

December 19, 2019

SEC Re-Proposes Rule 18f-4 Concerning Registered Funds' Use of Derivatives and Proposes New Rules and Retail Sales Practices for Leveraged/Inverse ETFs

The SEC has re-proposed Rule 18f-4 (the “Rule”) under the 1940 Act regarding the use of derivatives and certain related instruments by mutual funds (other than money market funds), ETFs, closed-end funds and companies that have elected to be treated as business development companies under the 1940 Act (collectively, “funds”). In the related release published on November 25, 2019 (the “Release”), the SEC stated that “funds’ current practices regarding derivatives use may not address the undue speculation and asset sufficiency concerns underlying section 18 [of the 1940 Act]” and, therefore, the Rule’s objectives are “to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds’ use of derivatives transactions and certain other transactions.”

The SEC proposed a substantially different formulation of Rule 18f-4 in December 2015 (the “2015 Proposal”), which received extensive comment and was not adopted. The Rule, as re-proposed, generally offers more flexibility to funds that use derivatives. Key differences between the 2015 Proposal and the Rule include the following:

- The Rule would limit derivatives exposure through one of two value-at-risk (“VaR”) tests. The 2015 Proposal required compliance with one of two different portfolio limits – an exposure-based portfolio limit or a risk-based portfolio limit – generally based on gross notional amounts of the fund’s derivatives transactions. Many industry participants noted that portfolio limits based on notional amounts are not necessarily indicative of the overall risk associated with a fund’s use of derivatives.
- The Rule would eliminate the asset segregation framework for covering derivatives and certain financial instruments arising from the SEC’s seminal 1979 Release IC-10666 (“Release 10666”) and ensuing SEC staff guidance. The 2015 Proposal included certain relatively complicated asset segregation requirements, which were widely criticized by commentators.
- The Rule would require a fund entering into reverse repurchase agreements (or other “similar financing transactions”) to count its exposure under such agreements/transactions toward its required asset coverage ratio under Section 18 (e.g., 300%).

The Rule does largely carry forward from the 2015 Proposal a requirement that funds entering into derivatives transactions (other than funds that qualify for the “limited derivatives user exception”) adopt a written derivatives risk management program (“Program”) with written policies and procedures designed to manage the fund’s “derivatives risks.” The Rule would also require a fund’s board to approve the designation of a “derivatives risk manager” for the fund (the “Derivatives Risk Manager”), who would be responsible for administering the Program. The Derivatives Risk Manager must be an officer (or group of officers) of the fund’s adviser (including any sub-adviser) with “relevant experience regarding derivatives risk management.”

Separately, the Rule would contain a carve-out for certain leveraged/inverse ETFs, and the SEC proposed to amend recently adopted Rule 6c-11 under the 1940 Act (the “ETF Rule”) to permit such ETFs to operate without obtaining an exemptive order.

The SEC also proposed new Rule 15l-2 under the Exchange Act and new Rule 211(h)-1 under the Advisers Act (the “Sales Practices Rules”). The proposed Sales Practices Rules would require a broker-dealer or investment adviser to exercise a heightened level of diligence when effecting a purchase or sale of shares of a “leveraged/inverse investment vehicle” on behalf of a customer or client who is a natural person.

The SEC’s proposals are discussed in detail below. Comments on the Release must be received by the SEC no later than **60 days after the Release’s publication in the *Federal Register***.¹

I. Overview of Proposed Rule 18f-4

The Rule would supplant a patchwork of SEC no-action letters and other guidance stretching back several decades to Release 10666 and ensuing SEC staff guidance. Generally, the Rule would permit any fund to enter into (i) “derivatives transactions,” (ii) reverse repurchase agreements and (iii) “unfunded commitment agreements,” provided the fund complies with the Rule’s conditions, which are described below. The Rule includes an exception from certain of these requirements for funds that are “limited derivatives users.”

Key aspects of the Rule and conforming changes include the following:

- **Limits on value-at-risk.** In general, the Rule would impose a VaR-based limit on a fund entering into derivatives transactions, based on either of two VaR tests.
- **Derivatives risk management program and derivatives risk manager.** A fund that uses derivatives would be required to adopt and implement a Program that includes policies and procedures that are reasonably designed to manage the fund’s “derivatives risks.” In addition, the Rule would require the fund’s board to approve the designation of a Derivatives Risk Manager for the fund, who would be responsible for administering the Program.
- **Board oversight and reporting.** At least annually, the Derivatives Risk Manager would be required to report to the fund’s board on the Program’s effectiveness. The Derivatives Risk Manager also would be required to provide periodic reports regarding breaches of the fund’s risk guidelines, stress test results and backtesting results.
- **Limited derivatives user exception.** The Rule would exempt a fund that is a “limited derivatives user” from the Program requirement and the VaR-based limits.
- **Asset coverage.** In connection with the Rule, the SEC would rescind Release 10666 and ensuing SEC staff guidance concerning asset segregation. Reverse repurchase agreements and other similar financing transactions would not be considered derivatives transactions under the Rule, but would be subject to the asset coverage requirements under Section 18. For an open-end fund, for example, reverse repurchase agreements and other similar financing transactions would be combined with any of the fund’s borrowings to track the fund’s compliance with the 300% asset coverage requirement.
- **SEC reporting.** The Rule would require both public and confidential reporting related to a fund’s use of derivatives.

II. More Information on Key Components of Proposed Rule 18f-4

Outer Limits on Value-at-Risk

The Rule would require a fund that engages in derivatives transactions² to comply with either a “**relative VaR**” limit or an “**absolute VaR**” limit. The applicable limit (*i.e.*, relative or absolute VaR) would depend on whether a fund’s Derivatives Risk Manager can identify a “**designated reference index**” (“DRI”) for the fund.

¹ As of the date of this Alert, the Release had not been published in the *Federal Register*.

² A derivatives transaction means “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; and any short sale borrowing.”

- VaR is defined in the Rule as “an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio’s net assets, over a specified time horizon and at a given confidence level.”³ The Release notes that VaR is a widely used metric in the industry that “integrates the market risk associated with different instruments into a single number that provides an overall indication of market risk, including the market risk associated with the fund’s derivatives transactions.”
- A DRI is an unleveraged index that (i) is selected by a fund’s Derivatives Risk Manager and reflects the markets or asset classes in which the fund invests, (ii) is not administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter (each, an “Affiliate”), or created at the request of the fund or its investment adviser, unless the index is widely recognized and used and (iii) is an “appropriate broad-based securities market index” or an “additional index,” as defined in the instruction to Item 27 in Form N-1A.⁴ The DRI is intended to provide an appropriate baseline VaR that approximates the VaR of the fund’s unleveraged portfolio. The fund would be required to disclose its DRI in its annual report.

If a fund’s Derivatives Risk Manager has identified a DRI for the fund, the fund must comply with a “*relative VaR test*,” which compares the fund’s VaR to the VaR of its DRI. A fund with a DRI would be required to limit its VaR to no more than 150% of the VaR of its DRI. The Release notes that the relative VaR test can be used to analyze the extent to which a Fund is using derivatives transactions to leverage the Fund’s portfolio, and to limit fund leverage risk.

Alternatively, if a fund’s Derivatives Risk Manager is unable to identify an appropriate DRI for the fund, the fund must instead comply with the “*absolute VaR test*.” A fund without a DRI would be required to limit its VaR to no more than 15% of the fund’s net assets.

The Release notes that there are a number of VaR models, and states that the Derivatives Risk Manager would choose the appropriate VaR model for the fund, thereby allowing funds to use a VaR model that is appropriate for the fund’s portfolio. The Release notes that “VaR models are often categorized according to three modeling methods – historical simulation, Monte Carlo simulation, or parametric models. Each method has certain benefits and drawbacks.” The Release also notes that a fund would be able to obtain the VaR of its DRI from a third-party vendor.⁵

Testing requirements. The Rule would require a fund (except a fund that is a limited derivatives user) to determine its compliance with the applicable VaR test at least once each business day.

Consequences of being out of compliance with the applicable VaR test. If a fund determines that it is not in compliance with the applicable VaR test, the Rule would require the fund to return to compliance promptly, and no more than three business days after the out-of-compliance determination. If the fund remains out of compliance for more than three business days (i) the Derivatives Risk Manager must report to the fund’s board and explain how and when (number of business days) the Derivatives Risk Manager reasonably expects that the fund will come back into compliance, (ii) the Derivatives Risk Manager must determine what caused the fund to be out of compliance for more than three business

³ The Rule requires that any VaR model used by a fund for purposes of determining the fund’s compliance with the relative VaR test or the absolute VaR test must:

- (1) Take into account and incorporate all significant, identifiable market risk factors associated with a fund’s investments, including, as applicable:
 - (A) Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
 - (B) Material risks arising from the nonlinear price characteristics of a fund’s investments, including options and positions with embedded optionality; and
 - (C) The sensitivity of the market value of the fund’s investments to changes in volatility;
- (2) Use a 99% confidence level and a time horizon of 20 trading days; and
- (3) Be based on at least three years of historical market data.

⁴ In the case of a blended index, none of the indexes that compose the blended index may be administered by an organization that is an Affiliate, unless the index is widely recognized and used.

⁵ The Release also notes that daily VaR testing is consistent with the practice recommended for UCITS by the European Securities and Markets Authority.

days and, if appropriate, make changes to the Program to address the identified causes, (iii) the fund may not enter into derivatives transactions – other than derivatives transactions that, individually or collectively, are designed to reduce the fund’s VaR – until the fund has been back in compliance with its applicable VaR test for three consecutive business days and the Derivatives Risk Manager has satisfied the board reporting and Program analysis and update requirements mentioned above. Funds also would be required to report information about VaR-based limit breaches to the SEC staff on a confidential basis (*see* discussion of Form N-RN, below, for more information).

Derivatives Risk Management Program and Its Administration

The Rule would require funds that engage in derivatives transactions (other than limited derivatives users) to have a written Program, which must include policies and procedures that are reasonably designed to manage the fund’s “derivatives risks,” taking into account the fund’s derivatives and other investments. The Rule would require the Program to identify and manage leverage, market, counterparty, liquidity, operational and legal risks, in addition to any other risks the Derivatives Risk Manager deems material. Under the Rule, a fund’s board is not required to approve the Program (including initially) or to approve any material changes to the Program, but the Derivatives Risk Manager is required to provide regular reporting to the board regarding the Program.

The Rule would require a fund to reasonably segregate the functions of the Program from the fund’s portfolio management. The Release notes that “reasonable segregation” does not mean a “firewall” between portfolio management and the Derivatives Risk Manager. Indeed, the Release states that the SEC acknowledges “the important perspective and insight regarding the fund’s use of derivatives that the portfolio manager can provide and generally understand[s] that the fund’s derivatives risk manager would work with the fund’s portfolio management in implementing the program requirement.”

Derivatives risk manager. In addition, the Rule would require a fund’s board, including a majority of its members who are not interested persons, to approve the designation of the Derivatives Risk Manager. The Derivatives Risk Manager must be an officer (or group of officers) of the fund’s adviser (including any sub-adviser) with “relevant experience regarding derivatives risk management,” who will be responsible for administering the Program. If a single officer serves in the position, the Derivatives Risk Manager may not be a portfolio manager of the fund. If a group of officers serve in the position, the Derivatives Risk Manager may not have a majority of the group composed of portfolio managers of the fund. The Derivatives Risk Manager also may not be a third party, but third parties may assist with the Program’s administration or provide relevant data.

In approving the Derivatives Risk Manager, the fund board is required to take into account the Derivatives Risk Manager’s “relevant experience” in derivatives risk management. The Rule does not prescribe specific qualifications, training or experience for the Derivatives Risk Manager, and the Release notes that the SEC believes that the fund board, in its oversight role, is best positioned to evaluate a prospective Derivatives Risk Manager’s experience. The Derivatives Risk Manager must have a direct line of communication with the board regarding material risks arising from the fund’s derivatives transactions.

Required elements of the program. The Rule would require a fund to adopt and implement a written Program that includes policies and procedures reasonably designed to manage the fund’s derivatives risks. The Program must include the following components:

- ***Risk identification and assessment.*** The Program must identify and assess a fund’s derivatives risks based upon the fund’s derivatives transactions and other investments.
- ***Risk guidelines.*** The Program must establish, maintain and enforce investment, risk management or related guidelines that include “quantitative or otherwise measureable criteria, metrics, or thresholds” related to the fund’s derivatives risks (the “*Guidelines*”), but does not prescribe specific criteria or risk limits. The Guidelines must specify levels of the given criteria that the fund does not normally expect to exceed and the measures to be taken if they are exceeded. The Release notes that criteria could include investment size controls or lists of approved transactions, and that a fund “could also consider establishing an approved list of specific derivative

instruments or strategies” that can be used and a list of persons authorized to enter into derivatives transactions on behalf of the fund. The Rule would not require funds to disclose their Guidelines, or to report breaches of the Guidelines, either publicly or to the SEC.

- **Stress testing.** The Program must provide for stress tests of derivatives risks to evaluate potential losses to the fund’s portfolio in response to extreme but plausible market changes that would have a significant adverse effect on the fund, taking into account correlations of market risk factors and resulting payments to derivatives counterparties. The Rule would permit a fund to determine the frequency of stress tests, taking into account the frequency of change in the fund’s investments and market conditions, but requires the testing to be performed at least weekly. The Rule would require information about stress testing to be provided to the board, but would not require disclosure of stress test results, either publicly or to the SEC staff.
- **Backtesting.** The Program must include backtesting of the results of the VaR calculation model used by the fund in connection with the relative VaR test or the absolute VaR test. The fund must compare, each business day, the fund’s gain or loss with the corresponding VaR calculation for that day, and identify as an exception any instance in which the fund experiences a loss greater than the corresponding VaR calculation’s estimated loss.
- **Internal reporting.** The SEC notes in the Release that a line of communication between a fund’s risk management and portfolio management is a key part of derivatives risk management. The Rule requires that the Program identify when a fund’s portfolio management personnel will be informed about the fund’s derivatives risk management and the operation of the Program. The Release notes that the Program could require the Derivatives Risk Manager to meet with portfolio management “on a regular and frequent basis” or to notify portfolio management of Guideline breaches or results of stress tests through software designed to provide automated updates.
- **Escalation of material risks.** The Derivatives Risk Manager must inform a fund’s portfolio management personnel in a timely manner, and also directly inform the fund’s board, as appropriate, of material risks arising from the fund’s derivatives transactions, including material risks identified when a fund exceeds any of the criteria included in the Guidelines or through stress testing. The Rule would not require the Derivatives Risk Manager to automatically report these risks to the fund’s board but, instead, would require that the Derivatives Risk Manager directly inform the board of these material risks if the Derivatives Risk Manager determines board escalation to be appropriate. In some cases, the Derivatives Risk Manager could determine that it is appropriate to disclose a material derivatives risk to portfolio management and the board at the same time.
- **Periodic review of the Program.** The Derivatives Risk Manager must review the Program at least annually to evaluate its effectiveness and to reflect changes in the fund’s derivatives risks over time, including regulatory, market or fund-specific developments affecting the Program. The periodic review must include a review of the VaR calculation model used by the fund (including the required backtesting) and an evaluation of whether the fund’s DRI (if any) remains appropriate.

Board Oversight and Reporting

While the Rule does not require a fund’s board to approve its Program, the Release notes that fund directors should “understand the [Program] and the derivatives risks it is designed to manage,” that directors should “ask questions and seek relevant information” regarding the adequacy of the Program and the effectiveness of its implementation, and that directors should “inquire about material risks arising from the fund’s derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including as those risks may change over time.”

To assist with the board’s oversight of the fund’s Program, the Rule would require the Derivatives Risk Manager to provide a written report on the effectiveness of the Program to the board at least annually and to provide regular written reports at a frequency determined by the board. Specifically:

- **Reporting on Program implementation and effectiveness.** Before or when the Program is implemented, and at least annually thereafter, the Rule would require the Derivatives Risk Manager to provide a written report to a fund's board providing a representation that the Program is reasonably designed to manage the fund's derivatives risks and incorporates the elements listed above (risk identification and assessment, risk guidelines, stress testing, backtesting, internal reporting, escalation of material risks and periodic review of the Program). The Derivatives Risk Manager's representation may be based on the Derivatives Risk Manager's reasonable belief after due inquiry. The written report must include the basis for the representation along with information reasonably necessary to evaluate the adequacy of the fund's Program and, for reports following the Program's initial implementation, the effectiveness of its implementation. Finally, the written report also must describe the Derivatives Risk Manager's basis for the selection of the fund's DRI or, if applicable, describe why the Derivatives Risk Manager is unable to identify a DRI appropriate for the fund.
- **Regular board reporting.** The Derivatives Risk Manager also must provide to the board, at a frequency determined by the board, a written report analyzing the instances in which the fund has exceeded its Guidelines, the results of the fund's stress tests and the results of the fund's backtesting. Each such report must include information necessary for the board to evaluate the fund's responses to exceeding the Guidelines and to the results of the stress tests.
- **Board approval.** While the Rule would not require a fund's board to approve its Program, the Release clarifies that the board is responsible for overseeing compliance with Rule 38a-1 under the 1940 Act, which would include board approval of policies and procedures reasonably designed to prevent violation of the Rule.

Limited Derivatives User Exception

The Rule includes an exception from the Program requirement (including the requirement to appoint a Derivatives Risk Manager), and the VaR-based limit, for funds that limit their derivatives use in either of two ways (the "Limited Derivatives User Exception"). The Rule would require funds relying on the Limited Derivatives User Exception to adopt and implement policies and procedures reasonably designed to manage a fund's derivatives risks. A fund may rely on the Limited Derivatives User Exception if it satisfies either of the two exceptions described below:

Exposure-based exception. A fund with "derivatives exposure" that does not exceed 10% of the fund's net assets may rely on the Limited Derivatives User Exception (the "Exposure-Based Exception").⁶ The Rule does not address the frequency of testing for compliance with the 10% threshold or impose limits on the number of breaches of the 10% limit a fund may experience.

- "*Derivatives exposure*" means the sum of the notional amounts of the fund's derivatives instruments and, in the case of short sale borrowings, the value of the asset sold short. The Rule would permit two adjustments to this definition, which are both designed to provide for more tailored notional amounts that better reflect a fund's exposure to an underlying reference asset.⁷ Specifically, a fund may (i) convert the notional amount of interest rate derivatives to 10-year bond equivalents and (ii) delta adjust the notional amounts of options contracts.⁸
- The Rule does not define "notional amount" or specify how to calculate notional amount, but it does acknowledge that a notional exposure-based test has limitations and could be "viewed as a relatively blunt measurement." The Release requests comment on whether the definition of notional amount and the specific

⁶ The Release cites a Division of Economic and Risk Analysis ("DERA") staff analysis based on Form N-PORT filings as of September 2019 indicating that 78% of surveyed funds have adjusted notional amounts below 10% of their respective net asset values.

⁷ For purposes of calculating a Fund's derivatives exposure, the Rule does not contemplate netting of any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms, as was proposed in the 2015 Proposal.

⁸ Delta means 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 would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta.

provisions for calculating a derivative transaction's notional amount, each as originally introduced in the 2015 Proposal, should be included in Rule 18f-4.

Currency hedging exception. A fund that limits its derivatives transactions to currency derivatives for hedging purposes also may rely on the Limited Derivatives User Exception. This exception is available only for a fund that limits its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign-currency-denominated equity or fixed-income investments held by the fund, provided that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount.⁹

Risk management. The Rule would require any fund that relies on the Limited Derivatives User Exception to adopt and implement written policies and procedures reasonably designed to manage a fund's derivatives risks. The Release generally provides that such policies and procedures would reflect the extent and nature of a fund's use of derivatives within the parameters of the Limited Derivatives User Exception. For example, a fund that uses derivatives only occasionally and for a limited purpose, such as to equitize cash, would have policies and procedures reflecting this limited use. A fund using more complex derivatives with derivatives exposure near the 10% threshold under the Exposure-Based Exception would need to tailor its policies and procedures to the risks presented by such complex derivatives. In the latter example, the Release suggests that such policies and procedures could be more extensive and could include elements similar to those required under a Program requirement, but does not identify which of those elements should be addressed.

Reporting by limited derivatives users. A fund that relies on the Limited Derivatives User Exception would be required to report its reliance on the Exception on Form N-CEN. Limited Derivatives Users also would be required to report the fund's derivatives exposure on Form N-PORT.

Reverse Repurchase Agreements and Unfunded Commitment Agreements

Reverse repurchase agreements. The Rule would not treat reverse repurchase agreements and other similar financing transactions as derivatives transactions.¹⁰ Instead, the Rule would permit a fund to enter into reverse repurchase agreements or other similar financing transactions, provided the fund (i) satisfies the applicable asset coverage requirements of Section 18 and (ii) combines the aggregate amount of indebtedness associated with any reverse repurchase agreement or similar financing transaction with the aggregate amount of any other senior securities representing indebtedness for purposes of complying with the asset coverage ratio required by Section 18. This is a departure from the current treatment of reverse repurchase agreements under Release 10666 and related SEC guidance, pursuant to which a fund is not required to treat such agreements as senior securities (and so not to include such transactions when calculating the required asset coverage ratio), as long as the fund segregates permissible assets against its reverse repurchase agreement obligations.¹¹ If the Rule is adopted as proposed, funds would be required to take reverse repurchase agreements and similar financing transactions into account, together with other permissible borrowings under the 1940 Act, when calculating the fund's asset coverage ratio under Section 18.

⁹ The Rule does not address what happens if the notional amount of currency derivatives held by a fund exceeds the value of the instruments denominated in a foreign currency by more than a "negligible amount," but requests comment on whether such breaches should be addressed and, if so, whether 1% or 2% would be considered a "negligible amount."

¹⁰ The Release notes that, "to the extent a fund concludes that there are economic similarities between a [tender option bond] financing and a reverse repurchase agreement, the fund should treat obligations with respect to the tender option bond financing" as it would a reverse repurchase agreement under the Rule."

¹¹ With respect to an open-end fund, Section 18(f) of the 1940 Act permits a fund to borrow from banks so long as the fund maintains at least 300% asset coverage for all such borrowings. Asset coverage generally means the ratio that the value of the fund's total assets, less all liabilities and indebtedness not represented by the borrowings, bears to the borrowings.

Unfunded commitment agreements. The Rule would permit a fund to enter into an unfunded commitment agreement,¹² provided the fund reasonably believes that, at the time it enters into such an agreement, it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due. For each unfunded commitment agreement that a fund enters into relying on the Rule, the fund would be required to document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its unfunded commitment agreement. Unfunded commitment agreements would not be taken into account in determining compliance with the asset coverage requirements set forth in Section 18.

In general. Reverse repurchase agreements and unfunded commitment agreements would not be treated as derivatives transactions for purposes of the Rule and, therefore (i) would not be included as derivatives transactions in the fund's calculation of whether it qualifies for the Limited Derivatives User Exception and (ii) would not subject a fund to the Program requirement or to any VaR-based limit. However, because the use of leverage created by reverse repurchase agreements would typically increase a fund's VaR, any increase in the fund's VaR due to reverse repurchase agreements or other similar financing transactions could impact the fund's ability to enter into derivatives transactions, because a fund's use of derivatives cannot exceed the fund's VaR-based limit.

Transition Period

The Release states that a one-year transition period following the Rule's effective date would be appropriate for funds to prepare to come into compliance with the Rule. The staff of the Division of Investment Management also is reviewing its no-action letters and other guidance concerning derivatives transactions and other types of transactions covered by the Rule to identify no-action letters and other staff guidance, or portions thereof, that should be withdrawn.¹³ The Release requests comments regarding "any additional letters or other staff guidance, or portions thereof" that interested parties believe should be withdrawn, including the reasons supporting the request.

Following the one-year transition period, Release 10666 would be rescinded and, as determined by the SEC staff, no-action letters and other staff guidance (or portions thereof) would be withdrawn. At that time, funds could enter into derivatives transactions, reverse repurchase agreements and similar financing transactions and unfunded commitments only as permitted by the Rule or Section 18.

Reporting/Form Requirements

The Release proposes amendments to the reporting requirements for funds that would rely on the Rule, including amendments to Forms N-PORT, N-LIQUID (proposed to be re-titled "Form N-RN") and N-CEN. Form N-2 also would be amended, and new disclosures would be required in all funds' annual reports.

Form N-PORT would be amended to include new reporting items about a fund's derivatives exposure as of the end of the reporting period (information would be publicly available for the third month of each of a fund's fiscal quarters). Form N-PORT also would be amended to require a fund subject to the VaR test to report its highest daily VaR during the reporting period and its corresponding date, as well as its median daily VaR for the monthly reporting period. A fund subject to the relative VaR test would be required to report the name of the fund's DRI and index identifier, as well as the fund's highest daily VaR ratio (*i.e.*, the value of the fund's VaR divided by the VaR of its DRI) and the corresponding date) and the fund's median daily VaR ratio for the reporting period. A fund also would have to report the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model.

¹² An unfunded commitment agreement is 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."

¹³ The staff's review would include, but not be limited to, all of the no-action letters and staff guidance listed in the Release – approximately 30 no-action letters and a "Dear CFO" letter – including the staff's position on tender option bonds.

Form N-LIQUID would be renamed “Form N-RN,”¹⁴ and the form would be amended to include new reportable events for funds that are subject to the Rule’s VaR-based limits on fund leverage risk. These funds would be required to file a Form N-RN to report information about certain VaR-based limit breaches. Specifically, when a fund determines that it is out of compliance with the applicable VaR-based limit and has not come back into compliance within three business days after such determination, the fund would be required to file a report – within one business day following the third business day after the fund determined that it was out of compliance – on Form N-RN providing certain information regarding its VaR-based limit breaches. The fund also would be required to file a report on Form N-RN when it is back in compliance with the applicable VaR-based limit. This information would be reported to the SEC Staff on a confidential basis.

Form N-CEN would be amended to require a fund to identify whether it relied on the Rule during the reporting period and whether it relied on any of the exceptions from various requirements under the Rule. A fund also would have to identify whether it entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements.

Form N-2 currently requires a closed-end fund to include a senior securities table with information about any senior securities it has issued. The Rule would provide that a fund’s derivatives transactions and unfunded commitment agreements not be considered for purposes of computing Section 18 asset coverage, and the Rule would amend Form N-2 to provide that closed-end funds relying on the Rule would not be required to include their derivatives transactions and unfunded commitment agreements in the senior securities table.

Annual Reports. An open-end fund complying with the relative VaR test would be required to disclose its DRI as the fund’s “appropriate broad-based securities market index” or an “additional index,” as defined in the instruction to Form N-1A Item 27, in its annual report. A closed-end fund or business development company complying with the relative VaR test must disclose its DRI in its annual report, along with a presentation of the fund’s performance relative to the DRI. A fund that is a “New Fund” (as defined in Form N-1A) at the time it files its annual report (or is a fund that would meet that definition at the time it files its annual report) is not required to include this disclosure in its annual report.

Record-keeping Provisions

New fund record-keeping requirements under the Rule would apply to:

- Policies and procedures that are designed to manage a fund’s derivatives risks, written records of the results of any stress tests and the results of any VaR backtesting and records documenting any periodic reviews of the Program.
- Any materials provided to the fund’s board in connection with approving the designation of the Derivatives Risk Manager, records of any written reports provided to the board relating to the Program, and any written reports provided to the board that the Rule requires concerning the fund’s non-compliance with the applicable VaR test.
- For a fund that is required to comply with a VaR-based limit on fund leverage risk, records documenting the fund’s determination of (i) the VaR of its portfolio, (ii) the VaR of the fund’s DRI, as applicable, (iii) the fund’s VaR ratio, as applicable, and (iv) any updates to any VaR calculation models used by the fund, as well as the basis for any material changes to those models.
- For a fund that is a limited derivatives user, a written record of its policies and procedures that are reasonably designed to manage its derivatives risk.

¹⁴ In view of the proposed amendments that would make current Form N-LIQUID applicable to all funds (other than money market funds), the Release would amend the form and Rule 30b1-10 under the 1940 Act to reflect the Rule’s requirement that all funds that are subject to the relative VaR test or absolute VaR test must file current reports regarding VaR-based limit breaches under the circumstances that Form N-RN sets forth.

- For a fund that enters into unfunded commitment agreements, a record documenting the basis for the fund's belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements.

III. Leveraged/Inverse ETFs Under the Rule and Amendments to the ETF Rule

The Rule would provide that any leveraged/inverse ETF would not be required to comply with any VaR-based limit on fund leverage risk, provided that such fund (i) is a "leveraged/inverse investment vehicle" as defined in the Sales Practices Rules, (ii) discloses in its prospectus that it is not subject to the Rule's VaR-based limits on fund leverage risk and (iii) does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return) of the underlying index. However, the Rule would require a leveraged/inverse fund to satisfy all of the additional conditions within the Rule, including the Program requirement.

In September 2019, the SEC adopted Rule 6c-11 (the "ETF Rule"), permitting ETFs that meet certain conditions to operate without obtaining an exemptive order from the SEC. However, the ETF Rule expressly excludes leveraged/inverse ETFs from the ETF Rule's coverage. In the Release, the SEC notes that the Rule, as well as the Sales Practices Rules, "would create an updated and more comprehensive regulatory framework for the use of derivatives by funds, including provisions specifically applicable to leveraged/inverse ETFs." Accordingly, the Release contains amendments to the ETF Rule to remove the provision excluding leveraged/inverse ETFs from the scope of that rule, effective one year following the publication of the final ETF Rule amendments in the Federal Register (to coincide with the compliance date for the Sales Practices Rules).

IV. Sales Practices Rules for Leveraged/Inverse Vehicles

The Sales Practices Rules would require broker-dealers (or any associated person of the broker-dealer) and investment advisers (or any supervised person of the investment adviser) (each, a "firm") to exercise due diligence on retail investors that are natural persons¹⁵ before approving retail investor accounts to invest in shares of a leveraged/inverse investment vehicle.

"Leveraged/inverse investment vehicle" means a registered investment company or an exchange-listed commodity or currency-based trust or fund that seeks, 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.¹⁶

Specifically, the Sales Practices Rules would require firms to exercise due diligence to ascertain certain essential facts about a customer or client who is a retail investor before accepting or placing that customer's or client's order to transact in shares of a leveraged/inverse investment vehicle, or approving that customer's or client's account to engage in such transactions. Under the Sales Practices Rules, a firm could approve a retail investor's account for transactions in leveraged/inverse investment vehicles *only if the firm had a reasonable basis to believe* that the investor is capable of evaluating the risks associated with such investment vehicles. The Sales Practices Rules, which are modeled after current FINRA options account approval requirements for broker-dealers, would require both investment adviser firms and broker-dealer firms to approve a retail investor's buying and selling shares of leveraged/inverse investment vehicles *before* any such investment.¹⁷ In making this "facts-and-circumstances" determination, the Sales Practices Rules would require a firm to (i) approve the retail investor's account for buying and selling shares of leveraged/inverse investment

¹⁵ The Sales Practices Rules limit the scope of "retail investor" to "a natural person" or the "legal representative of a natural person," where a "legal representative" of a natural person is interpreted to mean non-professional legal representatives of a natural person. The Release, citing to Form CRS, explains that this definition would exclude institutional and certain professional fiduciaries, but would include certain legal entities such as trusts that represent the assets of a natural person.

¹⁶ The Release notes that, although the scope of this definition extends beyond ETFs, this definition is substantively identical to the provision in the ETF Rule excluding leveraged/inverse ETFs from the scope of that rule.

¹⁷ The Release clarifies that firms would not be required to evaluate a retail investor's eligibility to invest in leveraged/inverse investment vehicles on a transaction-by-transaction basis.

vehicles pursuant to a due diligence requirement to ascertain certain essential facts about the retail investor and (ii) adopt and implement written policies and procedures reasonably designed to comply with the Sales Practices Rules.

The Release explains that the Sales Practices Rules are designed to establish a single, uniform set of enhanced due diligence and approval requirements for firms with respect to retail investors that invest in leveraged/inverse investment vehicles.¹⁸

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We expect a significant number of comments on the Release and Proposed Rule from various industry participants and other interested parties. Comments must be filed with the SEC no later than **60 days after the Release's publication** in the *Federal Register*.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

¹⁸ The Release also clarifies that compliance with the Sales Practices Rules would not supersede or otherwise satisfy any other firm obligations (*e.g.*, a broker-dealer's obligations under Regulation Best Interest or an investment adviser's fiduciary duties under the Advisers Act).