

December 23, 2020

# SEC Adopts New Derivatives Framework for Registered Investment Companies and Business Development Companies

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## **New Rule and Related Amendments Modernize Derivatives Regime and Streamline Fund Requirements**

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### **SUMMARY**

On October 28, 2020, the Securities and Exchange Commission (the “SEC” or “Commission”) adopted new rule 18f-4 under the Investment Company Act of 1940 (the “Investment Company Act”) and related amendments (the “Final Rule”) to provide an updated, comprehensive regulatory framework for derivatives use by registered investment companies, including mutual funds (other than money market funds), exchange-traded funds (“ETFs”) and closed-end funds, and business development companies (“BDCs”) (referred to collectively as “funds”).<sup>1</sup> The Commission also adopted new reporting requirements and amendments to certain disclosure forms, and amended rule 6c-11 under the Investment Company Act to allow leveraged or inverse ETFs that comply with all applicable provisions of the Final Rule to operate without obtaining an exemptive order.

The Final Rule is an exemptive rule under the Investment Company Act that permits a fund to enter into derivatives transactions and certain other transactions notwithstanding the restrictions on the use of leverage in Section 18 of the Investment Company Act, so long as the fund complies with certain conditions, which are set forth in the Final Rule and described below. On November 25, 2019, in response to comments received on an earlier version of the rule proposed in 2015, the Commission re-proposed rule 18f-4 (the “Proposed Rule”).<sup>2</sup> The Final Rule is largely consistent with the structure of the Proposed Rule, but reflects a number of changes made in response to comments. The Commission did not adopt proposed sales practices rules for leveraged/inverse funds, as discussed below.

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Key features of the Final Rule include:

- **Increased leverage limit.** The Final Rule increases the outer limit on fund leverage risk based on value-at-risk (“VAR”) from the proposed 150% limit to 200% of the fund’s designated reference portfolio under the relative VaR test, or 20% (increased from the proposed 15% limit) of the fund’s net assets under the absolute VaR test. The Final Rule also revises the calculation inputs for the relative VaR test, now allowing a fund to use its own securities portfolio as the reference portfolio as an alternative to an index if certain criteria are met.
- **Reverse repurchase agreements and similar financing transactions.** The Final Rule permits funds to enter into reverse repurchase agreements and similar financing transactions, as well as “unfunded commitments” to make certain loans or investments, notwithstanding the requirements of Section 18 of the Investment Company Act, subject to conditions tailored to these transactions. In a change from the proposal, the Final Rule includes a new alternative approach that permits funds to enter into reverse repurchase agreements and similar financing transactions by electing to treat them as derivatives transactions under the Final Rule rather than as subject to the asset coverage requirements of Section 18.<sup>3</sup>
- **Investing in securities on a when-issued or forward-settling basis.** The Final Rule includes a new provision that will permit funds, as well as money market funds, to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, notwithstanding the requirements of Section 18 of the Investment Company Act, subject to certain conditions.<sup>4</sup>
- **Non-public data reporting.** The final amendments to Forms N-PORT, N-LIQUID and N-CEN revised certain of the proposed data reporting requirements so that the information provided to the SEC will no longer be made publicly available.

As discussed further below, the Commission declined to adopt the proposed sales practices rules, which had received a great deal of attention from commenters and certain Commissioners. The proposed sales practices rules would have, among other things, required investment advisers and broker-dealers to conduct due diligence in advance of approving a client’s account to transact in a fund that “seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time” (a “leveraged/inverse fund”).<sup>5</sup> However, concurrently with the adoption of the Final Rule, a review of issues relating to leveraged/inverse funds by the Commission’s staff was announced, as discussed further below.

The Final Rule represents a significant achievement for the Commission following an extended effort by the staff of the Division of Investment Management, beginning with a concept release published by the SEC in 2011 that discussed and requested comments on issues related to the use of derivatives by funds and the adequacy of the existing regulatory framework in response to the dramatic growth in the volume and complexity of the derivatives markets and the use of derivatives by funds.<sup>6</sup> In December 2015, the SEC published a proposal for a rule on funds’ derivatives use, which was re-proposed in November 2019, to provide a workable, comprehensive framework regulating funds’ use of derivatives.<sup>7</sup> The Final Rule has generally been well received by the fund industry, but for many firms will involve a substantial undertaking to develop and implement the required derivatives risk management program and comply with the rule’s

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other requirements in line with the SEC's expectations set forth in the 450-page adopting release. In particular, it appears that some fund boards may be expected to participate more actively in overseeing the use of derivatives by funds they oversee, including by maintaining an ongoing dialogue with the board-approved derivatives risk manager and reviewing a variety of new reports relating to derivatives risk management required under the rule.

The Final Rule and related amendments will become effective on February 19, 2021 (60 days after publication in the Federal Register). However, funds will have an eighteen-month transition period, ending August 19, 2022, to comply with the Final Rule and related reporting requirements. The Final Rule was adopted by a 3-2 vote with Commissioners Lee and Crenshaw dissenting.

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### BACKGROUND

Section 18 of the Investment Company Act places significant restrictions on the ability of registered investment companies to issue "senior securities."<sup>8</sup> Section 18 was designed to limit the leverage a fund can obtain or incur through the issuance of senior securities.<sup>9</sup> At the time the Investment Company Act was enacted, a fund could typically achieve leverage only by issuing debt securities or preferred stock or by obtaining bank loans. In 1979, the Commission issued a general statement of policy in Investment Company Act Release No. 10666 that interpreted Section 18's restrictions on issuances of "senior securities" as being applicable to certain transactions, including reverse repurchase agreements, commitment agreements and other transactions that involve future payment obligations.<sup>10</sup> Release 10666 analyzes what falls within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18," taking an inclusive position that encompasses "all contractual obligations to pay in the future for consideration presently received," which brings transactions such as reverse repurchase agreements, firm commitment agreements, and standby commitment agreements within the scope of Section 18.<sup>11</sup> The Commission staff subsequently issued a series of no action letters and other guidance applying the principles of Release 1066 to various types of derivatives transactions over many years.<sup>12</sup>

As originally proposed in December 2015,<sup>13</sup> rule 18f-4 would have allowed a fund to enter into derivatives transactions subject to certain conditions, including compliance with (i) a limit on a fund's derivatives transactions based on the aggregate notional amount of such transactions and (ii) asset segregation requirements.<sup>14</sup> On November 25, 2019, in response to comments received on the original proposal, the Commission issued the Proposed Rule. The Proposed Rule was designed to respond to the concern that certain industry practices relating to the use of derivatives "may not address investor protection concerns that underlie Section 18's limitations on funds' issuance of senior securities" and in particular to address certain practices that can heighten leverage-related risks, such as the risks of potentially significant losses and increased fund volatility.<sup>15</sup> Over the course of the comment period the Commission received over 6,100 comment letters. The vast majority of these comments addressed the proposed sales practices rules,

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which would have required investment advisers and broker-dealers to conduct due diligence in advance of approving a client or client's account to transact in vehicles that seek to provide leveraged or inverse exposure to an underlying index. The Commission had also proposed to amend rule 6c-11 so that certain leveraged/inverse ETFs could rely on the rule instead of previously granted exemptive orders.<sup>16</sup> Only 70 comment letters addressed proposed rule 18f-4.<sup>17</sup>

The Adopting Release is noteworthy in that it rescinds Release 10666 while approving and incorporating the broad stance taken in Release 10666 regarding the scope of "senior securities" subject to the requirements of Section 18.<sup>18</sup> In the Adopting Release, the Commission maintains its position that the transactions described in Release 10666 fall within the functional meaning of the term "evidence of indebtedness" for purposes of Section 18 of the Investment Company Act, and the Commission notes that it will continue to apply the same analysis to all derivatives transactions that create future payment obligations,<sup>19</sup> although Commissioner Peirce expressed the view in a separate statement issued concurrently with the Adopting Release that Section 18 "provides an awkward basis" for the Final Rule and that "a simple derivatives-risk-management program requirement together with advisors' existing fiduciary duties would have sufficed."<sup>20</sup> The Commission chose to rescind Release 10666 on the view that the Final Rule provides an updated and comprehensive approach to the regulation of the use of derivatives by funds that incorporates the relevant positions taken in Release 10666.<sup>21</sup>

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## DERIVATIVES RISK MANAGEMENT PROGRAM

### A. PROGRAM OVERVIEW.

The Final Rule, consistent with the Proposed Rule, applies to a "fund," defined to include mutual funds, ETFs, registered closed-end funds and BDCs, but expressly excluding money market funds regulated under rule 2a-7 of the Investment Company Act. The Final Rule defines a "derivatives transaction" as (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 margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) any reverse repurchase agreement or similar financing transaction, for those funds that choose to treat these transactions as derivatives transactions under the rule.

A key requirement of the Final Rule is that funds engaging in derivatives transactions in reliance on the Final Rule must implement a formalized derivatives risk management program (a "DRMP"), with elements that are tailored to the particular types of derivatives that the fund uses and their related risks. The DRMP must include policies and procedures that are reasonably designed to manage the fund's derivatives risk and to reasonably segregate the functions associated with the program from the portfolio management of the fund. The Commission states that the DRMP requirement is drawn from existing fund best practices.<sup>22</sup>

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The program elements are described in further detail below.

## **1. Program Administration.**

The DRMP must be administered by an officer or officers of the fund's investment adviser serving as the fund's derivatives risk manager ("DRM"). As discussed further below, a fund's DRM must be specifically approved by the fund's board of directors.

The DRM's responsibilities under the Final Rule include administering the fund's DRMP and the related policies and procedures and fulfilling the Final Rule's board reporting requirements.<sup>23</sup> The Final Rule also governs which individuals are eligible to serve as DRM. The person or persons "serving in this role must have sufficient authority within the investment adviser to carry out [the] responsibilities" of the DRM under the Final Rule, and so each must be an officer or other employee with a comparable degree of seniority and authority to an officer.<sup>24</sup> The Commission rejected proposals from commenters to allow the fund's adviser to serve as the DRM, requiring that the role be filled by one or more natural persons in order to promote independence and objectivity in the role and accountability to the board by creating a direct reporting line between the board and the individual(s) responsible for administering the DRMP.<sup>25</sup> The Final Rule also prohibits the DRM position from being filled by the fund's portfolio manager (if a single person serves in this position).<sup>26</sup>

The Final Rule requires the DRM to have relevant experience regarding the management of derivatives risk,<sup>27</sup> but the Commission declined to provide further detail on what constitutes "relevant experience," so as to provide a fund with flexibility in selecting a DRM whose experience is appropriately tailored to that fund's particular risks and circumstances.<sup>28</sup> The Final Rule also provides flexibility for funds to involve sub-advisers in derivatives risk management. For a fund in which a sub-adviser manages the entirety of the fund's portfolio (as opposed to a portion, or "sleeve" of the fund's assets), one or more of the officers of the sub-adviser alone also could serve as a fund's DRM, if approved by the fund's board.<sup>29</sup> In addition, the Final Rule does not preclude a DRM from delegating to a sub-adviser specific derivatives risk management activities that are not specifically assigned to the DRM by the Final Rule, subject to appropriate oversight by the DRM. The DRM also may reasonably rely on information provided by sub-advisers in fulfilling his or her responsibilities under the rule, but remains responsible under the Final Rule for its reporting obligations to the board and the administration of the DRMP.<sup>30</sup>

## **2. Risk Identification and Assessment.**

The DRMP must provide for the identification and assessment of a fund's derivatives risks, which must take into account the fund's derivatives transactions and other investments. The derivatives risks that must be identified and assessed within a fund's DRMP include "leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other risks the DRM deems material."<sup>31</sup> The Adopting Release notes that, by requiring a fund's DRMP to manage other risks that the DRM deems to be material, the Final Rule does

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not limit a fund's identification and assessment of derivatives risks to only those specifically listed in the Final Rule.<sup>32</sup>

### 3. Risk Guidelines.

The DRMP must provide for the establishment, maintenance and enforcement of investment, risk management or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds related to a fund's derivatives risks (the "guidelines") which must specify "levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed and the measures to be taken if they are exceeded."<sup>33</sup> The Adopting Release also notes that a fund's risk guidelines should be designed to complement, and not duplicate, the stress testing and other aspects of the fund's DRMP.<sup>34</sup>

### 4. Stress Testing.

The DRMP must include stress testing of derivatives risks at least weekly to evaluate potential losses to a fund's portfolio under extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio. The stress tests must take into account correlations of market risk factors and resulting payments to derivatives counterparties.<sup>35</sup> The frequency with which stress testing is conducted must take into account the fund's strategy and investments and current market conditions, and must be conducted no less frequently than weekly.<sup>36</sup> The Commission declined to extend the minimum frequency of stress testing to monthly, as requested by some commenters, noting that "[d]uring periods of stress, returns, correlations, and volatilities tend to change dramatically over a very short period of time" and that "[w]eekly or more frequent stress testing may be particularly useful during times of unexpected or unprecedented market stress."<sup>37</sup>

### 5. Backtesting.

The DRMP must include backtesting of the results of the VaR calculation model used by the fund in connection with the relative VaR or absolute VaR test, as applicable. The backtesting requirement requires the fund to "compare its actual gain or loss for each business day with the VaR the fund had calculated for that day, and identify as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss."<sup>38</sup> The Final Rule requires weekly backtesting, rather than the daily backtesting requirement in the Proposed Rule, but the backtesting analysis must compare the fund's daily gain and loss to the estimated VaR for each business day in the week.<sup>39</sup>

The Final Rule requires that a fund's backtest be conducted using a 99% confidence level and over a one-day time horizon. The Commission reiterated guidance in the Proposing Release to the effect that, assuming 250 trading days in a year, a fund would be expected to experience a backtesting exception approximately 2.5 times a year, or 1% of the 250 trading days, and that if ten or more exceptions are

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generated in a year from such backtesting, it is statistically likely that such exceptions are a result of a VaR model that is not accurately estimating VaR.<sup>40</sup>

### **6. Internal Reporting and Escalation.**

The Final Rule requires the DRMP to include regular internal reporting as well as a protocol for the escalation of material risks. Specifically, the program must identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the DRMP, including exceedances of the DRMP's guidelines and the results of stress testing discussed above. If material risks arise from the fund's derivatives transactions, including risks identified by the fund's exceedance of a criterion, metric or threshold provided for in its guidelines or stress testing, the DRM must inform the persons responsible for the fund's portfolio management of such risks in a timely matter.<sup>41</sup> The DRM must also inform the fund's board of directors of such material risks "as appropriate".<sup>42</sup>

The Commission notes that it believes these lines of communication are a key part of derivatives risk management, and will provide the fund's board with key information to facilitate its oversight function.<sup>43</sup> The Adopting Release states that a fund's DRM is best positioned to determine when it is appropriate to escalate material risks to the fund's board, and accordingly the Final Rule grants a fund's DRM the discretion to determine when and what material risks that have been escalated to the fund's portfolio management should also be escalated to the fund's board of directors.<sup>44</sup> However, the Adopting Release also notes that the Final Rule does not limit the ability of a fund's board to engage with the DRM regarding the circumstances under which risks will be communicated to the board. The Adopting Release states that this engagement may help a DRM to develop an understanding of which risks the board would find most relevant, or most important to raise outside the context of regularly scheduled board meetings.<sup>45</sup>

### **7. Periodic Review.**

The DRM must review the DRMP at least annually to evaluate the DRMP's effectiveness and update the DRMP to reflect changes in the fund's derivatives risks over time. The review must consider the overall program and each of the specific program elements noted above, as well as a review of the fund's VaR calculation model and the fund's designated reference portfolio (if applicable) to evaluate whether it remains appropriate.<sup>46</sup>

The DRMP framework, as well as its required elements, is generally consistent with the framework set forth in the Proposed Rule, with the modifications noted above. Other than the required elements noted above, the Adopting Release notes that the program "will otherwise be tailored based on how the fund's use of derivatives may affect its investment portfolio and overall risk profile."<sup>47</sup> As discussed further below, a fund that is a limited derivatives user is excepted from the requirement to establish a DRMP, but is still required to adopt and implement policies and procedures reasonably designed to manage such fund's derivatives risks.

## B. BOARD OVERSIGHT AND REPORTING

The Final Rule includes board oversight and reporting requirements designed to facilitate the board's oversight of the fund's derivatives risk management, allow for the implementation and effective management of the DRMP, and provide for the board's participation in selecting the fund's DRM.<sup>48</sup> The Commission received many comments on the board's role in connection with a fund's DRMP, including comments urging the Commission to affirm that the board's role is one of oversight.<sup>49</sup> In response to these comments, the Adopting Release affirms the Commission's position that a board's role is one of "general oversight" in which board members may exercise their "reasonable business judgment in overseeing the program on behalf of the fund's investors." The Adopting Release notes that fund boards should view their oversight role as an "iterative process," in which a board should take an active role in inquiring about, and following up on, material risks arising from fund derivative transactions, although a board is not required to act in a day-to-day management capacity.<sup>50</sup> The Commission further states that effective board oversight "depends on the board receiving sufficient information on a regular basis to remain abreast of the specific derivatives risks that a fund faces. Boards should request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed."<sup>51</sup> The amount of information and follow up that a board will require for effective oversight will depend on the facts and circumstances and will change over time.<sup>52</sup>

The Adopting Release also notes that rule 38a-1 under the Investment Company Act, which requires a fund's board, including a majority of its independent directors, to approve policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers, would encompass a fund's compliance obligations with respect to rule 18f-4.<sup>53</sup>

### 1. Derivatives Risk Manager Approval.

The designation of a fund's DRM must be approved by the fund's board of directors, including a majority of directors who are not interested persons of the fund.<sup>54</sup> The Adopting Release notes that the board approval requirement would not preclude the adviser from participating in the selection process, and that the Commission anticipates that boards generally would request that the adviser carry out due diligence on appropriate candidates and articulate their qualifications to the board.<sup>55</sup> The Adopting Release omits the Proposed Rule's express requirement that the fund's board of directors "take into account the derivatives risk manager's relevant experience regarding the management of derivatives risk." However, the SEC notes that it believes that a fund's board "necessarily would take into account the candidate's experience, among other relevant factors," which makes an express requirement to consider the candidate's relevant experience unnecessary.<sup>56</sup>



## 2. Annual Reporting.

A fund's DRM must provide the fund's board with a written report on or before the implementation of the DRMP, and a written report at least annually thereafter, that addresses the implementation and effectiveness of the DRMP. The report must include a representation by the DRM, based on the DRM's reasonable belief after due inquiry, that the DRMP is "reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of [a DRMP]," and must also include the basis for the representation as well as any information that is reasonably necessary to evaluate the adequacy of the DRMP and the effectiveness of its implementation.<sup>57</sup> The report must also include the DRM's basis for the approval of the fund's designated reference portfolio (if applicable) or any change to the fund's designated reference portfolio, or the DRM's basis for determining that a designated reference portfolio would not provide an appropriate reference portfolio.<sup>58</sup>

## 3. Regular Reporting.

The DRM must provide written reports containing the DRM's analysis of exceedances of the fund's risk guidelines and results of its stress testing and backtesting conducted pursuant to rule 18f-4(c)(ii) through (iv) to the fund's board of directors regularly, "at a frequency determined by the board."<sup>59</sup> Each of these reports must include such information "as may be reasonably necessary for the board of directors to evaluate the fund's response to exceedances and the results of the fund's stress testing."<sup>60</sup> This provision reflects a change from the Proposed Rule, no longer requiring the disclosure of "any" exceedances of the risk guidelines, in order to clarify that the DRM need not report every single exceedance to the board. Instead, the reports to the board must include an *analysis* of exceedances that occurred during the period covered by the report, as well as stress testing and backtesting conducted during the period. The Adopting Release notes that the report reflecting this analysis may be in summary form, rather than an itemization of each exceedance, stress test, or backtest exception, but that "a simple listing of exceedances and stress testing and backtesting results without context, in contrast to an analysis of these matters, would provide less useful information for a fund's board." Accordingly, such a simple listing "would not satisfy the requirement that the reports include such information as may be reasonably necessary for the board of directors to evaluate the fund's response to exceedances and the results of the fund's stress testing."<sup>61</sup>

The DRM must also notify the fund's board of directors of certain events as they occur. As noted above, the DRM must escalate certain material risks to the fund's board "as appropriate." In addition, if the fund is out of compliance with the applicable VaR test for five business days, the DRM must provide a written report to the fund's board of directors and "explain how and by when (*i.e.*, number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance."<sup>62</sup> The DRM must provide a written report within thirty calendar days of the exceedance to the board of directors, either explaining how the fund came back into compliance or (in the event that the fund remains out of compliance) providing an update on the fund's progress in coming back into compliance. If the fund has come back into

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compliance, the report must include an analysis of, and updates with respect to, the circumstances that caused the fund to be out of compliance for more than five business days and any program elements that were updated to address those circumstances, as required by rule 18f-4(c)(2)(iii)(B). If the fund is not yet back in compliance, the DRM must continue to provide reports with updates concerning the fund's non-compliance at regularly scheduled intervals at a frequency determined by the fund board.<sup>63</sup> The reports produced in connection with the board reporting requirements are subject to recordkeeping requirements, discussed below.

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### LIMIT ON FUND LEVERAGE RISK

The Final Rule requires funds relying on the rule to engage in derivatives transactions to comply with a VaR-based limit on fund leverage risk.<sup>64</sup> VaR is defined in rule 18f-4(a) as “an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's assets (or net assets when computing a fund's VaR), over a specified time horizon and at a given confidence level, 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:

- Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable:
  - Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
  - Material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and
  - The sensitivity of the market value of the fund's investments to changes in volatility;
- Use a 99% confidence level and a time horizon of 20 trading days; and
- Be based on at least three years of historical market data.”<sup>65</sup>

A fund must determine its compliance with the applicable VaR test at least once each business day.<sup>66</sup> If a fund determines that it is not in compliance with the applicable VaR test, then 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.<sup>67</sup> As noted above, if the fund fails to return to compliance within five business days, the DRM must take certain remedial actions, including analyzing the circumstances that caused the fund to stay out of compliance, updating elements of the DRMP as necessary and providing a written report to the board regarding the DRM's plan for returning the fund to compliance, and the DRM must provide a further report to the fund's board within thirty calendar days of the exceedance (and further regular updates thereafter to the extent the fund remains out of compliance with the applicable VaR test).<sup>68</sup>

### A. RELATIVE VaR AS DEFAULT TEST

The relative VaR test is the default VaR-based test under the Final Rule, consistent with the Proposed Rule. The relative VaR test compares a fund's VaR to the VaR of a "designated reference portfolio," which is defined as "a designated index or the fund's securities portfolio."<sup>69</sup> The Final Rule "requires a fund to comply with the relative VaR test unless the fund's 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."<sup>70</sup> Any fund that does not apply the relative VaR test must instead comply with an absolute VaR test, which compares the fund's portfolio VaR to the value of its net assets.

In the Adopting Release, the Commission explains that it adopted the relative VaR test as the default means of limiting fund leverage because it believes that the relative VaR test "resembles the way that Section 18 limits a fund's leverage risk"—although different than the asset coverage requirements in Section 18, the test "limits the extent to which a fund can potentially increase its market exposure through leveraging by issuing senior securities, but it does not directly limit a fund's level of risk or volatility."<sup>71</sup> In contrast, the absolute VaR test may be "inconsistent with investors' expectations where there is an appropriate reference portfolio for purposes of the relative VaR test."<sup>72</sup>

With respect to the relative VaR test, the Adopting Release indicates that a fund may use an index that meets certain requirements or its own investments, excluding derivatives transactions, as its designated reference portfolio. A fund will satisfy the relative VaR test if its portfolio VaR does not exceed 200% of the VaR of its designated reference portfolio, and will satisfy the absolute VaR test if its portfolio VaR does not exceed 20% of the value of the fund's net assets. The final rule also provides relative and absolute VaR limits of 250% and 25%, respectively, for closed-end funds that have outstanding shares of a preferred stock issued to investors.<sup>73</sup>

Whereas the Proposed Rule would have required a fund seeking to enter into derivatives transactions in reliance on the Proposed Rule to comply with the relative VaR test unless the fund's DRM is "unable to identify a designated reference index that is appropriate for the fund,"<sup>74</sup> the Final Rule instead provides that a fund seeking to enter into derivatives transactions in reliance on the Final Rule must comply with the relative VaR test unless the fund's 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. The purpose of this modification is to clarify the scope of the diligence that a DRM is expected to undertake in considering potential reference indexes, and is "designed to make clear that this provision involves a derivatives risk manager's determination after reasonable inquiry and analysis regarding the feasibility of applying a relative VaR test to a fund and the appropriate reference portfolio for that purpose."<sup>75</sup>

## B. DESIGNATED REFERENCE PORTFOLIO

As noted above, a designated reference portfolio is defined as either a designated index or securities portfolio.

### 1. Designated Index

A “designated index” (renamed from “designated reference index” in the Proposed Rule to avoid confusion with the similar term “designated reference portfolio”) is defined as “an unleveraged index that: (1) is approved by the fund’s DRM 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.”<sup>76</sup>

A key change from the Proposed Rule is that the Final Rule permits a fund to use its own securities portfolio (excluding derivatives transactions) as its designated reference portfolio for the relative VaR test.<sup>77</sup> A similar proposal was included in the 2015 Proposing Release. This provision is applicable only for actively managed funds, as an index-tracking fund must use the index it tracks as its designated reference portfolio.<sup>78</sup> The definition of “securities portfolio” for purposes of rule 18f-4<sup>79</sup> excludes derivatives transactions in order to provide an unleveraged reference portfolio, akin to a designated index, to measure potential leverage risk introduced by the fund’s derivatives transactions.<sup>80</sup> This provision, along with requirements such as periodic review by the DRM and board reporting, which are “designed to promote a fund’s appropriate use of the securities portfolio approach that are analogous to the requirements for funds’ use of designated indexes,” are, taken together, “designed to produce a reference portfolio that, like a designated index, creates a baseline VaR that functions as the VaR of a fund’s unleveraged portfolio for purposes of the relative VaR test.”<sup>81</sup>

In another departure from the Proposed Rule, the Final Rule will not require that a fund publicly disclose its designated index in the fund’s annual report, which the Commission determined would be inconsistent with its goal of promoting concise fund disclosure to highlight key information to investors, as reflected in the Commission’s recent proposal to modernize the disclosure framework for open-end funds.<sup>82</sup>

## C. LIMITS UNDER THE RELATIVE VAR TEST AND ABSOLUTE VAR TEST

As noted above, a fund’s VaR must not exceed 200% of the VaR of the fund’s designated reference portfolio, unless the fund is a closed-end company that has then-outstanding shares of a preferred stock issued to investors, in which case the relative VaR limit is 250%.<sup>83</sup> The 200% relative VaR limit is an increase from the Proposed Rule, which set the limit at 150%, and was informed by, among other things, the 200% relative VaR limit used within the UCITS framework (*i.e.*, providing a degree of consistency could provide compliance and operational efficiencies for global asset managers) and the Commission’s

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recognition that factors other than a fund's use of derivatives (e.g., a fund's security selection, or other differences between a fund's portfolio and its reference portfolio) could cause a fund's VaR to exceed the VaR of its designated index.<sup>84</sup> In addition, while the relative VaR test in the Proposed Rule did not distinguish between different types of investment companies, the Final Rule provides for a higher VaR limit of 250% of the VaR of a fund's designated reference portfolio for a closed-end fund with outstanding preferred stock.<sup>85</sup>

To comply with the absolute VaR test, a fund's VaR must not exceed 20% of the value of the fund's net assets, unless the fund is a closed-end fund that has outstanding preferred stock. For such closed-end funds, the VaR must not exceed 25% of the value of the fund's net assets. The 20% and 25% absolute VaR tests reflect increases from the Proposed Rule, which had proposed an absolute VaR limit of 15% of the value of a fund's net assets, and did not differentiate between a closed-end fund and other types of funds.<sup>86</sup>

The final rule does not provide an exemption from the rule's VaR-based limit for funds that limit their investors to "qualified clients," as defined in rule 205-3 under the Advisers Act, and/or are sold exclusively to "qualified clients," "accredited investors," or "qualified purchasers," as requested by some commenters.<sup>87</sup>

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### LIMITED DERIVATIVES USERS

The Final Rule allows limited derivatives users to engage in derivatives transactions in reliance on the Final Rule without complying with a VaR-based limit on fund leverage risk or adopting a DRMP and complying with the related board oversight and reporting requirements. This exception is intended to alleviate costs and compliance burdens that may be disproportionate with the resulting benefit for funds that have limited derivatives exposure. For purposes of the Final Rule, a limited derivatives user is a fund that limits its derivatives exposure to 10% of its net assets (a fund may exclude from the 10% threshold derivatives transactions that are used to hedge certain currency and/or interest rate risks and meet certain conditions).<sup>88</sup> In the event that a firm exceeds the 10% threshold, the Final Rule, in a departure from the Proposed Rule, includes two alternative paths for remediation. If a fund's derivatives exposure exceeds the 10% derivatives exposure threshold for five business days, the fund's investment adviser must provide a written report to the fund's board of directors informing it whether the investment adviser intends either to: (1) promptly, but within no more than thirty calendar days of the exceedance, reduce the fund's derivatives exposure to be in compliance with the 10% threshold in a manner that is in the best interests of the fund and its shareholders; or (2) establish a DRMP, comply with the VaR-based limit on fund leverage risk, and comply with the related board oversight and reporting requirements as soon as reasonably practicable ("DRMP adoption").<sup>89</sup> The fund must report the number of days (beyond five business days) during which the fund exceeded the 10% threshold on Form N-PORT.<sup>90</sup>

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To take advantage of the exception for limited derivatives users, a fund must adopt and implement written policies and procedures reasonably designed to manage its derivatives risk.<sup>91</sup> The policies and procedures adopted by a fund relying on the limited derivatives user exception should be tailored to the extent and nature of the fund's use of derivatives.<sup>92</sup> In the Adopting Release, the Commission stated that this approach was adopted over a more prescriptive model to avoid a potentially over- or under-inclusive rule and to permit appropriate consideration of the breadth of the funds' use of derivatives and the derivatives' particular risks.<sup>93</sup> The Commission's approach "allows funds to scale their policies and procedures to address the different strategies funds may pursue, the different level of derivatives exposure they may seek (so long as they remain below the 10% derivatives exposure threshold), and the different risks associated with their derivatives transactions."<sup>94</sup>

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### APPROACH TO LEVERAGED/INVERSE FUNDS

As noted above, the Proposed Rule included an alternative set of sales practice rules for a leveraged/inverse fund, which the Commission determined not to adopt.<sup>95</sup> Under the proposal, a leveraged/inverse fund would not have been required to comply with rule 18f-4's VaR-based leverage risk limit if: (1) transactions in the fund's shares would be subject to the proposed sales practices rules, discussed below; (2) the fund sought to achieve no more than 300% of the return (or inverse of the return) of the underlying index; and (3) the fund disclosed in its prospectus that it was not subject to rule 18f-4's leverage risk limit.<sup>96</sup>

Under the Final Rule, leveraged/inverse funds are generally subject to rule 18f-4 to the same extent as other funds, including the requirement to comply with the VaR-based limit on fund leverage risk. The Commission recognizes in the Adopting Release that this will effectively limit leveraged/inverse funds' targeted daily return to 200% of the return (or inverse of the return) of the fund's underlying index.<sup>97</sup> However, the Final Rule excepts a leveraged/inverse fund in operation as of October 28, 2020 that seeks an investment result above 200% of the return (or inverse of the return) of an underlying index from the Final Rule's requirement of compliance with a VaR-based limit on fund leverage risk, provided that such a fund complies with all other applicable provisions of rule 18f-4 and meets certain additional requirements, including that the fund must disclose in its prospectus a leverage multiple or inverse multiple that exceeds 200% of the performance (or inverse of the performance) of the underlying index, and that a fund may not change its underlying index or increase the level of leveraged or inverse market exposure that the fund seeks to provide.<sup>98</sup>

The Final Rule also amends existing rule 6c-11 to bring leveraged/inverse funds within the scope of the rule, consistent with the proposal, provided that they comply with the applicable provisions of rule 18f-4. Because leveraged/inverse funds will now rely on rule 6c-11, existing exemptive relief will be rescinded.<sup>99</sup>

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The proposed sales practices rules would have required broker-dealers to satisfy the following requirements before accepting retail investor orders for or approving retail investor accounts to engage in transactions in leveraged/inverse funds, and would have required investment advisers to satisfy the same requirements before placing an order for the account of a retail advisory client to buy or sell shares of leveraged/inverse funds:

- engage in due diligence to ascertain certain key factors about the retail investor, and (on the basis of this inquiry) form a reasonable basis that the investor is capable of evaluating the risks associated with leveraged/inverse investment vehicles; and
- adopt policies and procedures reasonably designed to effectuate compliance with the proposed sales practices rules.<sup>100</sup>

The Commission received a significant number of comments in opposition to the proposed sales practices rules. The comments raised (among others) the concerns that the proposed sales practices would unduly restrict investor choice, would be duplicative of existing investor protections (including those provided by Regulation Best Interest) and would have the effect of causing intermediaries to stop offering leveraged/inverse products to investors.<sup>101</sup> In response to these comments, the Commission acknowledged that the enhanced standard of conduct for broker-dealers under Regulation Best Interest and the fiduciary obligations of registered investment advisers “help address some of the sales practice concerns that leveraged/inverse funds and listed commodity pools following the same strategies may raise, in the context of recommended transactions and transactions occurring in an advisory relationship” and determined not to adopt the proposed sales practice rules.<sup>102</sup> However, the Commission notes in the Adopting Release that the Divisions of Investment Management, Corporation Finance, and Trading and Markets will undertake a review of “the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex products,” and will make recommendations to the Commission for potential future rulemakings, guidance or other policy actions, and solicit feedback from market participants and members of the public.<sup>103</sup>

Chairman Jay Clayton, Division of Investment Management Director Dalia Blass, Division of Corporation Finance Director Bill Hinman and Division of Trading and Markets Director Brett Redfearn issued a joint statement concurrently with the Adopting Release (the “Joint Statement”) that describes in further detail the review that the Divisions of Investment Management, Corporation Finance and Trading and Markets will undertake.<sup>104</sup> The Joint Statement also analyzes a number of potential investor protection issues presented by leveraged/inverse products, including that investors may fail to appreciate that complex leveraged/inverse products are governed by different regulatory requirements and may not fully understand the risks that such products pose, and that retail investors who can directly access complex products may

not benefit from the protections that would apply were they to receive recommendations from a broker-dealer or investment adviser.<sup>105</sup>

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### ADDITIONAL PROVISIONS

#### A. REPORTING REQUIREMENTS.

The SEC also adopted amendments to the reporting requirements for funds that will rely on new rule 18f-4, including amendments to Form N-PORT, Form N-LIQUID (which is retitled Form N-RN), and Form N-CEN. As a result, any fund relying on the Final Rule must report its median daily VaR, the number of exceptions identified in its backtesting results, the identity of its designated index (if applicable), and certain breaches of its VaR-based leverage limit, and limited derivatives users must report their derivatives exposure.<sup>106</sup> A number of commenters objected to the proposal to make information reported by funds in response to the proposed VaR disclosure items public. In response to these comments, the Adopting Release notes that, in a change from the Proposed Rules, a fund's median VaR information and highest daily VaR during the reporting period will not be publicly reported.<sup>107</sup>

#### B. REVERSE REPURCHASE AGREEMENTS AND UNFUNDED COMMITMENT AGREEMENTS.

Rule 18f-4(d)(1) permits funds to enter into reverse repurchase agreements or similar financing transactions so long as they meet the relevant asset coverage requirements of Section 18 of the Investment Company Act. In a change from the Proposed Rule, the Final Rule also provides funds with the option to treat reverse repurchase agreements or similar financing transactions as derivatives transactions, rather than including such transactions in the fund's asset coverage calculation.<sup>108</sup> The Commission noted that this change is intended to provide flexibility for a fund to choose the approach that best suits its investment strategy or operational needs, while maintaining Section 18's requirements designed to address asset sufficiency and leverage concerns.<sup>109</sup> The Commission notes in the Adopting Release that reverse repurchase agreements and other similar financing transactions achieve effectively identical results to a bank borrowing or other borrowing (by allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets), which is why it is appropriate to treat these transactions in an equivalent fashion to borrowings under the Investment Company Act.<sup>110</sup> In reevaluating the regulatory scheme around fund derivatives use, the Commission determined that reverse repurchase agreements and similar financing transactions, like derivatives transactions, may provide an efficient and cost-effective form of financing or leverage.<sup>111</sup> As a result, the Final Rule allows a fund that wishes to engage in these transactions beyond the asset coverage requirements for borrowings to choose to treat them as derivatives transactions for purposes of Rule 18f-4 instead.<sup>112</sup> Although the Commission recognizes concerns that these transactions could have the effect of introducing leverage into a fund's portfolio, it believes that the DRMP requirements will address these concerns.<sup>113</sup>



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Consistent with the Proposed Rule, the Final Rule permits a fund to enter into unfunded commitment agreements to make certain loans or investments if the fund reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements, pursuant to rule 18f-4(e)(1).<sup>114</sup> The Final Rule defines an “unfunded commitment agreement” 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 at the discretion of the fund’s general partner.”<sup>115</sup> The Commission acknowledges that a fund may be unable to meet its obligations under an unfunded commitment agreement, but notes that such transactions “do not generally involve the leverage and other risks associated with derivatives transactions.”<sup>116</sup>

### **C. WHEN-ISSUED, FORWARD-SETTLING AND NON-STANDARD SETTLEMENT CYCLE SECURITIES.**

The Final Rule includes a new provision that permits funds, in this instance including money market funds, to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, without such transactions being deemed to involve a senior security, subject to certain conditions including that the fund must intend to settle the transaction physically within 35 days. The Adopting Release notes that this provision reflects the Commission’s view that the potential for leveraging is limited in these transactions when they meet the conditions set forth in the Final Rule.<sup>117</sup>

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### **RECORDKEEPING.**

The Final Rule contains recordkeeping requirements, codified in rule 18f-4(c)(6), that are designed to provide the Commission Staff and the fund’s compliance personnel the ability to evaluate the fund’s compliance with the Final Rule’s requirements. The recordkeeping requirements are consistent with the Proposed Rule, except for conforming changes in light of changes to other aspects of the Final Rule.<sup>118</sup> The recordkeeping provisions of the Final Rule require the fund to maintain certain records, including:

- Records documenting the fund’s DRMP, including written records of its policies and procedures designed to manage derivatives risks;
- Results of any stress testing, VaR backtesting, and internal reporting or escalation of material risks under the DRMP and any periodic reviews of the DRMP;
- Records of any materials provided to the fund’s board of directors in connection with approving the designation of the DRM and any reports provided to the board about the DRMP or regarding non-compliance with the DRMP;
- Records documenting the fund’s determination of: the VaR of its portfolio; the VaR of the fund’s designated reference portfolio, as applicable; the fund’s VaR ratio (the value of the VaR of the fund’s portfolio divided by the VaR of the designated reference portfolio), as applicable; and any updates to any VaR calculation models used by the fund, as well as the basis for any material changes made to those models, as applicable to funds required to comply with the VaR-based limit on fund leverage risk;

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- For a limited derivatives user, written records of its derivatives risk management policies and procedures;
- Records documenting the fund's basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its obligations for any unfunded commitment agreements the fund enters into; and
- For funds that enter into reverse repurchase agreements, 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.<sup>119</sup>

These records must be maintained for a period of five years, generally with the two most recent years in an easily accessible place, except that any written policies or procedures that are or were in effect within the five year period must be easily accessible.<sup>120</sup>

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### COMPLIANCE DATE AND RELEVANT GUIDANCE

The Final Rule will become effective on February 19, 2021 (60 days after publication in the Federal Register). Funds using derivatives will have until August 19, 2022 (18 months after the effective date) before compliance is mandatory.

In connection with the implementation of the Final Rule, the Commission has reviewed its past guidance and will rescind Release 10666. The Commission's staff will also be withdrawing certain no action letters and other staff guidance that addresses topics now covered by the Final Rule.

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ENDNOTES

- 1 Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Rel. No. IC-34084 (Oct. 28, 2020), 85 Fed. Reg. 83162 (Dec. 21, 2020) (“Adopting Release”).
- 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, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (Jan. 24, 2020) (“Proposing Release”).
- 3 Adopting Release at 34. Section 61 of the Investment Company Act makes Section 18 thereof applicable to BDCs, with certain modifications. Except as otherwise noted, or unless the context dictates otherwise, references to Section 18 of the Act in this memorandum should be understood to refer to Section 61 with respect to BDCs. *Id.* at 7.
- 4 *Id.*
- 5 Final Rule 18f-4(a).
- 6 See generally Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)].
- 7 See generally Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015) [80 FR 80883 (Dec. 28, 2015)].
- 8 Section 18(g) of the Investment Company Act defines “senior security” in part as “any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness” and also includes “any stock of a class having priority over any other class as to the distribution of assets or payment of dividends” and excludes certain limited temporary borrowings.”
- 9 Adopting Release at 13.
- 10 See generally Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 FR 25128 (Apr. 27, 1979) (“Release 10666”).
- 11 Adopting Release at 17-18.
- 12 *Id.* at 24-26.
- 13 Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80883 (Dec. 28, 2015) (“2015 Proposing Release”).
- 14 *Id.* at 153.
- 15 Adopting Release at 8.
- 16 Proposing Release at 12.
- 17 Adopting Release at 10.
- 18 Release 10666 at n.5.
- 19 Adopting Release at 19. The Commission notes that “[a]s was the case for trading practices that Release 10666 describes, where the fund has entered into a derivatives transaction and has such a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of Section 18.” *Id.*
- 20 Hester M. Peirce, Opening Statement on Use of Derivatives by Registered Investment Companies and Business Development Companies (October 28, 2020), available at [SEC.gov | Opening](https://www.sec.gov/newsroom/opening-statement-on-use-of-derivatives-by-registered-investment-companies-and-business-development-companies)

ENDNOTES (CONTINUED)

Statement on Use of Derivatives by Registered Investment Companies and Business Development Companies.

21 Adopting Release at 36.

22 *Id.* at 53.

23 *Id.* at 55.

24 *Id.* at 55-56.

25 *Id.* at 57.

26 *Id.* at 59. If multiple officers serve as a DRM, a majority of these persons may not be portfolio managers.

27 Rule 18f-4(a).

28 Adopting Release at 62.

29 Adopting Release at 63.

30 *Id.*

31 Rule 18f-4(a). The Adopting Release provides further guidance on what each of these risks generally entail. See Adopting Release at 65-66.

32 Adopting Release at 67.

33 Rule 18f-4(c)(1)(ii); Adopting Release at 67. The final rule, as proposed, does not impose specific risk limits for these guidelines, but instead requires a fund to adopt guidelines that provide for quantitative thresholds tailored to the fund. The Adopting Release states that the Commission “believe[s] that the quantitative thresholds should be those the fund determines to be appropriate and that are most pertinent to its investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure.” Adopting Release at 69.

34 Adopting Release at 67-68.

35 *Id.* at 70-71.

36 Rule 18f-4(c)(iii). While a fund must run stress tests on a weekly basis, the scope of stress testing may vary. Funds may, for example, conduct more-detailed scenario analyses on a less-frequent basis—such as the monthly frequency suggested by some commenters—while conducting more-focused weekly stress tests under rule 18f-4. Adopting Release at 71.

37 Adopting Release at 73-74.

38 *Id.* at 75.

39 *Id.*

40 Adopting Release at 75, note 212; Proposing Release at 70-71, notes 150-151 and accompanying text.

41 Rule 18f-4(c)(iv)(A), (B).

42 Adopting Release at 81.

43 *Id.* at 79-80.

44 *Id.* at 81.

45 *Id.* at 82.

46 *Id.*

47 *Id.* at 30.

ENDNOTES (CONTINUED)

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- 48 *Id.* at 89-90.
- 49 *Id.* at 90. Commenters raised a range of concerns with respect to the proposed board reporting obligations, including that the heavy volume of information to be provided to fund boards might “shift the board’s role away from one of oversight to day-to-day risk management.”
- 50 *Id.* at 85-86.
- 51 *Id.* at 86.
- 52 *Id.* at 84-86.
- 53 *Id.* at 86.
- 54 Rule 18f-4(c)(3)(i).
- 55 Adopting Release at 88.
- 56 *Id.* at 89.
- 57 Rule 18f-4(c)(3)(ii).
- 58 *Id.*
- 59 Adopting Release at 94. The Commission addressed comments about frequency, noting that the frequency will vary based on the fund and that it is important to provide this flexibility for boards to tailor their oversight.
- 60 *Id.* at 97.
- 61 *Id.*
- 62 *Id.* at 158.
- 63 Rule 18f-(c)(2)(iii).
- 64 *Id.*
- 65 Rule 18f-4(a).
- 66 Rule 18f-4(c)(2)(ii).
- 67 *Id.*
- 68 *Id.*
- 69 Rule 18f-4(a). The rule specifies that 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.
- 70 Adopting Release at 107 (citing rule 18f-4(a)).
- 71 *Id.* at 110.
- 72 *Id.*
- 73 *Id.* at 97-98.
- 74 Proposed Rule 18f-4(2)(i).
- 75 Adopting Release at 111.
- 76 Rule 18f-4(a). 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. *Id.*

ENDNOTES (CONTINUED)

- 77 Adopting Release at 122. As noted in note 79, *infra*, the Final Rule’s definition of securities portfolio for purposes of the reference portfolio for compliance with the requirements in rule 18f-4(c) excludes derivatives transactions.
- 78 Adopting Release at 122.
- 79 “*Securities portfolio* 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).” Rule 18f-4(a).
- 80 Adopting Release at 123.
- 81 *Id.* at 124. This approach may allow funds to use a VaR reference portfolio that is more tailored to the fund’s investments than an index, and may allow the fund to avoid the added expense of blending or licensing an index solely to comply with the Final Rule’s relative VaR test.
- 82 Adopting Release at 121. *See also* Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Investment Company Act Release No. 33963 (Aug. 5, 2020); Sullivan & Cromwell LLP Memorandum, SEC Proposes to Modernize Fund Shareholder Reports and Disclosures (August 13, 2020), *available at* [SC-Publication-SEC-Proposes-Modernize-Fund-Shareholder-Reports-Disclosures.pdf \(sullcrom.com\)](https://www.sullcrom.com/publications/sec-proposes-modernize-fund-shareholder-reports-disclosures).
- 83 Adopting Release at 125.
- 84 *Id.* at 126.
- 85 *Id.* at 134.
- 86 *Id.* at 138.
- 87 *Id.* at 143-45. Commenters had suggested that the relatively sophisticated investors in such funds do not require the same investor protections as investors in other registered funds, and that subjecting such funds to a VaR limit could impair their operations and cause investors to move to private funds. In response, the Commission noted that a fund that limits its investor base in the manner described by these commenters would be able to qualify for an exclusion from the definition of “investment company”, and would be able to operate as a private fund without being subject to Section 18.
- 88 Rule 18f-4(c)(4)(B). The currency or interest rate derivatives must be entered into and maintained by the fund for hedging purposes, and the notional amounts of such derivatives may not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10 percent.
- 89 Adopting Release at 190.
- 90 *Id.*
- 91 Rule 18f-4(c)(4)(i)(A).
- 92 Adopting Release at 187.
- 93 *Id.* at 188.
- 94 *Id.*
- 95 Adopting Release at 10-11.
- 96 *Id.* at 194 (citing Proposing Release at Section II.G.3).
- 97 *Id.* at 32.

## ENDNOTES (CONTINUED)

- 98 *Id.* at 194-95; 212-13.
- 99 *Id.* at 216.
- 100 Proposed rule 250-151-1.
- 101 Adopting Release at 201-202. See generally Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 FR 33318 (July 12, 2019)] (“Regulation Best Interest Adopting Release”).
- 102 *Id.* at 33.
- 103 *Id.* at 211.
- 104 See Jay Clayton, Dalia Blass, William Hinman & Brett Redfearn, Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2020), available at <https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28>.
- 105 *Id.*
- 106 Adopting Release at 217-238.
- 107 *Id.* at 228-229.
- 108 *Id.* at 239-40.
- 109 *Id.* at 240.
- 110 *Id.* at 243.
- 111 *Id.* at 244.
- 112 *Id.*
- 113 *Id.* at 245.
- 114 *Id.* at 252.
- 115 Rule 18f-4(a).
- 116 Adopting Release at 252-254. The Commission notes that it continues to believe that unfunded commitment agreements are distinguishable from the derivatives transactions covered by the rule 18f-4, as a fund would not enter into unfunded commitment agreements to leverage its portfolio, and unfunded commitment agreements do not implicate the Investment Company Act’s concern of undue speculation. However, on the rationale that unfunded commitment agreements can (depending on the circumstances) raise asset sufficiency concerns, the Commission adopted the proposed approach pursuant to which a fund may enter into an unfunded commitment agreement if it reasonably believes, at the time of entry into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations under such agreement as they come due. *Id.*
- 117 *Id.* at 45-46, 323.
- 118 *Id.* at 259.
- 119 *Id.* at 262.
- 120 Rule 18f-4(c)(6)(ii); rule 18f-4(d)(2); rule 18f-4(e)(2).

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