November 6, 2020

SEC Adopts Rule 18f-4 Concerning Registered Funds' Use of Derivatives

On October 28, 2020, the SEC adopted Rule 18f-4 (the "Rule"), which will dramatically change the regulation of the use of derivative instruments and certain related transactions by mutual funds (other than money market funds), exchange-traded funds ("ETFs"), closed-end funds and business development companies (collectively, "funds"). The adopting release (the "Release") follows a proposal of the Rule in December 2015 and a re-proposal of the Rule in November 2019 (the "2019 Proposal," which is described in this Ropes & Gray Alert). Both proposals received extensive comments.

I. OVERVIEW OF RULE 18f-4

The Rule supplants a patchwork of SEC no-action letters and other guidance stretching back to Release 10666 (issued in 1979) and ensuing SEC staff guidance. Generally, the Rule permits a fund to enter into "derivatives transactions," notwithstanding prohibitions and restrictions on the issuance of senior securities under Section 18 of the 1940 Act, provided the fund complies with the Rule's conditions, which are described below.[1] The Rule also addresses a fund's ability to (i) enter into reverse repurchase agreements and similar financing transactions, (ii) enter into "unfunded commitment agreements" and (iii) purchase securities that trade on a when-issued or forward-settling basis, or with a non-standard settlement cycle.

Key aspects of the Rule are as follows:

- ***Limits on value-at-risk ("VaR").*** The Rule imposes a VaR-based limit on a fund entering into derivatives transactions, based on either of two VaR limits – a "relative VaR" limit or an "absolute VaR" limit.

- ***Derivatives risk management program and derivatives risk manager.*** Unless it is a limited derivatives user (detailed below), a fund that uses derivatives is required to adopt and implement a derivatives risk management program (the "Program") that includes policies and procedures that are reasonably designed to manage the fund's "derivatives risks."[2] In addition, the Rule requires the fund's board to approve the designation of a Derivatives Risk Manager for the fund, who is responsible for administering the Program, including required stress testing and backtesting.

- ***Board oversight and reporting.*** At least annually, the Derivatives Risk Manager is required to report to the fund's board on the Program's effectiveness. The Derivatives Risk Manager must also provide reports to the fund's board regarding stress test results, backtesting results and breaches of the fund's risk guidelines related to the fund's use of derivatives.

- ***SEC reporting.*** The Release requires both public and confidential reporting related to a fund's use of derivatives.

- ***Limited derivatives user exception.*** Subject to conditions, the Rule exempts a fund that is a "limited derivatives user" from the Program requirement and the VaR-based limits. Limited derivatives users must adopt and implement written policies and procedures reasonably designed to manage the fund's derivatives risks.

II. DIFFERENCES FROM THE 2019 PROPOSAL

Key differences between the 2019 Proposal and the Rule include the following:

- The SEC maintained the basic framework of the relative and absolute VaR tests, with some modifications, including increasing the outer limits on fund leverage risk. Under the Rule, a fund will satisfy the ***relative VaR test*** if its

portfolio VaR does not exceed ***200%*** of the VaR of its "designated reference portfolio" (***250%*** in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock). A fund will satisfy the ***absolute VaR test*** if its portfolio VaR does not exceed ***20%*** of the value of the fund's net assets (***25%*** in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock). Under the 2019 Proposal, the VaR limits were 150% and 15%, respectively, including for closed-end funds.

- The Rule employs the term "designated reference *portfolio*," instead of the proposed "designated reference *index*," because the Rule permits a fund to use either a "designated index" or its "securities portfolio" (defined as the fund's investment portfolio, excluding derivatives transactions) as the fund's designated reference portfolio for the relative VaR test.

- Under the Rule, a fund is permitted to engage in reverse repurchase agreements and similar financing transactions so long as the fund meets the asset coverage requirements under Section 18. Alternatively, a fund may elect to treat such transactions as "derivatives transactions" under the Rule, which would allow a fund to apply a consistent set of requirements to its derivatives transactions and any reverse repurchase agreements or similar financing transactions. The 2019 Proposal did not allow funds to elect to treat these transactions as derivatives transactions.

- In approving the designation of a Derivatives Risk Manager, the Rule omits the 2019 Proposal's requirement that a fund board must take into account "the derivatives risk manager's relevant experience regarding the management of derivatives risk." The Rule still requires that the individuals designated have "relevant experience regarding the management of derivatives risk."

- The Rule permits money market funds (and other funds) to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, provided that the fund intends to settle the transaction physically, and that the transaction will settle within 35 days of the trade date. If these conditions are satisfied, these transactions are deemed not to involve a senior security.

- Under the Rule, leveraged/inverse funds may seek leveraged/inverse market exposure of no more than 200% of the return/inverse return of an index, subject to compliance with a relative VaR test and certain other conditions.[3] The SEC also amended Rule 6c-11 (the "ETF Rule") to permit these funds to rely on the ETF Rule.

- The SEC chose not to adopt the sales practice rules that would have required investment advisers and broker-dealers to exercise due diligence with respect to retail investors before approving retail investor accounts to invest in shares of a "leveraged/inverse investment vehicle."

III. DETAILED INFORMATION ON RULE 18f-4

Outer Limits on Value-at-Risk

The Rule requires a fund (other than a limited derivatives user) that engages in derivatives transactions[4] to comply with either a "***relative VaR***" limit or an "***absolute VaR***" limit. The applicable limit (*i.e.*, relative or absolute VaR) depends on whether a fund's Derivatives Risk Manager can identify a "***designated reference portfolio***" (as described below) for the fund.

- 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 assets (or net assets when computing a fund's VaR), over a specified time horizon and at a given confidence level."[5]

- The Rule employs the term "designated reference portfolio," instead of the 2019 Proposal's "designated reference index," because the Rule permits a fund to use, as its designated reference portfolio ("DRP"), either a "designated

index" ***or*** its "securities portfolio"[6] (excluding any derivatives transactions) for the relative VaR test.[7] The Release states that a fund's DRP "is designed to create a baseline VaR that functions as the VaR of a fund's unleveraged portfolio."

- A designated index is an unleveraged index that (i) is approved by the Derivatives Risk Manager for purposes of the relative VaR test and that reflects the markets or asset classes in which the fund invests and (ii) is not 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 its investment adviser (each, an "Affiliate"), unless the index is widely recognized and used.[8]

If a fund's Derivatives Risk Manager has approved a DRP for the fund, the fund must comply with a "***relative VaR test***," which compares the fund's VaR to the VaR of its DRP. A fund with a DRP is required to limit its VaR to no more than 200% of the VaR of its DRP (250% in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock).

Alternatively, if a fund's Derivatives Risk Manager reasonably determines that a DRP would not provide an appropriate reference portfolio for purposes of the relative VaR test (taking into account the fund's investments, investment objectives and strategy), the fund must comply with the "***absolute VaR test***." A fund without a DRP is required to limit the VaR of the fund's portfolio to no more than 20% of the value of the fund's net assets (25% in the case of a closed-end fund that has outstanding a class of senior security that is a stock).

Testing requirements. The Rule requires a fund 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 requires the fund to return to compliance promptly, in a manner that is in the best interests of the fund and its shareholders.[9]

If the fund remains out of compliance for more than five business days,[10] the Derivatives Risk Manager (i) must provide a written report to the fund's board and explain how and when (number of business days) the Derivatives Risk Manager reasonably expects the fund will return to being in compliance and (ii) must determine what caused the fund to be out of compliance for more than five business days and, if appropriate, make changes to the Program to address the identified causes. Additionally, the Derivatives Risk Manager must provide a second written report to the fund's board within 30 calendar days of the fund's determination that it is out of compliance with its applicable VaR test explaining the results of the analysis and updating the reports described above and, if the fund has come into compliance with its VaR test, explaining how the fund was able to come back into compliance. If the fund remains out of compliance with the applicable VaR test at that time, this second report must update the explanation of how and when the fund would come into compliance that was included in the initial report provided to the board, and the Derivatives Risk Manager must update the fund's board regarding the fund's progress in coming back into compliance at regularly scheduled intervals determined by the board. Funds also are 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 requires funds that engage in derivatives transactions (other than limited derivatives users) to have a 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 requires 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)[11] 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 requires a fund to "reasonably segregate" the functions of the Program from the fund's portfolio management. The Release notes that the reasonable segregation requirement does not mean that the Derivatives Risk Manager and portfolio management must be separated by a communications "firewall." Instead, the SEC recognized "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]."

Derivatives Risk Manager. The Rule requires 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)[12] 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, portfolio managers of the fund may not comprise a majority of the Derivatives Risk Manager group. 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.

While a fund's board is required to approve the designation of the Derivatives Risk Manager, the Rule does not prescribe specific qualifications, training or experience for the Derivatives Risk Manager. The Release notes that its use of the term "relevant experience" is intended to provide flexibility such that the person(s) who serve in this role have experience that is relevant in light of the derivatives risks unique to the fund, instead of requiring a specific amount or type of experience in derivatives risk management. With respect to the approval requirement, the SEC stated that "[w]e continue to believe that requiring the board to designate the [Derivatives Risk Manager] is important to establish the foundation for an effective relationship and line of communication between a fund's board and its [Derivatives Risk Manager]."

Required elements of a Program. The Rule requires 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 taking into account 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 the Rule 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.
- ***Stress testing.*** The Program must include stress testing to evaluate potential losses to a fund's portfolio in response to "extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties." The frequency of the testing must take into account the fund's strategy and investments and current market conditions, and must be conducted at least weekly.
- ***Backtesting.*** The Program must provide for backtesting, to be conducted no less frequently than weekly,[13] of the results of the VaR calculation model used by the fund in connection with the applicable VaR test by comparing 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. The backtesting must identify as an exception any instance in which the fund experiences a loss exceeding the VaR calculation's estimated loss. The backtesting requirement is intended to require a fund to monitor the effectiveness of its VaR model.

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- ***Internal reporting.*** The Rule requires that the Program identify when a fund's portfolio management personnel will be informed about the operation of the Program, breaches of the Guidelines and the results of fund stress tests.

- ***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 does not require the Derivatives Risk Manager to automatically inform the fund's board but, instead, requires that the Derivatives Risk Manager directly inform the board of these material risks if the Derivatives Risk Manager determines board escalation to be appropriate.

- ***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 DRP (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." Moreover, the Release notes that directors "should ask questions and seek relevant information regarding the adequacy of the [Program] and the effectiveness of its implementation" and that the Rule's board reporting requirements are "designed to equip board members with the information they need to provide effective oversight." However, the SEC stated that "the role of the board under the rule is one of general oversight, and consistent with that obligation, [the SEC] expect[s] that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."[14]

To assist with the board's oversight of the fund's Program, the Rule requires 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 requires the Derivatives Risk Manager to provide a written report to a fund's board including a representation that the Program is reasonably designed to manage the fund's derivatives risks and that the Program 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 also must include, as applicable, the Derivatives Risk Manager's basis for the approval of any DRP or any change in the DRP during the period covered by the report, or an explanation of the basis for the Derivatives Risk Manager's determination that a DRP would not provide an appropriate reference portfolio for purposes of the relative VaR test.

- ***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.

Reverse Repurchase Agreements and Unfunded Commitment Agreements

Reverse repurchase agreements. The Rule permits, but does not require, a fund to treat reverse repurchase agreements and other similar financing transactions as derivatives transactions.[15] The Rule permits a fund to enter into reverse

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repurchase agreements or other similar financing transactions, if the fund (i) complies with the asset coverage requirements of Section 18, and combines the aggregate amount of indebtedness associated with all reverse repurchase agreements or similar financing with the aggregate amount of any other senior securities representing indebtedness when calculating the relevant asset coverage ratio or (ii) treats all reverse repurchase agreements or similar financing transactions as derivatives transactions for all purposes under the Rule. A fund is permitted to switch between these options. The Rule requires a fund to maintain a written record that documents the fund's choice of alternative (i) or alternative (ii), including any switch to the other option.[16]

Unfunded commitment agreements. The Rule permits a fund to enter into an unfunded commitment agreement,[17] 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 is 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 are not "derivatives transactions" for purposes of the Rule.

When-Issued, Forward-Settling, and Non-Standard Settlement Cycle Securities Transactions

The Rule also permits money market funds (and other funds) to invest in securities on a when-issued or forward-settling basis or with a non-standard settlement cycle, provided (i) the fund intends to physically settle the transaction and (ii) the transaction will settle within 35 days of its trade date (the "delayed-settlement securities provision"). The Release states that "[p]hysical settlement may occur electronically through the Depository Trust Company or other electronic platforms" and that "[t]his condition distinguishes these investments from bond forwards and other derivatives transactions where a fund commonly intends to execute an offsetting transaction rather than to actually purchase (or sell) the security."[18] If the conditions of the delayed-settlement securities provision are satisfied, these transactions are deemed not to involve a senior security.

Recordkeeping Provisions

Recordkeeping requirements under the Rule 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, any internal reporting or escalation of material risks under the Program 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 DRP, 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.
- 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.

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- A record documenting whether the fund is treating its reverse repurchase agreements and other similar financing transactions as derivatives transactions or as senior securities subject to the asset coverage requirements of Section 18.

IV. THE LIMITED DERIVATIVES USER EXCEPTION UNDER RULE 18f-4

For funds that limit their derivatives transactions, the Rule includes an exception from the Program requirement (including the requirement to appoint a Derivatives Risk Manager) and the VaR-based limits (the "Limited Derivatives User Exception"). The Rule requires funds relying on the Limited Derivatives User Exception to satisfy the following conditions:

Derivatives exposure. The fund's "derivatives exposure"[19] must not exceed 10% of the fund's net assets, excluding currency or interest rate derivatives that hedge currency or interest rate risks associated with (i) one or more specific equity or fixed-income investments held by the fund (which must be foreign-currency-denominated in the case of currency derivatives) or (ii) the fund's borrowings, provided that in each case the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts[20] of such derivatives do not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10%.

Risk management. The Rule requires 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 states that the policies and procedures for a fund relying on the Limited Derivatives User Exception "should be tailored to the extent and nature of the fund's derivatives use." For example, a fund that uses derivatives occasionally and for a limited purpose, such as to equitize cash, "is likely to have limited policies and procedures commensurate with this limited use."

Breaches of the 10% limit. If the derivatives exposure of a fund relying upon the Limited Derivatives User Exception exceeds 10% of the fund's net assets, the fund has five business days to come back into compliance with the 10% limit. If the fund is not back in compliance within five business days, the fund's investment adviser must provide a written report to the fund's board informing the board whether the investment adviser intends either:

- To reduce the fund's derivatives exposure to less than 10% of the fund's net assets promptly, but within no more than 30 calendar days of the breach, in a manner that is in the best interests of the fund and its shareholders, or

- To establish a Program, comply with the VaR-based limit on fund leverage risk and comply with the related board oversight and reporting requirements, as soon as reasonably practicable (*i.e.*, to no longer rely on the Limited Derivatives User Exception).

Reporting by limited derivatives users. A fund that relies on the Limited Derivatives User Exception is required to report on Form N-PORT its derivatives exposure as of the end of the reporting period. See the discussion of Form N-PORT changes, below. Limited Derivatives Users also are required to report their reliance on the exception in Form N-CEN.

V. EFFECTIVE DATE AND COMPLIANCE DATE

The Rule's effective date is 60 days after publication of the Release in the *Federal Register*.[21] The Release provides for an 18-month transition period following the Rule's effective date for funds to prepare to come into compliance with the Rule. Following the 18-month transition period, Release 10666 will be rescinded and related no-action letters and other staff guidance (or portions thereof) will 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 and Section 18.

The Release states that the staff of the Division of Investment Management has reviewed its no-action letters and other guidance addressing derivatives transactions and other transactions covered by the 2019 Proposal "to determine which

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letters and other staff guidance, should be withdrawn in connection with the final rule." The 2019 Proposal stated that the staff's review included, but was limited to, all of the no-action letters and staff guidance listed in the 2019 Proposal – approximately 30 no-action letters and a "Dear CFO" letter – including the staff's position on tender option bonds. The Release states that the staff's review has now included, but was not limited to, the staff no-action letters and other guidance identified in the 2019 Proposal. The Release does not provide a list of additional no-action letters, if any, that will be withdrawn.

In addition, on the compliance date for the Rule, the SEC will rescind the exemptive orders provided to leveraged/inverse ETFs, which will be permitted to rely on the ETF Rule, as amended by the Release. See Section VII, below.

VI. REPORTING/FORM REQUIREMENTS

The Release adopts amendments to the reporting requirements for funds that rely on the Rule, including amendments to Forms N-PORT, N-LIQUID (re-titled "Form N-RN") and N-CEN. Form N-2 is also amended.

Form N-PORT. Only funds that rely on the Limited Derivatives User Exception are required to report derivatives exposure as of the end of the reporting period. A fund that relies on the exception must report (i) its derivatives exposure, (ii) its exposure from currency derivatives that hedge currency risks and (iii) its exposure from interest rate derivatives that hedge interest rate risks. In addition, a fund that relies on the exception will have to report the number of business days, if any, in excess of the five-business-day remediation period permitted by the Rule that the fund's derivatives exposure exceeded 10% of its net assets during the reporting period. The derivatives exposure information reported by funds that rely on the Limited Derivatives User Exception will not be made publicly available.[22]

Form N-PORT also is amended to require funds subject to a VaR test to report their median daily VaR for the monthly reporting period. Funds subject to the relative VaR test during the reporting period will report, as applicable, the name of the fund's designated index or a statement that the fund's DRP is the fund's securities portfolio, as well as their median VaR Ratio during the reporting period (reported as a percentage of the VaR of the Fund's DRP). Funds subject to the absolute VaR test will report their median daily VaR during the reporting period (reported as a percentage of the fund's net asset value). In a change from the 2019 Proposal, a fund's median VaR information (its median daily VaR, and its median VaR ratio for funds subject to the relative VaR test) will not be made publicly available.[23]

A fund also must report the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model, but this information will not be made publicly available.

Form N-LIQUID is renamed "Form N-RN,"[24] and the form is amended to include new reportable events for funds that are subject to the Rule's VaR-based limits. These funds are 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 five business days after such determination, the fund is required to file a report – within one business day following the fifth 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 is required to file a report on Form N-RN when it is back in compliance with the applicable VaR-based limit. This information reported to the SEC staff will not be made public.

Form N-CEN is 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 has to identify whether it entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements. A fund will also be required to identify whether it is relying on the Rule provision concerning investments in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle.

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 provides that a fund's derivatives transactions and unfunded commitment agreements are not to be considered for purposes of computing asset coverage under Section 18(h), and the Release amends Form N-

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2 to provide that closed-end funds relying on the Rule are not required to include their derivatives transactions and unfunded commitment agreements in the senior securities table.

Annual reports. In a change from the 2019 Proposal, the Release does not require a fund to publicly disclose its designated index in the fund's annual report.

Conforming amendments. The Release amends Rule 22e-4 and a related reporting requirement on Form N-PORT to remove references to assets "segregated to cover" derivatives transactions.

VII. LEVERAGED/INVERSE ETFS AND AMENDMENTS TO THE ETF RULE

The Release's approach regarding leveraged/inverse funds[25] is quite different from the 2019 Proposal.[26] Specifically, the SEC recognized that, under the relative VaR test with a 200% limit, as adopted, leveraged/inverse funds that seek leveraged/inverse market exposure greater than 200% of the return/inverse return of an index ("over-200% leveraged/inverse funds") generally will be unable to satisfy the Rule's limit on fund leverage risk.[27] Therefore, the Rule includes a provision permitting over-200% leveraged/inverse funds to continue to operate at their current leverage levels, provided they comply with all the provisions of the Rule, except the VaR-based limit on fund leverage risk, and satisfy the following additional requirements:

- The fund was in operation as of October 28, 2020, and the fund has outstanding shares issued in one or more public offerings to investors, and discloses in its prospectus a leverage multiple or inverse multiple that exceeds 200% of the performance or the inverse of the performance of the underlying index,
- The fund does not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide, and
- The fund discloses in its prospectus that it is not subject to the limit on fund leverage risk specified by the Rule.

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, as adopted, the ETF Rule expressly excluded leveraged/inverse ETFs from the ETF Rule's coverage. The Release amends the ETF Rule to permit a leveraged/inverse ETF, including over-200% leveraged/inverse funds, to rely on the ETF Rule, provided the ETF complies with the applicable provisions of the Rule. Because the amendments to the ETF Rule will permit a leveraged/inverse ETF to rely on that rule instead of an existing order, the SEC stated that, on the compliance date of the Rule, it will rescind the exemptive orders already issued to leveraged/inverse ETFs.

Separately, the Release does not adopt the sales practices rules proposed in the 2019 Proposal. The rules would have required investment advisers and broker-dealers to exercise due diligence with respect to retail investors that are natural persons before approving retail investor accounts to invest in shares of a "leveraged/inverse investment vehicle."[28]

VIII. OBSERVATIONS

"Competition" between types of leverage. The Rule applies either a relative or absolute VaR-based ceiling as a means to limit the total leverage a fund can achieve from a mix of different transactions, including loans, reverse repurchase agreements and derivatives transactions, placing such exposures in more direct competition for a fund's available "capacity" under the VaR limit.[29] For funds that have utilized transactions involving a significant amount of leverage, their investment advisers will need to assess carefully the leveraging transactions that provide the most attractive exposure in light of all relevant considerations, including cost. Such an analysis raises interesting issues of fiduciary duty, especially when an adviser may be entitled to compensation under its investment advisory agreement for some leveraging transactions (*e.g.*, borrowings, reverse repurchase agreements) and not others (*e.g.*, derivatives transactions where the investment exposure is principally notional). With the Rule in effect, there may not be a principled reason why – as is commonly the case – investment advisers to registered investment companies should earn advisory fees on the

invested proceeds from borrowings or reverse repurchase agreements (without reduction for the related liabilities), but not on the notional value of certain derivatives transactions, such as total return swaps, which can be used to provide similar economic exposure.

Objective designated indexes. Under the Rule, a fund may not use a designated index as its DRP for purposes of applying the relative VaR limit if the designated index was "created at the request of the fund or its investment adviser."[30] It is common for fund sponsors, especially ETF sponsors, to have some involvement in the formulation of an index used in the management of a fund. Additionally, index sponsors may seek to gauge commercial interest in a particular index before determining whether to invest the resources necessary to "create" an index and bring it to market. To the extent fund sponsors are (or were) so involved, they may wish to document the level of their involvement internally and to document their understandings with index sponsors as to whether (or not) the index was created at the request of the fund sponsor. Interestingly, the limitation appears to apply without limit in time, such that it would apply to indices created at the request of a fund or its investment adviser long before the Rule was formulated.

Derivatives Risk Manager. In approving the designation of a Derivatives Risk Manager, the Rule omits the 2019 Proposal's requirement that a fund's board must take into account "the derivatives risk manager's relevant experience regarding the management of derivatives risk," but the Rule still requires that the individual(s) designated have "relevant experience regarding the management of derivatives risk." The board will need to take that "relevant experience" into account, along with all other relevant factors, in appointing the Derivatives Risk Manager.

The Rule does not specify what "relevant experience regarding the management of derivatives risk" means or what qualifications or experience the derivatives risk manager must possess. The SEC notes in the Release that this aspect of the Rule is designed to provide flexibility to boards to determine what experience is relevant in light of the derivatives risks applicable to the fund, but it is unclear what kinds of experience and qualifications will be required for this position. Presumably, risk experts in the derivatives field are already gainfully employed in positions – like portfolio manager, quantitative analyst or trader – that provide more attractive compensation and bonus opportunities than a mutual fund compliance role. Some advisers (smaller advisers, in particular) may find the cost of hiring a new senior-level employee to serve in the Derivatives Risk Manager role to be burdensome as a business matter.

Derivatives Risk Manager and manager-of-managers situations. The Rule requires that the Derivatives Risk Manager be an officer or officers of the fund's investment adviser, which the Release clarifies includes sub-advisers (as long as the sub-adviser manages the fund's entire portfolio and not a sleeve of the fund's assets). Neither the Rule nor the Release otherwise addresses the allocation of responsibilities between personnel of the primary investment adviser and the personnel of a sub-adviser for funds that employ a manager-of-managers structure, leaving such a fund considerable flexibility to tailor its Program to its particular facts and circumstances. Even for a fund that designates one or more officers of its primary investment adviser as the Derivatives Risk Manager, it seems likely that the Derivatives Risk Manager will look to personnel of the sub-adviser(s) for assistance in administering the Program. At a minimum, if a fund were to be out of compliance with its VaR test, it would presumably be necessary for the applicable sub-adviser(s) to be involved in promptly returning the fund to compliance in a manner that is in the best interests of the fund and its shareholders. Because existing sub-advisory agreements were not drafted in contemplation of the Rule, it may be necessary for primary investment advisers and sub-advisers to address and negotiate their respective roles.

Derivatives Risk Manager's communications with the board.

- While the Rule does not specifically require that the Derivatives Risk Manager meet in person with the board (or the independent directors), the SEC clearly contemplates a relationship between the Derivatives Risk Manager and the board, noting multiple times in the Release that the Derivatives Risk Manager will have a "direct reporting line" to the board. As noted above, one of the reasons cited by the SEC for requiring board approval of the Derivatives Risk Manager is that the SEC believes that board approval "is important to establish the foundation for an effective relationship and line of communication" between the board and the Derivatives Risk Manager. In contrast to Rule 22e-4, where the administrator of a fund's liquidity risk management program can be the adviser itself, the SEC

noted that requiring the Derivatives Risk Manager to be an officer or officers of the adviser would "promote accountability" to the board. As a result, we expect boards may seek periodic meetings with the Derivatives Risk Manager as well as special meetings with the Derivatives Risk Manager (*e.g.*, during periods of extended non-compliance by a fund with its applicable VaR test). In addition, a board should expect to receive multiple written reports from the Derivatives Risk Manager, as required under the Rule.

- Because the Derivatives Risk Manager has discretion when determining whether to escalate a material risk arising from a fund's derivatives use to the board, a board could find itself being brought into situations where the Derivatives Risk Manager and a fund's portfolio managers disagree as to the evaluation or materiality of the risks. While the Release indicates that the Derivatives Risk Manager's decision to escalate is intended to provide the board with information to facilitate its oversight, a board will want to take care that it keeps its oversight role as opposed to becoming a referee between the portfolio management and derivatives risk management functions.

Limited Derivatives User Exception. The test for the Limited Derivatives User Exception, which requires that the derivatives exposure of a fund not exceed 10% of the net assets of the fund, is not calibrated to the risk of the fund's derivatives positions. With limited exceptions, derivatives that tend to have lower risk relative to their notional amount (such as many interest rate derivatives) are treated the same as derivatives that tend to have higher risk relative to their notional amount. Also, no credit is given for margin posted or received with respect to derivatives contracts. While the Rule excludes from this 10% threshold close-out transactions with the same counterparty, it does not exclude positions that offset or hedge derivatives transactions with a different counterparty, leading to the result that a derivatives transaction that hedges interest rate or currency risk of an equity or fixed income instrument held by a fund is excluded from derivatives exposure for purposes of the 10% test, while a derivatives transaction that hedges interest rate or currency risk of another derivatives transaction held by the fund might need to be included.

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1. As a technical matter, the Rule exempts funds that enter into derivatives transactions from various provisions under Section 18, which generally restricts a fund's ability to issue "senior securities." The SEC notes in the Release its belief that "a derivatives transaction creating a future payment obligation involves an evidence of indebtedness that is a senior security for purposes of [S]ection 18."
2. Derivatives risks means the risks associated with a fund's derivatives transactions or its use of derivatives transactions, including leverage, market, counterparty, liquidity, operational and legal risks and any other risks the Derivatives Risk Manager (or, in the case of a limited derivatives user, the fund's investment adviser) deems material.
3. Existing funds seeking a greater-than-200% leveraged/inverse market exposure are grandfathered under the Rule, subject to conditions.
4. A derivatives transaction means (i) 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, (ii) any short sale borrowing and (iii) if the fund treats ***all*** reverse repurchase agreements or similar financing transactions as derivatives transactions, any reverse repurchase agreement or similar financing transaction.
5. 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.
6. Securities portfolio means the fund's portfolio of securities and other investments, ***excluding*** any derivatives transactions, approved by the Derivatives Risk Manager for purposes of the relative VaR test, provided that the fund's securities portfolio reflects the markets or asset classes in which the fund invests. The Release notes that allowing a fund to use its securities portfolio may provide the fund with the ability to (i) use a VaR reference portfolio that is more tailored to the fund's investments than an index and/or (ii) avoid the expense associated with blending or licensing an index just for purposes of the Rule's VaR test.
7. If a fund's investment objective is to track the performance, including a multiple or inverse multiple, of an unleveraged index, the fund must use that index as its DRP (even if that unleveraged index would otherwise be a prohibited index under the Rule).
8. 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. In changes from the 2019 Proposal regarding a designated reference index (i) the Rule does not require a fund's designated index to be an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N-1A and (ii) a fund is not required to disclose its designated index in its annual report. However, a fund's designated index, if any, will be reported publicly on Form N-PORT.
9. The 2019 Proposal also would have precluded a fund from entering into new derivatives transactions (other than transactions reducing the fund's VaR) until the fund had complied with its VaR test for three consecutive business days.
10. The 2019 Proposal allowed for a three business day cure period.
11. In contrast, Rule 22e-4 requires board approval of a fund's liquidity risk management program.
12. The Release notes that the Derivatives Risk Manager does not have to be an "officer" of the investment adviser in accordance with the adviser's corporate bylaws and can be any person with a "comparable degree of seniority and authority within the organization" who is otherwise qualified for the position.
13. The 2019 Proposal would have required daily backtesting.
14. While the Rule does 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 includes board approval of policies and procedures reasonably designed to prevent violation of the federal securities laws, of which the Rule is a part.
15. The Release notes that, "[t]o the extent that a fund engages in transactions similar to firm or standby commitment agreements, they may fall within the 'any similar instrument' definitional language, depending on the facts and circumstances."
16. This is a change from the 2019 Proposal, which would have required funds 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.

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17. 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.
18. Some commenters asked the SEC to clarify how to-be-announced ("TBA") transactions should be treated under the Rule. The SEC notes in the Release that TBAs and dollar rolls are included in the final rule's derivatives transaction definition (because they are forward contracts or "similar instruments"), and that funds may invest in TBAs under the delayed-settlement securities provision, if its conditions are satisfied.
19. Derivatives exposure means the sum of (i) the gross notional amounts of the fund's derivatives transactions described in clause "(i)" within the definition of the term "derivatives transaction" and (ii) in the case of short sale borrowings, the value of the assets sold short. If a fund's derivatives transactions include reverse repurchase agreements or similar financing transactions, the fund's derivatives exposure also includes, for each transaction, the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction. In determining derivatives exposure a fund may (i) convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts and (ii) exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund. According to the Release, "[d]elta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta."
20. The Rule does not define "notional amount" or specify how to determine notional amount. The Release states that "using gross notional amounts to measure market exposure could be viewed as a relatively blunt measurement," but using such concept in the Limited Derivatives User Exception "is designed to serve as an efficient way to identify funds that use derivatives in a limited way."
21. A fund may rely on the Rule after its effective date, but before the compliance date, provided that the fund satisfies the Rule's conditions. Any funds that do so must rely only on the Rule and may not rely on Release 10666 or any no-action letters or other staff guidance. In such cases, early compliance requirements extend to the amendments to Form N-PORT and Form N-CEN, as applicable, once these updated forms are available for filing on EDGAR, as well as filing Form N-RN to report any reportable event.
22. The 2019 Proposal would have required all funds to report their derivatives exposure.
23. While the 2019 Proposal would have required funds to report their highest daily VaR (and for funds that use the relative VaR test, their highest daily VaR ratio) and these measures' corresponding dates, the Form N-PORT amendments do not include these requirements.
24. In view of the amendments that make current Form N-LIQUID (Form N-RN) applicable to all funds (other than money market funds), the Release amends 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.
25. Leveraged/inverse fund means 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 performance of a market index ("inverse multiple"), over a predetermined period of time.
26. The 2019 Proposal would have exempted leveraged/inverse funds from the Rule's VaR requirements, provided the fund did not seek investment results exceeding 300% of the return (or inverse of the return) of an underlying index. Investment advisers and broker-dealers also would have been subject to sales practice rules with respect to sales of these funds to retail investors.
27. The SEC stated that there were 70 leveraged/inverse ETFs, with total net assets of $15.7 billion, that currently seek to provide leveraged/inverse market exposure exceeding 200% of the return/inverse return of an index.
28. The same day that the Release was published, Chairman Clayton, with the Director of the Division of Investment Management and the Director of the Division of Corporation Finance, issued a joint statement regarding complex products, including leveraged/inverse products. The joint statement reported that the SEC staff will be reviewing the existing regulatory requirements concerning protecting investors who invest in complex products. Based on this review, the staff will make recommendations to the SEC regarding potential new rulemakings, guidance, or other policy actions, if appropriate. The joint statement also invited public comment on these topics.
29. As noted, funds may treat reverse repurchase agreements as senior securities representing indebtedness and subject to the asset coverage requirements of Section 18 or treat them as "derivatives transactions" under the Rule.
30. This prohibition does not apply if (i) the index is widely recognized and used or (ii) the fund's investment objective is to track the performance, including a multiple or inverse multiple, of a particular index.

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