K&L GATES

LEGAL INSIGHT

12 November 2020

Practice Group:

Asset Management and Investment Funds

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

By Michael W. McGrath, Kenneth Holston, Fatima Sulaiman, Matthew J. Rogers, and Britney E. Ryan

Executive Summary

On 28 October 2020, the U.S. Securities and Exchange Commission (SEC) adopted Rule 18f-4 (Rule or 18f-4) under the Investment Company Act of 1940, as amended (1940 Act).[1] The Rule replaces the SEC's decades-old patchwork of guidance with a comprehensive framework for the use of derivatives transactions by registered funds. The final Rule retains the key elements of the proposal (2019 Proposal), with certain modifications in consideration of industry feedback and market disruptions surrounding the coronavirus (COVID-19) outbreak.[2]

The Rule, which is structured as an exemption from restrictions on the issuance of "senior securities" set forth in Sections 18 and 61 of the 1940 Act, imposes several conditions on funds that make significant use of derivatives transactions (defined below), including:

- value at risk (VaR) limitations in lieu of asset segregation requirements;
- adoption of a written derivatives risk management program (DRMP);
- new oversight responsibilities on a fund's board of directors (the Board);
- an exception for funds that make limited use of derivatives;
- alternative requirements for certain leveraged/inverse funds;[3]
- special treatment for reverse repurchase agreements (reverse repos) and similar financing transactions under the Rule;
- special treatment for unfunded commitment agreements under the Rule; and
- new reporting and recordkeeping requirements.

[1] The Rule applies to mutual funds (other than money market funds), exchange-traded funds (ETFs), registered closed-end funds and business development companies (BDCs) (collectively, funds). The Rule's adopting release (Release) is available at https://www.sec.gov/rules/final/2020/ic-34078.pdf.

[2] The 2019 Proposal was released on 25 November 2019 and is available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf. The 2019 Proposal was technically a re-proposal of Rule 18f-4, which was originally proposed by the SEC on 11 December 2015 (2015 Proposal) and is available at www.sec.gov/rules/proposed/2015/ic-31933.pdf. The 2015 Proposal required a derivatives program for funds with notional exposure to derivatives of at least 50% of net assets, or funds engaging in "complex derivatives transactions," but as adopted, Rule 18f-4 establishes a DRMP requirement for any fund that does not qualify for a "limited derivatives user" exception described herein. In addition, unlike the 2015 Proposal, the Rule does not mandate notional portfolio limits and eliminates asset segregation requirements.

[3] The SEC did not adopt sales practices rules for broker-dealers and investment advisers or an exception from the VaR test for leveraged/inverse funds that were included in the 2019 Proposal. Accordingly, leveraged/inverse funds will generally be subject to the Rule, with an exception from the VaR test requirement for certain leveraged/inverse funds currently in operation. "Leveraged/inverse funds" are defined as funds that seek, "directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time."

The Rule defines "derivatives transactions"[4] to mean:

(1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise;[5]

(2) any short sale or borrowing; and

(3) (optionally) reverse repos and similar financing transactions.[6]

Notably, the final definition adopted in 18f-4 provides an option for funds to consider reverse purchase agreements and similar financing transactions *as either* derivatives transactions for purposes of meeting the requirements set forth in the Rule or as senior securities equivalent to bank borrowings for purposes of Sections 18 of the 1940 Act.

In conjunction with the Rule, the SEC will rescind Investment Company Act Release No. 10666 (Release 10666)[7], as well as subsequent SEC staff no-action letters and other guidance that together have governed the use of derivatives and certain other financing transactions in registered funds for over 40 years.

Key Dates

- **Effective Date** – The Rule is effective 60 days after publication in the *Federal Register*.[8]
- **Compliance Date** – Eighteen months after the effective date, funds (except those relying on the "limited derivatives user" exception) must implement VaR testing and a DRMP. The SEC will simultaneously rescind Release 10666 and its related guidance.

A fund may operate in reliance on 18f-4 after the effective date but prior to the compliance date, provided that the fund satisfies all conditions set forth in 18f-4.

Summary Of Key Elements

In this alert, we provide summaries and practical takeaways for the three key elements of the Rule—VaR limits, derivatives risk management, and Board responsibilities—as well as an overview of key exceptions, alternatives, and reporting requirements.

- **VaR Limits.** The Rule will entirely replace the asset segregation regime set forth in Release 10666 and subsequent SEC staff guidance with a VaR test intended to impose an "outer limit" on leverage risk in funds. The VaR test will measure the VaR

[4] *See* Rule 18f-4(a) (defining "derivatives transactions").
[5] The Release clarifies that to-be-announced investments such as mortgage-backed securities and dollar rolls are included in the definition of a "derivatives transaction" as either forward contracts or "similar instruments."
[6] Funds may elect whether to treat reverse repos and similar financing transactions as "derivatives transactions" subject to the requirements set forth in 18f-4. See *Part 6: Reverse Repurchase Agreements and Similar Financing Transactions*.
[7] *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979).
[8] As of the date of this Article, the Rule has not been published in the *Federal Register*.

of the fund relative to the VaR of a "designated reference portfolio" that reflects the markets or asset classes in which the fund invests. The designated reference portfolio can generally be either (i) an index selected by the fund's derivatives risk manager (DRM), or (ii) the fund's own securities portfolio (excluding derivatives transactions). Under the Rule, the VaR of a fund's portfolio cannot exceed 200% (250% for certain closed-end funds) of the VaR of the designated reference portfolio.[9] If the fund's DRM reasonably determines that no designated reference portfolio can be identified, the Rule instead requires an "absolute VaR test," which limits the VaR of the fund's portfolio to no more than 20% (25% for certain closed-end funds) of the fund's net assets.

- **Derivatives Risk Management Program.** A formalized risk management program is a second key element of the Rule. The Rule will require funds to adopt a written DRMP that includes policies and procedures reasonably designed to manage a fund's derivatives risks.[10] The Rule grants a fund the flexibility to tailor its DRMP to suit its derivatives usage, but each DRMP must include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing on at least a weekly basis, (4) weekly backtesting, (5) internal reporting and escalation, and (6) periodic reviews of the DRMP.
- **Board Responsibilities.** The Rule will require a fund Board's heightened attention to and oversight of the fund's derivatives usage and the attendant material risks. In particular, the Board must approve the designation of an officer or officers of the fund's investment adviser as the fund's DRM, and it must review the DRM's initial and annual written report on the DRMP. In addition, the Board is expected to review periodic written reports describing information related to the implementation of the DRMP.
- **Exception for Limited Derivatives Users**. Funds that limit derivatives exposure to 10% of net assets (excluding certain currency and interest rate hedging transactions) are excepted from the VaR test, DRMP requirements, and Board oversight and reporting requirements of the Rule, provided that such funds implement written policies and procedures reasonably designed to manage their derivatives risks.
- **Other Provisions.** The Rule contains several exceptions and provisions related to specific types of funds and instruments. Money market funds are excluded from the definition of "funds" for purposes of the Rule. Consequently, under the Rule, money market funds are effectively prohibited from engaging in derivatives transactions, with the narrow exception of delayed-settlement securities.[11] The Rule also contains detailed provisions regarding the definition of "derivatives transactions" and special treatment for leveraged/inverse funds, reverse repos and similar financing transactions, delayed-settlement securities, and unfunded commitment agreements, as well as expanded reporting and recordkeeping requirements.

[9] As discussed herein, certain closed-end funds are subject to a different VaR limitation.

[10] While similar in certain respects to the liquidity risk management program required by Rule 22e-4 under the 1940 Act, the Rule provides more flexibility for a fund to tailor the DRMP based upon its derivatives use.

[11] See Rule 18f-4(f).

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

Table of Contents

Executive Summary 1

PART 1: VaR Testing 5

PART 2: Derivatives Risk Management Program 8

PART 3: Board Responsibilities 14

PART 4: The "Limited Derivatives User" Exception 16

PART 5: Leveraged/Inverse Funds including ETFs 17

PART 6: Reverse Repos and Similar Financing Transactions 19

PART 7: Special Treatment for Unfunded Commitment Agreements 21

PART 8: Fund Reporting and Recordkeeping Requirements 23

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 1: VaR Testing

Overview

VaR tests are a commonly used industry metric designed to estimate an instrument or portfolio's potential loss at a specified confidence level. As used in the Rule, VaR testing is a means to limit the amount of leverage risk a fund will be able to incur through the use of derivatives transactions. VaR testing will replace limitations on leverage imposed by the asset segregation regime of Release 10666 and the related no-action letters. Under the Rule, Funds with more than limited derivatives usage will need to comply with one of two VaR tests.

- **Relative VaR Test** – A fund satisfies its relative VaR test if the fund's portfolio does not exceed **200%** of the VaR of the designated reference portfolio[12] selected by the DRM. A closed-end fund with then-outstanding shares of a preferred stock issued to investors (a CEF) satisfies the relative VaR test if the CEF's portfolio does not exceed **250%** of the VaR of the designated reference portfolio.[13]
- **Absolute VaR Test** – A fund may use an absolute VaR test only if its DRM reasonably determines that a designated reference portfolio 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.[14] A fund passes the absolute VaR test if the VaR of the fund's portfolio does not exceed **20%** of the value of the fund's net assets. A CEF passes the absolute VaR test if the VaR of the CEF's portfolio does not exceed **25%** of the value of the CEF's net assets.[15]

A "designated reference portfolio" means a "designated index" or the fund's "securities portfolio," and it is selected at the discretion of the fund's DRM (except for index-tracking funds). "Designated index" means an unleveraged index that is approved by the DRM for purposes of the relative VaR test and that reflects the markets or asset classes in which the fund invests.[16] "Securities portfolio" means the fund's portfolio of securities and other investments, excluding any derivatives transactions, that is approved by the DRM for purposes of the relative VaR test (provided that the fund's securities portfolio must actually reflect the markets or asset classes in which the fund invests).[17]

[12] The Rule requires index-tracking funds to use the index they track as the designated reference portfolio. Actively managed funds may elect to use either a designated index or the fund's securities portfolio as the designated reference portfolio.

[13] *See* Rule 18f-4(a) (defining the term "relative VaR test").

[14] *See* Rule 18f-4(b)(2).

[15] *See* Rule 18f-4(a) (defining the term "absolute VaR test").

[16] The designated index must not be an index that is administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used. However, if a fund tracks the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its designated reference portfolio, even if the index otherwise would be a prohibited index under the Rule.

[17] *See* Rule 18f-4(a) (defining the term "designated reference portfolio" and "securities portfolio").

Requirements

Regardless of the VaR tests a DRM elects on behalf of a fund, the VaR calculation model must meet the following requirements:

- Incorporate and reflect all significant, identifiable market risk characteristics of the fund's particular investments;
- Contain a 99% confidence level and a time horizon of 20 trading days; and
- Contain at least three years of historical market data.[18]

A fund must determine its compliance with the applicable VaR test at least *once each business day*, and if a fund is not in compliance, the Rule requires that the fund come back into compliance promptly after such determination, in a manner that is in the best interest of the fund and its shareholders. A fund that does not return to compliance with the VaR test *within five business days* is subject to an escalating reporting regime:

- If the fund fails to come into compliance within five business days, the DRM must (i) provide a written report to the Board explaining how and by when (i.e., number of business days) the DRM expects the fund will come back into compliance, and (ii) file a confidential report with the SEC on Form N-RN (see Part 8: Fund Reporting and Recordkeeping Requirements below).[20]

In addition to the initial written report to the Board, the DRM must also provide the Board with a written report *within 30 calendar days* of the date that the fund exceeded the VaR threshold that explains how the fund came back into compliance and the DRM's analysis of the circumstances that caused the fund to be out of compliance for *more than five business days (see Part 2: Derivatives Risk Management Program* and *Part 3: Board Responsibilities* below).[21]

Practical Considerations:

- While the Rule does not prescribe a specific VaR method, for the first time funds will have a regulatory obligation to implement VaR testing.
- This requirement is not intended to replace testing performed by investment advisers that informs their portfolio management decisions; it is an additional and distinct requirement meant to replace the SEC's current piecemeal asset segregation approach to limiting leverage risk.
  - Many investment advisers currently use historical simulations, Monte Carlo simulations, and parametric models to test their derivatives exposure and related risks. The Release notes that these types of tests may continue to be relevant to assessing the risks of a fund's use of derivatives (particularly tail risks that may not be adequately addressed by VaR), but they would be considered an element of the fund's DRMP. Please see *Part 2: Derivatives Risk Management Program* for practical considerations on how to integrate VaR testing into a fund's DRMP.

[18] *See* Rule 18f-4(a) (defining "value-at-risk" or "VaR").

[19] *See* Rule 18f-4(b)(2)(ii).

[20] *See id.*

[21] *See* Rule 18f-4(b)(2)(iii)(C).

- The requirements for VaR testing are substantially similar to other regulatory regimes requiring VaR testing, including the European Securities Market Authority's (ESMA) requirements for Undertakings for the Collective Investment in Transferable Securities (UCITS).[22]
  - Notably, the final Rule and the rules adopted by ESMA for UCITS each impose a 200% threshold for funds that use a relative VaR test, and 20% of net asset value for funds that use an absolute VaR test.
- VaR testing may not adequately capture a fund's leverage risk in idiosyncratic circumstances.[23] The SEC has left open the possibility of exemptive relief for such situations.

[22] *See* CESR's (now ESMA) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (July 28, 2010), https://www.fsc.gi/uploads/legacy/download/ucits/CESR-10-788.pdf.

[23] *See* Release at p. 102.

PART 2: Derivatives Risk Management Program

Overview

A key feature of the Rule is the requirement for funds to adopt and implement a written DRMP for all derivative transactions except in limited circumstances and designate a DRM to administer the program.[24] The DRMP must be tailored to fit the types of derivatives used by a fund and the particular needs of a fund based on its investment strategy and portfolio holdings. In addition to mandating a DRM, the Rule specifies six elements required for a DRMP.

Importantly, most funds (and their investment advisers) will need to make wholesale modifications to their current policies and procedures to satisfy some or all of the elements prescribed by the Rule.

Derivatives Risk Manager

As a threshold matter, each investment adviser must designate an officer or officers of the fund's investment adviser to serve as the fund's DRM. The DRM must: (i) be approved by a fund's Board; (ii) maintain a direct line of communication with the Board, including periodic reporting to the Board; and (iii) segregate its functions as DRM from those of the portfolio management team in order to promote objective and independent assessments of the risks associated with derivative transactions.[25] Generally, the DRM must be an officer of the fund's investment adviser; however, the Rule permits a sub-adviser that manages a fund's entire portfolio to be the DRM, if approved by the fund's Board. A sub-adviser responsible for a portion or "sleeve" of a portfolio is not permitted to be the DRM. The DRM may also seek assistance and guidance from an independent third party to administer the DRMP even though the third party itself cannot serve as the fund's DRM. In addition, the Rule expressly forbids a single portfolio manager or a committee, the majority of which are portfolio managers, from serving as the DRM.[26]

Practical Considerations:

- Investment advisers may consider designating the same individual(s) to be the DRM and the administrator of their Liquidity Risk Management Program.[27]
  - While there are some overlapping responsibilities between the two roles, such as providing periodic reports to the Board, investment advisers must ensure the DRM has the resources and capacity to fulfill its obligations to manage the DRMP. Notably, the Rule does not permit the fund's adviser to serve as the DRM—the Board must designate one or more natural persons for this role. By contrast, the Liquidity Rule permits a Board to designate the fund's adviser as the liquidity program administrator.

[24] *See* 18f-4(c); *see also Part 4: The Limited Derivatives User Exemption*.
[25] *See* 18f-4(c)(3)(i).
[26] *See* Rule 18f-4(a)
[27] *See* Rule 22e-4 of the 1940 Act, as amended (the Liquidity Rule).

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

- We anticipate questions about the potential for personal liability in the event that a fund under a DRM's oversight suffers significant losses arising from the use of derivatives. Unhelpfully, the SEC stated in the Release that the Rule "does not change the standards that apply in determining whether a person is liable for aiding or abetting or causing a violation of the federal securities laws," and "[t]hat a fund suffers losses does not, itself, mean that a fund's derivatives risk manager acted inappropriately."[28]
- As a practical matter, funds and their Boards should review each fund's and/or adviser's D&O/E&O policies to determine whether the DRM will be covered for any potential personal liability under those policies and, if not, consider seeking expanded coverage to address this issue.

Element 1: Risk Identification and Assessment

Overview

A DRMP must identify and assess a fund's "derivatives risks," which is broadly defined to include: (i) leverage, (ii) general market conditions, (iii) liquidity, (iv) legal, and (v) operational risks, but they may include any other risks the DRM deems material.[30]

Practical Considerations:

- This element of the DRMP is broad in scope and should address risks associated with derivatives transactions that extend beyond the specific requirements of the Rule.
  - For example, Section 17(f)(5) the 1940 Act generally requires that if a fund maintains securities with a qualified custodian, the cash proceeds from the sale of such securities should also be kept with the qualified custodian. To address this requirement, cash collateral may be maintained with the funds' custodian, subject to a tripartite agreement (e.g., a three-way agreement between the custodial bank, the dealer-counterparty, and the investment adviser on the fund's behalf), which dictates the movement of a fund's collateral. We anticipate that most funds will integrate procedures accounting for the management and movement of cash and collateral into the DRMP.
- Similarly, the DRMP may incorporate elements of an investment adviser's counterparty credit assessment or require certain key terms be included in trading, credit, and service provider agreements.
  - For example, investment advisers may adopt a policy of only entering into account control agreements containing a pledgor access provision that allows a fund to unilaterally request the transfer of collateral from the segregated account at its custodian to its main custody account if the counterparty becomes subject to certain adverse events.

[28] *See* Release at p. 58–59.

[29] *See* Rule 18f-4(a). "Derivatives risk" is defined broadly to include any risks that must be identified and managed to include leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other risks the derivatives risk manager deems material.

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

Element 2: Risk Guidelines

Overview

A DRMP must establish, maintain, and enforce investment, risk management, and other guidelines in a quantitative or otherwise measurable manner. Even though the Rule does not impose any specific risk limits, it does require that the DRMP specify quantitative risk measures it does not normally expect to breach.[31]

Practical Considerations:

- When developing a DRMP, the DRM should consider how funds categorize the liquidity of each portfolio holding to satisfy its Liquidity Rule[32] obligations and incorporate or differentiate these assumptions into their quantitative models.[33]
    - For example, if an investment manager designates a certain derivatives transaction to be a Moderately Liquid Investment for Liquidity Risk Management Program purposes,[34] it should consider incorporating this data into its risk guidelines or justify the apparent discrepancies.
- DRMs should consider tying certain aspects of the Risk Identification and Assessment element to this Risk Guidelines element.
    - For example, the development of quantitative models for measuring counterparty risk would satisfy both elements, and it may also facilitate policies and procedures that allow for more streamlined onboarding and account opening processes by actively monitoring select counterparties for expedited credit approvals.

Element 3: Weekly Stress Testing

Overview

The Rule mandates stress testing, which is intended to provide the DRM with data regarding risks in a fund's portfolio that are not exposed through VaR testing. Stress testing must be conducted on a *weekly* basis, but more frequent testing is permissible. At a minimum, a stress test analysis should provide the DRM with sufficient information to determine how the

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

[32] See supra note 2.

[33] See Fatima S. Sulaiman & Jin H. Ahn, SEC Amends Liquidity Rule Reporting and Disclosure Requirements, K&L Gates (June 28, 2018), http://www.klgates.com/sec-amends-liquidity-rule-reporting-and-disclosure-requirements-07-25-2018/.

[34] See supra note 6.

fund's portfolio would perform during tail risk events and other designated periods of market stress.[35]

Practical Considerations:

- In order to ensure the DRM receives meaningful feedback from the stress test analysis, the parameters of a stress test must be carefully considered, including what constitutes significant adversity under extreme, but plausible, market conditions.
  - A stress test may simulate, for example, how the fund would perform if it lost a percentage of its net asset value or if a key counterparty experienced a sudden credit downgrade. The DRM should also consider adopting procedures outlining the types of results that may warrant off-cycle Board notification and whether certain results must prompt the fund to reduce its derivatives exposure.
- A DRM may also consider increasing the frequency of stress testing during periods of market volatility or stress. The DRMP could require more frequent stress testing if the fund's benchmark drops a predefined percentage over the course of a designated period or if a market volatility index, such as the CBOE Volatility Index (VIX),[36] crosses a predetermined threshold.

Element 4: Backtesting Over a One-Trading Day Horizon at 99% Confidence

Overview

VaR would be estimated over a one-trading day time horizon, and the backtest must be conducted using a 99% confidence level. Assuming 250 trading days in a year, and given the requirement that backtests be conducted using a 99% confidence level over a one-trading day time horizon, the SEC would expect a fund to experience a backtesting exception approximately 2.5 times per year, or 1% of the 250 trading days. The fund must identify as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss. A fund must perform the analysis on a weekly basis, comparing the fund's daily gain and loss to the estimated VaR for each business day in the week.[37]

Practical Considerations:

- Firms should closely monitor backtesting exceptions to ensure this percentage is not exceeded more frequently than 2.5 times per year.
  - For example, if 10 or more exceptions are generated in a year using the above parameters, the SEC would consider it statistically likely such exceptions are a result of a VaR model that is not accurately estimating VaR given the facts and

[35] *See* Rule 18f-4(c)(1)(iii).

[36] VIX is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. It is derived from the price inputs of the S&P 500 index options and provides a measure of market risk and investors' sentiments.

[37] *See* Rule 18f-4(c)(1)(iv).

circumstances of the fund's derivatives usage. DRMs should consider such results as an indicator to review and update certain aspects of the DRMP, including the VaR model and the fund's designated reference portfolio.

- European regulations require UCITS to perform backtests on a monthly basis. For investment advisers operating both UCITS and funds required to adopt a DRMP, advisers must be mindful of the jurisdictional differences imposed by different regulatory regimes.

Element 5: Internal Reporting and Escalation

Overview

The Rule would require the DRM to maintain communication with the fund's portfolio management personnel and, if appropriate, the fund's Board, regarding operation of the DRMP. The Rule provides the DRM with flexibility to determine when communications with these groups are appropriate based on the fund's facts and circumstances. Instead of prescribing reporting obligations if certain events occur, the Rule permits the DRM to identify the circumstances under which it must communicate with a fund's portfolio management about the fund's derivative risk management. The DRM also must communicate material risks regarding the fund's derivative use to the fund's portfolio management personnel and, as appropriate, its Board.[38]

Practical Considerations:

- DRMs should consider meeting with the fund's portfolio management team on a regular or frequent basis.
  - However, a DRM may also utilize software designed to provide automated updates to portfolio management regarding the fund's VaR testing and stress tests as a method of providing sufficiently frequent communications to portfolio management.
  - In addition, a DRM may determine that, given a fund's specific facts and circumstances surrounding its derivatives usage, it is sufficient to e-mail portfolio management with updated information on a frequent basis, rather than holding in-person meetings.
- DRMs should consider what types of risk identified in the DRMP's operations would require more immediate notice to the Board, including when more frequent communication is necessary to provide the Board with key information necessary for the Board to fulfill its oversight function.
  - For example, DRMs may determine at the outset that certain material derivatives risks (e.g., those that put more than a certain percentage of the fund's assets at imminent risk) should always be escalated promptly to the Board.
  - Alternatively, the DRM may determine that certain material derivatives risks do not need to be reported immediately to the Board and, instead, may first be presented to investment adviser senior officers and portfolio managers.

[38] *See* Rule 18f-4(c)(1)(v).

Element 6: Periodic Review of the DRMP

Overview

The Rule requires the DRM to review the DRMP at least annually to evaluate the DRMP's effectiveness and to reflect changes in the fund's derivatives risks over time. The DRM's review must include, at a minimum, the VaR calculation model, including the fund's backtesting of the model, and whether any designated reference portfolio remains appropriate.[39]

Practical Considerations:

- When performing the review, DRMs should consider whether all elements of the DRMP are operating at maximum efficiency, including whether the DRMP could be updated to better reflect the true derivatives risks experienced by the fund and whether the fund's VaR calculation model or any designated reference portfolio needs alterations.
- DRMs generally should implement periodic review procedures for evaluating regulatory, market-wide, and fund-specific developments affecting the fund's DRMP so that it is well positioned to evaluate the DRMP's effectiveness.
    - These review procedures may include imposing a more frequent review requirement than annually or requiring a more frequent review of certain elements of the DRMP.

[39] *See* Rule 18f-4(c)(1)(vi).

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 3: Board Responsibilities

Overview

The Rule seeks to balance the management of derivatives risk and the optimal use of derivatives by a fund. Consistent with this goal and the Board's general oversight responsibilities,[40] the Rule seeks to ensure sufficient Board oversight of the DRMP without requiring such an extreme degree of oversight that the DRMP is rendered ineffective.

Requirements

- **Approval of the DRM.** The Board is required to approve the DRM, but it is not required to approve the DRMP itself.[41] The Release notes that the Board is well positioned to consider and designate the DRM based on all relevant facts and circumstances.[42] Nevertheless, the fund's adviser is expected to participate in the selection process, for example, by nominating candidates, reviewing resumes, conducting initial interviews, and communicating the adviser's views of candidates.
- **Reviews of Annual Reports.** To fulfill its oversight function, the Board must review, at the initial implementation of a DRMP, and at least annually thereafter, a written report from the DRM that includes a representation that the DRMP is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the DRMP.[43] These annual reports must address the effectiveness of the DRMP's implementation, provide the DRM's basis for selecting (or changing)[44] the designated reference portfolio to be used under the applicable VaR test, and, if applicable, provide an explanation of why the DRM was unable to identify a designated reference portfolio for a fund.
- **Reviews of Frequent Reports.** In addition to the annual reports, the DRM must provide to the Board, at a frequency determined by the Board, written reports that analyze, in a summary form or otherwise, instances when the fund's derivatives investments exceeded the fund's risk guidelines (as set forth in the DRMP) and the stress test and backtesting results.[45]

[40] *See* Rule 38a-1 under the 1940 Act.
[41] *See* Rule 18f-4(c)(3)(i).
[42] While the Rule does not contain the requirement from the 2019 Proposal that the Board take into account the DRM's relevant experience regarding the management of derivatives risk, the Release highlights the SEC's expectation that the Board will take into account the candidate's experience, among all other relevant factors.
[43] *See* Rule 18f-4(c)(3)(ii).
[44] The Rule requires the DRM to include in the annual report the basis for any change in the designated reference portfolio. This requirement is a clarifying change from the 2019 Proposal.
[45] *See* Rule 18f-4(c)(3)(iii).

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

Practical Considerations:

- Consistent with a Board's responsibility to oversee fund compliance pursuant to Rule 38a-1 under the 1940 Act, a Board will be responsible for oversight of a fund's compliance with the Rule. On this point, the Release stated that the "board should view oversight as an iterative process" and, as such, remain informed regarding the material risks associated with a fund's derivatives transactions and how the fund addresses these risks. The Release further stated that the Board's role is distinct from that of the DRM, and it is not one that requires the Board to be involved in the day-to-day management of the fund.
- While many Boards already have some degree of oversight over a fund's use of derivative instruments, Boards now have a regulatory obligation to review reports produced by the DRM and oversee the fund's use of derivatives, even if they are not obligated to approve a fund's DRMP. Some Boards may consider the establishment of a derivatives committee to help the Board fulfill its obligations in an efficient, organized, and practical manner. However, a derivatives committee will not absolve the rest of the Board from meeting its obligations with respect to the fund and fund investors.

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 4: The "Limited Derivatives User" Exception

Overview

The rule contains a "limited derivatives user" exception that releases a fund meeting certain criteria from establishing a DRMP and performing the VaR test requirements of the Rule.[46] This exception is available only for those funds with derivatives exposure not exceeding 10% of the fund's net assets. If a fund breaches this level and does not reduce its exposure to fall below the 10% threshold within five business days, it must notify its Board of its intent to reduce its derivatives exposure below 10% promptly, but within no more than 30 calendar days, or adopt a DRMP as soon as reasonably practicable. A fund may exclude from the 10% threshold certain currency and interest rate hedges and positions closed out with the same counterparty. A fund relying on the "limited derivatives user" exception must nevertheless adopt policies and procedures reasonably designed to manage the fund's derivatives risks.

Requirements

- **10% Derivatives Exposure.** The Rule defines "derivatives exposure" as the sum of notional amounts of a fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short.[47] In addition, the Rule expressly states that exposure is to be calculated on a gross basis.[48]
- **Currency and Interest Rate Derivatives for Hedging Purposes.** A fund may exclude from the 10% exposure calculation currency or interest rate derivatives used to hedge risk related to specific equity or fixed-income investments in the fund's portfolio or the principal amount of borrowings by the fund.
- **Closed-Out Positions.** The Rule does not permit a fund to exclude offsetting positions across multiple counterparties for purposes of calculating the 10% exposure calculation, but it does permit a fund seeking to exit a derivatives position to enter into a directly offsetting position to eliminate the fund's market exposure if the position is closed out with the same counterparty and results in no credit or market exposure to the fund.[49]

Practical Considerations:

- The risk management policies and procedures of a fund relying on the "limited derivatives user" exception should be tailored to the extent and nature of the fund's derivatives use. These policies and procedures *do not* need to contain all of the elements of a DRMP.
- The SEC declined to provide prescriptive guidance on these policies and procedures. Therefore, the Rule's tailored-to-fit requirement will likely mean that a fund using more complex derivatives transactions approaching the 10% threshold will need more extensive policies and procedures than a fund with irregular derivatives usage.

[46] See Rule 18f-4(c)(4).
[47] See Rule 18f-4(a).
[48] See id.
[49] See id.

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 5: Leveraged/Inverse Funds including ETFs

Leveraged/Inverse Funds Generally

With the exception of certain ETFs that have been granted "grandfathered" status, leveraged/inverse funds must comply with all requirements set forth in the Rule, including the relative VaR test. This is a notable change from the 2019 Proposal, which set forth distinct requirements applicable to leveraged/inverse funds that would have permitted the greater use of leverage to the extent transactions in a fund's shares were subject to new sales practices rules.[50] The SEC did not adopt these sales practices rules, which were controversial in the industry, or other elements of the proposed alternative set of requirements.[51] Notably, leveraged/inverse funds will be required in all cases to use the relative VaR test rather than the absolute VaR test because they are designed and marketed to provide the leveraged return of an index. The underlying index will constitute the designated reference portfolio.[52]

Practical Considerations:

- If a leveraged/inverse fund seeks, directly or indirectly, to provide investment returns that correspond to 200% of the performance or inverse performance of an index, there may be minor deviations between the VaR of the fund and 200% of the VaR of its designated index. The VaR of such fund may slightly exceed 200% of the VaR of its designated index.[53] The Release notes that these de minimis deviations would not be considered breaches of the relative VaR test under these circumstances.

Permitted Operations of Certain Leveraged/Inverse Funds

The Rule permits leveraged/inverse funds in operation as of 28 October 2020 that seek to provide leveraged or inverse market exposure exceeding 200% of the return or inverse return of an index to continue operating at their current leverage levels, despite exceeding the VaR limit.[54] Only leveraged/inverse funds with outstanding shares issued in one or more public offerings to investors may rely on this provision. Such funds must disclose in their prospectus that they have a leverage multiple or inverse multiple that exceeds 200% of the performance or the inverse performance of the underlying index. The funds must also disclose in their prospectus that they are not relying on the Release limit on fund leverage risk.

[50] *See* proposed Rule 15*l*-2 under the Securities Exchange Act of 1934, as amended, and proposed Rule 211(h)-1 under the Investment Advisers Act of 1940, as amended.

[51] The SEC published a statement on leveraged and inverse funds and required the staff to further study complex derivatives products. Comments on the sales practice rules comprised the vast majority of the more than 6,000 comments on the 2019 Proposal.

[52] The leveraged/inverse fund's underlying index will constitute the "designated index" as defined in the Rule.

[53] The Release provides that these minor deviations are attributable to financing costs embedded in the fund's derivatives and valuation differences between the leveraged/inverse fund's portfolio and the index it tracks.

[54] *See* Rule 18f-4(5).

Practical Considerations:

- Leveraged/inverse funds relying on this exception may not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide.
- Only funds in operation as of 28 October 2020 may rely on this provision. Accordingly, the number of leveraged/inverse funds operating with VaR exposure exceeding 200% of the relevant index return or inverse return is likely to decrease over time.

Leveraged/Inverse ETFs

Many leverage/inverse funds are structured as ETFs. In connection with the Rule, the SEC also adopted amendments to Rule 6c-11 under the 1940 Act. As originally adopted, Rule 6c-11 does not include leveraged/inverse ETFs among the types of ETFs eligible to rely on it to operate as ETFs. However, since leveraged/inverse ETFs are similar in structure and operation to the other types of ETFs that are permitted by Rule 6c-11, the SEC determined that it is appropriate to permit leveraged/inverse ETFs to rely on Rule 6c-11, provided that such ETFs satisfy the Rule. Accordingly, the SEC amended Rule 6c-11 such that following the effective date of the Rule, all leveraged/inverse ETF orders previously issued by the SEC to ETFs will be rescinded in their entirety.

Practical Considerations:

- Leveraged/inverse ETFs that comply with the Rule may rely on Rule 6c-11.

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 6: Reverse Repos and Similar Financing Transactions

Reverse Repos

In a notable departure from the 2019 Proposal, the Rule allows funds the option to either (i) treat reverse repos or similar financing transactions[55] as derivatives transactions subject to the VaR test, or (ii) treat such transactions as senior securities in the fund's asset coverage calculations.[56] The SEC reasoned that other similar financing transactions have the effect of allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets and thus is effectively identical to a bank borrowing or other borrowing.[57] This change gives fund complexes the flexibility to choose the approach best suited for its investment and operational needs.

Securities Lending Arrangements

Although securities lending arrangements are structurally similar to reverse repos, the Rule does not view a fund's obligation to return securities lending collateral as a "similar financing transaction" and, therefore, not a derivatives transaction provided that the following conditions are true: (1) the obligation relates to an agreement under which a fund engages in securities lending; (2) the fund does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio, and (3) the fund invests cash collateral solely in cash or cash equivalents.

Delayed-Settlement Securities

Delayed-settlement securities are securities issued on a when-issued or forward-settling basis, or with a non-standard settlement cycle, that a fund intends to settle physically and which must settle within 35 days. The Rule includes a provision stating that transactions in delayed-settlement securities will not be deemed to involve a senior security, in essence expressly permitting transactions in these securities without further consideration of the Rule's requirements.

Money Market Funds

Money market funds operated in accordance with Rule 2a-7 under the 1940 Act are excluded from the Rule's definition of "fund" and, therefore, are not permitted to engage in derivatives transactions. The SEC noted in the Release that derivatives transactions are not eligible securities in which money market funds are permitted to invest under Rule 2a-7 in any event. However, the Rule's treatment of delayed-settlement securities does extend to money market funds.

[55] The Release specifies two examples of "similar financing transactions": (a) tender offer bond financing, and (b) purchase of a security on margin.
[56] See Rule 18f-4(d).
[57] See Release at p. 243.

Short Sales As "Derivatives Transactions"

The Rule treats short sale borrowings as "derivatives transactions." The SEC reasoned that the value of a short position is directly derived from the price of another asset and, accordingly, provides the same economic exposure as a derivatives instrument. A fund must therefore treat short sales and derivative transactions identically under the Rule and must include short sale borrowing in its calculations for determining whether it qualifies for the limited derivatives user exemption.

Practical Considerations:

- The optionality to treat reverse repos and similar financing transactions as derivatives transactions or as senior securities is a welcome change from the 2019 Proposal. For example, a fund that otherwise does not invest in derivatives would likely elect to include repurchase agreements and similar financing transactions towards its asset coverage calculations in order limit derivatives exposure to 10% of net assets and bypass the more onerous requirements of the Rule.
- While the Rule gives funds the option to treat reverse repos or similar financing transactions as derivatives transactions, a fund may not adopt a "mix and match" approach.
- Accordingly, a fund must either classify all or none of its reverse repos and similar financing transactions as a derivatives transaction.
- As discussed in the subsequent bullet points, astute managers will thoughtfully consider the overall impact of electing to treat reverse repos and similar financing transactions as a derivative transaction prior to making an election.
- Funds that presently use a combination of bank lending, securities lending, and reverse repos and similar financing arrangements to obtain portfolio leverage should carefully review the treatment of these instruments.
- Notably, the exclusion of securities lending from the requirements of the Rule is only available for traditional securities lending programs that involve the reinvestment of securities lending collateral in cash or cash equivalents and not for funds that use securities lending as a means to obtain portfolio leverage.
- Funds (including money market funds) generally segregate assets in connection with delayed-settlement securities transactions. Funds may discontinue this practice after the effective date of the Rule, as there are no conditions to the exclusion of delayed-settlement securities from senior security status beyond the 35-day and physical settlement prongs of the definition.

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 7: Special Treatment for Unfunded Commitment Agreements

Overview

The Rule clarifies that certain types of investment commitment agreements that funds enter into are neither derivative transactions nor financing transactions intended to leverage a fund's portfolio that would otherwise be treated as senior securities. Unfunded commitment agreements (Unfunded Commitments) most often involve a commitment to loan money to, or to invest capital into, another party, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner. In excluding Unfunded Commitments from the requirements of the Rule, the SEC stated its belief that Unfunded Commitments do not raise 1940 Act concerns regarding the risks of "undue speculation" and do not generally involve leverage and other risks typically associated with derivatives transactions.[58] While any fund may enter into an Unfunded Commitment, the treatment set forth in the Rule will most likely impact closed-end funds and BDCs that engage in direct lending and/or invest in private funds.

Requirements

The Rule defines an "Unfunded Commitment" as 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 (or "called") at the discretion of the private fund's general partner. The SEC particularly stated that such transactions do not present an opportunity for the committing fund to realize gains or losses between the time of making a commitment and the actual investment.

However, because a fund potentially could fail to have cash available to meet its obligation arising from an Unfunded Commitment, and thus potentially become subject to varying default provisions, in the SEC's view, the potential that a fund would not have sufficient assets to satisfy its obligations under Unfunded Commitments warrants a degree of regulation. The Rule permits a fund to enter into Unfunded Commitments if the fund reasonably believes at the time it enters into such an agreement that it will have sufficient cash and cash equivalents to meet its obligations as they come due. The Rule prescribes specific factors a fund must take into account when making such a determination:

- A fund must take into account reasonable expectations with respect to other obligations that could place competing demands on cash, such as obligations with respect to senior securities or redemptions.
- A fund may not take into account cash that may come available from a sale or disposition of assets at a price(s) that deviates from the market value of the investment(s).
- A fund may not consider cash that may come available from issuing additional equity.

[58] See Rule 18f-4(e).

- A fund may consider the issuance of debt, such as use of a line of credit, to support a reasonable belief that it could meet an Unfunded Commitment (with any such borrowings subject to Section 18 asset coverage in the normal course).

Finally, as a cautionary matter, the Rule provides that an agreement that meets the Rule's definition of a derivatives transaction is not an Unfunded Commitment. The SEC cited the example of a binding commitment to make a loan or purchase a note from a borrower, with a stated principal and term and fixed interest rate, which would resemble a standby commitment agreement or written put option.[59] The SEC stated that such a transaction would be a derivatives transaction rather than an Unfunded Commitment because the fund will be exposed to investment risk during the lifetime of the transaction because the value of the commitment would change as interest rates change.

[59] *See* Release p. 24-25.

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

PART 8: Fund Reporting and Recordkeeping Requirements

Recordkeeping Overview

A fund operating in reliance on the Rule and subject to the DRMP requirements must maintain a written record of such fund's policies and procedures that are designed to manage the fund's derivatives risk.[60] The Rule will require a fund subject to the DRMP to maintain a written record of its policies and procedures that are designed to manage the fund's derivatives risk. The Rule also requires a fund to maintain:

- (i) a written record of the results of any stress testing of its portfolio;
- (ii) the results of any VaR test backtesting;
- (iii) internal reporting or escalation of material risks;
- (iv) periodic reviews of the DRMP.

A fund that is required to comply with the VaR test must maintain records documenting the fund's determination of:

- (i) the VaR of its portfolio;
- (ii) the VaR of the fund's designated reference portfolio;
- (iii) the fund's VaR ratio (the value of the VaR of the fund's portfolio divided by the VaR of the designated reference portfolio); and
- (iv) any updates to any VaR calculation models used by the fund, as well as the basis for any material changes made to those models.

A fund that enters into unfunded commitment agreements will be required to maintain a record documenting the basis for the fund's basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements.

In addition, the Rule includes a new recordkeeping requirement that contains a new conforming change in light of the Rule providing two separate treatment options for a fund that enters into a reverse repo or similar financing transaction. Under this new recordkeeping requirement, the fund must maintain a written record documenting whether the fund is treating these transactions, as set forth in the rule, under (1) an asset coverage requirements approach, or (2) a derivatives transactions treatment approach.

The Rule also requires funds to keep records of any materials provided to the fund's Board in connection with the designation of the derivatives risk manager and any reports relating to the DRMP. The Rule requires the derivatives risk manager to provide a written report to the fund's Board within 30 days when a fund is out of compliance with its applicable VaR test.

The Rule requires that these records, including any policies in effect over the preceding five years, be maintained for a period of five years, the first two years of which are in an "easily accessible place."

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

Reporting Overview

The Rule amends Form N-PORT, Form N-LIQUID (which would be renamed Form N-RN), and Form N-CEN to provide information regarding a fund's derivatives exposure and provide the SEC and the public with greater insight into the impact that funds' use of derivatives would have on their portfolios.

Requirements

- Form N-PORT. The Rule requires disclosure on Form N-PORT of: (1) a fund's derivatives exposure[61] as of the end of the reporting period; (2) if applicable, the fund's highest daily VaR and median daily VaR for the reporting period; (3) if applicable, the fund's designative reference index, as well as the fund's highest daily VaR ratio (i.e., the value of the fund's portfolio VaR divided by the designated reference portfolio's VaR) and median VaR ratio for the reporting period; and (4) if applicable, the number of exceptions identified during the reporting period from backtesting the VaR model. The Rule amended Form N-PORT's general instructions to make clear that the term "derivatives transactions" has the same meaning as in 18f-4 solely with respect to N-PORT items that relate specifically to the Rule.
- Form N-RN. The Rule would retitle Form N-LIQUID as Form N-RN, and it would require a fund to file Form N-RN if the fund is not in compliance with its VaR limit relative to a designated reference portfolio or absolute VaR test limit for a period of five business days.[62]
- Form N-CEN. The Rule would require that a fund indicate on Form N-CEN whether it: (1) relied on the Rule during the reporting period; (2) entered into reverse repos (or similar transactions) or unfunded commitments, as provided under the Rule; (3) qualifies for the 10% derivatives exposure exception or the currency hedging exception described above; and (4) is a leveraged/inverse fund that qualifies for the exception to the VaR test.

[61] Rule 18f-4 would define "derivatives exposure" as "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. In determining derivatives exposure, a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts."

[62] *See* Rule 18f-4(c)(7).

Goodbye to All That: SEC Adopts Rules Overhauling Funds' Use of Derivatives; Ends Asset Segregation

Authors:

Michael W. McGrath
michael.mcgrath@klgates.com
+1. .617.951.9123

Kenneth Holston
kenneth.holston@klgates.com
+1.617.261.3154

Fatima S. Sulaiman
fatima.sulaiman@klgates.com
+1.202.778.9082

Matthew J. Rogers
matthew.rogers@klgates.com
+1.617.951.9147

Britney E. Ryan
britney.ryan@klgates.com
+1.617.951.9195

K&L GATES

K&L Gates is a fully integrated global law firm with lawyers located across five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2020 K&L Gates LLP. All Rights Reserved.