SEC Adopts New Rules and Amendments to Update the Approach to the Regulation of Registered Funds' and BDCs' Use of Derivatives and Other Transactions

Authored by Philip T. Hinkle, Audrey Wagner, Mark D. Perlow, and Ashley N. Rodriguez.

October 2020

SEC Adopts New Rules and Amendments to Update the Approach to the Regulation of Registered Funds' and BDCs' Use of Derivatives and Other Transactions

The U.S. Securities and Exchange Commission on October 28, 2020 approved by a 3-2 vote a new rule and rule amendments (collectively, Final Rule) related to the use of derivatives and certain other transactions by registered investment companies (*i.e.*, open-end funds other than money market funds (with a limited exception); exchange-traded funds; and closed-end funds) and business development companies (collectively, funds).[1]

The Final Rule includes: (1) new Rule 18f-4 under the Investment Company Act of 1940; (2) a related rule amendment under the 1940 Act pertaining to leveraged/inverse exchange-traded funds; (3) related fund reporting requirements and form amendments; and (4) a conforming amendment to Rule 22e-4 under the 1940 Act.

The Final Rule was proposed in November 2019[2] and was a re-proposal of a 2015 SEC rulemaking effort.[3] The 2015 proposed rulemaking was the first significant SEC or staff action relating to funds' use of derivatives and certain other transactions that create leverage since the SEC's issuance of a Concept Release in 2011.[4] Rule 18f-4 and the related items discussed in this *OnPoint* represent the most significant change to the way the SEC regulates funds' use of derivatives and the other transactions and the obligations of fund boards since the seminal Release 10666 was published.[5]

The Final Rule includes a number of significant changes to the 2019 Proposed Rule. The Adopting Release highlights that many of the changes to the Proposed Rule were made in response to industry comments and that certain changes take into account in particular commenters' experiences in managing funds' derivatives risk through the period of market volatility following the 2020 outbreak of the COVID-19 coronavirus across the world.

---

1 Use of Derivatives by Registered Investment Companies and Business Development Companies (Adopting Release), SEC Rel. No. IC-34078. A copy of the SEC's press release including a "fact sheet" is available on the SEC's website.

2 Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (Proposed Rule), 85 Fed. Reg. 4446 (Jan. 24, 2020). The Proposed Rule was approved for publication by the SEC on November 25, 2019 and subsequently published in the Federal Register on January 24, 2020.

3 For further information regarding the 2015 proposed rulemaking, please refer to *Dechert OnPoint*, SEC Proposes Significant New Restrictions on the Use of Derivatives and Other Transactions by Registered Funds and BDCs. For further information regarding the industry response to the 2015 proposed rulemaking, please refer to Industry Response to SEC Derivatives and Senior Securities Rule Proposal, The Investment Lawyer, Vol. 23, No. 6 (June 2016).

4 Notably, the Final Rule addresses only compliance with Section 18 of the 1940 Act, and does not address other issues that arise under the 1940 Act with respect to the use of derivatives, such as the appropriate treatment of derivatives under the provisions of the 1940 Act governing issuer diversification, industry concentration and investments in securities-related issuers.

5 Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (Apr. 18, 1979).

In view of the Final Rule, and consistent with the approach identified under the Proposed Rule, the SEC is rescinding Release 10666 and the related "asset segregation" requirements articulated in that release, after an 18-month transition period for funds to prepare to come into compliance with Rule 18f-4 following the effective date of the Final Rule, which will be 60 days after publication of the Final Rule in the Federal Register. The SEC staff also will withdraw related no-action letters and other guidance or portions thereof to the extent moot, superseded or otherwise inconsistent with the Final Rule. As a result, any fund will need to comply with the conditions set forth in the Proposed Rule in order to engage in the applicable transactions.

Rule 18f-4 under the 1940 Act

Rule 18f-4 provides an exemption from the applicable prohibitions and restrictions on issuing "senior securities" under Sections 18 and 61 of the 1940 Act, and permits funds to enter into certain transactions that create leverage, subject to the conditions outlined below. The Adopting Release states that Rule 18f-4 is designed to address the investor protection purposes and concerns underlying Section 18, as well as to provide an "updated and more comprehensive approach" to the regulation of funds' use of derivatives and the other types of transactions than under the current approach under Release 10666 and the related patchwork of staff letters and guidance.

Scope of Rule 18f-4

As noted above, Rule 18f-4 applies to open-end funds (other than money market funds); exchange-traded funds; and closed-end funds.

Rule 18f-4 generally treats separately a fund's (1) "derivatives transactions" (*i.e.*, transactions in derivatives and other similar instruments involving a potential future payment or delivery obligation and short sale borrowings), (2) reverse repurchase agreements and other "similar financing transactions," and (3) unfunded commitment agreements; the Rule subjects each such category of fund transactions to different conditions. However, Rule 18f-4 also allows a fund the option to treat reverse repurchase agreements or similar financing transactions as derivatives transactions, as described below. In such case, the reverse repurchase agreement or similar financing transaction would be included in the definition of a derivatives transaction for purposes of Rule 18f-4.

Rule 18f-4 also provides that a fund or a registered open-end company regulated as a money market fund under Rule 2a-7 under the 1940 Act may invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle, and the transactions will be deemed not to involve a senior security, so long as: (1) the fund intends to physically settle the transaction; and (2) the transaction will settle within 35 days of its trade date. The Proposed Rule had not accounted for money market funds. The Adopting Release notes that this will allow money market funds to continue to be able to invest in when-issued Treasury securities "notwithstanding that these investments trade on a forward basis involving a temporary delay between the transaction's trade date and settlement date."

Conditions to Enter into Derivatives Transactions

Rule 18f-4 permits a fund (other than a fund that qualifies for the limited derivatives user exception, as discussed below) to enter into derivatives transactions subject to the following key conditions:

1. *Derivatives Risk Management Program.* A fund is required to adopt and implement a written derivatives risk management program. The program must include policies and procedures that are "reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund." The program also must include elements relating to: (1) risk identification and assessment; (2) risk guidelines; (3) weekly or more frequent stress testing; (4) weekly or more frequent backtesting (as opposed to testing each business day, under the Proposed Rule); (5) internal reporting to portfolio management on "exceedances" of risk guidelines and stress testing results, as well as escalation to portfolio management and the fund's board of material risks arising from the fund's derivatives transactions; and (6) periodic program review to evaluate the program's effectiveness and reflect changes in risk over time, which must include a review of each of the fund's VaR (as defined below) calculation model and backtesting and designated reference portfolio (discussed below) to evaluate whether it remains appropriate. The program requirement otherwise allows "principles-based" tailoring of the program to the fund's particular risks. The program requirement largely was adopted as it was proposed.

2. *Limit on Fund Leverage Risk.* A fund is required to comply with an outer limit on fund leverage risk based on the fund's value at risk (VaR).[6] Under this condition, a fund must comply with a VaR-based limit as follows.

    a. A fund generally must comply with the "relative VaR test." However, a fund is not required to comply with the relative VaR test if the derivatives risk manager (discussed below) "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." Such a fund must instead comply with the "absolute VaR test."

       Under the proposed VaR framework, a fund would not have been required to comply with the relative VaR test as the default test only if the derivatives risk manager was "unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy."

---

6 Under Rule 18f-4(a), the term "value at risk" means "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, provided 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."

b. Under the relative VaR test, the VaR of a fund's portfolio cannot exceed 200% of the VaR of the fund's designated reference portfolio.[7] In the case of a closed-end fund that has issued to investors and has then outstanding shares of preferred stock, this limit is 250%. The relative VaR test, rather than the absolute VaR test, remains the default test.

Under the proposed relative VaR test, the VaR could not have exceeded 150% of the VaR of a designated reference index. In addition, the proposed relative VaR test did not take into account the structural leverage that a closed-end fund can obtain through the issuance of preferred stock in accordance with the 1940 Act (which potentially could cause such a fund to exceed the proposed relative VaR test before the fund entered into any derivatives transactions). In addition, the proposed relative VaR test was based solely on a designated reference index, whereas the definition of designated reference portfolio in the Final Rule allows the potential use of a fund's securities portfolio as the point of comparison for the relative VaR test.

c. Under the absolute VaR test, the VaR of a fund's portfolio cannot exceed 20% of the value of the fund's net assets. In the case of a closed-end fund that has issued to investors and has then outstanding shares of preferred stock, this limit is 25%.

Under the proposed absolute VaR test, the VaR could not have exceeded 15% of the fund's net assets. Similar to the proposed relative VaR test, the proposed absolute VaR test did not take into

---

[7] Definitions under Rule 18f-4(a) relevant to the relative VaR test include:

- The term "designated reference portfolio," which means "a designated index or the fund's securities portfolio." However, notwithstanding the provisions under the definition of designated index (below) requiring administration of an index by a non-affiliate, "if the fund's investment objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its designated reference portfolio." This requirement for funds whose investment objective is to track the performance of an index to use that index is a departure from the Proposed Rule.
  - The term "designated index," which means "an unleveraged index that: (1) 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 (2) 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, unless the index is widely recognized and used. 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 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, the investment adviser may create the blended index so long as the components of the blended index meet the requirements. In a change from the Proposed Rule, the designated index will not be required to be disclosed in a fund's annual report.
  - The term "securities portfolio," which means "the fund's portfolio of securities and other investments, excluding any derivatives transactions, that is 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 (i.e., the markets or asset classes in which the fund invests directly through securities and other investments and indirectly through derivatives transactions)."

account the structural leverage that a closed-end fund can obtain through the issuance of preferred stock.

d. A fund is required to determine its compliance with the applicable VaR test at least once each business day. If the fund determines that it is not in compliance with the applicable VaR test and does not come back into compliance with the VaR test promptly after such determination, the fund "must come back into compliance promptly after such determination, in a manner that is in the best interests of the fund and its shareholders."

   If a fund is not in compliance within five business days, the fund's derivatives risk manager (discussed below) must: (1) provide a written report to the fund's board explaining how, and by when, the derivatives risk manager reasonably expects the fund to come back into compliance; (2) analyze the circumstances causing the fund to be out of compliance and update any program elements as appropriate to address those circumstances; and (3) provide a written report within 30 calendar days to the fund's board explaining how the fund came back into compliance, as well as the results of such analysis and updates. If the fund remains out of compliance at the time of the second report, the written report must update the initial report provided, and the derivatives risk manager then must update the board as to the fund's progress in coming back into compliance, at regularly scheduled intervals at a frequency determined by the board. As discussed below, a fund that is not in compliance within five business days also must report such event confidentially on Form N-RN to the SEC, and then report confidentially to the SEC on Form N-RN once the fund comes back into compliance.

   Under the Proposed Rule, if a fund were not in compliance within three business days, the fund could not have entered into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, were designed to reduce the fund's VaR) until the fund had been back in compliance with the applicable VaR test for three consecutive business days, and the analysis and update requirements were satisfied.

e. The Final Rule requires a fund's VaR model to take into account and incorporate certain market risk factors associated with the fund's investments, and to provide parameters for the VaR calculation's confidence level, time horizon and market data. Additionally, consistent with the Proposed Rule, a fund is not required to use the same VaR model for calculating its portfolio VaR and the VaR of its designated reference portfolio.

   In an important departure from the Proposed Rule, the Adopting Release provides guidance that a fund's VaR model may rescale the confidence level and time horizon used (which commenters had stated should provide additional observations for a more precise, stable and appropriately sensitive metric of risk).

3. *Board Oversight and Reporting.* A derivatives risk manager responsible for administering a fund's derivatives risk management program must be approved by the fund's board, including a majority of directors who are not interested persons of the fund. The derivatives risk manager will need to provide a

written report to the board on or before implementation of the program, and annually thereafter, regarding the program's implementation and effectiveness. In this report, the derivatives risk manager must represent that the program is reasonably designed to manage a fund's derivatives risks and to incorporate the required elements (based on the derivatives risk manager's reasonable belief after due inquiry). Separately, the derivatives risk manager will need to provide to the board (at a frequency determined by the board) a written report regarding analysis of risk guideline exceedances, stress testing results and backtesting results (including such information as may be reasonably necessary for the board to evaluate the fund's responses to exceedances and the results of stress testing). As noted above, the limit on fund leverage risk also requires the derivatives risk manager to submit certain written reports to the board regarding the fund's failure to return to compliance with the VaR test.

Exception for Limited Derivatives Users

Provided a fund requires with two conditions, Rule 18f-4 provides that a fund entering into derivatives transactions will not be required to: adopt a derivatives risk management program; comply with the limit on fund leverage risk; or comply with the board oversight and reporting requirements discussed above.

- First, such a fund also must adopt and implement policies and procedures "reasonably designed to manage the fund's derivatives risks."
- Second, such a fund's derivatives exposure cannot exceed 10% of its net assets.[8]

For purposes of the 10% limit, derivatives exposure excludes currency or interest rate derivatives that hedge: currency risk associated with one or more specific equity or fixed-income investments held by the fund; interest rate risks associated with one or more specific equity or fixed-income investment held by the fund; or the fund's borrowings.[9] The notional amounts of currency or interest rate derivatives may exceed the value of the hedged investments (or the par value of hedged fixed-income investments or the principal amount of hedged borrowings) by no more than 10 percent.

If a fund's derivatives exposure exceeds 10% of its net assets, and the fund is not in compliance with this limit within five business days, the fund's investment adviser must provide a written report to the fund's board. The report must inform the board whether the investment adviser intends to: (1) reduce the fund's derivatives exposure to comply with the limit promptly, but within no more than 30 calendar days of the exceedance, "in a manner that is in the best

---

[8] Rule 18f-4 defines the term "derivatives exposure" as "the sum of (1) the gross notional amounts of the fund's derivatives transactions ... and (2) in the case of short sale borrowings, the value of the assets sold short." For purposes of this definition, if a fund's derivatives transactions include reverse repurchase agreements or similar financing transactions (as described below), the fund's derivatives exposure also includes the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction. Also, "a fund may (1) convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts and (2) exclude any closed-out positions, if these positions were closed out with the same counterparty and result in no credit or market exposure for the fund."

[9] Such currency or interest rate derivatives must be entered into and maintained by the fund for hedging purposes, and the specific investments being hedged must be foreign-currency-denominated (in the case of currency derivatives).

interests of the fund and its shareholders;" or (2) come into compliance with the standard derivatives conditions discussed above "as soon as reasonably practicable."

The exclusion of both currency and interest rate hedging derivatives is an important departure from the Proposed Rule, which would have provided two mutually exclusive bases for relying on the limited derivatives user exception: either limiting fund derivatives exposure to less than 10% of net assets; or only engaging in certain currency hedging transactions. In addition, the Proposed Rule would not have defined the steps that must be taken if a fund's derivatives exposure exceeded 10% of its net assets.

Leveraged/Inverse Funds

The Proposed Rule would have included alternative conditions applicable to certain funds that satisfied a proposed definition of a "leveraged/inverse investment vehicle" and would have imposed new "sales practices rules" on broker-dealers and investment advisers under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, respectively, in order to accept an order from or place an order for certain investors involving shares of a leveraged/inverse investment vehicle. The Proposed Rule did not require such funds to comply with the limit on fund leverage risk. In response to industry comments, the Final Rule does not include the sales practices rules. However, the Final Rule also does not generally provide for alternative conditions applicable to such funds.

Accordingly, leveraged/inverse funds generally will be subject to full compliance with Rule 18f-4. However, the Adopting Release indicates that *de minimis* deviations that cause a leveraged/inverse fund, in following its strategy, to exceed the relative VaR test under certain circumstances (*e.g.*, financing costs, valuation differences) from time to time, do not alone give rise to remediation or reporting requirements under Rule 18f-4; however, such *de minimis* deviations may not increase such fund's leveraged/inverse market exposure.

Additionally, the Final Rule provides that a currently existing fund that meets the definition of a leveraged/inverse fund included in Rule 18f-4[10] is not required to comply with the limit on fund leverage risk, if:

- As of October 28, 2020, the fund: was in operation; had outstanding shares issued in one or more public offerings to investors; and disclosed in its prospectus a leverage multiple or inverse multiple in excess of 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 to provide, directly or indirectly; and
- The fund discloses in its prospectus that it is not subject to the limit on fund leverage risk.

---

10 Rule 18f-4 defines the term "leveraged/inverse fund" to mean "a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple ('leverage multiple'), or to provide investment returns that have an inverse relationship to the performance of a market index ('inverse multiple'), over a predetermined period of time."

The Adopting Release states that the Final Rule seeks to preserve investor choice and allow leveraged/inverse funds to continue to operate under Rule 18f-4.

The Adopting Release also explains that the SEC staff will "review the effectiveness of the existing regulatory requirements in protecting investors who invest in leveraged/inverse funds and other complex investment products." In particular, the Adopting Release recognizes that Regulation Best Interest applies to a broker-dealer's recommendation with respect to leveraged/inverse investment vehicles, and that investment advisers have fiduciary obligations with respect to their investment advice in connection with leveraged/inverse investment vehicles. However, the Adopting Release emphasizes that these regimes address only certain of the investor protection concerns expressed in the proposing release for the Proposed Rule. The Adopting Release indicates that the SEC has directed the SEC staff to review the effectiveness of these existing regulatory regimes in protecting investors, particularly those with self-directed accounts, who invest in complex financial products. In this regard, a joint statement by Chairman Clayton and several Division Directors released on the date the Final Rule was adopted highlights certain potential issues posed by complex financial products and retail investors, as well as investor protection concerns in an increasingly accessible and volatile marketplace.[11] The joint statement highlights that the SEC staff will review the effectiveness of the existing regulatory requirements in protecting investors (including those with self-directed accounts) who invest in leveraged/inverse products and other complex products, and requests public comment on the issues raised in the joint statement.

Conditions to Enter into Reverse Repurchase Agreements, Similar Financing Transactions

Consistent with the Proposed Rule, Rule 18f-4 permits funds to enter into reverse repurchase agreements or similar financing transactions,[12] if the fund complies with the asset coverage requirements under Section 18 of the 1940 Act and combines the aggregate amount of indebtedness associated with all such agreements and transactions with the aggregate amount of any other senior securities representing indebtedness (*e.g.*, bank borrowings or other borrowings permitted under the 1940 Act and constituting senior securities) when calculating the asset coverage ratio. This approach allows reverse repurchase agreements and similar financial transactions not to be counted as derivatives transactions for purposes of the limited derivatives user exception.

Rule 18f-4 also allows a fund to elect to treat all of its reverse repurchase agreements or similar financing transactions as derivatives transactions for all purposes under Rule 18f-4, rather than including such transactions in the fund's asset coverage calculations. The Adopting Release states that this alternative approach "is designed to

---

[11] Joint Statement Regarding Complex Financial Products and Retail Investors, SEC Chairman Jay Clayton; Dalia Blass, Director, Division of Investment Management; William Hinman, Director, Division of Corporation Finance; Brett Redfearn, Director, Division of Trading and Markets, SEC Public Statement (Oct. 28, 2020).

[12] The Adopting Release notes that: such transactions involve senior securities primarily as a means of obtaining financing; and reverse repurchase agreements are economically equivalent to secured borrowings. The Adopting Release notes that an example of a similar financing transaction would be a fund's purchase of a security on margin, and a tender option bond (TOB) financing transaction (as opposed to purchasing an "inverse floater" issued by a TOB) would constitute a similar financing transaction. However, the Adopting Release reiterates guidance provided in connection with the Proposed Rule that a fund's obligation to return securities lending collateral is not treated as a similar financing transaction for purposes of Rule 18f-4, so long as the fund: does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio; and invests cash collateral solely in cash or cash equivalents.

provide a fund flexibility to choose the approach that is best suited to its investment strategy or operational needs, while still addressing section 18's asset sufficiency and leverage concerns." The election to rely on this alternative approach will apply to all of a fund's reverse repurchase agreements or similar financing transactions. Allowing an alternative approach is an important departure from the Proposed Rule, which would have required all such transactions to be included with any other relevant indebtedness in a fund's asset coverage calculations.

A fund must maintain a written record documenting the approach to compliance with Rule 18f-4 that it determines to use.

Conditions to Enter into Unfunded Commitment Agreements

Unfunded commitment agreements are not considered to be derivatives transactions or required to be treated in the same manner as reverse repurchase agreements under Rule 18f-4.[13] Under Rule 18f-4, a fund is permitted to enter into an unfunded commitment agreement if the fund reasonably believes, at the time it enters such agreement, that 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, subject to certain limitations.[14] This requirement was adopted as it was proposed.

Recordkeeping Requirements

Rule 18f-4 requires funds to maintain certain records. The Adopting Release states that these requirements are designed to provide the SEC and a fund's board of directors and compliance personnel with "the ability to evaluate the fund's compliance with the rule's requirements."

Effective Date and Transition Period

The Adopting Release provides for an 18-month transition period following the effective date of the Final Rule, which will be 60 days after publication of the Final Rule in the Federal Register. During this time, funds will be able to prepare to come into compliance with Rule 18f-4 before Release 10666 is rescinded and the related SEC staff guidance is withdrawn.

However, a fund may rely on Rule 18f-4 after the effective date but before the compliance date, provided that the fund satisfies the rule's conditions and complies with the other new related requirements adopted with Rule 18f-4.

---

[13] Rule 18f-4 defines the term "unfunded commitment agreement" to mean "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."

[14] Rule 18f-4 provides guidance on factors relevant to a fund forming a reasonable belief.

Amendments to Rule 6c-11 under the 1940 Act

Rule 6c-11 generally permits ETFs to operate without obtaining an SEC exemptive order, subject to certain conditions.[15]

Currently, Rule 6c-11(c)(4) excludes leveraged/inverse ETFs from relying on Rule 6c-11, in order to allow the SEC to consider Section 18 issues raised by ETFs as part of the SEC's broader consideration of derivatives use by registered funds and BDCs. In connection with other aspects of the Final Rule, the SEC is modifying this provision to permit leveraged/inverse ETFs to rely on Rule 6c-11 if they comply with the applicable provisions of Rule 18f-4. This will permit new leveraged/inverse ETFs to come to market under Rule 6c-11 without obtaining a separate exemptive order.

The SEC also is rescinding the exemptive orders previously issued to the sponsors of leveraged/inverse ETFs that permitted them to operate as ETFs, "as these orders will be superseded." The Adopting Release states that amending Rule 6c-11 and rescinding these orders "will help promote a more level playing field by allowing any sponsor (in addition to sponsors currently granted exemptive orders) to form and launch a leveraged/inverse ETF subject to the conditions in Rule 6c-11 and Rule 18f-4." The SEC is rescinding these exemptive orders on the compliance date for Rule 18f-4.

The effective date for the amendments to Rule 6c-11 is 60 days following the publication of the Final Rule in the Federal Register.

Fund Reporting Requirements and Disclosure Form Amendments

As part of the Final Rule, the SEC amended Forms N-PORT, N-LIQUID (which will be re-titled as Form N-RN), and N-CEN "to enhance the Commission's ability to oversee funds' use of and compliance with the new rule effectively, and to provide the Commission and the public additional information regarding funds' use of derivatives."

The amendments to Form N-PORT add new reporting items as follows:

- *Limited Derivatives Users:* A fund that relies on the limited derivatives user exception will be required to report: (1) the fund's aggregate derivatives exposure; (2) the fund's exposure from currency derivatives that hedge currency risks; (3) the fund's exposure from interest rate derivatives that hedge interest rate risks; and (4) the number of business days beyond the five-business-day remediation period that the fund's derivatives exposure exceeded 10% of the fund's net assets. (This information will not be made publicly available.)
- *VaR Information:* A fund complying with a VaR-based limit will be required to report: (1) median daily VaR or VaR ratio (this information will not be made publicly available); and (2) the name of the fund's designated

[15] For a detailed discussion of Rule 6c-11, please refer to *Dechert OnPoint*, SEC Adopts Final ETF Rule and Issues Related Exchange Act Relief.

reference index and index identifier (if applicable) or a statement that the fund's designated reference portfolio is the fund's securities portfolio (if applicable) (this information will be made publicly available).

- *Backtesting:* A fund complying with a VaR-based limit will be required to report the number of exceptions it identified during the reporting period arising from backtesting the fund's VaR calculation model (this information will not be made publicly available).

The Form N-PORT information noted as publicly available will be publicly available for the final month of each fund's quarter. BDCs are not required to file Form N-CEN or Form N-PORT, and therefore are not subject to these reporting requirements.

The amendments re-title Form N-LIQUID as Form N-RN and add certain reporting events for funds that are subject to the VaR-based limit. If the portfolio VaR of a fund exceeds the applicable VaR test for five business days, the fund will be required to report on Form N-RN within one business day following the fifth business day: (1) the dates on which the fund portfolio's VaR exceeded the applicable VaR limit; (2) the VaR of the portfolio for each of those dates; (3) the VaR of the designated reference portfolio for each of those dates (for funds complying with the relative VaR test); (4) the name of the designated index or a statement that the fund's designated reference portfolio is the fund's securities portfolio (as applicable, for funds complying with the relative VaR test); (5) the index identifier for the fund's designated index (as applicable, for funds complying with the relative VaR test); and (6) the value of the fund's net assets for each of those dates (for funds complying with the absolute VaR test). Such a fund also will be required to report on Form RN when it is back in compliance with the relevant VaR test. In addition, the SEC has adopted a related amendment to Rule 30b1-10 under the 1940 Act to reflect the requirement that all funds subject to the VaR test (not just registered open-end funds) file current reports. Funds' reporting on Form N-RN regarding VaR test breaches will be non-public, in a departure from the Proposed Rule.

The amendments to Form N-CEN add an item requiring funds (other than BDCs, which are not required to file Form N-CEN or Form N-PORT) to indicate whether: (1) the fund has relied on Rule 18f-4; (2) the fund relied on the limited derivatives user exception; (3) the fund is a leveraged/inverse fund that will be excepted from the limit on fund leverage risk; (4) the fund entered into any reverse repurchase agreements or similar financing transactions and the element of Rule 18f-4(d) on which the fund relied to enter into such transactions; (5) the fund entered into any unfunded commitment agreements under Rule 18f-4; and (6) the fund is relying on the provision of Rule 18f-4 that addresses investments in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle. All information reported on Form N-CEN will be publicly available.

The SEC also has amended Form N-2 to provide that closed-end funds and BDCs relying on Rule 18f-4 are not required to include their derivatives transactions or unfunded commitment agreements in the senior securities table disclosure on Form N-2.

Conforming Amendments to Rule 22e-4

The Final Rule amends Rule 22e-4 and a related reporting requirement on Form N-PORT to remove references to assets "segregated to cover" derivatives transactions, because Release 10666 and related guidance are being rescinded and withdrawn, as applicable.

*   *   *   *

An upcoming *OnPoint* will provide further analysis of these matters.

This update was authored by:

Philip T. Hinkle
Partner, Washington, D.C.
+1 202 261 3460
philip.hinkle@dechert.com

Audrey Wagner
Counsel, Washington, D.C.
+1 202 261 3365
audrey.wagner@dechert.com

Mark D. Perlow
Partner, San Francisco
+1 415 262 4530
mark.perlow@dechert.com

Ashley N. Rodriguez
Associate, Washington, D.C.
+1 202 261 3446
ashley.rodriguez@dechert.com

© 2020 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.