AIMA

# Derivatives risk management:

## Adapting to the new SEC rule

**(October 2021)**

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# FOREWORD

By August 19, 2022, registered investment companies must comply with Rule 18f-4 of the U.S. Investment Company Act of 1940, as amended ("Investment Company Act"). The new regulatory framework for the use of derivatives creates a set of rules and requirements that will significantly impact how investment advisers and fund Boards evaluate a fund's use of derivatives. In combination with Rule 18f-4, the U.S. Securities and Exchange Commission (SEC) will rescind Investment Company Act Release No. 10666, as well as subsequent SEC staff no-action letters, which have governed the use of derivatives and certain other financing transactions in registered funds for over 40 years.

Rule 18f-4 will require a Board's heightened attention to and oversight of a fund's derivatives usage and material risks. The Board must approve the designation of an officer or officers to serve as the fund's derivatives risk manager ("DRM"), and it must review the DRM's initial and annual written report on the derivatives risk management program. In addition, the Board is expected to review periodic written reports describing information related to the implementation of the derivatives risk management program.

Additionally, Rule 18f-4 mandates a VaR test (either the default of relative VaR or, if the conditions are met, absolute VaR). The relative VaR test is intended to measure the VaR of the fund relative to the VaR of a designated reference portfolio. The designated reference portfolio can generally be either (i) an index selected by the fund's DRM, or (ii) the fund's own securities portfolio (excluding derivative transactions).

Another key component of Rule 18f-4 is a written derivatives risk management program. While Rule 18f-4 allows funds to tailor their derivatives risk management programs to suit their derivatives usage, each program must include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing on at least a weekly basis, (4) weekly backtesting, (5) internal reporting and escalation, and (6) periodic reviews of the derivatives risk management program.

Finally, Rule 18f-4 contains several exceptions specific to certain fund types and financial instruments. For example, funds limiting their derivatives exposure to 10% of net assets (excluding certain currency and interest rate hedging transactions) are excepted from the VaR testing, derivatives risk management program requirements, and Board oversight requirements, provided that such funds implement written policies and procedures reasonably designed to manage their derivatives risks. Rule 18f-4 also contains detailed provisions regarding the definition of "derivatives transactions" and special treatment for leveraged/inverse funds, reverse repos and similar financing transactions, delayed-settlement securities, and unfunded commitment agreements, as well as expanded reporting and recordkeeping requirements.

While funds have until next August to comply with Rule 18f-4's requirements, investment advisers and Boards should begin planning and ensuring all of Rule 18f-4's requirements can be satisfied prior to the August compliance date. We hope that this Guide will provide a practical resource for AIMA members seeking to achieve compliance with Rule 18f-4. It is intended to provide a summary of key portions of Rule 18f-4, as well as notable exceptions and alternatives.

**K&L Gates LLP**

**October 2021**

# GLOSSARY

| | |
|---|---|
| Adopting Release | "Use of Derivatives by Registered Investment Companies and Business Development Companies", SEC Rel. No. IC-34084 (Nov. 2, 2020) |
| Advisers Act | the U.S. Investment Advisers Act of 1940, as amended |
| AUM | assets under management |
| board | a board of directors for an entity established as a corporation or, with respect to other types of entities, the body performing similar functions |
| CCO | chief compliance officer |
| derivatives transaction | for purposes of this Guide, as defined in "What is an in scope 'derivatives transaction' for purposes of these requirements?" in the Introduction |
| director | any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust |
| DRM | the derivatives risk manager, as discussed in chapter 4 |
| ETF | an exchange-traded fund as defined in Rule 6c-11(a) under the Investment Company Act |
| fund | for purposes of this Guide, as defined in "What is a 'fund' for purposes of these requirements?" in the introduction |
| Investment Company Act | the U.S. Investment Company Act of 1940, as amended |
| Liquidity Risk Management Program | the liquidity risk management program registered investment companies are required to establish pursuant to the Liquidity Rule |
| Liquidity Rule | Rule 22e-4 under the Investment Company Act |
| money market fund | an open-end fund regulated under Rule 2a-7 under the Investment Company Act |
| prospectus | a prospectus as defined in the U.S. Securities Act of 1933 |
| SEC | U.S. Securities and Exchange Commission |
| senior security | as defined in Section 18(g) of the Investment Company Act, but in relevant part for the purposes of this Guide, it includes "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness" |

# INTRODUCTION

Under Section 18 of the Investment Company Act, registered investment companies are subject to limits on their use of leverage and their ability to incur obligations through the issuance of "senior securities". For purposes of the discussion in this Guide, the definition of "senior security" in Section 18(g) of the Investment Company Act includes "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." This definition is generally interpreted to include the types of derivatives transactions and other transactions discussed throughout this Guide.

Section 18 prohibits open-end funds from issuing or selling any "senior security," other than borrowing from a bank subject to a requirement to maintain 300% "asset coverage", and it prohibits closed-end funds from issuing or selling any "senior security [that] represents an indebtedness" unless it maintains at least 300% "asset coverage".

Section 61 of Investment Company Act extends the requirements of Section 18 for closed-end funds to business development companies, although the relevant asset coverage threshold is 200% rather than 300% and that amount can be decreased in certain circumstances. Section 18(h) defines "asset coverage" for these purposes as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer."

Historically, compliance with these requirements has required investment companies to wade through a variety of guidance published by the SEC, staff no-action letters and disclosure practice notes to ascertain the bounds of use for various specific derivatives instruments and practices. The SEC has adopted reforms that provide an updated, comprehensive approach to the use of derivatives (and certain other types of instruments) by investment companies.

Principal among these reformed requirements is a new Rule 18f-4 which permits a "fund" to enter into:

- certain in-scope "derivatives transactions";
- unfunded commitment agreements; and/or
- when-issued, forward-settling and non-standard settlement cycle securities transactions,

notwithstanding prohibitions and restrictions on the issuance of senior securities under Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the Investment Company Act, provided the fund complies with the rule's conditions.[1] Transactions entered into by investment companies in compliance with Rule 18f-4 will not be considered for purposes of computing the relevant asset coverage under Section 18(h) of the Investment Company Act.

The SEC has rescinded previous guidance under Release 10666 effective August 19, 2022. The SEC staff is reviewing other related staff guidance and no-action letters and is expected to announce that additional existing guidance and no-action letters will be rescinded as of that date as well.

**What is a "fund" for purposes of these requirements?**

For purposes of the reformed requirements (and for purposes of the discussion in this paper), the term "fund" encompasses mutual funds, ETFs, registered closed-end funds and business development companies, including any separate series thereof, but does not include any money

1 Before a fund can make any of these types of investments, however, appropriate disclosures will need to be made (e.g., in the fund's prospectus and/or statement of additional information and the investment adviser's Form ADV).

markets funds regulated under Rule 2a-7 under the Investment Company Act. Despite being carved out from the definition of "fund" for purposes of Rule 18f-4, money market funds are subject to some aspects of Rule 18f-4 that will nevertheless apply, as indicated specifically in the relevant places below.

**What is an in-scope "derivatives transaction" for purposes of these requirements?**

For purposes of the reformed requirements (and for purposes of the discussion in this paper), the term "derivatives transaction" includes:

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.

**When is compliance required and can funds choose to come into compliance early?**

The reformed senior security related requirements apply to all in-scope funds from August 19, 2022. Early compliance is permitted provided the fund complies with all the relevant requirements. Selective early compliance is not permitted.

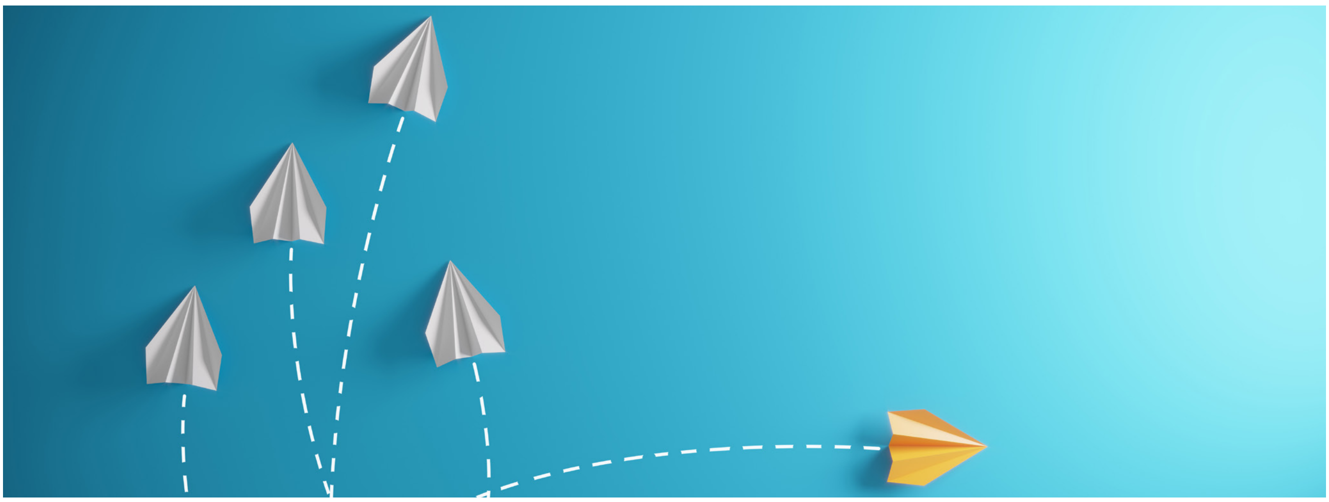
# 1. Determining whether Rule 18f-4 applies

There are a series of threshold questions that should be asked (in order) to determine if the Rule 18f-4 requirements apply.

## (a) Is the entity an investment company?

If the entity is a registered investment company or a business development company, some portion of Rule 18f-4 may apply so the next threshold question should be considered.

If the entity would be an investment company but for an exclusion under Section 3(c) of the Investment Company Act (e.g., private funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act), Rule 18f-4 will not apply and none of the requirements discussed in this paper will apply.



## (b) Is the investment company a money market fund that is permitted to invest in securities on a when-issued basis or forward-settling basis or with a non-standard settlement cycle?

If yes, skip straight to chapter 5.H, as this is the only portion of the paper that will apply.

If the investment company is a money market fund but is prohibited from investing in securities on a when-issued basis (i.e., a contract or the purchase and sale of a new security before the security has been issued) or forward-settling basis[2] or with a non-standard settlement cycle, none of the provisions discussed in this paper will apply. Although no further action is required by Rule 18f-4 in this case, the money market fund's board should record in the board meeting minutes that it considered whether the rule applied and the basis on which the board concluded that the rule did not apply for good order and to assure compliance under the fund compliance program rule (Rule 38a-1 under the Investment Company Act).

If the investment company is not a money market fund, some portion of Rule 18f-4 may still apply, so the next threshold question should be considered.

## (c) Is the investment company an ETF?

If the investment company is not an ETF, the next threshold question should be considered.

Rule 18f-4 does not apply to ETFs that are unit investment trusts ("UITs"); UITs do not actively trade their investment portfolios and generally do not use derivatives.

If the investment company is an ETF but is not a UIT, some portion of Rule 18f-4 may still apply, so the next threshold question should also be considered.

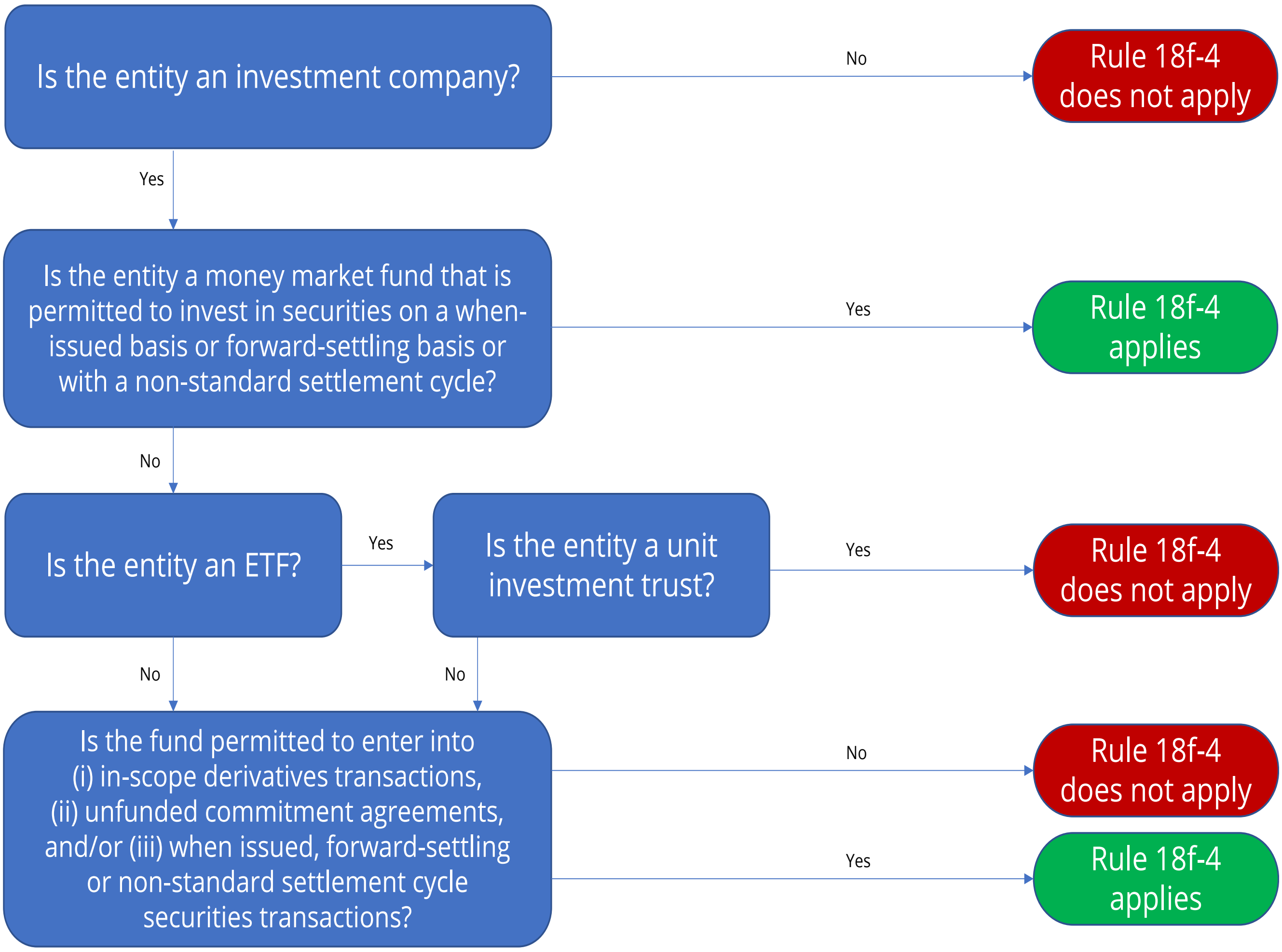
## (d) Is the fund permitted to enter into (i) in-scope derivatives transactions (as defined above), (ii) unfunded commitment agreements, and/or (iii) when-issued, forward-settling or non-standard settlement cycle securities transactions?

If the fund is not permitted to enter into any of these types of transactions, Rule 18f-4 will not apply. Although in that instance no further action is required by Rule 18f-4, the fund board should record in the board meeting minutes that it considered whether the rule applied and the basis on which the board concluded that the rule did not apply for good order and to assure compliance under the fund compliance program rule (Rule 38a-1 under the Investment Company Act).

If the fund is permitted to enter into derivatives transactions, continue to chapter 2.

If the fund is not permitted to enter into derivatives transactions but is permitted to enter into (i) unfunded commitment agreements and/or (ii) when-issued, forward-settling or non-standard settlement cycle securities transactions, continue to chapter 5.G and/or chapter 5.H, as applicable, as these will be the only parts of this paper that will apply. Skip chapters 2 – 5.F.

2 Investing in a security on a forward-settling basis involves the parties becoming contractually bound to sell and buy the relevant security on the date they agree to the forward transaction ("trade date"), but not settle the trade until a specified date ("settlement date") later than the ordinary spot delivery date.




# 2. Limited derivatives users

The investment adviser should consider whether the fund qualifies as a "limited derivatives user".

If the fund qualifies as a "limited derivatives user", the fund should complete requirements described in this chapter and skip the rest of the paper. If the fund does not qualify as a "limited derivatives user", the investment adviser should skip the rest of this chapter and pick up again at chapter 3.

**What is the test for whether a fund is a "limited derivatives user"?**

A fund will qualify as a "limited derivatives user" if its derivatives exposure does not exceed 10% of the fund's net assets (the "10% test limit").

When calculating the fund's derivatives exposure for purposes of the 10% test limit, the fund may exclude currency or interest rate derivatives that hedge currency or interest rate risks associated with (i) one or more specific equity or fixed-income investments held by the fund (which must be foreign currency-denominated in the case of currency derivatives) or (ii) the fund's borrowings, provided that:

1. the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes; and

2. the notional amounts of such derivatives do not exceed by more than 10% the value of the hedged investments (or the par value thereof, in the case of fixed-income investments) or the principal amount of the borrowing.

When making this calculation, the currency or interest rate derivatives to be excluded as hedging positions need to be paired with a specific equity or fixed-income investment or a specific borrowing. This is likely to be something that will be examined in routine SEC exams so the fund's recordkeeping around compliance with the 10% test limit should include details of the specific matching.

The exclusions in the 10% test limit are presumably only from the derivatives exposure calculation and not from the calculation of the fund's net assets for this purpose, although the Adopting Release does not address this.

**What is a fund's "derivatives exposure"?**

A fund's derivatives exposure is calculated as the sum of:

1. the gross notional amounts (i.e., the sum of the absolute values of the notional amounts) of the fund's transactions in any 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. For purposes of this calculation, the fund may:

    a. convert the notional amount of interest rate derivatives to 10-year bond equivalents;

    b. delta adjust the notional amounts of options contracts (i.e., by multiplying the option's unadjusted notional amount by the option's delta); and

    c. exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund;

2. in the case of short sale borrowings, the value of the assets sold short; and

3. if the fund's derivatives transactions include reverse repurchase agreements or similar financing transactions (see chapter 5.F), for each transaction, the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction.

**What is the benefit of being a limited derivatives user?**

If a fund is a "limited derivatives user", the fund is not required to:

1. adopt the type of derivatives risk management program otherwise required by the rule (see chapters 3–7 below);

2. comply with the limits on fund leverage risk (e.g., the VaR limits discussed at chapter 5.B below); or

3. comply with the board oversight and reporting requirements (as discussed at chapter 8 below).

**Is the limited derivatives user 10% test a one-off test or does it apply continuously?**

A fund that is self-designated as a limited derivatives user will have to monitor itself on a continuous basis (i.e., considering the effect of each trade on compliance with the limit).

**What is the consequence of the fund exceeding the 10% test limit?**

According to Rule 18f-4(c)(4)(ii), if the fund exceeds the 10% test limit, the fund must try to come back into compliance with the 10% test limit within five business days of exceeding the 10% test limit. If the fund is not back in compliance with the 10% test limit within that time, the fund's investment adviser must provide a written report to the fund's board informing it whether the investment adviser intends either:

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

B. for the fund to (i) establish a derivatives risk management program (including appointment of a derivatives risk manager ("DRM")) (see chapters 3-7), (ii) comply with the limit on fund leverage risk (see chapter 5.B), and (iii) comply with the board oversight and reporting requirements (see chapter 8), as soon as reasonably practicable.

In addition, if the fund's derivatives exposure exceeds the 10% test limit for longer than the five-business day grace period, the fund's next filing on form N-PORT must specify the number of business days in excess of the five-business day grace period that the fund's derivatives exposure exceeded 10% of its net assets during the applicable reporting period. This is regardless of whether the investment adviser is intending to reduce the fund's derivatives exposure or proceed with the adoption of a derivatives risk management program. If the continuing exceedance straddles two or more Form N-PORT reporting periods, the further days of exceedance would be included as applicable in the later Form N-PORT filings. While information provided in response to this new Form N-PORT reporting item will be available to the SEC for regulatory compliance verification purposes, the information will not be made public.[3]

**Would it be a problem if the fund were to exceed the 10% test limit more than occasionally?**

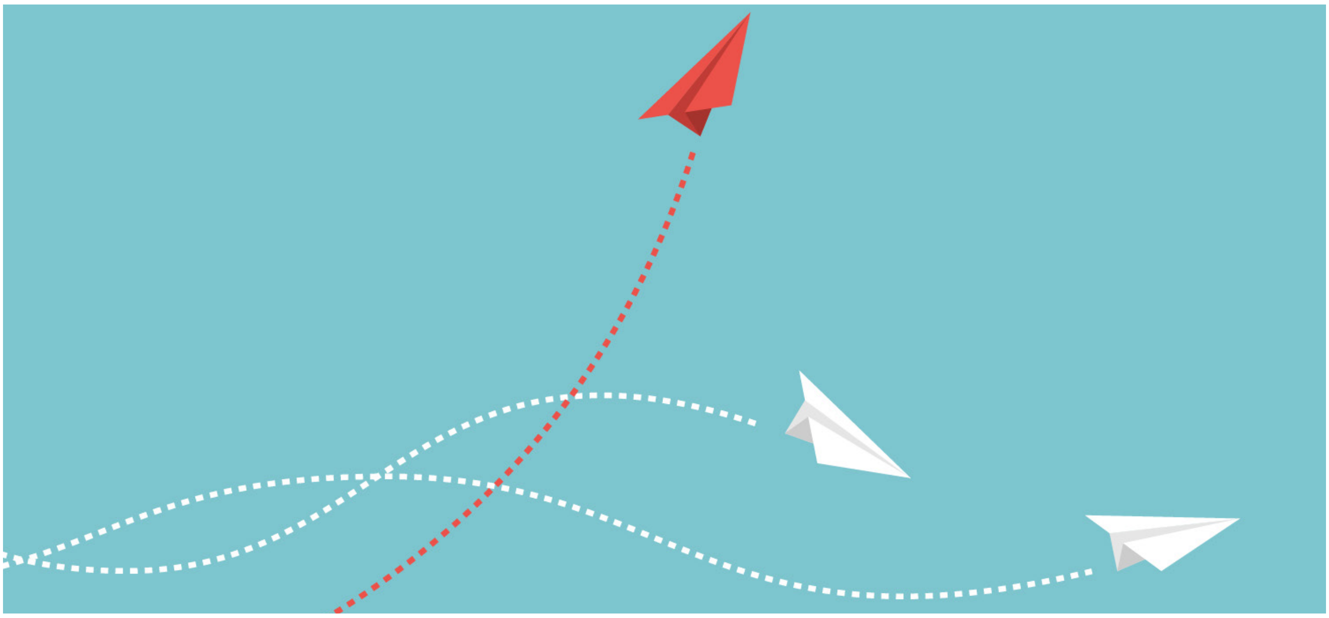
Potentially, yes. According to the Adopting Release, "if a fund were to exceed the 10% threshold repeatedly, and particularly if those exceedances occurred over a long period of time and did not occur in connection with extreme market events that may cause rapid and significant changes in a fund's net asset value, the fund would not appear to be using derivatives in a limited manner."[4]

**How long after the five-business day grace period does the investment adviser have to prepare and deliver the required written report to the fund's board?**

The Adopting Release does not specify how long the investment adviser has to get the written report to the board. However, the investment adviser should seek to deliver this report as promptly as possible and in all events before the end of the 30-calendar day cure period, assuming this is the compliance remediation approach that has been selected. If the fund's written policies and procedures specify a deadline and/or process for the delivery of the required report, the investment adviser should follow those.

3 Adopting Release at footnote 552.

4 Adopting Release at footnote 561.



**What happens if the fund is not back within the 10% test limit within the 30-calendar day cure period despite the investment adviser's choice of that option?**

In this instance, the fund should be transitioning from being a limited derivatives user to full compliance with the other requirements of Rule 18f-4(c) as soon as reasonably practicable. The Adopting Release does note, however, that "[a fund] transitioning from a limited derivatives user to full compliance with the rule's other requirements may be able to reduce its exposure below the 10% threshold. If the fund were able to resume operating below the 10% threshold as a limited derivatives user, the fund could do so rather than finalizing the fund's derivatives risk management program and complying with the rule's VaR test (see chapter 5.B). As noted above, however, if a fund were to exceed the 10% threshold repeatedly, and particularly if those exceedances occurred over a long period of time and did not occur in connection with extreme market events that may cause rapid and significant changes in a fund's net asset value, the fund would not appear to be using derivatives in a limited manner."[5]

**If the investment adviser's written report chooses the option for establishing a derivatives risk management program, etc., what does "as soon as reasonably practicable" mean in practice?**

The Adopting Release does not specify what this means but notes that "there are practical considerations that would prevent a fund that is no longer a limited derivatives user from coming into immediate compliance with the VaR and program requirements. ... We recognize that some funds may be able to comply with the VaR and program requirements relatively quickly. Their ability to comply quickly would vary based on a variety of factors, including the complexity of a fund's derivatives use. Other funds may require additional time."[6] As a result, what is "as soon as reasonably practicable" will depend on the facts and circumstances and funds and their DRMs may be called upon to justify how long it takes to establish a derivatives risk management program.

**How can the fund's status as a limited derivatives user be established?**

Although a fund designated as a limited derivatives user is not subject to many of the requirements applicable to other funds under Rule 18f-4, there are still some requirements that do apply, as well

5 Id.

6 Adopting Release at page 172.

as some practical actions to be taken by the fund's board to establish the fund's designation as a limited derivatives user.

Once the investment adviser has determined that the fund is (and is likely to continue to be) a limited derivatives user, the investment adviser should prepare materials to present to the fund board in advance of the meeting at which the board will consider the designation of the fund as a limited derivatives user. Those materials should:

1. explain the basis on which the investment adviser believes the fund qualifies as a limited derivative user and provide the results of the 10% test limit calculated as of a recent date (demonstrating the work);
2. indicate whether the investment adviser intends to monitor this limit at 10% or at a designated internal limit to minimize the potential that the fund would exceed the 10% test limit for any reason;
3. explain the consequences for the fund of failing to meet the 10% test limit at any point for any reason and the remediation required by Rule 18f-4(c)(4)(ii) (i.e., reduce its derivatives exposure promptly or establish a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable); and
4. include a draft of written policies and procedures reasonably designed to manage the fund's "derivatives risks", as well as a policy and procedure designed to ensure the 10% test limit is continuously monitored and the required remediation measures are taken in a timely manner. To be reasonably designed to achieve compliance, the fund's compliance policies and procedures should be designed to prevent repeated exceedances.

As a limited derivatives user, the fund is required to maintain, in an easily accessible place, copies of the fund's mandatory written policies and procedures that are in effect, or at any time within the past five years were in effect, along with copies of any written reports provided to the board.

Limited derivatives users are also required to report certain additional information on their regular Form N-PORT filings including:

- the aggregate derivatives exposure;
- the exposure from currency and interest rate derivatives that hedge related risks; and
- the number of business days (in excess of the five-business-day remediation period), if any, the fund's derivatives exposure exceeded 10% of its net assets.

Limited derivatives users are also required to report their use of the exception in a filing on Form N-CEN.

**What types of risks are the limited derivatives user's written policies and procedures required to be reasonably designed to manage?**

If the fund is intending to be treated as a limited derivatives user, the fund must adopt written policies and procedures to manage the risks associated with a fund's derivatives transactions or its use of derivatives transactions, including leverage, market, counterparty, liquidity, operational and legal risks and any other risks the fund's investment adviser deems material. These policies and procedures should be "tailored to the extent and nature of the fund's derivatives use".[7]

7 Adopting Release at page 167.

**Can the policies and procedures for managing a limited derivatives user's derivatives risks be established (and periodically amended) by the investment adviser?**

No. While the required policies and procedures have to be reasonably designed to manage "any other risks the fund's investment adviser deems material" and thus the investment adviser will have to provide input into the policies and procedure, Rule 18f-4(c)(4)(i)(A) specifies that these policies and procedures must be adopted by the fund. The investment adviser and/or the fund's CCO should provide the board with a draft of the policies and procedures and explain how the policies and procedures are reasonably designed to manage the fund's "derivatives risks," as well as to comply with the applicable requirements of Rule 18f-4. If the fund's board chooses to adopt the investment adviser's derivatives risk management policies and procedures as policies and procedures for the fund, care should be taken to assure that the investment adviser's policies and procedures will appropriately manage the fund's derivatives risks and the board continues to be apprised of any material changes to the policies and procedures.

**Will the policies and procedures required by Rule 18f-4(c)(4)(i)(A) need to be considered as part of the reviews required by the fund compliance program rule (Rule 38a-1)?**

Yes. Rule 38a-1 encompasses a fund's compliance obligations with respect to Rule 18f-4. As a result, any policies and procedures in place to comply with Rule 38a-1 will also need to be followed.

**What does the board need to do to establish the fund's status as a limited derivatives user?**

For its part, the fund's board should

1. understand the basis upon which the investment adviser has determined that the fund should be designated as a "limited derivatives user" for purposes of Rule 18f-4;
2. review the fund's written policies and procedures reasonably designed to manage the fund's derivatives risk, including a policy and procedure designed to ensure the 10% test limit (as set out in Rule 18f-4(c)(4)(i)(B)) is continuously monitored and the required remediation measures (as set out in Rule 18f-4(c)(4)(ii)) are taken in a timely manner;
3. instruct the investment adviser to manage the fund in a manner intended to comply on an ongoing basis with the 10% test limit (as set out in Rule 18f-4(c)(4)(i)(B)); and
4. document these actions in the board meeting minutes.

These steps are in addition to the actions the board would normally take to adopt any new policies and procedures in compliance with Rule 38a-1.

**Practical considerations**

- The risk management policies and procedures of a fund relying on the "limited derivatives user" exception should be tailored to the extent and nature of the fund's derivatives use. These policies and procedures do not need to contain all of the elements of a derivatives risk management program.
- The SEC declined to provide prescriptive guidance on these policies and procedures. Therefore, Rule 18f-4's tailored-to-fit requirement will likely mean that a fund using more complex derivatives transactions approaching the 10% threshold will need more extensive policies and procedures than a fund with irregular derivatives usage.

# 3. Risk identification and assessment

If the investment adviser has determined that Rule 18f-4 applies because the fund engages in derivatives transactions in-scope of the rule and has determined that the fund does not qualify as a limited derivatives user, the investment adviser should start developing the derivatives risk management program required by Rule 18f-4(c)(1).

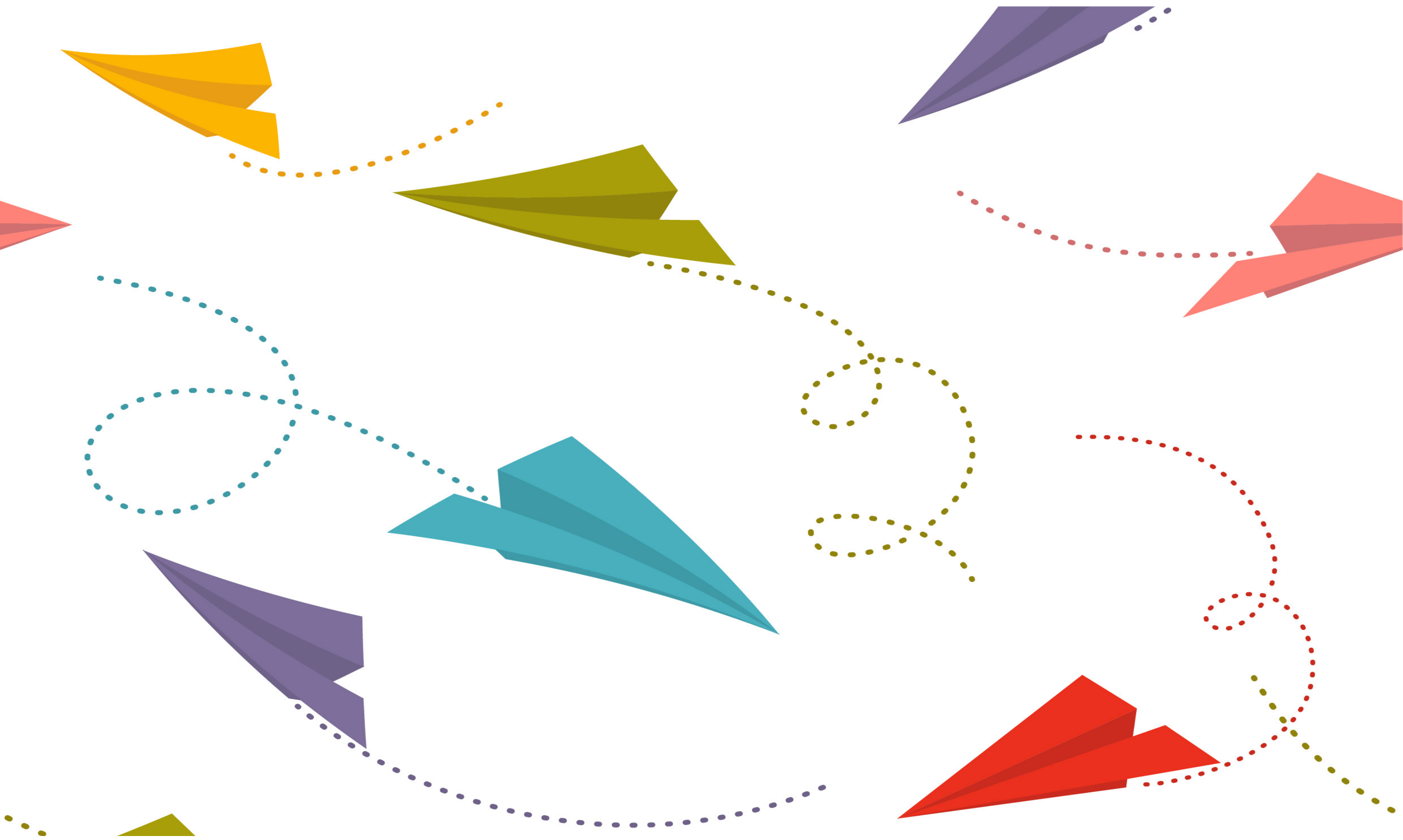
The investment adviser must identify and assess the fund's derivatives risks, taking into account "how a fund's derivatives may interact with the fund's other investments or whether the fund's derivatives have the effect of helping the fund manage risks".[8] Rule 18f-4 requires an assessment of the following types of derivatives risks in the context of the fund's derivatives transactions:

- **Leverage risk:** the risk that derivatives transactions can magnify the fund's gains and losses;
- **Market risk:** the 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 (including any leveraged exposures);
- **Counterparty risk:** the risk that a counterparty on a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty;
- **Liquidity risk:** the risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties;
- **Operational risk:** the risk related to potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls and human error;
- **Legal risk:** the risk of insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract; and
- **Other risks:** any risks that the fund's DRM deems material, which could include idiosyncratic risks, risks that complex OTC derivatives could fail to produce the expected result or pose a political risk, etc.

**Are there any factors the investment adviser should consider regarding the timing of the nomination of the DRM?**

The inclusion of "any other risks the fund's DRM deems material" in the definition of "derivatives risks" creates a sort of "chicken or egg" problem. In this instance, logic suggests (although the Adopting Release does not specify) that the investment adviser should identify and assess the risks associated with a fund's derivatives transactions or its use of derivatives transactions, including leverage, market, counterparty, liquidity, operational and legal risks, including any such risks unique to the fund, before nominating the DRM. The board would then need to consider the nomination and appoint a DRM before the derivatives risk management program is fully developed as the appointed DRM will need to assess whether any other risks are material and will, therefore, need to be included in the derivatives risk management program. This suggests as well that the nomination of the DRM should not be done at the same meeting at which the required report of the DRM on the derivatives risk management program is delivered (see chapter 7). This paper proceeds with the next several chapters covering the appointment of the DRM and returns to the development of the derivatives risk management program at chapter 5.

8 Adopting Release at page 59 text at footnote 170.



# 4. The derivatives risk manager

A key part of the required derivatives risk management program is the derivatives risk manager or DRM. The responsibilities and roles of the DRM are prescribed and should be considered when selecting a DRM. The DRM will be an employee or group of employees of the investment adviser but must have a direct reporting line to the fund's board.

## Identify a nominee to serve as DRM

The investment adviser should identify the person or persons that the investment adviser (or sub-adviser) would like the fund's board to consider for designation as the fund's DRM.

**What are the responsibilities of a DRM?**

The DRM is responsible for:

1. *administering the fund's derivatives risk management program under Rule 18f-4 and the related required policies and procedures* (as described further in chapter 5 below). However, this does not mean that the DRM needs to carry out all the activities associated with the fund's derivatives risk management program. Other employees of the investment adviser (or sub-adviser) can assist with the required activities, subject to appropriate oversight. The DRM can seek (and reasonably rely on) inputs and information from third parties (including a sub-adviser to the fund) to inform risk management (e.g., risk identification, risk assessment and monitoring the program's risk guidelines); and
2. *reporting to the fund board*.

### How do the responsibilities of a DRM differ from those of a fund's CCO?

While many fund complexes are expected to choose the fund's CCO to serve as the DRM, Rule 18f-4 does not mandate this outcome. As a result, if a fund chooses to nominate a DRM who is not also the fund's CCO, the CCO must ensure it can fulfill its responsibilities for administering the fund's policies and procedures approved by the board, while permitting the DRM to oversee the fund's responsibilities under Rule 18f-4. Unfortunately, as of the date of this Guide, the SEC has not provided any express guidance on best practice for this issue.

### What are the required qualifications for a DRM?

To be eligible to be appointed as a DRM, the identified person must:

1. be a natural person or a group of natural persons;
2. be able to carry out their responsibilities under Rule 18f-4, including administering the derivatives risk management program and policies and procedures and the required reporting to the fund board, and have "sufficient authority within the investment adviser [(sub-adviser)] to carry out these responsibilities";
3. be an officer (see below) or group of officers of the fund's investment adviser (or sub-adviser), although a sub-adviser officer can only be designated as a solo DRM if the sub-adviser manages the fund's entire portfolio and not just a portion of the fund's assets;
4. not be a portfolio manager of the fund for which the person is serving as DRM. However, if there is to be only one DRM, that person can be a portfolio manager of another fund that is not the fund for which the person is designated a DRM. If there are to be multiple DRMs designated, one or more portfolio managers can be designated as DRMs so long as portfolio managers do not make up a majority of the total number of DRMs designated with respect to the fund and none is a portfolio manager for the fund with respect to which they are designated as DRM;
5. have relevant experience (see below) regarding the management of derivative risk; and
6. not be a third party not affiliated with the investment adviser (or sub-adviser).

The purpose of these qualification requirements is to "promote independence and objectivity"[9] in the role of the DRM.

### Why can the DRM not be a portfolio manager?

According to the Adopting Release, the functions of the derivatives risk management program must be segregated from the fund's portfolio management "to promote objective and independent identification, assessment, and management of the risks associated with derivatives use. Accordingly, this element of the [DRM] requirement is designed to enhance the independence of the [DRM] and other risk management personnel and, therefore, to enhance the program's effectiveness."[10] Separation of the derivatives risk management functions from portfolio management functions:

- is meant to create checks and balances;
- can be established via independent reporting chains, oversight arrangements and/or separate monitoring systems and personnel; and

9 Adopting Release at first full paragraph of page 52.

10 See Adopting Release at page 54.

- does not require a communications "firewall" – a portfolio manager can provide "important perspective and insight regarding the fund's use of derivatives".[11]

**Can multiple individuals share the role of DRM?**

Yes. Multiple people can be designated as the fund's DRM, but they all must meet the required qualifications individually.

**Who is an "officer" for this purpose?**

An "officer" is a person designated as an officer (e.g., president, vice president) in the investment adviser's (or sub-adviser's) corporate bylaws (or similar organizational documents if the firm has not been established in corporate form).

**Would a person not designated as an "officer" ever qualify to serve as a DRM?**

In the Adopting Release, the SEC notes that, in the absence of person being designated as an "officer", a person with "a comparable degree of seniority and authority within the organization" could be "treated as an officer" for purposes of Rule 18f-4 and serve as the DRM if the person otherwise meets the qualifications for being a DRM.[12]

**What would be considered "relevant experience"?**

The types of derivatives risk experience that may be considered relevant will vary depending on the derivatives risks unique to the fund. The Adopting Release does not identify a specific amount or type of derivatives risk experience that is necessary. As a result, the investment adviser (sub-adviser) should:

1. identify and assess the fund's overall derivatives risks as well as the derivatives risks unique to the fund; and
2. identify what it thinks are the relevant types of experience for a DRM based on the fund's derivatives risks, including the derivatives risks unique to the fund.

**What if employees other than the "officers" of the investment adviser have the most relevant derivatives risk management expertise at the investment adviser?**

The DRM is required to be an officer (or comparable, as discussed above). Employees that are not officers cannot be designated as the DRM. The Adopting Release acknowledges that such employees may have "relevant derivatives risk management experience that would be helpful to the [DRM]" and concedes that such employees may "provide support" to the DRM and may "carry out derivatives risk management activities" (see chapter 5 below).

**Does the person(s) designated as DRM face a greater potential for liability if the fund suffers losses?**

No. According to the Adopting Release, "[t]he final rule … does not change the standards that apply in determining whether a person is liable for aiding or abetting or causing a violation of the federal securities laws. [The SEC recognizes] that risk management necessarily involves judgment. That a fund suffers losses does not, itself, mean that a fund's derivatives risk manager acted inappropriately."[13]

11 See Adopting Release at page 55.

12 See Adopting Release at page 50 text near footnote 137.

13 Adopting Release at page 53 text following footnote 146.

**Practical considerations**

- Investment advisers may consider designating the same individual(s) to be the DRM and the administrator of their Liquidity Risk Management Program.
  - While there are some overlapping responsibilities between the two roles, such as providing periodic reports to the board, investment advisers must ensure the DRM has the resources and capacity to fulfill its obligations to manage the derivatives risk management program. Notably, Rule 18f-4 does not permit the fund's investment adviser to serve as the DRM—the board must designate one or more natural persons for this role. By contrast, the Liquidity Rule permits a board to designate the fund's investment adviser as the liquidity program administrator.

## Nominate the fund's DRM

Once a DRM nominee has been identified, the investment adviser (or sub-adviser where relevant) should prepare materials to present to the fund board in advance of the meeting at which the board will consider the designation of the DRM. [14] Those materials should:

1. identify and explain what the investment adviser (sub-adviser) believes are the fund's derivative risks, including the derivatives risks unique to the fund;
2. identify each DRM nominee and their current role with the investment manager (sub-adviser) and their past experience;
3. explain the criteria used to identify the DRM candidate(s) and how the experience of the person(s) proposed is relevant to managing the derivatives risks unique to the fund; and
4. confirm that each DRM nominee meets the qualification requirements (see above).

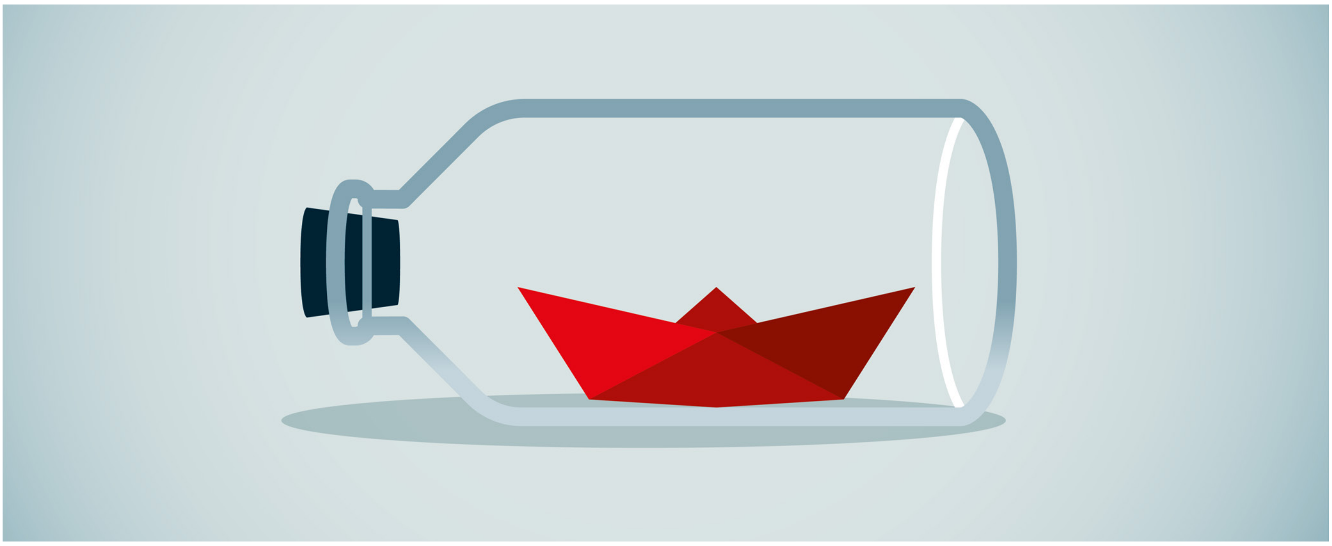
## Board designation of the fund's DRM

The fund's board, including a majority of directors who are not interested persons of the fund, must designate one or more natural persons to be the fund's DRM after assessing their relevant experience (see above) and whether they meet the other eligibility requirements under Rule 18f-4 (see above).

The board should consider the information offered by the investment adviser (sub-adviser) with respect to the derivatives risks unique to the fund and what would constitute relevant experience in light of those risks (see chapter 2) and then make its own determination about whether the proposed DRM has the necessary relevant experience and meets the other eligibility requirements. A discussion of the factors considered, as well as the board's conclusions, should be recorded as a part of the minutes of the meeting.

As part of the resolution designating the DRM, a direct reporting line from the designated DRM to the fund board should be established and management of any related conflicts of interest needs to be considered.

14 The SEC notes that it anticipates that "boards generally would request that the adviser carry out due diligence on appropriate candidates and articulate the qualifications of the candidate(s) that the adviser puts forward to the board. The adviser to the fund could, for example, nominate potential candidates, review résumés, conduct initial interviews, and articulate the adviser's view of the candidate." Adopting Release at page 79.



# 5. The derivatives risk management program

Once the DRM is in place, the rest of the derivatives risk management program and the related policies and procedures should be assembled.

## A. Risk guidelines

Once the fund's derivatives risks have been identified and assessed (see chapter 3), a series of investment, risk management or related guidelines for the management of those risks needs to be established. The guidelines need to set out specific "quantitative or otherwise measurable criteria, metrics, or thresholds" that the fund does not normally expect to exceed. The fund's derivatives transactions will need to be managed to those limits and the fund's compliance with those criteria, metrics and thresholds will need to be routinely monitored. The written policies and procedures should:

- set out the relevant criteria, metrics and thresholds to be used;
- specify how each criterion, metric or threshold is to be measured and when and how each is to be monitored; and
- provide what measures should be taken if the criterion, metric or threshold is exceeded.

Rule 18f-4 sets out some specific guidelines that must be included and met, namely leverage limits (see chapter 5.B), stress testing (see chapter 5.C) and backtesting (see chapter 5.D). Although these limits and requirements have been specified, the requirement for the fund to establish its own risk guidelines as part of the development of the derivatives risk management program is meant to be read more broadly. The SEC staff will expect the fund's policies and procedures to include additional quantitative or otherwise measurable criteria, metrics or thresholds to complement these required elements rather than duplicating them.

The specific criteria/metrics/thresholds set should be:

- tailored to the fund;
- appropriate and pertinent to the fund's investment portfolio;

- consistent with the fund's risk disclosure; and
- designed to monitor the relevant risk and permit the DRM to measure changes in that risk regularly so that timely action can be taken to manage the risk.

The guidelines also need to set out what the response should be when the metric has been exceeded and provide "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".[15]

Some derivatives risks may not be readily quantifiable or measurable. However, these risks do still need to be covered in the guidelines. In these circumstances, the investment adviser could consider other practices to manage these risks which could still be considered to be consistent with the fund's general obligation to adopt written policies and procedures reasonably designed to manage the fund's derivatives risks.

Although neither Rule 18f-4 nor the Adopting Release specify criteria/metrics/thresholds, the Adopting Release provides a few examples an investment adviser could consider, including:

- providing information about the fund's portfolio risks in current market conditions, as opposed to the fund's stress testing, which would evaluate the effects of stressed conditions;
- creating corresponding investment size controls;
- implementing review and approval procedures for derivatives contracts;
- developing lists of approved transactions across the fund;
- creating an approved list of specific derivatives instruments or strategies that can be used;
- creating a list of persons authorized to engage in the transactions on behalf of the fund; and
- providing new instruments (or instruments newly used by the fund) additional scrutiny.[16]

**Practical considerations**

- When developing a derivatives risk management program, the DRM should consider how funds categorize the liquidity of each portfolio holding to satisfy its Liquidity Rule obligations and incorporate or differentiate these assumptions into their quantitative models.
    - For example, if an investment adviser designates a certain derivatives transaction to be a "moderately liquid investment" for Liquidity Risk Management Program purposes, it should consider incorporating this data into its risk guidelines or justify the apparent discrepancies.
- DRMs should consider tying certain aspects of the risk identification and assessment element (see chapter 3) to this risk guidelines element.
    - For example, the development of quantitative models for measuring counterparty risk would satisfy both elements, and it may also facilitate policies and procedures that allow for more streamlined onboarding and account opening processes by actively monitoring select counterparties for expedited credit approvals.

15 Adopting Release at page 62 text at footnote 188.

16 Adopting Release at pages 62-63.

# B. Leverage risk limits

One of the quantitative metrics that must be applied is a once every business day measurement of the fund's value at risk ("VaR") based on one of two testing methods: (i) the relative VaR test, or (ii) where applicable, the absolute VaR test. The relative VaR test is the default requirement.

Depending on the circumstances, a 'leveraged/inverse fund' that was in operation as of October 28, 2020 may qualify for an exception to the VaR limits (the "leveraged/inverse fund exception").

**What is "VaR"?**

Value at risk, or VaR, is 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.

When used as a general risk management tool, VaR can be calculated various ways taking into account various factors and risks and measured over various time horizons with different levels of confidence. Rule 18f-4, though, places some constraints around the way VaR should be determined for purposes of compliance with the leverage risk limits to assure comparable calculations are being made.

**How should VaR be calculated?**

The VaR model used by a fund for purposes of determining the fund's compliance with the relative VaR test or the absolute VaR test must:

1. Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including the following non-exhaustive list of common market risk factors, as applicable:[17]

   (i) Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;

   (ii) Material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and

   (iii) The sensitivity of the market value of the fund's investments to changes in volatility;

2. Use a 99% confidence level and a time horizon of 20 trading days; and

3. Be based on at least three years of historical market data.

Although certain parameters are required by the rule, the VaR model can be based on:

**1.** **Historical simulation:** "Historical simulation models rely on past observed historical returns to estimate VaR. Historical VaR involves taking a fund's current portfolio, subjecting it to changes in the relevant market risk factors observed over a prior historical period, and constructing a distribution of hypothetical profits and losses. The resulting VaR is then determined by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution."[18]

**2.** **Monte Carlo simulation:** "Monte Carlo simulation uses a random number generator to produce a large number (often tens of thousands) of hypothetical changes in market values that simulate changes in market factors. These outputs are then used to construct a distribution of

17 Other market risk factors may also be relevant. Adopting Release at page 131.

18 Adopting Release at footnote 425.

hypothetical profits and losses on the fund's current portfolio, from which the resulting VaR is ascertained by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution."[19]

3. **Parametric methods:** "Parametric methods for calculating VaR rely on estimates of key parameters (such as the mean returns, standard deviations of returns, and correlations among the returns of the instruments in a fund's portfolio) to create a hypothetical statistical distribution of returns for a fund, and use statistical methods to calculate VaR at a given confidence level."[20]

The flexibility to use various VaR models is meant to permit the fund to use a VaR model appropriate to the fund's investments. The fund is not required to use the same VaR model for calculating its portfolio's VaR and the VaR of the designated reference portfolio, but it does have to use the specified model requirements in both instances.

**Can the fund use parameters other than a 99% confidence level and a time horizon of 20 days?**

Although these are the required parameters under the rule, the fund could choose to take into account additional observations for example by also measuring at a 95% confidence level and on shorter time horizons. However, the rule's parameters will nevertheless define the outer leverage limits.[21]

The Adopting Release explains that fund could choose to rescale the confidence interval from a 95% confidence level to a 99% confidence level. The Adopting Release notes that, "[u]nder this approach, a fund would first compute its VaR at a 95% confidence level, which will involve more observations because this approach looks to losses in 5% of the distribution rather than 1%. The fund would then use the statistical relationship of the normal distribution between the 99th percentile and the 95th percentile, using the ratio of their respective Z-scores, in calculating a fund's VaR consistent with the VaR model and parameters requirements under the rule."[22] The footnote accompanying this text goes on to explain that "[t]he Z-scores for these confidence levels are: (1) the value of the 99th percentile minus the population mean and (2) the value of the 95th percentile minus the population mean, both divided by the population standard deviation."[23]

Time-scaling is also permitted. The Adopting Release endorses the time-scaling technique discussed in the proposing release,[24] namely:

> "A VaR calculation based on a one-day time horizon can be scaled to a 20-day time horizon. For example, a common VaR model time-scaling technique is to multiply the one-day VaR by the square root of the designated time period (i.e., for the proposed rule it would be the square root of 20). But for funds with returns that are not identically and independently normally distributed, simple time-scaling techniques may be inaccurate. If this inaccuracy results in meaningful underestimation of VaR, this simple time-scaling technique would be inappropriate."[25]

19 Id.

20 Id.

21 See Adopting Release at page 134.

22 Adopting Release at page 133, text accompanying footnote 431.

23 Adopting Release at footnote 431.

24 See Adopting Release at page 134, text accompanying footnote 438.

25 "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", SEC Rel. No. IC-33704 (Nov. 25, 2019), at footnote 230.

The DRM could also choose to base the calculations on additional historical data.[26]

**Can the fund use other measures besides VaR as leverage risk metrics?**

Yes, but the relative VaR or absolute VaR test must be used regardless. The SEC encourages DRMs not to over-rely on VaR as a standalone risk management tool and states that the VaR tests should not be the sole component of the derivatives risk management program as it may not adequately address tail risks and does not capture risks like counterparty risk and liquidity risk. Funds could choose to measure stressed VaR or expected shortfall as well as part of their derivatives risk management programs for example. Stressed VaR refers to a VaR model that is calibrated to a period of market stress. Expected shortfall analysis is similar to VaR, but accounts for tail risk by taking the average of the potential losses beyond the specified confidence level.[27]

**How do the leverage requirements apply in a fund of funds context?**

According to the Adopting Release, “in general, an acquiring fund that does not use derivatives transactions would not be required to comply with the final rule or to look through to an underlying registered investment company or BDC’s use of derivatives transactions for purposes of determining the acquiring fund’s derivatives exposure. These underlying funds, themselves, will be subject to rule 18f-4 with respect to their investments in derivatives.“[28] If the fund of funds invests in derivatives transactions, the rule will apply with respect to such transactions and, if the fund of funds does not qualify as a limited derivatives user (see chapter 2), it will have to calculate its own VaR using the historic returns of the underlying funds rather than the fund of fund’s own historic return.[29]

**How do the leverage requirements apply in the context of controlled foreign corporations (“CFC“)?**

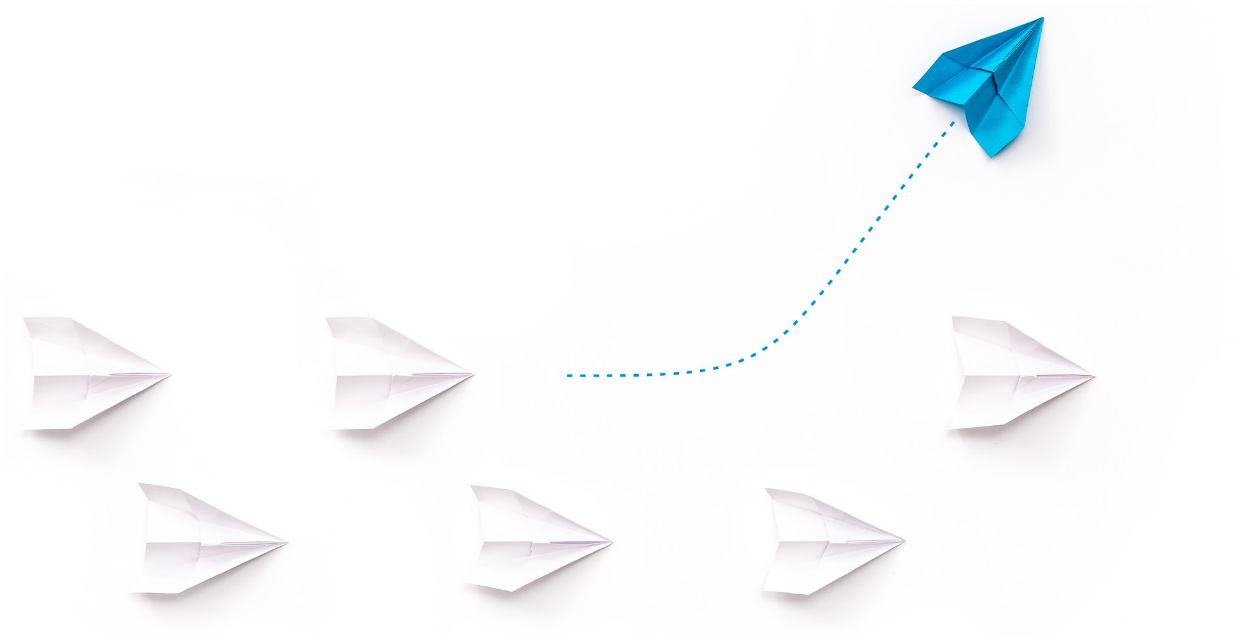
Where a fund enters into derivatives transactions via a CFC, the derivatives transactions are treated as direct investments of the fund for purposes of Section 18 and Rule 18f-4.

26 Adopting Release at page 136.

27 See Adopting Release at page 90-92.

28 Adopting Release at page 138.

29 See Adopting Release at page 138.



## (a) Determine if the fund qualifies for the leveraged/inverse fund exception

Some leveraged/inverse funds may qualify for a grandfathered exception to the leverage risk limits.

**What is a "leveraged/inverse fund"?**

A fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple ("leverage multiple"), or to provide investment returns that have an inverse relationship to the performance of a market index ("inverse multiple"), over a predetermined period of time is deemed to be a "leveraged/inverse fund" for purposes of Rule 18f-4.

**What requirements would a leveraged/inverse fund have to meet in order to qualify for the leveraged/inverse fund exception from the VaR limits?**

A leveraged/inverse fund that cannot comply with the VaR limits is not required to comply with either VaR limit if:

1. as of October 28, 2020, the fund:
    a. was in operation;
    b. had outstanding shares issued in one or more public offerings to investors; and
    c. disclosed in its prospectus a leverage multiple or inverse multiple that exceeds 200% of the performance or the inverse of the performance of the underlying index;
2. the fund does not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide; and
3. the fund discloses in its prospectus that it is not subject to the VaR limits on fund leverage risk.

This exception is only with respect to the VaR limits discussed in (b) and (c) below. The fund would still have to meet all of the other requirements of Rule 18f-4.

**What needs to be done if the fund is eligible and wants to use the leveraged/inverse fund exception?**

If the fund is potentially eligible, the DRM should determine whether all of the requirements for eligibility are met. The DRM should explain its rationale for concluding that the fund is eligible for the exclusion provided it amends its prospectus to include the required disclosure. The board's conclusions after considering the DRM's report should be recorded in the minutes.

Funds relying on the leveraged/inverse fund exception are also required to report their use of the exception in a filing on Form N-CEN.

**Practical considerations**

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

## (b) Operationalize the relative VaR test

Unless the fund qualifies for the leveraged/inverse fund exception (discussed in sub-part (a) above) or the limited circumstances under which an absolute VaR test can be used instead (as discussed in sub-part (c) below), the fund's written policies and procedures adopted as part of the derivatives risk management program must include the compliance testing and reporting procedures for the relative VaR test.

Under the relative VaR test, the VaR of the fund's portfolio cannot exceed 200% (or 250% in the case of closed-end funds with an outstanding class of senior security that is a stock) of the VaR of the *designated reference portfolio* approved by the DRM.[30]

**What is a designated reference portfolio?**

A fund's designated reference portfolio will form a baseline VaR, i.e., a representation of the VaR of a fund's unleveraged portfolio. To the extent a fund then enters into derivatives to leverage its portfolio, comparing the VaR of the fund to the VaR of the designated reference portfolio is meant to identify the leveraging effect of the derivatives.

A fund's designated reference portfolio can be either:

1. a *designated index*; or
2. the fund's *securities portfolio*.

However, if the fund's objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the designated reference portfolio can only be the index being tracked even if the index would otherwise be a prohibited index under Rule 18f-4.[31]

**What are the requirements for a "designated index"?**

To be permitted as a designated index, the index:

- must be unleveraged;[32]
- must reflect the markets or asset classes in which the fund invests; and
- cannot 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. For blended indexes, all of the indexes that compose the blended index have to meet this condition.

The designated index does not need to be the same as the "appropriate broad-based securities market index" or an "additional index" as defined in Item 27 of Form N-1A or Item 24 of Form N-2. However, the SEC does not want to see actively managed funds using an index or blending an index for use for the purpose of obtaining additional fund leverage risk.[33]

The DRM could discount using a particular index even if the index meets these requirements, such as in cases in which, "although an index is available that reflects the markets or asset classes in

30 Although the DRM is required to approve the designated reference portfolio, "other advisory personnel may recommend an index to the derivatives risk manager based on their market expertise and knowledge of the fund's investment strategy and seek the derivatives risk manager's approval." Adopting Release at footnote 331.

31 See Adopting Release at page 107-8.

32 According to the Adopting Release, "whether a particular index is 'leveraged' would depend on the economic characteristics of the index's constituents, and not just on whether some or all of the constituents are derivatives. An index would be leveraged if, for example, the derivatives included in the index multiply the returns of the index or index constituents…". Adopting Release at page 103.

33 See Adopting Release at pages 104-5.

which the fund invests, the funds' strategies do not involve the kind of risk that is associated with the market risk of the index".[34]

**What does "widely recognized and used" mean in this context?**

In this regard, the Adopting Release states that "[t]his "widely recognized and used" standard has historically been used to permit a fund to employ affiliated-administered indexes for disclosure purposes, when the use of such indexes otherwise would not be permitted" (citing to Instructions 5 and 6 to Item 27(b)(7)(ii) of Form N-1A and Instruction 4 to Item 24 of Form N-2 (discussing the terms "appropriate broad-based securities market index" and "additional index")).[35]

**How is the fund's "securities portfolio" defined for this purpose?**

For purpose of the relative VaR test, the DRM can choose to measure against the fund's securities portfolio instead of a designated index unless the fund's objective is to track an index. The fund's securities portfolio for this purpose is the fund's portfolio of securities and other investments, excluding any derivatives transactions, 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).

**How much diligence is a DRM expected to do when approving a potential designated reference portfolio?**

The DRM would make this determination after reasonable inquiry and analysis regarding the feasibility of applying the relative VaR test to a fund and the appropriate reference portfolio for that purpose.

**How should the VaR of the designated reference portfolio be calculated?**

A fund is not required to use the same VaR model for calculating its portfolio's VaR and the VaR of the designated reference portfolio, but it does have to use the specified model requirements in both instances.

The VaR of an index could be obtained from a third-party vendor provided the model requirements are met. The fund could also calculate the VaR of a designated index based on the index levels over time without having to obtain more-detailed information about the index constituents.[36]

Where the fund is using its securities portfolio as its designated reference portfolio, "[a] simpler VaR model may be appropriate to calculate the VaR of the fund's securities portfolio, and a comparatively more complex VaR model could be more appropriate for calculating the VaR of the fund's total portfolio that includes the fund's derivatives transactions."[37]

**When does the relative VaR need to be calculated?**

The DRM should calculate the VaR of the fund's portfolio and the VaR of the designated reference portfolio every business day. Although the SEC believes that funds will calculate their VaR at a consistent time every day, either in the mornings before markets open or in the evenings after markets close, the rule does not specify a specific time of day.[38]

34 Adopting Release at page 104.

35 Adopting Release at footnote 339.

36 See Adopting Release at pages 136-7.

37 Adopting Release at page 137.

38 See Adopting Release at page 140.

**What if there is not an appropriate designated reference portfolio?**

If the DRM reasonably determines that:

- there is no index that would provide an appropriate designated reference portfolio for purposes of the relative VaR test, taking into account the fund's investments, investment objectives and strategy; and
- the fund's securities portfolio would not provide an appropriate designated reference portfolio for purposes of the relative VaR test, taking into account the fund's investments, investment objectives and strategy,

the DRM may choose to apply the absolute VaR test instead. See sub-part (c) below.

The Adopting Release contains a few examples of where a DRM might determine that relative VaR is inappropriate.[39]

**Practical considerations**

- While Rule 18f-4 does not prescribe a specific VaR method, for the first time, funds will have a regulatory obligation to implement VaR testing.
- This requirement is not intended to replace testing performed by investment advisers that informs their portfolio management decisions; it is an additional and distinct requirement meant to replace the SEC's current piecemeal asset segregation approach to limiting leverage risk.
  - Many investment advisers currently use historical simulations, Monte Carlo simulations, and parametric models to test their derivatives exposure and related risks. The Adopting Release notes that these types of tests may continue to be relevant to assessing the risks of a fund's use of derivatives (particularly tail risks that may not be adequately addressed by VaR), but they would be considered an element of the fund's derivatives risk management program.
- The requirements for VaR testing are substantially similar to those of other regulatory regimes requiring VaR testing, including the European Securities Market Authority's (ESMA) requirements for Undertakings for the Collective Investment in Transferable Securities ("UCITS").
- Notably, Rule 18f-4 and the rules adopted by ESMA for UCITS each impose a 200% threshold for funds that use a relative VaR test, and 20% of net asset value for funds that use an absolute VaR test.
- VaR testing may not adequately capture a fund's leverage risk in idiosyncratic circumstances. The SEC has left open the possibility of exemptive relief for such situations.

## (c) Operationalize the absolute VaR test

Under the absolute VaR test, the VaR of the fund's portfolio cannot exceed 20% (or 25% in the case of closed-end funds with an outstanding class of senior security that is a stock) of the value of the fund's net assets.

**When does the absolute VaR need to be calculated?**

The fund's absolute VaR calculation must be made at least once each business day.

39 See Adopting Release at pages 100-1.

## (d) Include escalation and board reporting policies and procedures within the derivatives risk management program

The derivatives risk management program should set out the process to follow if there is a breach of the set limits.

**What if the fund exceeds the applicable VaR limit?**

If the fund determines that it is not in compliance with the applicable VaR test, 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. The rule gives the fund a short grace period of five business days to come back into compliance without having to take additional measures.

The Adopting Release acknowledges that for leveraged/inverse fund "there may be minor deviations between the VaR of the fund and 200% of the VaR of its designated index" due to the financing costs embedded in the fund's derivatives and valuation differences between the fund's portfolio and the index it tracks. The SEC "would not view these de minimis deviations by a leveraged/inverse fund as exceedances of the relative VaR test under these circumstances because they do not reflect an increase in the fund's leveraged or inverse market exposure."[40]

**What if the fund has not come back into compliance with the applicable VaR test within five business days?**

If the fund is not in compliance with the applicable VaR test within five business days, the DRM must:

1. provide a written report to the fund's board of directors and explain how and by when (i.e., number of business days) the DRM reasonably expects that the fund will come back into compliance (the "five-day report");
2. file the required report on Form N-RN (more on this below);
3. analyze the circumstances that caused the fund to be out of compliance for more than five business days;
4. update any program elements as appropriate to address those circumstances; and

40 Adopting Release at page 184.

5. provide a written report within 30 calendar days of the exceedance (the "30-day report") to the fund's board of directors explaining:
   (i) how the fund came back into compliance;
   (ii) the results of the DRM's analysis of the circumstances that caused the fund to be out of compliance for more than five business days; and
   (iii) the updates the DRM made to any program elements to address the circumstances that caused the fund to be out of compliance for more than five business days.

If the fund remains out of compliance with the applicable VaR test at the time of the 30-day report, the 30-day report must also update the five-day report.

If the fund continues to be out of compliance with the applicable VaR test after the 30-day report is delivered, the DRM must update the board of directors on the fund's progress in coming back into compliance at regularly scheduled intervals at a frequency determined by the board. The SEC also anticipates "staff outreach to a fund concerning its remediation plans where the fund has remained out of compliance for a longer period of time".[41]

The fund would also then be required to report to the SEC on Form N-RN (see sub-part (e) below) if it has been out of compliance for longer than the five-business day grace period. The fund should not engage in "fire sales" to avoid filing a report on Form N-RN as this will violate the rule's requirement that the fund must come back into compliance "in a manner that is in the best interests of the fund and its shareholders."[42]

A further filing on Form N-RN is required once the fund comes back into compliance.

**What if the Fund is repeatedly out of compliance with its applicable VaR test for more than five business days?**

In these circumstances, the SEC would expect the fund and the board to "reconsider whether the fund's derivatives risk management program is appropriately designed and operating effectively."[43] Addressing this may involve making changes to the fund's derivatives risk management program and/or changing the fund's investment practices with respect to derivatives use.

## (e) Required regulatory reporting

There are also several new regulatory reporting requirements related to the derivatives risk management program.

*Form N-PORT*

Funds (other than limited derivatives users) will also be required to report certain VaR-related information on Form N-PORT in their regular filings. The information required regarding:

1. the fund's median daily VaR for the monthly reporting period;
2. for funds using relative VaR:
   a. the name of the fund's designated index and its index identifier (or a statement that the fund's designated reference portfolio is its securities portfolio, where applicable);
   b. the fund's median daily VaR ratio for the reporting period; and

41 Adopting Release at page 148.
42 See Adopting Release at page 149.
43 Adopting Release at page 147.

3. the number of exceptions identified during the reporting period arising from backtesting the fund's VaR calculation model (see chapter 5.D regarding the backtesting requirements).

However, only the reporting information about the fund's designated reference portfolio will be made publicly available. The other additional Form N-PORT reporting elements will not be made public.

The Adopting Release notes that funds will not be able to comply with these reporting requirements until the Form N-PORT has been updated and explains that a fund may elect to rely on Rule 18f-4 prior to the rule's compliance date without also complying with these reporting requirements until the update form is available for filing on EDGAR.[44]

*Form N-RN*

Form N-RN was formerly called Form N-LIQUID.

*For funds using relative VaR*, Form N-RN has to be filed within one business day following the fifth business day after the fund has determined that the portfolio's VaR exceeds the applicable 200% or 250% of its designated reference portfolio VaR. The Form N-RN report has to include:

1. the dates on which the fund portfolio's VaR exceeded 200% or 250% of the VaR of its designated reference portfolio, depending on the applicable threshold;
2. the VaR of the fund's portfolio for each of these days;
3. the VaR of its designated reference portfolio for each of these days;
4. as applicable, either the name of the designated index, or a statement that the fund's designated reference portfolio is its securities portfolio; and
5. as applicable, the index identifier for the fund's designated index.

A further Form N-RN filing will need to be filed when the fund is back in compliance.

*For funds using absolute VaR*, Form N-RN has to be filed within one business day following the fifth business day after the fund has determined that the portfolio's VaR exceeds the applicable 20% or 25% of the value of the fund's net assets. The Form N-RN report has to include:

1. the dates on which the fund portfolio's VaR exceeded 20% or 25% of the value of its net assets;
2. the VaR of the fund's portfolio for each of these days; and
3. the value of the fund's net assets for each of these days.

A further Form N-RN filing will need to be filed when the fund is back in compliance.

Form N-RN filings are confidential filings made to the SEC and are not made publicly available.

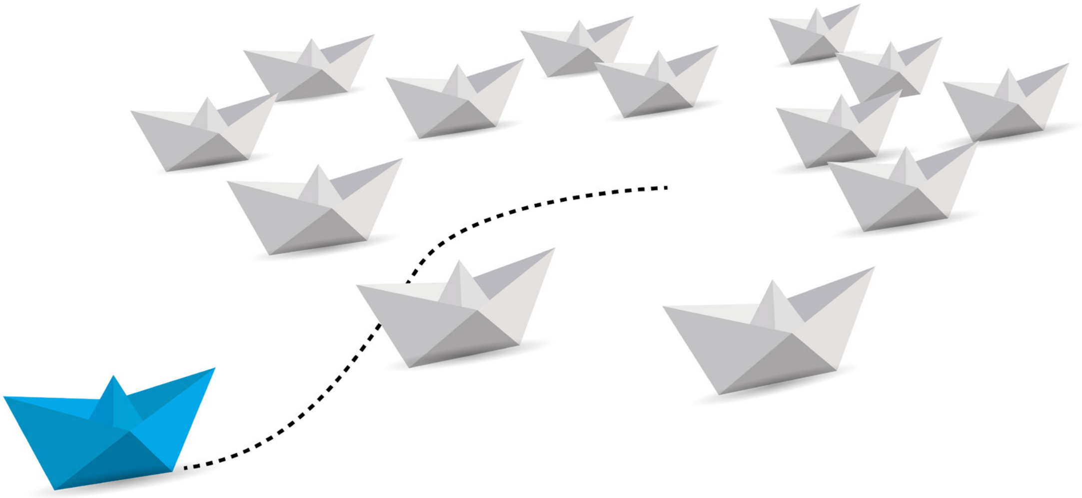
Until the SEC staff completes the process of updating current Form N-LIQUID on EDGAR to reflect the new requirements, a fund relying on Rule 18f-4 may satisfy the requirement to file a report on Form N-RN by including information that Form N-RN requires in a report on Form N-LIQUID filed on EDGAR.[45]

*Form N-CEN*

Funds relying on Rule 18f-4 are also required to report their reliance on the rule in the reporting period in its filing on Form N-CEN, once the updated Form N-CEN is available for filing on EDGAR.

44 Adopting Release at page 237.

45 Adopting Release at page 237.



# C. Stress testing

The fund's derivatives risk management program is required to provide for stress testing to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties.

**What factors should be included in the stress testing?**

The Adopting Release notes that "[t]he specific factors to consider in a particular stress test may vary from fund to fund" but goes on to suggest the following possible factors to consider:

- liquidity;
- volatility;
- yield curve shifts;
- sector movements;
- changes in the price of the underlying reference security or asset;
- interest rates;
- credit spreads; and
- foreign exchange rates.

**What is an "extreme but plausible" market change in risk factors?**

This requirement is meant to capture "potentially extreme market conditions that the rule's VaR test may not capture".[46] It should include testing of "non-linear derivatives risks that may be understated by metrics or analyses that do not focus on periods of stress."[47]

The SEC notes, by way of example, that "[r]ecent episodes of market volatility related to the COVID-19 global health pandemic have highlighted the importance of analyzing such future potential swings in a fund's portfolio."[48] During the first half of 2020, margin costs increased

46 Adopting Release at page 63, text at footnote 195.

47 Adopting Release at page 63.

48 Adopting Release at page 250.

significantly and unexpectedly. Now that this possibility has been highlighted, this previously extreme event has become much more plausible. The DRM should be considering whether and to what extent other "black swan" scenarios should be made part of the fund's stress testing on a regular or periodic basis.

**Is the stress testing requirement applicable to all the fund's investments or just the fund's derivatives transactions?**

The fund's derivatives risk management program must include stress testing of the fund's entire portfolio, including all of its investments and not just the derivatives transactions.[49]

**How frequently is stress testing of the fund's portfolio required to be conducted?**

At least once a week. However, more frequent testing may be advisable and ultimately the frequency with which the stress testing under this paragraph is conducted must take into account the fund's strategy and investments and current market conditions.[50]

The Adopting Release concedes, however, that the scope of the weekly stress testing can vary and suggests that "[f]unds may … conduct more-detailed scenario analyses on a less-frequent basis … while conducting more-focused weekly stress tests under rule 18f-4."[51]

**Practical considerations**

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

## D. Backtesting

The fund's derivatives risk management program also must provide for backtesting of the results of the chosen VaR calculation model to help the fund confirm the appropriateness of its model and the related assumptions and to identify whether changes to the model are needed.

**In what manner is the fund required to perform the backtesting?**

To perform backtesting of the results of the VaR calculation model used by the fund in connection with the relative VaR test or the absolute VaR test, the fund must compare the fund's actual gain or loss that occurred on each business day during the backtesting period with the corresponding

49 See Adopting Release at footnote 193.

50 See Adopting Release at footnote 209.

51 Adopting Release at page 67.

VaR calculation for that day, estimated over a one-trading day time horizon with a 99% confidence level, and identifying as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss.

**How frequently is backtesting of the VaR calculation model required to be done?**

Backtesting must be performed no less frequently than weekly with respect to each business day in the week, so the backtesting data for each business day will have to be collected, although the testing itself need not be done each business day.

**What happens if the fund identifies an exception?**

The SEC anticipates that funds will experience backtesting exceedances from time-to-time. As a result, the SEC does not expect the DRM to report every such exceedance to the fund's board.[52]

**What if the fund identifies an exception more than once?**

According to the Adopting Release, "if 10 or more exceptions are generated in a year from backtesting that is conducted using a 99% confidence level and over a one-day time horizon, and assuming 250 trading days in a year, it is statistically likely that such exceptions are a result of a VaR model that is not accurately estimating VaR."[53] As a result, the SEC will expect the VaR modelling to be adjusted.

**Practical considerations**

- Firms should closely monitor backtesting exceptions to ensure this percentage is not exceeded more frequently than 2.5 times per year.
    - For example, if 10 or more exceptions are generated in a year using the above parameters, the SEC would consider it statistically likely such exceptions are a result of a VaR model that is not accurately estimating VaR given the facts and circumstances of the fund's derivatives usage. DRMs should consider such results as an indicator to review and update certain aspects of the derivatives risk management program, including the VaR model and the fund's designated reference portfolio.
- European regulations require UCITS to perform backtests on a monthly basis. If they are operating both UCITS and funds required to adopt a derivatives risk management program, investment advisers must be mindful of the jurisdictional differences imposed by different regulatory regimes.

# E. Internal reporting and escalation

As is the case with respect to many of the fund's policies and procedures, the fund's derivatives risk management program is required to include internal reporting and escalation procedures. The program must identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the program, including exceedances of the guidelines (see chapter 5.A) and the results of the stress tests (see chapter 5.C). The DRM should inform the portfolio management team of the material risks arising from the fund's derivatives transactions in a timely manner.

52 See Adopting Release at footnote 229.

53 Adopting Release at footnote 212.

The DRM must inform in a timely manner persons responsible for portfolio management of the fund, and directly inform the fund's board of directors as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified by the fund's exceedance of a criterion, metric, or threshold provided for in the fund's risk guidelines (see chapter 5.A) or by the stress testing (see chapter 5.C). The timing of escalations to the board are left to the discretion of the DRM, however, the escalation requirements to be followed by the DRM should be "tailored based on the fund's size, sophistication, and needs."[54]

The DRM may also want to engage with the board to develop an understanding of what the board wants to see or have raised outside of the regular board meetings.[55] See the board reporting discussion in chapter 8 in this regard as well.

**Practical considerations**

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

## F. Reverse repurchase agreements/similar financing transactions

The Investment Company Act generally allows a fund to enter into reverse repurchase agreements[56] or similar financing transactions provided that the fund treats the transactions as a borrowing and meets the asset coverage requirements under Section 18 of the Investment Company Act (the "asset coverage approach"). Under this approach, the fund must treat reverse repurchase

54 Adopting Release at page 74 in text accompanying footnote 237.

55 See Adopting Release at page 74.

56 "In a reverse repurchase agreement, a fund transfers a security to another party in return for a percentage of the value of the security. At an agreed-upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the initial sale transaction plus interest." Adopting Release at footnote 714. A reverse repurchase agreement that does not have an agreed-upon repurchase date would be treated as if it were re-established each day.

agreements and similar financing transactions as economically equivalent to bank borrowings or other indebtedness subject to the full asset coverage requirements of Section 18.

However, Rule 18f-4(d)(1)(ii) permits a fund entering into reverse repurchase agreements or similar financing transactions to treat such transactions as “derivatives transactions“ under Rule 18f-4, rather than including such transactions in the fund’s asset coverage calculations (the “Rule 18f-4 approach“).

Depending on which option the fund may choose to adopt moving forward, a different set of requirements will apply. In either event, any board decisions regarding the approach to be chosen should be recorded in the board minutes and the fund must report and maintain in its books and records for a period of five years which option it decides to use.

Choices among the available compliance options may be affected by whether and to what extent the fund enters into reverse repurchase agreements and whether the fund has otherwise adopted a derivatives risk management program to comply with Rule 18f-4 with respect to other derivatives transactions.

Silence about whether a fund is permitted to enter into reverse repurchase agreements and similar financing transactions in the fund’s prospectus or other disclosure documents may not be dispositive of whether such investments are permitted as many funds' investment parameters are purposefully written in a very broad manner. If the fund is affirmatively permitted to engage in reverse repurchase agreements or similar financing transactions (or in the alternative is not affirmatively prohibited from doing so), the fund will have to choose whether to comply via the asset coverage approach or the Rule 18f-4 approach, each of which has specific requirements as discussed further below.

If the fund is not permitted to engage in reverse repurchase agreements and similar financing transactions, this should be recorded in the board meeting minutes to account for the absence of relevant policies and procedures.

**What is a “similar financing transaction“ for purposes of these requirements?**

Although the Adopting Release does not provide a full and complete overview of what constitutes a “similar financing transaction“ for this purpose, the Adopting Release notes that tender offer bond financings fall into this category.[57]

The Adopting Release also notes that securities lending may constitute as a “similar financing transaction“ as long as it does not invest the cash collateral in securities other than cash or cash equivalents (i.e., short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates) and the fund does not sell or otherwise use any non-cash collateral to leverage its portfolio.[58] Items commonly considered to be cash equivalents include certain Treasury bills, agency securities, bank deposits, commercial paper and shares of money market funds.[59]

In the absence of a well-defined definition of “similar financing transactions“, funds should document why they believe a particular transaction is a “similar financing transaction“.

57 Adopting Release at page 218.

58 Adopting Release at pages 221-4.

59 Adopting Release at page 224.

**What are the fund's obligations if it chooses to adopt the asset coverage approach?**

The Investment Company Act allows funds to use reverse repurchase agreements up to the Section 18 limits on borrowings without necessarily having to adopt a derivatives risk management program. Under this asset coverage approach, reverse repurchase agreements and similar financing transactions will not be included in calculating a fund's derivatives exposure under the limited derivatives user provisions of Rule 18f-4.

However, if a fund does not qualify as a limited derivatives user due to its other investment activity, any portfolio leveraging effect of reverse repurchase agreements or similar financing transactions will be included and restricted through the VaR-based limit on fund leverage risk. According to the Adopting Release "this is because the VaR tests estimate a fund's risk of loss taking into account all of its investments, including the proceeds of reverse repurchase agreements and investments the fund purchased with those proceeds."[60]

**What are the fund's obligations if it treats all reverse repurchase agreements or similar financings as derivatives transactions?**

A fund that does not avail itself of the asset coverage treatment, may instead choose to treat reverse repurchase agreements as derivatives transactions for all purposes under Rule 18f-4. The Adopting Release acknowledges that "such transactions could have the effect of introducing leverage into a fund's portfolio if the fund were to use the proceeds of the financing transactions to purchase additional investments."[61] However, it argues that the derivatives risk management program is specifically designed to address these concerns.

If the fund decides to treat its reverse repurchase agreements or similar financings as derivatives transactions, this will apply to all of its reverse repurchase agreements or similar financing transactions so that all such transactions are subject to a consistent treatment under the final rule. A fund could not, for example, elect to treat reverse repurchase agreements as derivatives transactions while at the same time electing to treat similar financing transactions, such as tender option bond financings, like bank borrowings under the rule's asset coverage option.[62]

**Are funds permitted to switch between the options?**

Yes, but if the fund were to switch between the two options on a dynamic or frequent basis, this might indicate to the SEC that "the fund has not effectively evaluated the appropriate approach".[63] Frequent changing may indicate gaming or create evasion concerns. However, the Adopting Release acknowledges that a fund could reasonably decide to switch between options if circumstances change or it otherwise re-evaluates how it should best treat such transactions. In that case, the fund must maintain a record of its original choice and its switch to the other options for the appropriate period.[64]

**Are there additional reporting requirements related to these requirements?**

Funds that invest in transactions in reverse repurchase agreements or similar financing transactions will have to report on Form N-CEN whether it entered into such transactions either under:

1. the provision of Rule 18f-4 that requires compliance with section 18's asset coverage requirements; or

60 Adopting Release at footnote 730.

61 Adopting Release at page 218.

62 Adopting Release at pages 217-8.

63 Adopting Release at page 219.

64 Id.

2. the provision that allows funds to treat these transactions as derivatives transactions for all purposes under Rule 18f-4.

**Practical considerations**

- The optionality to treat reverse repurchase agreements and similar financing transactions as derivatives transactions or as senior securities is a welcome change from the 2019 Proposal. For example, a fund that otherwise does not invest in derivatives would likely elect to include reverse repurchase agreements and similar financing transactions towards its asset coverage calculations in order to limit derivatives exposure to 10% of net assets and bypass the more onerous requirements of Rule 18f-4.
- While Rule 18f-4 gives funds the option to treat reverse repurchase agreements or similar financing transactions as derivatives transactions, a fund may not adopt a "mix and match" approach.
- Accordingly, a fund must either classify all or none of its reverse repurchase agreements and similar financing transactions as derivatives transactions.
- As discussed in the subsequent bullet points, astute investment advisers will thoughtfully consider the overall impact of electing to treat reverse repurchase agreements and similar financing transactions as derivative transactions prior to making an election.
- Funds that presently use a combination of bank lending, securities lending and reverse repurchase agreements and similar financing arrangements to obtain portfolio leverage should carefully review the treatment of these instruments.
- Notably, the exclusion of securities lending from the requirements of Rule 18f-4 is only available for traditional securities lending programs that involve the reinvestment of securities lending collateral in cash or cash equivalents and not for funds that use securities lending as a means to obtain portfolio leverage.
- Funds (including money market funds) generally segregate assets in connection with delayed-settlement securities transactions. Funds may discontinue this practice after the effective date of Rule 18f-4, as there are no conditions to the exclusion of delayed-settlement securities from senior security status beyond the 35-day and physical settlement prongs of the definition.

## G. Unfunded commitment agreements

Rule 18f-4 permits a fund to enter into an unfunded commitment agreement, provided the fund reasonably believes that, at the time it enters into such an agreement, it will have sufficient cash and cash equivalents to meet its obligations with respect to all its unfunded commitment agreements as they come due. The SEC recognises that while entering into unfunded commitment agreements may raise the risk that a fund may be unable to meet its obligations under these transactions, unfunded commitments do not generally involve the leverage and other risks associated with derivatives transactions.

For each unfunded commitment agreement that a fund enters into relying on Rule 18f-4, the fund is required to document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its unfunded commitment agreement.

**What is an "unfunded commitment agreement" for purposes of these requirements?**

Rule 18f-4 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" (emphasis added).[65]

**What constitutes "reasonable belief" for the purposes of these requirements?**

The Adopting Release provides specific factors a fund must consider to form a "reasonable belief". In particular, a fund must:

1. take into account its reasonable expectations with respect to other obligations, including any obligation with respect to senior securities or redemptions;
2. not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments; and
3. not consider cash that may become available from issuing additional equity.

Rule 18f-4 will not, however, prevent a fund from considering issuing debt (e.g., borrowings from financial institutions, or the issuance of debt securities) to support a reasonable belief that it could cover an unfunded commitment.

To have a reasonable belief, the fund could also consider:

- its strategy;
- its assets' liquidity;
- its borrowing capacity under existing committed lines of credit;
- the contractual provisions of its unfunded commitment agreements; and
- its assessment of the likelihood that subsequent market or other events could impair the fund's ability to have sufficient cash and cash equivalents to meet its unfunded commitment obligations.

**Are there additional reporting requirements related to these requirements?**

Funds that invest in transactions in unfunded commitment agreements will have to report on Form N-CEN whether it entered into such transactions.

## H. When-issued, forward-settling and non-standard settlement cycle securities transactions

Rule 18f-4 allows funds, and registered open-end companies that are regulated as money market funds, to invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle without the transaction being deemed to involve a senior security, provided that:

1. the fund intends to settle the transaction physically (as physical settlement requires sufficient assets to meet the obligation regardless of a separate asset segregation requirement); and
2. the transaction settles within 35 days.

65 Adopting Release at pages 224-5.

Silence about whether a fund is permitted to invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle in the fund's prospectus or other disclosure documents may not be dispositive of whether such investments are permitted, as many fund's investment parameters are purposefully written in a very broad manner. If the fund is affirmatively permitted to invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle (or in the alternative is not affirmatively prohibited from doing so), and the fund wants to rely on the senior securities calculation relief provided by Rule 18f-4, the fund's written policies and procedures should include:

- a process for memorialising the intention to settle the transaction physically;
- a process for monitoring the number of days it is taking for the transaction to settle; and
- a process for dealing with addressing the senior securities calculation if the 35-day settlement period will not be or has not been met.

If the fund is not permitted to invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle, this should be recorded in the board meeting minutes to account for the absence of relevant policies and procedures.

**What constitutes physical settlement for the purposes of these requirements?**

Physical settlement must occur electronically through the Depository Trust Company or though other electronic platforms. This condition "distinguishes these investments from bond forwards and other derivatives transactions where a fund commonly intends to execute an offsetting transaction rather than to actually purchase (or sell) the security".[66]

**Are there additional reporting requirements related to these requirements?**

Funds that invest in transactions in when-issued or forward-settling basis, or with a non-standard settlement cycle will have to report on Form N-CEN whether they entered into such transactions.

# I. Investment adviser approval of the program

Although they have to be adopted by the fund, the derivatives risk management program and the related policies and procedures will be ones the investment adviser will have to follow. As a result, the derivatives risk management program and the related policies and procedures should be reviewed and approved in accordance with the investment adviser's own governance and risk management processes.

66 Adopting Release at page 41.

# 6. Review and assessment of the program by the DRM

On or before the implementation of the program, the DRM must perform and complete a review of the derivatives risk management program and assess whether the program is reasonably designed to manage the fund's derivatives risks and incorporates all the rule's required elements.

Before the meeting at which the board is to consider adoption of the fund's derivatives risk management program and the related policies and procedures, the DRM is required to provide a written report to the fund board, based on the DRM's reasonable belief and after due inquiry, which provide a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate all of the rule's required elements.

The DRM's report should summarise the derivatives risk management program and the related policies and procedures, including the compliance choices made, especially as relates to compliance with the leverage risk limits. The written report must include:

1. the basis for the representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program; and
2. the DRM's basis for the approval of any designated reference portfolio; or an explanation of the basis for the DRM's determination that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test.

**Practical considerations**

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

# 7. Board consideration and adoption of the program

According to the Adopting Release, "the board is not required to ***approve*** the derivatives risk management program" (emphasis added).[67] This distinguishes the derivatives risk management program from the requirement that a fund's board initially approve a liquidity risk management program containing specific program elements. The Adopting Release goes on to note that the board will, however, be responsible for overseeing compliance with Rule 18f-4 under the terms of the compliance program rule (Rule 38a-1).[68]

By contrast, Rule 18f-4(c)(1) specifically requires that the "fund ***adopt[ ]*** and implement[ ] a written derivatives risk management program ('program'), which must include policies and procedures

67 See Adopting Release at page 52 text accompanying footnote 145.

68 See Adopting Release at page 52 text at footnote 145.

that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund" (emphasis added).

Rule 38a-1(a)(2) 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. Since the SEC acknowledges that Rule 38a-1 encompasses a fund's compliance obligations with respect to Rule 18f-4, this suggests that board approval of the Rule 18f-4 policies and procedures may be required due to the terms of Rule 38a-1 even though Rule 18f-4(c)(1) specifies fund adoption rather than board approval. Rule 38a-1 requires a fund to obtain board approval of the fund's compliance policies and procedures. Therefore if the derivatives risk management program is considered a material change to the compliance program (e.g., because the previously approved policies and procedures included policies and procedures reasonably designed to comply with Section 18 of the Investment Company Act), board reporting is required, but approval is not required. Under Rule 38a-1(a)(4)(iii), the board must review an annual written report from the CCO (who may or may not be the same person as the DRM, although more likely will not be) regarding the operation of the fund's policies and procedures and any material changes made to those policies and procedures since the date of the last report, and any recommended material changes to the policies and procedures

**Practical considerations**

- Consistent with a board's responsibility to oversee fund compliance pursuant to Rule 38a-1 under the Investment Company Act, a board will be responsible for oversight of a fund's compliance with Rule 18f-4. On this point, the Adopting Release stated that the "board should view oversight as an iterative process" and, as such, remain informed regarding the material risks associated with a fund's derivatives transactions and how the fund addresses these risks. The Adopting Release further stated that the board's role is distinct from that of the DRM, and it is not one that requires the board to be involved in the day-to-day management of the fund.
- While many boards already have some degree of oversight over a fund's use of derivative instruments, boards now have a regulatory obligation to review reports produced by the DRM and oversee the fund's use of derivatives, even if they are not obligated to approve a fund's derivatives risk management program. Some boards may consider the establishment of a derivatives committee to help the board fulfill its obligations in an efficient, organized and practical manner. However, a derivatives committee will not absolve the rest of the board from meeting its obligations with respect to the fund and fund investors.

# 8. Program implementation and ongoing monitoring

The SEC believes "the role of the board under the rule is one of general oversight, and consistent with that obligation, [it expects] that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."[69] However, oversight should be an iterative process, requiring regular engagement with the DRM rather than a one-time assessment. In this regard, the SEC expects boards to take an active role featuring "inquiry into material risks arising from the fund's derivatives transactions and follow-up regarding the steps the fund has taken to address such risks, including as those risks may change over time". According to the SEC, "[e]ffective board oversight depends on the board receiving sufficient information on a regular

69 Adopting Release at text accompanying footnote 244.

basis to remain abreast of the specific derivatives risks that the fund faces. Boards should request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed".[70]

# A. Annual review of program by the DRM

The DRM must review the fund's derivatives risk management program at least annually to evaluate the program's effectiveness and to reflect changes in risk over time. The periodic review must include:

- a review of the VaR calculation model used by the fund including the results of the required backtesting; and
- an evaluation of whether any designated reference portfolio remains appropriate.

Although Rule 18f-4 specifies these two required elements, the review requirement applies to the overall program, including each of the elements discussed in chapter 5 and the additional reporting, recordkeeping and retention requirements discussed below. To assist with this process, the SEC believes that a DRM "should implement periodic review procedures for evaluating regulatory, market-wide, and fund-specific developments affecting the fund's program" to be well positioned to evaluate the effectiveness of the program.[71]

# B. Annual and other periodic board reporting

The SEC believes that "directors should understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program. They also should ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation. Therefore, we believe that the board should inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks and any change in those risks over time."[72] To facilitate this, the SEC requires the DRM to prepare various reporting to the board at least annually, but more frequently should the fund's board require it.

## (a) Annual DRM report to the board

The DRM is required to provide an annual report to the board providing a representation that the fund's derivatives risk management program is reasonably designed to manage the fund's derivatives risks and incorporates the required elements, based on the DRM's reasonable belief after due inquiry. "A derivatives risk manager, for example, could form its reasonable belief based on an assessment of the program and taking into account input from fund personnel, including the fund's portfolio management, or data that third parties provide."[73]

The report also must explain the basis for the representation along with the information reasonably necessary to evaluate the adequacy of the fund's program and the effectiveness of its implementation. This annual written report must also include the DRM's basis for the approval of any change in the designated reference portfolio during the period covered by the report. If the fund were to change from relative VaR to absolute VaR, the report would also have to include an explanation of the basis for the DRM's determination that a designated reference portfolio would

70 See Adopting Release at page 77.

71 Adopting Release at page 75.

72 Adopting Release at page 76.

73 Adopting Release at page 82.

not provide an appropriate reference portfolio for purposes of the relative VaR test. This annual reporting obligation is separate from the CCO's annual compliance program report under Rule 38a-1.

## (b) Other periodic board reporting

The DRM is also required to provide to the board of directors, at a frequency determined by the board, a written report regarding the DRM's analysis of (i) any exceedances of the fund's guidelines or VaR limits (see chapter 5.A and chapter 5.B), (ii) the results of the stress testing (see chapter 5.C), and (iii) the results of the backtesting (see chapter 5.D) since the last report to the board. 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.

**Is there a minimum frequency for these written reports to be delivered?**

Yes, as a practical matter. Because of the annual report on the effectiveness of the program (see above), as a practical matter the written report regarding the DRM's analysis of any exceedances of the fund's guidelines (including the applicable VaR limit), stress testing results and backtesting results will need to be provided at least annually.

The board could decide that it wants a written report regarding the DRM's analysis of any exceedances, stress testing results and backtesting results on a more frequent basis than annually.

**Does the report need to identify/itemize every exceedance?**

No. The reports do not need to report every single exceedance to the board. In fact, the SEC is of the view that a simple listing of the exceedances and stress testing and backtesting results without context or analysis would not be satisfactory. The DRM's reports to the board must instead include the DRM's analysis of the exceedances, stress testing results and backtesting results, instead of and not in addition to a simple list of the exceedances.[74]

74 Adopting Release at page 87.

# C. Recordkeeping and retention

Rule 18f-4 also includes several specific recordkeeping and retention requirements.

The fund must maintain in an easily accessible place a copy of the fund's written policies and procedures under the derivatives risk management program that are in effect, or were in effect at any time within the past five years.

The fund must retain a written record documenting:

1. the results of the fund's stress tests;
2. the results of the backtesting;
3. any internal reporting or escalation of material risks; and
4. any DRM reviews.

The fund is also required to maintain copies of:

1. any materials provided to the board in connection with its approval of the designation of the DRM;
2. any written reports provided to the board relating to the program; and
3. any annual or other periodic written reports provided to the board.

With respect to the leverage risk limits requirements, the fund must keep records of any determination and/or action the fund makes, including a fund's determination of:

- the VaR of its portfolio;
- the VaR of the fund's designated reference portfolio, as applicable;
- its 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 and the basis for any material changes thereto.

A fund that enters into unfunded commitment agreements must maintain a record documenting the basis for the fund's basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements. The fund must make such a record each time it enters into such an agreement.[75] The required records have to be maintained for a period of not less than five years (the first two years in an easily accessible place) following each applicable determination, action or review.

75 Adopting Release at page 232.

# Appendix A: About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

For further information, please visit AIMA's website, www.aima.org.

# Appendix B: About the Sponsor

**K&L Gates LLP**

K&L Gates' asset management and investment funds practice has over 50 years of experience in the financial services industry and comprises more than 150 lawyers in Asia, Australia, Europe, the Middle East, North America, and South America. The practice covers many disciplines that require highly specialized knowledge and experience. No matter the size or location of your company, the practice's lawyers provide seamless advice across jurisdictions so you can focus on growing your business. The practice is recognized globally by leading legal and business publications, including Chambers & Partners, The Legal 500, U.S. News – Best Lawyers®, Fund Intelligence, and ETF Express.

For more information about our practice, please visit https://www.klgates.com/asset-mgmt-and-investment-fund.

AIMA

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