option of choosing (1) to limit these transactions to the Section 18 asset coverage limits for senior securities or (2) to treat them as derivatives transactions under the New Rule, subject to the New Rule's VaR tests. For purposes of consistency, the method that a fund elects to treat reverse repurchase agreements and other similar financing transactions will apply to all such transactions.[57]

Unfunded Commitment Agreements

Rule 18f-4 allows a fund to enter into unfunded commitment agreements if the fund reasonably believes, at the time it enters into the agreement, that it will have sufficient cash and cash equivalents to meet its obligations under the agreement. The New Rule distinguishes these unfunded arrangements from the derivatives transactions, because even though unfunded commitment agreements involve a degree of risk, they generally do not involve leverage and other risks associated with derivatives transactions.[58]

[54] Rule 18f-4 does not impose a limit on how much leverage an over 200% leveraged/inverse fund can take on, because as of the grandfather date, no such fund with a leveraged return of more than 300% existed, so any further limit was not necessary. Adopting Release, *supra* note 1, at 83218.

[55] Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2019), *available at* https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28 [hereinafter the Joint Statement].

[56] In a reverse repurchase agreement from the perspective of the fund, the 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. *See* Adopting Release, *supra* note 1, at 83225 n.714.

[57] Rule 18f-4(d)(1)(i) and (ii).

[58] Adopting Release, *supra* note 1, at 83171.

Rule 18f-4 provides that in forming a reasonable belief that it will have sufficient cash to meet its obligation under the agreement, the fund must take into account its reasonable expectations with respect to its other obligations (including with respect to senior securities or redemptions) but not take into account cash that may become available for the sale of an investment at a price that deviates significantly from the market price or from issuing additional equity.

When-Issued or Forward Transactions

Rule 18f-4 permits funds, including money market funds, to invest in securities on a when-issued or forward-settling basis or with a non-standard settlement cycle, provided that the fund complies with certain conditions. This provision reflects the SEC's view that the potential for leveraging is limited when funds meet the enumerated conditions.[59] While Rule 18f-4 generally does not apply to them, money market funds may rely on the New Rule to invest in when-issued and similar securities.[60]

Rescind and Withdraw Existing Guidance

The SEC rescinded Release 10666 and its progeny with respect to treatment of senior securities under Section 18 and other no-action letters and staff guidance that have been superseded by the New Rule, effective August 19, 2022.

Remediation

In a significant departure from the 2019 Proposing Release, the New Rule does not restrict a fund's ability to enter into derivatives transactions while out of compliance with its VaR test. The SEC said that the requirement to report violations to the board of directors and to the SEC creates "a strong incentive" for funds to return to compliance without the need to limit the fund's investment activities in a manner that may disadvantage shareholders.[61]

Fund Reporting Requirements

The SEC amended Form N-PORT, N-CEN and Form N-LIQUID (renamed as "Form N-RN").

Form N-PORT requires funds that rely on the limited derivatives users exception to report their aggregate derivatives exposure, breaking out various types of exposure. The 2019 Proposing Release would have required all funds to report this data. These funds must also report the number of business days (in excess of the five-business-day remediation period) that derivatives exposure exceeds 10% of net assets. Funds subject to a VaR-based limit on leverage must report their median daily VaR for the monthly reporting period, the name of the fund's designated index, and its index identifier. Funds must also report the number of exceptions it has identified during the reporting period arising from backtesting of a VaR calculation model. In a change from the 2019 Proposing Release, certain information the limited derivatives user reports concerning its derivatives exposure and VaR calculations, including backtesting exceptions, will not be publicly disclosed.

Form N-RN (f/k/a Form N-LIQUID) requires all funds subject to the VaR-based risk limits to report detailed information about VaR breaches under certain circumstances within one business day following the fifth business day after the fund has determined a breach of a VaR limit. Prior to the Rule, only open-end funds were required to file form N-LIQUID. The SEC will not make VaR test breaches reported on form N-RN available to the public.

Form N-CEN requires a fund to disclose whether it relied on the Rule during the reporting period and whether it relied on the limited derivatives user exception or is a leveraged/inverse fund that is excepted from the leverage risk limits. A fund must also report on Form N-CEN whether it has entered into reverse repurchase agreements or similar financing transactions under the provision of the New Rule that (1) requires compliance with Section 18's asset coverage requirements or (2) allows the funds to treat the transactions as derivatives transactions for all purposes. Funds must also report whether they have entered into unfunded compliance commitments under the New Rule.

Recordkeeping

Rule 18f-4 subjects funds to additional recordkeeping requirements. Specifically, a fund must maintain certain records and document its DRMP's written policies and procedures, its portfolio stress test results, VaR backtesting results, any internal reporting or escalation of material risks under the DRMP, and periodic reviews of the DRMP.[62] A fund must also maintain records of materials provided to the board of directors in connection with designating the derivatives risk manager

[59] *Id.* at 83248.

[60] *Id.* at 83171.

[61] *Id.* at 83205.

[62] Rule 18f-4(c)(1)(A).

and reports relating to the DRMP. In addition, a fund must keep records that document its determination of its VaR, the designated reference portfolio, the VaR ratio and updates to VaR calculation model, and any non-compliance with the applicable VaR-based test. Limited derivative users must keep records of their policies and procedures, and reports to the board of directors describing when the fund exceeds its 10% derivatives exposure limit.

Statement on Complex Financial Products

The Joint Statement expressed concern that leveraged/inverse products and other similar complex products "may present investor protection issues – particularly for retail investors who may not fully appreciate the particular characteristics or risks" of these products, noting that these risks may be heightened in times of market stress. Acknowledging advances in technology that have fueled an increase in investment options and the ability of retail investors to access them, the Joint Statement recognized that investors can now trade complex products in self-directed accounts through their desktops and phones. The staff will review the effectiveness of the existing investor protection requirements, particularly with respect to self-directed accounts, and consider whether any additional requirements would be appropriate. The SEC invited public comment on this issue.

The Dissents

Commissioners Allison Herren Lee and Caroline A. Crenshaw voted against adopting the New Rule. Rule 18f-4, as adopted, "fails to provide a meaningful limit on registered funds' ability to take on leverage," Commissioner Crenshaw wrote in a dissent. Similarly, Commissioner Lee said she was "deeply disappointed" that the SEC did not adopt the proposed controversial sales practice rules.

Compliance Dates

Rule 18f-4 became effective February 19, 2021, and the compliance date is August 19, 2022. A fund that relies on it before the date that Release 10666 is amended can only rely on Rule 18f-4, and cannot consider Release 10666 or other related guidance or no-action letters. A fund that relies on Rule 18f-4 prior to the compliance date must comply with the new reporting requirements of Form N-PORT and N-CEN once the forms are available for filing on EDGAR. Until the forms are available on EDGAR, a fund can rely on Rule 18f-4 without also complying with these new reporting requirements.

CONCLUSION — LOOKING AHEAD

If nothing else, the SEC finally completed a decades-long journey to consolidate and modernize the regulation of investment company use of derivatives. Like it or not, the New Rule removes much uncertainty as to how funds can use derivatives and to leverage their portfolios, by combining principles-based concepts and rule-based concepts in one package. The New Rule is flexible enough to accommodate investment innovations and advances in technology.

Looking ahead, many stakeholders – including funds, advisers, fund directors, fund administrators, chief compliance officers, counsel, and independent accountants – face the daunting task of retooling to understand and comply with the new requirements. It is an open question as to what the SEC's staff will conclude in its study of complex financial products or how the Securities and Exchange Commission, under Chair Gary Gensler, will react to the staff's conclusions.[63]

Also, down the road, the SEC may address other regulatory challenges presented by derivatives, such as how to measure compliance with limitations on diversification, concentration, and investments in securities issued by persons engaged in securities-related businesses, to name a few. Meanwhile, the fund industry has its work cut out for it as the compliance date approaches. ■

[63] Acknowledging the growth of investor interest in digital assets, the staff of the SEC's Division of Investment Management has addressed investment by mutual funds in Bitcoin futures. *See* Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market (May 11, 2021), *available at* https://www.sec.gov/news/public-statement/staff-statement-investing-bitcoin-futures-market.