New Derivative Rules for Investment Funds

The compliance period for the SEC's final rule creating a new regulatory framework for derivative use by registered investment companies came to an end on August 19, 2022. The rule provides a modernized, comprehensive approach to the regulation of funds' derivatives and reflects the evolution of derivatives usage over the past decades. Highlights include:

- New Rule 18f-4 will permit mutual funds (other than money market funds (MMF)), exchange-traded funds (ETF), registered closed-end funds, and business development companies (BDC) (collectively "funds") to enter into derivatives transactions and certain other transactions notwithstanding the restriction, under Section 18 of the *Investment Company Act of 1940* (the Act)
- Streamlined requirements for funds that use derivatives in a limited way. Funds can enter into reverse repurchase agreements and certain unfunded commitments. Funds, including MMFs, will now be permitted to invest in securities on a forward-settling basis
- The new rule requirements also will apply to leveraged or inverse ETFs. Rule 6c-11 was amended to allow leveraged or inverse ETFs to operate without obtaining an exemptive order
- New reporting requirements and updates to certain disclosure forms

Compliance Date | **August 19, 2022**

Background

Section 18 of the Act limits funds' ability to engage in transactions that involve potential future payment obligations, including obligations under derivatives such as forwards, futures, swaps, and written options. The new rule permits funds to enter into these transactions if they comply with certain conditions designed to address the undue speculation and asset sufficiency concerns underlying §18, described below. In a 1979 release (Release 10666), and in no-action and comment letters issued since then, the SEC has provided guidance on the application of §18 limits to reverse repurchase agreements, firm and standby commitment agreements, various derivative instruments, and short sale transactions. Under previous guidance, a registered fund generally could engage in derivative and financial commitment agreements without a transaction limit, only if the fund segregates liquid assets sufficient to cover the transaction's risk of loss. Different interpretations of SEC guidance have led to varying practices among registered funds regarding the amounts and types of assets segregated for the same transaction types. The SEC first addressed this issue in 2015, but that proposal was roundly criticized as too restrictive. A second proposal was issued in November 2019, which forms the basis of this final rule.

Rule 18f-4

Rule 18f-4 provides certain exemptions from the Act, subject to conditions including the following:

- Derivatives Risk Management Program
- Limit on Fund Leverage Risk
- Exception for Limited Users of Derivatives
- Alternative Requirements for Certain Leveraged/Inverse Funds
- Reverse Repurchase Agreements and Unfunded Commitment Agreements
- When-Issued, Forward-Settling, and Nonstandard Settlement Cycle Securities

Derivatives Risk Management Program (DRMP)

Funds will generally be required to implement a written DRMP that includes policies and procedures reasonably designed to manage a fund's derivatives risks. Rule 18f-4 provides a framework for funds, while also permitting principles-based tailoring for a fund's particular risks. The DRMP will be administered by a derivatives risk manager (DRM) approved by the fund's board of directors (BOD). The DRM must be an officer of the fund's investment adviser but cannot be a portfolio manager and must have relevant experience in managing derivatives risk. The fund's DRM must report to the fund's board on the DRMP's implementation and effectiveness to facilitate the BOD's oversight of the fund's derivatives risk management. The DRMP must include the following elements:

- Risk Identification and Assessment – The DRMP must include identification and assessment of the registered fund's derivatives risks, including leverage, market, counterparty credit, liquidity, operational, legal, and any other risks that are deemed material by the fund's DRM.
- Risk Guidelines – The DRMP must provide for the establishment, maintenance, and enforcement of investment, risk management, or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks (the guidelines). The guidelines must specify levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed and the measures to be taken if they are exceeded.
- Stress Testing – The DRMP must include stress testing to evaluate potential losses to the fund's portfolio. The stress tests must include extreme—but plausible—market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio. The stress tests must be conducted no less than weekly.
- Back Testing – A fund must back test the results of the value-at-risk[1] (VaR) calculation model. On a weekly basis, a fund must compare its actual gain or loss for each business day with the VaR calculated for that day and identify as an exception any instance in which the fund experienced a loss exceeding the VaR calculation's estimated loss. A fund would need to collect back-testing data for each business day but would run the back test weekly.
- Internal Reporting and Escalation – The DRMP must identify the circumstances under which a portfolio manager would be informed about the program's operation, including guidelines exceedances and stress testing results. The DRM also must directly inform the fund's BODs—as appropriate—of material risks arising from the fund's derivatives use, including risks that exceedance of the guidelines and stress testing results indicate.
- Periodic Review of the Program – At least annually, the DRM must evaluate the program's effectiveness and reflect changes in the fund's derivatives risks over time. The review applies to the overall program, including each of the elements above. The review must include a review of the fund's VaR calculation model and any designated reference

[1] Value at risk is a measure of the risk of loss for investments. It estimates how much a set of investments might lose—given normal market conditions—in a set time period such as a day.

portfolio to evaluate whether it remains appropriate. The DRM can then decide to update the program, its VaR calculation model, or any designated reference portfolio. The evaluation should include regulatory, marketwide, and fund-specific developments affecting the program.

Limit on Fund Leverage Risk

Funds relying on Rule 18f-4 for derivatives transactions must comply with a VaR-based limit on fund leverage risk. The default calculation is a relative VaR test that compares the fund’s VaR to the VaR of a designated reference portfolio for that fund. A designated reference portfolio is designed to create a baseline VaR that functions as the VaR of a fund’s unleveraged portfolio. A fund can use as its reference portfolio either an index that meets certain requirements or the fund’s own investments, excluding derivatives transactions. If the fund’s DRM reasonably determines that a designated reference portfolio would not be appropriate, the fund would be required to comply with an absolute VaR test.

A fund’s VaR generally is not permitted to exceed 200% of the VaR of the fund’s designated reference portfolio under the relative VaR test or 20% of the fund’s net assets under the absolute VaR test.

Exception for Limited Users of Derivatives

Rule 18f-4 provides an exception from the DRMP requirements, compliance with the VaR-based leverage limit, and BOD oversight and reporting provisions for funds that use derivatives in a limited way. A fund may rely on this exception if the fund’s derivatives exposure is limited to 10% of its net assets, excluding certain currency and interest rate hedging transactions. Derivatives exposure is defined as the sum of the gross notional amounts of a fund’s derivatives transactions such as futures, swaps, options, and the value of any assets sold short, *i.e.*, the absolute value of the notional amounts of a fund’s derivatives. For an interest rate or currency hedging transaction to be excluded, the transaction must be directly matched to specific foreign currency-denominated equity or fixed income investments held by the fund, or the principal amount of the fund’s borrowings. The notional value of excluded derivatives may not exceed the value of the hedged instruments, the par value for fixed income investments, or a borrowing’s principal amount by more than 10%. If the notional amount of a derivative transaction exceeds the value of the hedged investment by more than 10%, it will no longer qualify as a hedge under the limited derivatives user exception.

A fund that relies on this exception will be required to adopt policies and procedures that are reasonably designed to manage its derivatives risk.

If a fund’s derivatives exposure exceeds the 10% threshold for five business days, the fund’s investment adviser must provide a written report to the fund’s BODs informing them whether the investment adviser intends to either:

- 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% threshold, **or**
- Establish a DRMP, comply with the VaR-based limits, and comply with the BOD oversight and reporting requirements as soon as reasonably practicable

In either case, the fund’s next Form N-PORT filing must specify the number of business days—in excess of the five-business-day period that the final rule provides for remediation—that the fund’s derivatives exposure exceeded 10% of its net assets during the applicable reporting period.

Alternative Requirements for Certain Leveraged/Inverse Funds

The strategy of a leveraged/inverse fund is to use derivatives to amplify the returns—or to correspond to the inverse of the returns—of an underlying index by a specified multiplier. These funds are primarily structured as ETFs and generally use derivatives extensively to pursue their investment strategies. Leveraged/inverse funds will generally be subject to Rule 18f-4 like other funds, including the VaR-based limit on fund leverage risk. An exception from the VaR test requirement is provided for existing leveraged/inverse funds that seek an investment result above 200% of the return—or inverse of the return—of an underlying index if the following conditions are met:

- In operation as of October 28, 2020
- Has outstanding shares issued in one or more public offerings to investors
- Discloses in its prospectus a leverage or inverse multiple that exceeds 200% of the performance of the underlying index

An over 200%-leveraged fund relying on this exception may not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks—directly or indirectly—to provide. Such funds also must disclose in their prospectuses that they are not subject to the condition of Rule 18f-4 limiting fund leverage risk.

Reverse Repurchase Agreements & Unfunded Commitment Agreements

Rule 18f-4 permits a fund to enter reverse repurchase agreements and similar financing transactions, as well as “unfunded commitments” to make certain loans or investments, if the fund **reasonably believes**—at the time it enters into such agreement—that it will have sufficient cash and cash equivalents to meet its obligation on the unfunded commitment. A fund should consider the following specific factors in forming a “reasonable belief”:

- A fund may consider its reasonable expectation with respect to other obligations, including senior securities or redemptions
- A fund may not consider cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the investment’s market value
- A fund may not consider cash that may become available from issuing additional equity

A fund is not precluded from considering a debt issuance to support its reasonable belief. To have a reasonable belief, a fund could consider its strategy, its assets’ liquidity, its borrowing capacity under existing lines of credit, and the contractual provisions of its unfunded commitment agreements.

When-Issued, Forward-Settling, & Nonstandard Settlement Cycle Securities

The rule permits funds—including MMFs—to invest in securities on a when-issued or forward-settling basis, or with a nonstandard settlement cycle, subject to conditions.

Record-Keeping

A fund must comply with record-keeping requirements designed to provide the SEC, the fund’s BODs, and compliance personnel the ability to evaluate the fund’s compliance with the rule’s requirements. A fund should maintain documents related to its DRMP, including a written record of policies and procedures. The fund also must maintain a written record of any portfolio stress-testing results, any VaR back-testing results, and internal reporting or escalation of material risks under the program and any periodic program reviews. A fund is required to keep records of any materials provided to the fund's BODs in approving the DRM.

Amendments to Rule 6c-11

Rule 6c-11 permits ETFs that meet certain conditions to operate without obtaining an SEC exemptive order. Previously, leveraged/inverse ETFs were excluded from the scope of this rule and had to obtain SEC exemptive orders. However, amendments will now include leveraged/inverse ETFs in the scope of Rule 6c-11 if they comply with all applicable provisions of Rule 18f-4. Because of this scope expansion, the SEC is rescinding previously issued exemptive orders for the sponsors of leveraged/inverse ETFs.

Reporting Requirements

Funds will be required to report confidentially to the SEC on a current basis on Form N-RN if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than five business days. Funds currently required to file reports on Forms N-PORT and N-CEN will be required to provide certain information regarding a fund's derivatives use. This will include information regarding the fund's VaR—as applicable—and information about the fund's derivatives exposure (for funds that rely on the limited derivatives user exception in Rule 18f-4).

Relevant Staff Guidance

As of the compliance date of August 19, 2022, the SEC rescinded the 1979 General Statement of Policy (Release 10666), as well as any no-action letters and other guidance addressing funds' use of derivatives and other transactions covered by Rule 18f-4 issued by the Division of Investment Management.

Conclusion

FORVIS will continue to follow SEC regulatory developments. If you have questions about these changes, contact one of our professionals today or visit forvis.com.

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