



Investment Management Update

December 2020

SEC Adopts New Fund Derivatives Rule

Key Notes:

- Rule 18f-4 will provide a standardized and risk-based regulatory framework for funds that use derivatives.
- Funds will be subject to leverage limits based on value at risk (VaR).
- Funds using derivatives will need to adopt derivatives risk management programs that include the designation of a derivative risk manager.

On October 28, 2020, the Securities and Exchange Commission (the “Commission”) adopted Rule 18f-4 (the “Rule”) under the Investment Company Act of 1940 (the “1940 Act”). The Rule is designed to provide an updated and comprehensive approach to the regulation of derivatives use by registered investment companies and business development companies. Notwithstanding Section 18 restrictions, the Rule permits funds to enter into derivatives transactions subject to certain conditions.

I. Background

Section 18 of the 1940 Act limits the ability of mutual funds, exchange-traded funds, registered closed-end funds, and business development companies (collectively, “funds”) to obtain leverage which includes limiting a fund’s ability to engage in transactions that involve potential future payment obligations. While leverage is commonly viewed as purchasing securities with borrowed funds, derivatives, such as forwards, futures, swaps, and written options, can also create future payment obligations.

Until recently, a patchwork system of Commission and staff guidance allowed funds to invest in derivatives. In an effort to create a consistent regulatory framework, the Commission proposed Rule 18f-4 on November 25, 2019. In its proposal, the Commission noted that inconsistent

industry practices “may not address investor protection concerns that underlie Section 18’s limitation on funds’ issuance of senior securities.” Under the proposed rule, funds could enter into derivatives transactions notwithstanding Section 18 limitations. In order to address investor protection concerns, the proposed rule came subject to certain conditions, such as adopting a derivatives risk management program and limiting the amount of leverage-related risk that funds could obtain.

II. Scope of Rule 18f-4

The Rule permits funds to enter into derivative transactions, meaning (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) reverse repurchase agreements and similar financing transactions. The list of derivative instruments was designed to be sufficiently comprehensive to include derivatives that may be developed in the future. Also, the derivatives instrument definition provides that a derivatives instrument, for purposes of the Rule, must involve a future payment obligation. This aspect of the definition recognizes that not every derivatives instrument imposes such an obligation, and therefore not every derivatives instrument will involve the issuance of a senior security.

III. Derivatives Risk Management Program

Given the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds and their related risks, the Rule requires funds that are users of

derivatives (other than limited derivatives users) to have a formalized risk management program with certain specified elements (a “program”). A fund must adopt and implement a written derivatives risk management program that includes policies and procedures reasonably designed to manage the fund’s derivatives risks. A fund’s board will be required to approve a derivatives risk manager, who will be responsible for administering the program. A fund’s program must include the following elements:

- *Program Administration.* Each program will be administered by an officer or officers of the fund’s adviser. A fund’s derivatives risk manager:
 - Cannot be a fund’s portfolio manager, if a single person serves in this position, and if multiple officers serve as a derivatives risk manager, a majority of these persons may not be composed of portfolio managers.
 - Must have relevant experience regarding the management of derivatives risk. The Rule does not identify a specific amount or type of experience but is designed to provide flexibility such that the person(s) serving in this role may have experience that is relevant in light of the derivatives risks unique to the fund.
 - For a fund in which a sub-adviser manages the entirety of a fund’s portfolio (as opposed to a portion, or “sleeve” of the fund’s assets), the officer(s) of a sub-adviser alone also could serve as a fund’s derivatives risk manager, if approved by a fund’s board.
- *Risk Identification and Assessment.* The program must provide for the identification and assessment of a fund’s derivatives risks and must consider the fund’s derivatives transactions and other investments. The Rule defines the derivatives risks that must be identified and managed to include leverage, market, counterparty, liquidity, operational, and legal risks as well as any other risks the derivatives risk manager deems material.
 - Leverage risk generally refers to the risk that derivatives transactions can magnify the fund’s gains and losses.
 - Market risk generally refers to risk from potential adverse market movements in relation to the fund’s derivatives positions, or the risk that markets could experience a change in volatility that adversely impacts fund returns and the fund’s obligations and exposures.
 - Counterparty risk generally refers to the risk that a counterparty on a derivatives transaction may not be willing or able to perform its obligations of the derivatives contract, and the related risks of having concentrated exposure to such a counterparty.
 - Liquidity risk generally refers to risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties.
 - Operational risk generally refers to risk related to potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human error.
 - Legal risk generally refers to insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract.
- *Risk Guidelines.* A program will have to 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 program’s guidelines 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. The Rule 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. A fund must establish discrete metrics to monitor its derivatives risks, which will require a fund and its derivatives risk manager to measure changes in the fund’s risks regularly. Moreover, a fund must identify its response when these metrics have been exceeded, which should provide the fund’s derivatives risk manager with a clear basis from which to determine

whether to involve other persons, such as the fund's portfolio management or board of directors, in addressing derivatives risks appropriately.

- *Stress Testing.* A program will have to provide for stress testing of derivatives risks to evaluate potential losses to a fund's portfolio under stressed conditions. A program's stress testing must:
 - Evaluate potential losses in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio.
 - Consider correlations of market risk factors and resulting payments to derivatives counterparties.
 - Occur with a frequency that is determined by the fund's strategy and investments and current market conditions, if stress tests are conducted no less frequently than weekly.
- *Backtesting.* A program will have to provide for backtesting of the value-at-risk ("VaR") calculation model that the fund uses under the Rule with a required weekly minimum frequency. The backtesting requirement requires that a fund 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. The derivatives risk manager may alter the frequency of backtesting, so long as the frequency is no less frequent than weekly.
- *Internal Reporting and Escalation.* The program will have to provide for the reporting of certain matters relating to a fund's derivatives use to the fund's portfolio management and board of directors. Specifically, the program must identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the program, including guidelines exceedances and the results of the fund's stress testing. The fund's derivatives risk manager must also directly inform the fund's board, as appropriate, of material risks arising from the fund's derivatives use, including risks that exceedances of the guidelines and results of the fund's stress tests indicate.

- *Periodic Review of the Program.* A fund's derivatives risk manager will be required to periodically review the program, at least annually, to evaluate the program's effectiveness and to reflect changes in risk over time.

IV. Board Oversight and Reporting

A fund's board of directors must approve the designation of the fund's derivatives risk manager and the derivatives risk manager must provide regular written reports to the board regarding the program's implementation, effectiveness, exceedances of the fund's guidelines, and the results of the fund's stress testing.

- *Board Approval of the Derivatives Risk Manager.* A board must approve the designation of the fund's derivatives risk manager, but the Rule does not preclude the adviser from participating in the selection process.
- *Board Reporting.* A fund's derivatives risk manager must provide a written report on the effectiveness of the program to the board at least annually and provide regular written reports at a frequency determined by the board. The Rule does not place day-to-day responsibility for the fund's derivatives risk management on a fund's board, but board oversight should not be a passive activity.
 - *Reporting on Program Implementation and Effectiveness.* A fund's derivatives risk manager must provide to the fund's board, on or before the implementation of the program, and at least annually thereafter, a written report providing a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program. The report must include the basis for the derivatives risk manager's representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program and the effectiveness of its implementation. The representation may be based on the derivatives risk manager's reasonable belief after due inquiry. Additionally, the written report must include, as applicable, the fund's derivatives risk manager's basis for the approval of the designated reference portfolio (or any change in the designated reference portfolio) used

under the relative VaR test; or an explanation of the basis for the derivatives risk manager's determination that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test such that the fund relied on the absolute VaR test.

- **Regular Board Reporting.** A fund's derivatives risk manager must provide to the fund's board, at a frequency determined by the board, written reports analyzing exceedances of the fund's risk guidelines and the results of the fund's stress tests and backtesting. These reports must include information reasonably necessary for the board to evaluate the fund's response to exceedances and the results of the fund's stress testing.

V. Limit on Fund Leverage Risk

When engaging in derivatives transactions, a fund must comply with a Value at Risk ("VaR") based limit on leverage risk. A fund can use an index that meets certain requirements or its own investments, excluding derivatives transactions, as its designated reference portfolio. If the fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund will be required to comply with an absolute VaR test. 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.

What is VAR?

VaR is an estimate of an instrument's or portfolio's potential losses over a given time horizon and at a specified confidence. VaR is not itself a leverage measure. A fund must calculate the VaR of its portfolio and compare it to the VaR of a "designated reference portfolio." A fund must comply with the relative VaR test unless the fund's derivatives risk manager 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.

Relative VAR Test

The relative VaR test requires a fund to calculate the VaR of the fund's portfolio and compare it to the VaR of a designated reference portfolio. A fund is permitted to use either an index that meets certain requirements (a "designated index") or the fund's own investments, excluding derivatives transactions (the fund's "securities portfolio"), as its reference portfolio. A fund's designated reference portfolio is designed to create a baseline VaR that functions as the VaR of a fund's unleveraged portfolio. To the extent a fund entered into derivatives to leverage its portfolio, the relative VaR test is designed to identify this leveraging effect. If a fund is using derivatives and its VaR exceeds that of the designated reference portfolio, this difference may be attributable to leverage risk.

Step 1: Calculate the Fund's VAR

The Rule requires that if a fund uses a model to determine its VaR, the model must meet certain requirements such as:

- **Market Risk Factors.** The Rule includes a non-exhaustive list of common market risk factors that a fund must account for in its VaR model. These market risk factors are: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk, and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility.
- **Confidence Level and Time Horizon.** A fund's VaR model must use a 99% confidence level and a time horizon of 20 trading days.
- **Historical Market Data.** A fund's VaR model must be based on three years of historical market data.
- **VaR Models for the Fund's Portfolio and Its Designated Reference Portfolio.** The Rule does not require a fund to apply its VaR model consistently (i.e., the same VaR model applied in the same way) when calculating (1) the VaR of its portfolio and (2) the VaR of its designated reference portfolio.

Step 2: Determine the Fund's Designated Reference Portfolio

Under the Rule, a fund can use a designated index or, if the fund is actively managed, it can utilize its securities portfolio.

Designated Index. A designated index is an unleveraged index, approved by the derivatives risk manager for purposes of the relative VaR test, that reflects the markets or asset classes in which the fund invests. The designated index cannot be an index that is administered by an organization that is an affiliated person of the fund, its 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, a designated index does not have to be a broad-based securities index or an additional index as those terms are defined on Form N-1A and Form N-2, respectively. A designated index must meet the following requirements: (1) must be unleveraged, (2) reflects the markets or asset classes in which the fund invests, and (3) must be widely recognized and used and must not be an index administered by an organization that is an affiliated person of the fund, its adviser, or its principal underwriter, or created at the request of the fund or its adviser.

Securities Portfolio (Actively Managed Funds Only). An actively managed fund can use its securities portfolio as the reference portfolio for the relative VaR test. A fund's securities portfolio is the fund's portfolio of securities and other investments, excluding any derivatives transactions. The securities portfolio must be approved by the derivatives risk manager for purposes of the relative VaR test and must reflect 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).

Step 3: Compare the Fund's VaR to the Fund's Designated Reference Portfolio

200% Limit. 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 fund that has then-outstanding shares of a preferred stock issued to investors. A fund's VaR may exceed 250% if it is a closed-end fund that has outstanding shares of a preferred stock issued to investors.

Absolute VaR Test

If the fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund must comply with an absolute VaR test. A fund complying with the absolute VaR test will satisfy the test if its VaR does not exceed 20% of the value of the fund's net assets, unless the fund is a closed-end fund that has then-outstanding preferred stock. For such closed-end funds, the VaR must not exceed 25% of the value of the fund's net assets.

Implementation

A fund must determine its compliance with the applicable VaR test at least once each business day. If a fund determines that it is not in compliance with its 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. If the fund is not in compliance within five business days:

- The derivatives risk manager must provide a written report to the fund's board of directors and explain how and by when (i.e., the number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance;
- The derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than five business days and update any program elements as appropriate to address those circumstances; and
- The derivatives risk manager must provide a written report within 30 calendar days of the exceedance to the fund's board of directors explaining how the fund came back into compliance and the results of the derivatives risk manager's analysis of the circumstances that caused the fund to be out of compliance for more than five business days and any updates to the program elements.

VI. Limited Derivatives Users

The Rule includes an exemption from the rule's general requirements to adopt a derivatives risk management program, comply with the VaR-based limit on fund leverage risk, and comply with the related board oversight and reporting provisions ("derivatives risk management

program”) for funds that use derivatives in a limited manner, if the fund:

- Either (a) limits its derivatives exposure to 10% of its net assets (“10% threshold”) or (b) uses derivatives transactions solely to hedge certain currency and/or interest rate risks; and
- Adopts policies and procedures that are reasonably designed to manage its derivatives risks.

Limited Derivatives Exposure. In order to identify funds that use derivatives in accordance with the 10% threshold, the Rule includes an expanded definition regarding what transactions must be included when a fund is contemplating its derivatives exposure. Derivatives exposure is defined as the sum of gross notional amounts of the fund’s derivatives instruments and, in the case of short sale borrowings, the value of any asset sold short, subject to certain adjustments for interest rate derivatives and options. The Rule also clarifies that derivatives instruments that do not involve future payment obligations are not included in a fund’s derivatives exposure. Additionally, a fund is permitted to exclude from its derivative exposure any closed-out positions. These positions must be closed out with the same counterparty and must result in no credit or market exposure to the fund.

Hedging Transactions. In the alternative, a fund may also qualify for exemption from certain requirements if it uses derivative transactions to hedge certain interest rate or currency hedging transactions directly matched to particular investments held by the fund, or the principal amount of borrowings by the fund.

Exceeding the Threshold. In contrast to the proposing release, the Rule puts in place more specific guidelines for funds that exceed the limited use threshold. If a fund’s derivatives exposure exceeds the 10% threshold for five business days (“temporary exceedance”), the adviser must notify the fund’s board of directors, via written report, whether it intends to:

- Reduce the fund’s derivatives exposure within 30 days after the fund exceeds the 10% threshold; or

- Adopt a derivatives risk management program as soon as practicable.¹

Additionally, if a Fund exceeds the 10% threshold, beyond a temporary exceedance, the Fund must disclose the number of days it has exceeded the 10% threshold in the Fund’s next filing on Form N-PORT.

VII. Approach to Leveraged/Inverse Funds

Generally, leveraged/inverse funds will be required to comply with the Rule. However, the Rule provides an exception for a fund that cannot comply with the VaR-based leveraged risk limit if the fund:

- Was in operation as of October 28, 2020;
- Has outstanding shares issued in one or more public offerings to investors; and
- Discloses in its prospectus that it is
 - seeking an investment return above 200% of the return (or inverse of the return) of the fund’s underlying index; and
 - not subject to the VaR-based leveraged risk limit of the Rule.

Amendments to Rule 6c-11

Rule 6c-11 previously excluded leveraged/inverse ETFs from the scope of ETFs permitted to rely on that rule. However, the SEC amended Rule 6c-11 to permit a leveraged/inverse ETF to rely on that rule under certain conditions. For example, a fund must comply with the requirements of the Rule. As a result of the amendment to Rule 6c-11, the exemptive orders previously provided to leveraged/inverse ETFs will be rescinded on the compliance date for Rule.

Compliance Date

The Commission is providing a transition period to give funds sufficient time to comply with the provisions of the Rule and the related reporting requirements. Specifically, the Commission adopted a compliance date that is 18

¹ Understanding that various factors can impact a fund’s ability to fully comply with the requirements of the derivatives risk management program (i.e. complexity of derivatives usage), the SEC declined to provide a definitive time period for compliance under this provision.

months after the Rule is published in the Federal Register and will rescind Release 10666 on the effective date.

FOR MORE INFORMATION

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