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Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

SEC Adopts New Rule on the Use of Derivatives by Registered Funds and BDCs

On Oct. 28, 2020, the Securities and Exchange Commission (the SEC) approved new Rule 18f-4 under the Investment Company Act of 1940 (the 1940 Act) and further amended other rules and related forms that govern the use of derivatives and certain other transactions by registered open-end funds, closed-end funds, and business development companies (the Final Rule).[1] The Final Rule comes nearly five years after the SEC first proposed modernizing its approach to the use of derivatives by registered funds in December 2015.

The Final Rule ushers in a new era of derivatives regulation for registered funds and business development companies (BDCs) that discards the SEC's historical "asset segregation" and "cover" regime in favor of a regime that relies on Value-at-Risk (VaR) and a derivatives risk management program, which includes stress testing, to limit the amount of leverage that a registered fund or BDC can employ. In doing so, the Final Rule sweeps away the SEC and the SEC staff's patchwork of derivatives regulation that it promulgated over the last 40 years and creates a harmonized set of ground rules for funds that use derivatives.

The key components of the Final Rule are similar to the proposed version published in November 2019 (the 2019 Proposal), including its centerpiece, new Rule 18f-4, which sets forth the conditions under which open-end funds, closed-end funds and BDCs can enter into derivatives transactions. However, the Final Rule contains several important revisions in response to industry comments, which are highlighted in Exhibit A to this alert.

This alert summarizes the key components of the Final Rule, which include:

(i) a new derivatives risk management program;
(ii) new limits on fund leverage risk that is based on VaR;
(iii) exceptions for limited derivatives users;
(iv) new responsibilities for boards of registered funds and BDCs that use derivatives and related reporting;
(v) specific provisions for funds that engage in reverse repos and similar transactions and unfunded commitments;
(vi) updated guidance for funds that engage in when-issued, forward settling, and non-standard settlement cycle securities;
(vii) clarity regarding the impact of the rulemaking on money market funds;
(viii) special rules for leveraged/inverse funds, including amendments to the SEC's recently adopted Rule 6c-11;
(ix) amendments to fund reporting and disclosure requirements; and
(x) new recordkeeping requirements.

Exhibit B to this Alert contains a summarizes the annual, quarterly and current reporting requirements of the Final Rule.

(continued)

The Final Rule will become effective 60 days after its publication in the Federal Register (the Effective Date), which has not yet occurred. The compliance date for the Final Rule will be 18 months thereafter (the Compliance Date).

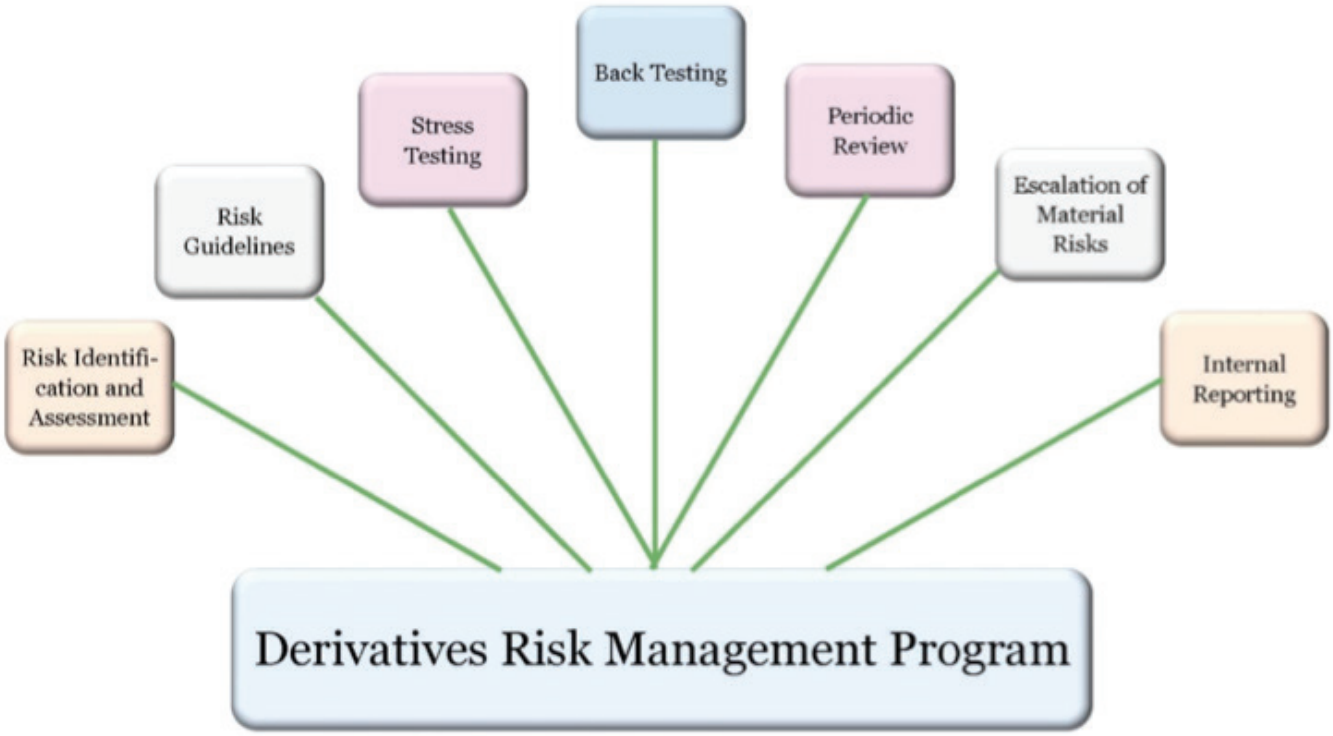
I. Derivatives Risk Management Program

Rule 18f-4 will generally require that a fund that enters into derivatives transactions (other than a fund that qualifies as a "limited derivatives user," as discussed further below) to adopt and implement a written derivatives risk management program, which must include policies and procedures that are reasonably designed to manage the fund's derivatives risks and to reasonably segregate the functions associated with the program from the portfolio management of the fund. For purposes of the Final Rule, derivatives transactions include any "derivatives instrument"[2] and short sale borrowings and *may* include reverse repurchase agreements or similar financing transactions, as further discussed below under "Reverse Repurchase Agreements or Similar Financing Transactions and Unfunded Commitments." Instruments that do not include a future payment obligation would not be considered derivatives transactions under the Final Rule.[3] Derivatives risks are defined as the risk associated with a fund's derivatives transactions or use of derivatives transactions, including leverage, market, counterparty, liquidity, operational, and legal risks, but could include additional risks deemed material.[4] A derivatives risk manager meeting the requirements of Rule 18f-4, as discussed below, must administer the program.

The program requirement is designed to result in a program with elements that are tailored to the particular types of derivatives that the fund uses and their related risks, as well as how those derivatives impact the fund's investment portfolio and strategy. The program must include the following elements:

- *Derivatives risk identification and assessment*, which must take into account the fund's derivatives transactions and other investments.
- *Risk guidelines* that provide for quantitative or other measurable criteria, metrics, or thresholds of a fund's derivatives risks, including specifying the levels that the fund is not normally expected to exceed, and measures to be taken if such levels are exceeded. In the Adopting Release, the SEC stated that a fund's risk guidelines are designed to complement, and not duplicate, the stress testing requirements, among other things, and that some risks may not be readily quantifiable or measurable and reflected in a risk guideline.
- *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, to be conducted no less frequently than weekly.[5]
- *Backtesting* the results of the VaR calculation model by the fund. In a change from the 2019 Proposal, the Final Rule permits a fund to perform the analysis on a weekly basis, instead of a daily basis, comparing the fund's daily gain and loss to the estimated VaR for each business day in the week.
- *Internal reporting*, which must identify the circumstances under which portfolio management will be informed of the operation of the program, including exceeding the risk guidelines or the results of the stress testing.
- *Escalation of material risks* by the derivatives risk manager, in a timely manner, to inform portfolio management and the board, as appropriate, of material risks arising from derivatives transaction, including exceeding the risk guidelines or the results of the stress testing.
- *Periodic review* that conducted by the derivatives risk manager at least annually to evaluate the program's effectiveness and to reflect changes in risk over time, which must include a review of the VaR calculation model and any designated reference portfolio to evaluate whether it remains appropriate.

The designation of a fund's derivatives risk manager must be approved by the fund's board, as discussed further below under "Board Oversight and Reporting." Such person must have relevant experience regarding the management of derivatives risk and could be either an individual officer or group of officers of the fund's investment adviser; provided, that if an individual officer serves as the derivatives risk manager, such officer may not be a portfolio manager of the fund, or if a group of officers serve as the derivatives risk manager, such group may not have a majority composed of portfolio managers of the fund. Notwithstanding this requirement in the Adopting Release, the SEC specifically "recognize[d] that investment advisers may have personnel who, although not designated as 'officers' in accordance with the adviser's corporate bylaws, have a comparable degree of seniority and authority within the organization" and clarified that such a person could be treated as an "officer" for purposes of the Final Rule and serve as a fund's derivatives risk manager if approved by the fund's board. The SEC, in the Adopting Release, also provided guidance on the program administration in the context of sub-advised funds.[6]



Key Takeaways

- Funds must adopt and implement a derivatives risk management program that incorporates specific guidelines and other required elements, which is intended to institute a standardized risk management framework for funds while allowing principles-based tailoring to a fund's particular risks.
- A derivatives risk manager, who must be a natural person(s) with relevant experience and sufficient authority within the investment adviser, must administer the program.

II. Limits on Fund Leverage Risk Based on VaR

Rule 18f-4 will require a fund that engages in derivatives transactions (other than a fund that qualifies as a "limited derivatives user," discussed further below under "Exceptions for Limited Derivatives Users") to comply with an outer limit on fund leverage risk based on VaR, which is an estimate of potential losses on an instrument or portfolio over a given time horizon and at a specified confidence level.[7] This VaR-based limit on fund leverage risk will replace the current regime of asset segregation for purposes of limiting leverage-related risks in registered funds.[8]

VaR Limits Generally— Under 18f-4, a fund portfolio's VaR generally would not be permitted to exceed 200% (250% for closed-end funds) of the VaR of a designated reference portfolio (the "Relative VaR Test").[9] For this purpose, a designated reference portfolio may be either an index that meets certain requirements or alternatively, in a significant change from the 2019 Proposal, the fund's own securities portfolio (excluding derivatives transactions).[10] A fund will be required to comply with the Relative VaR Test unless the fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the Relative VaR Test, taking into account the fund's investments, investment objectives, and strategy, in which case the fund would instead be required to comply with an absolute VaR test (the "Absolute VaR Test").[11] Under the Absolute VaR Test, the VaR of a fund's portfolio would not be permitted to exceed 20% (25% for closed-end funds) of the value of the fund's net assets.[12]

Selecting a Designated Reference Portfolio—Under the Final Rule, a designated reference portfolio may be either a "designated index" or the fund's securities portfolio. A designated index must be an unleveraged index that reflects the markets or asset classes in which the fund invests and must be approved by the fund's derivatives risk manager.[13] Like the 2019 Proposal, the Final Rule permits a fund to use a blended index as its designated index, provided that each constituent index meets the rule's requirements.[14] The index (or, in the case of a blended index, each index composing such index) must not 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.[15] Notwithstanding the foregoing, in a change from the 2019 Proposal, the Final Rule provides that, if the fund's investment objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its Designated Reference Portfolio, even if the index otherwise would be a prohibited index that would not be permitted under the Final Rule.[16] In another departure from the 2019 Proposal, a fund's designated index is not required to be an "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. And finally, unlike the 2019 Proposal, a fund will not be required to disclose its designated index in its annual report, though it will remain publicly available on Form N-PORT.[17]

As an alternative to using a designated index, a fund may calculate the Relative VaR Test of its portfolio against that of its portfolio of securities and other investments, excluding any derivatives transactions, subject to certain additional requirements.[18] The use of a fund's securities portfolio for this purpose must be approved by the derivatives risk manager, and in such case, it must reflect the markets or asset classes in which the fund invests (i.e., the markets or asset classes in which the fund invests directly through securities and other investments and indirectly through derivatives transactions).[19]

VaR Model Requirements—Any VaR model that a fund uses for purposes of either the Relative VaR Test or the Absolute VaR Test must take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments. The Final Rule includes the following non-exhaustive list of market risk factors that a fund must account for in its VaR model, if applicable: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility.[20]

VaR Calculations—The Final Rule would require that a fund's VaR model use a 99% confidence level and a time horizon of 20 trading days (which may be calculated on a rolling, overlapping basis or on a non-overlapping basis), and all VaR calculations must be based on at least three years of historical data, rather than historical simulation.[21] Consistent with the 2019 Proposal, the Final Rule will not require a fund to apply its VaR models consistently (*i.e.*, the same VaR model applied in the same way) when calculating the VaR of its portfolio and the VaR of its designated reference portfolio.[22] It would, however, require that VaR calculations comply with the same proposed VaR definition and specified model requirements.[23]

Considerations for Funds of Funds—In the Adopting Release, the SEC clarified some aspects of the leverage limits of particular concern to certain types of funds. Specifically, the SEC clarified that funds of funds that do not use derivatives will not be required to look through to exposure in underlying funds, noting that underlying funds would be required to comply with their own limitations, as applicable. The SEC further noted that for purposes of calculating its own VaR, a fund of funds would be permitted to use the historic returns of underlying funds and would not require daily transparency into the holdings of underlying funds.[24]

Compliance Testing and Remediation—Rule 18f-4 will require that a fund test for compliance under the Relative VaR Test or Absolute VaR Test, as applicable, at a consistent time at least once each business day, either in the mornings before market open or in the evenings after market close.[25] If a fund determines that it is not in compliance with its applicable VaR test, the Final Rule will require the fund to come back into compliance promptly after such determination in a manner that is in the best interests of the fund and its shareholders.[26] Unlike the 2019 Proposal, the Final Rule does not impose a strict three-day remediation deadline, nor does it impose a bar on the use of derivatives in the event of a VaR exceedance. Instead, the Final Rule will require that if a fund is not in compliance within five business days, then (1) the derivatives risk manager must report to the fund's board and explain how and by when (*i.e.*, the number of business days) the derivatives risk manager reasonably expects that the fund will come back into compliance; (2) the derivatives risk manager must analyze the circumstances that caused the fund to be out of compliance for more than five business days and update any program elements as appropriate to address those circumstances; and (3) the derivatives risk manager must provide a written report within thirty calendar days of the exceedance to the fund's board explaining how the fund came back into compliance and the results of the derivatives risk manager's analysis of the circumstances that caused the fund to be out of compliance for more than five business days and any updates to the program elements. If the fund remains out of compliance with the applicable VaR test at that time, the derivatives risk manager's written report must update the report explaining how and by when he or she reasonably expects the fund will come

back into compliance, and the derivatives risk manager 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.[27]

Key Takeaways

- Funds will be required to comply with a 200% Relative VaR Limit (250% for closed-end funds) or an alternative 20% Absolute VaR Limit (25% for closed-end funds).
- Under the Final Rule, a fund's Relative VaR will be measured against a "designated reference portfolio," which may be either a "designated index" or the fund's securities portfolio, subject to certain requirements.
- The SEC estimates that few existing funds will fail the VaR tests.

III. Exceptions for Limited Derivatives Users

A. 10% Notional Test

Under Rule 18f-4, a fund will be considered a "limited derivatives user" and thus not be required to adopt a derivatives risk management program meeting the requirements set forth above, nor will it be required to comply with the VaR limits on fund leverage risk and the related board oversight and reporting requirements, if the fund (i) adopts and implements policies and procedures reasonably designed to manage the fund's derivative risks and (ii) limits its derivatives exposure to 10% of its net assets.[28]

For this purpose, derivatives exposure is defined as the sum of the gross notional amounts of the fund's derivatives instruments and, in the case of short sale borrowing, the value of securities sold short, subject to certain adjustments for interest rate derivatives and options.[29] Under 18f-4, a fund will be permitted to exclude derivatives transactions that it uses to hedge certain currency and interest rate risks[30] and positions closed out with the same counterparty for purposes of calculating whether a fund qualifies as a limited derivatives user.[31] A fund electing to treat reverse repurchase agreements as derivatives under Rule 18f-4 (as explained further below) will be required to include in its derivatives exposure the proceeds that the fund received but has not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with each such transactions.[32] Derivatives instruments that do not involve future payment obligations—and therefore are not a "derivatives transaction" under the Final Rule—are not included in a fund's derivatives exposure.[33]

B. Exceedances of 10% Threshold

In a change from the 2019 Proposal, the Final Rule includes requirements for a fund that exceeds the 10% threshold test.

First, the Final Rule provides an initial five-business-day period for a fund to address any temporary exceedance of the 10% threshold.[34] The SEC explained in the Adopting Release that the five-business-day remediation period is designed to provide funds with some flexibility in coming back into compliance with the limited derivatives user exception without triggering an obligation to inform the fund's board of directors or a Form N-PORT reporting requirement, as discussed in greater detail below. Notwithstanding the foregoing, the SEC in the Final Rule clarified that 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, then the fund would not appear to be using derivatives in a limited manner, and its compliance policies should be designed to prevent such repeat temporary exceedances.[35]

If a fund's derivatives exposure exceeds the 10% derivatives exposure threshold for five business days, the fund's investment adviser must provide a written report to the fund's board of directors informing it whether the investment adviser intends either to: (1) promptly, but within no more than thirty calendar days of the exceedance, reduce the fund's derivatives exposure to be in compliance with the 10% threshold;[36] or (2) establish a derivatives risk management program, comply with the VaR-based limit on fund leverage risk, and comply with the related board oversight and reporting requirements as soon as reasonably practicable.[37] In either case, the fund's next filing on Form N-PORT must specify the number of business days,

in excess of the five-business-day period that the Final Rule provides for remediation, that the fund's derivatives exposure exceeded 10% of its net assets during the applicable reporting period.[38]

Key Takeaway

- Funds that (i) adopt and implement policies and procedures reasonably designed to manage their derivative risks and (ii) limit their derivatives exposure to 10% of their respective net assets will be considered "limited derivatives users" and will not be subject to the Final Rule's VaR limits or required derivatives risk management program adoption, or related board oversight requirements.

IV. Board Oversight and Reporting

Rule 18f-4 includes requirements for fund boards that the SEC indicated are designed to facilitate board oversight of derivatives risk management by funds.

First, Rule 18f-4 will require a fund's board, including a majority of the independent directors, to approve the designation of the fund's derivatives risk manager meeting the requirements of the Final Rule, as described above under "Derivatives Risk Management Program." The SEC stated in the Adopting Release that it believed that requiring a board to approve the designation of the derivatives risk manager was important in the establishment of the foundation for an effective relationship and a direct reporting line between the board and the derivatives risk manager.

Second, the Final Rule will require the derivatives risk manager to provide to the board at least annually a written report on the effectiveness of the derivatives risk management program. The report must include a representation from the derivatives risk manager that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program, and the basis for that representation, among other things. The SEC noted in the Adopting Release that the Final Rule reinforces that the fund and the adviser are responsible for derivatives risk management while the board's role is that of oversight.

Third, the Final Rule will require the derivatives risk manager to provide regular written reports at a frequency determined by the board. These regular reports must analyze exceedances of the fund's risk guidelines and the results of the fund's stress tests and backtesting and must include such information as reasonably necessary for the board to evaluate the fund's responses. The SEC explained in the Adopting Release that these written reports could be in summary form, rather than a specific itemization of exceedances, stress testing, or backtesting exceptions, and that a simple listing of the results without context or analysis would not satisfy the requirements of the Final Rule.

Finally, the board also is responsible for overseeing the fund's compliance with Rule 18f-4. The SEC stated in the Adopting Release that the board will be responsible for overseeing a fund's compliance with Rule 18f-4 and that Rule 38a-1 encompasses a fund's compliance obligations with respect to Rue 18f-4.[39]

Although the Adopting Release emphasized that a board's role is one of general oversight, the Final Rule will require boards to use their business judgment in evaluating areas such as the qualifications of the recommended derivatives risk manager, explanations from the derivative risk manager of changes to a fund's designated reference portfolio for purposes of applying the VaR test, and establishing a reporting protocol for exceptions to derivatives risk guidelines.

Key Takeaways

- The new rule will require boards to establish new reporting protocols related to its oversight of the use of derivatives by funds.
- A fund board must: (1) approve the derivatives risk manager; and (2) receive an annual written report, as well as other written reports at a frequency determined by the board, from the derivatives risk manager.

V. Reverse Repurchase Agreements or Similar Financing Transactions and Unfunded Commitments

Reverse Repurchase Agreements. Under Rule 18f-4, a fund may engage in reverse repurchase agreements (reverse repos) or similar financing transactions if: (1) the fund combines the aggregate amount of indebtedness associated with all reverse repos or similar financing transactions when calculating the asset coverage ratio under Section 18 of the 1940 Act; or (2) treats all reverse repos or similar financing transactions as derivative transactions, and documents which option it is relying upon. The SEC discussed in the Adopting Release that a fund's election will apply to all of its reverse repos or similar financing transactions so that all such transactions are subject to a consistent treatment under the Final Rule. The SEC further noted in the Adopting Release that it believed tender option bond (TOB) financing was economically similar to reverse repos and therefore, "similar financing transactions" under the Final Rule.[40]

Securities Lending Transactions. Consistent with the 2019 Proposal, the Adopting Release explained that securities lending transactions will not be considered "similar financing transactions" unless a fund were to invest the cash collateral in securities other than cash or cash equivalents. The Adopting Release noted that U.S. generally accepted accounting principles define cash equivalents as 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.[41] The Adopting Release states further that cash equivalents may include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.

Unfunded Commitments. Rule 18f-4 will permit a fund to enter into an unfunded commitment agreement if the fund reasonably believes, subject to certain considerations, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meets its obligations with respect to all of its unfunded commitment agreements, and documents the basis for its reasonable belief. Unfunded commitment agreements mean a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future.[42] Such commitments would not be included in or subject to the asset coverage requirements under Sections 18(a), 18(c), 18(f)(1) or Section 61 of the 1940 Act.

Key Takeaways

- Allowing a fund to treat reverse repos and similar financing transactions as derivatives transactions will provide flexibility for funds to enter into these agreements.
- The investment of securities lending cash collateral in securities other than cash equivalents would be deemed to create leverage and subject the securities loan to the requirements of the Final Rule.
- Unfunded commitment agreements will not be subject to the asset coverage ratio requirements of the 1940 Act, but a fund must have a reasonable belief it has sufficient cash and cash equivalents to meet its obligations.
- Funds should also carefully consider the SEC guidance with respect to securities lending and the effect on a fund's securities lending program.

VI. When-Issued, Forward Settling, and Non-Standard Settlement Cycle Securities

In a deviation from the 2019 Proposal and in response to concerns raised by commenters, investments in securities on a when-issued or forward-settling basis or with a non-standard settlement cycle will be deemed not to involve a senior security and, therefore, not subject to the Section 18 leverage limits, provided that the: (1) the fund intends to physically settle the transaction; and (2) the transaction will settle within 35 days of its trade date. The Adopting Release states that the SEC's position reflects its view that these short-term transactions generally do not raise concerns about fund leverage risk, and the 35-day settlement threshold more closely resembles regular way securities transactions than forward transactions that have the potential to create leverage. Physical settlement may occur electronically through the Depository Trust Company or other electronic platforms. Funds must have sufficient assets to meet their obligation to physically settle these transactions, although Rule 18f-4 does not subject these transactions to an asset segregation requirement.

A when-issued or forward-settling transaction, including to-be-announced investments (TBAs) and dollar rolls, that does not settle physically within 35 days of its trade date will be deemed a derivatives transaction and subject to the requirements of Rule 18f-4.

VII. Money Market Funds

Under the 2019 Proposal and the Final Rule, money market funds are excluded from the definition of a "fund" and therefore are generally not permitted to rely on Rule 18f-4. As a result of this exclusion, together with the rescission of SEC Release 10666 and related guidance, any investment in a derivatives transaction by a money market fund would be an impermissible senior security issuance under Section 18 of the 1940 Act. The Adopting Release highlights the SEC's position that entering into derivatives transactions would be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, especially if the money market fund were to use derivatives to leverage the money market fund's portfolio.

Notwithstanding an inability to rely on Rule 18f-4, money market funds may still invest in when-issued, forward settling, and non-standard settlement securities, including TBAs, that are not deemed to be derivatives transactions because they meet the conditions of physical settlement within 35 days of the trade date. Money market funds will not be eligible to transact in investments that do not meet these conditions, which will be deemed derivatives transactions.[43]

The Final Rule does not include a blanket exception, as some commenters recommended, allowing money market funds to invest in any eligible security as defined in Rule 2a-7 as the SEC stated that Rule 2a-7 is not designed to address senior security concerns.[44]

Key Takeaway

- Money market funds and other funds may continue to invest in securities on a when-issued or forward-settled basis, or with a non-standard settlement cycle, including TBAs, provided these securities settle physically within 35 days of their trade date.

VIII. Special Rules for Leveraged/Inverse Funds[45] and Amendments to Rule 6c-11

A. Alternative Leverage Limit Not Adopted; Relative VaR Test to Apply with Certain Exceptions

General Rule. Leveraged/inverse funds will generally be subject to the requirements of Rule 18f-4 on the same basis as other funds. Unless otherwise excepted from the requirements, a leveraged/inverse fund will be subject to the Relative VaR Test and must use the index it seeks to track as its designated reference portfolio. This is a significant change from the 2019 Proposal, which would have required a leveraged/inverse fund to limit its leverage to 300% of the return (or inverse of the return) of its underlying index instead of complying with the VaR-based leverage limit.

Calculating VaR for Inverse Funds. Where a fund's investment strategy is to provide the inverse performance, or a multiple of the inverse performance, of an index, the SEC anticipates the fund would calculate the VaR of the index based upon the index's inverse performance for purposes of the Relative VaR Test. The SEC states that this is because, for inverse funds, the potential for losses that VaR seeks to measure is driven by the potential for increases in the index.

VaR Deviations for 2x Leveraged/Inverse Funds. For a leveraged/inverse fund that seeks, directly or indirectly, to provide investment returns that correspond to 200% of the performance or inverse performance of an index, the SEC recognizes that there may be minor deviations between the VaR of the fund and 200% of the VaR of its designated index,[46] which would be expected to cause a fund's VaR to exceed 200% of the VaR of its designated index by a de minimis amount.[47] The SEC would not view these de minimis deviations 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. Accordingly, the SEC would not view these deviations, alone, as giving rise to the remediation or reporting requirements in the Final Rule for funds that are not in compliance with the Relative VaR Test.[48]

Grandfathered Exchange-Traded Funds (ETFs) Seeking Exposure Exceeding 200% of the Returns or Inverse Returns of an Index. Under the Final Rule, leveraged/inverse funds that seek to provide leveraged or inverse market exposure exceeding 200% of the return or inverse return of an index generally cannot satisfy the Relative VaR Test. In order to allow these funds to continue to operate without interruption, Rule 18f-4 excludes from the requirement to comply with the limit on fund leverage risk leveraged/inverse funds that, as of Oct. 28, 2020: are in operation; have outstanding shares issued in one or more public offerings to investors; and disclose in their prospectuses a leverage multiple or inverse multiple that exceeds 200% of the performance or inverse of the performance of an underlying index.[49] These funds must comply with all of the other provisions of Rule 18f-4 to qualify for the exclusion and may not change their underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide.[50] In addition, these funds will be required to disclose in their prospectuses that they are not subject to the condition of Rule 18f-4 limiting leverage risk.[51]

The SEC stated that it will continue to assess these over-200% leveraged/inverse funds in connection with the staff review discussed below under "No Adoption of Sales Practices Rules."

B. Amendments to Rule 6c-11

The Final Rule amends Rule 6c-11 under the 1940 Act (the "ETF Rule") to modify the condition that prevents leveraged/inverse ETFs from relying on the ETF Rule to state that such ETFs may rely on the ETF Rule if they comply with all applicable conditions of the Final Rule.[52] The amendment permitting leveraged/inverse ETFs to rely on the ETF Rule will be effective on the Compliance Date. In addition, effective on the Compliance Date, the SEC will rescind exemptive orders previously issued to sponsors of leveraged/inverse ETFs to promote a more level playing field between sponsors who wish to offer leveraged/inverse ETFs whose target multiple is equal to or less than 200% of its reference index. Following the Compliance Date, existing leveraged/inverse ETFs would be required to rely upon the conditions of the ETF Rule and Rule 18f-4 instead of existing exemptive orders. New sponsors of leveraged/inverse ETFs will be permitted to launch and operate leverage/inverse ETFs in reliance on the ETF Rule, so long as they comply with all of the applicable conditions of Rule 18f-4, including the Relative VaR Test.

The SEC also made clear that the order it previously issued granting an exemption from certain provisions of the Securities Exchange Act of 1934 and the rules thereunder to broker-dealers and certain other persons engaging in certain transactions in securities of ETFs relying on the ETF Rule shall apply to transactions in securities of leveraged/inverse ETFs that rely on the ETF Rule, provided that the conditions of such order are satisfied.[53]

C. No Adoption of Sales Practices Rules

The 2019 Proposal proposed new sales practices rules, which would have required broker-dealers and investment advisers to engage in due diligence before (i) accepting or placing an order for a retail investor to trade a leveraged/inverse investment vehicle; or (ii) approving a retail investor's account for such trading. These sales practices rules would have applied to various leverage/inverse investment vehicles, including leveraged/inverse funds and certain exchange-traded commodity- or currency-based trusts or funds that use a similar leverage/inverse strategy.

The SEC determined not to adopt the proposed sales practices rules in light of the overwhelming opposition by commentators and because the SEC acknowledged that certain of the investor protection concerns it raised in the 2019 Proposal would be addressed by the best interest standard of conduct for broker-dealers under Regulation Best Interest[54] and the fiduciary obligations investment advisers owe to their clients.[55]

Because the investor protections afforded by Regulation Best Interest and Rule 18f-4 do not apply to all complex financial products that use leverage/inverse strategies, or the ways in which investors may invest in such products, the SEC has directed its staff to review the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex investment products. The SEC has therefore left open the possibility of additional rulemakings, guidance, or other policy actions depending upon the outcome of this review.[56]

Key Takeaways

- Leveraged/inverse funds will generally be subject to Rule 18f-4 like other funds, including the requirement to comply with the VaR-based limit on fund leverage risk. This will effectively limit leveraged/inverse funds' targeted daily return to 200% of the return (or inverse of the return) of the fund's underlying index.
- The Final Rule provides an exception from the VaR test for leveraged/inverse funds currently in operation that seek an investment return above 200% of the return (or inverse of the return) of the fund's underlying index and satisfy certain conditions. These funds will be the subject of further study by the SEC.

IX. Amendments to Fund Reporting and Disclosure Requirements

A. Reporting to Shareholders

In a significant divergence from the 2019 Proposal, the Adopting Release limits the amount of new information about a funds' derivatives usage that must be disclosed publicly. The SEC ultimately determined that many of the new disclosure obligations are better suited for its purposes of monitoring regulatory compliance and that public disclosure is not in the public interest. As a result, only the information reported on Form N-CEN and limited information on Form N-PORT will be made publicly available, and the remaining information will be reported confidentially to the Commission, as discussed below.

Form N-CEN. Amendments to Form N-CEN will require funds to report whether they have relied on Rule 18f-4 or any of its exceptions during the annual reporting period. The amendments will specifically require funds to disclose whether: (i) the fund is a "limited derivatives user" and excepted from the Final Rule's requirement to adopt a derivatives risk management program and VaR-based limit on fund leverage risk; (ii) whether the fund is a leveraged/inverse fund that will be excepted from the limit on fund leverage risk; (iii) whether the fund has entered into reverse repos or similar financing transactions pursuant to the Final Rule, including the applicable provision of the Final Rule that the fund relied on as the basis for entering the transaction;[57] (iv) whether the fund has entered into unfunded commitment agreements under the Final Rule; and (v) whether the fund relied on the Final Rule to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle. All of the information required by the Form N-CEN amendments will be publicly available.

B. Reporting to the SEC

Form N-PORT. Rule 18f-4 requires funds relying on the limited derivatives user exception to report information about their aggregate derivatives exposure and applicable VaR information on Form N-PORT. A fund relying on the limited derivatives user exception must report: (i) its derivatives exposure, expressed as a percentage of the fund's net asset value; (ii) its derivatives exposure from currency and interest rate derivatives used for hedging purposes; and (iii) the number of business days in excess of the five-business-day remediation period that its derivatives exposure exceeded 10% of its net assets. This is a change from the 2019 Proposal, which would have required all funds to report information about their aggregate derivatives exposure and VaR information on Form N-PORT. The SEC acknowledged that funds already publicly disclose information regarding their derivatives positions, and additional disclosure would not have provided more meaningful information to investors.

All funds must report on Form N-PORT their median daily VaR for the monthly reporting period, as a percentage of the fund's net assets. Also, funds subject to the Relative VaR Test during the reporting period must report: (i) the name of its designated index and its index identifier, if applicable; and (ii) the median daily VaR ratio for the reporting period, as a percentage of the fund's designated reference portfolio. If applicable, funds subject to the Relative VaR Test must include a statement that the fund's designated reference portfolio is the fund's securities portfolio.

Only information about a fund's designated reference index and designated reference portfolio, as applicable, reported on Form N-PORT will be made publicly available. The SEC determined that additional public disclosure of derivatives exposure is not necessary nor appropriate in the public interest or for the protection of investors.[58]

Form N-RN. In connection with the adoption of the Final Rule, Form N-LIQUID will be renamed Form N-RN and amended to include new reporting events for funds that are subject to either the Relative VaR Test or the Absolute VaR Test.[59] Currently, only registered open-end investment companies, other than money market funds, are required to file reports on Form N-LIQUID. Under new Form N-RN, registered open-end funds, closed-end funds, and BDCs that are subject to the Final Rule's limit on fund leverage risk will be required to file information regarding non-compliance with its applicable VaR test.[60]

The Final Rule amendments to the new Form N-RN, adopted substantially as proposed, will require funds subject to the Relative VaR Test to report certain information related to test breaches, including: (i) the dates that the fund's portfolio was in breach; (ii) the VaR of the fund's portfolio and VaR of the designated reference portfolio each day while in breach; (iii) the name of the designated index and its index identifier, as applicable; and (iv) a statement that the fund's securities portfolio is its designated reference portfolio, as applicable.[61] Similarly, the Final Rule amendments will require funds subject to the Absolute VaR Test to report certain information related to VaR test breaches, including: (i) the dates that the fund's portfolio was in breach; (ii) the VaR of the fund's portfolio each day while in breach; and (iii) the value of the fund's net assets each day while in breach.[62] The preceding information must be filed on Form N-RN within one business day following the fifth business day that the fund was determined to be in breach of the applicable VaR test.[63] For funds that reported breaches under either VaR test, they must file a second Form N-RN when the fund is back in compliance with its applicable VaR test and report: (i) the dates the fund was in breach; and (ii) the current VaR of the fund's portfolio as of the filing date.[64]

All information reported on Form N-RN with respect to the applicable VaR test information will be made confidential to the SEC and non-public.[65]

Exhibit B provides a table that summarizes the new reporting requirements based on the Final Rule amendments to the applicable forms. The table does not otherwise include existing reporting requirements with respect to each form that was not modified by the adoption of the Final Rule.

Key Takeaway

- Funds will be subject to significant new reporting and disclosure requirements about their use of derivatives, although certain of that information will only be reported to the SEC on a non-public basis.

X. New Recordkeeping Requirements

The Final Rule has imposed certain recordkeeping requirements that are substantially consistent with those included in the 2019 Proposal. The Final Rule generally requires the following be maintained:

(i) records related to the derivatives risk management program, including written policies and procedures, results of stress testing and backtesting, documentation of any internal reporting escalation and periodic reviews;[66]
(ii) materials provided to a fund's board of directors in connection with approving the designation of the derivatives risk manager, reports related to the derivatives risk management program, and reports with respect to non-compliance with VaR testing;[67]
(iii) documentation and/or action taken regarding a fund's compliance with its VaR testing, including the VaR of its portfolio, the VaR of the fund's designated reference portfolio, as applicable, the fund's VaR ratio, as applicable, and any updates to VaR calculation models used by the fund including the basis for any material changes thereto;[68]
(iv) written policies and procedures and board reporting regarding a funds compliance with respect to its status as a limited derivatives user, as applicable;[69]
(v) a written record documenting whether a fund entered into a reverse repo or similar financing transaction, including whether such transactions were entered into based on the asset coverage requirements approach or a derivatives transactions treatment approach;[70] and
(vi) records documenting the basis for a fund's reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to entering unfunded commitment agreements for each such transaction.[71]

Funds must maintain a copy of their written policies and procedures that are currently in effect or have been in effect at any time within the past five years in an easily accessible place.[72] Written copies of all other records required under Rule 18f-4(c)(6)(i) must be maintained for a period of not less than five years, with the first two years in an easily accessible place, following each determination, action, or review described therein.[73]

XI. Effective and Compliance Dates

The Effective Date of the Final Rule is 60 days after its publication in the Federal Register, which has not yet occurred. The Compliance Date for the Final Rule will be eighteen months after the Final Rule's Effective Date. The final Compliance Date is longer than the one-year compliance date suggested in the 2019 Proposal.[74] The 18-month transition period is intended to provide sufficient time to implement the derivatives risk management program and the VaR limits and applicable testing, and to designate a qualified derivatives risk manager.[75] Funds may comply with Rule 18f-4 after the Effective Date, but prior to the Compliance Date, if the Final Rule's conditions are satisfied; provided, however, that funds electing to rely on Rule 18f-4 prior to the Compliance Date:

(a) may:

1. Rely on Rule 18f-4 when determining compliance with Section 18 of the 1940 Act based on its use of derivatives and other transaction covered by Rule 18f-4, and need not consider SEC Release 10666, staff no-action letters, or other staff guidance;[76]
2. Satisfy the requirement to file a report on Form N-RN by including information that Form N-RN requires in a report on current Form N-LIQUID;[77] and
3. Forgo complying with reporting requirements on Form N-RN, Form N-PORT and Form N-CEN until the forms are properly updated for filing on EDGAR;[78]

but

(b) must:

1. File a report on Form N-RN in compliance with its requirements and instructions if the fund experiences a reportable event;[79] and
2. Comply with Final Rule amendments adopted to Form N-RN, Form N-PORT and Form N-CEN, as applicable, once the update forms are available for filing on EDGAR.[80]

Key Takeaways

- An 18-month compliance period, although longer than the 2019 Proposal, will force funds to adopt an aggressive timeline in an effort to come into compliance with the series of prescriptive requirements of the Final Rule. Among other issues, funds will need to:
  - significantly revise existing compliance policies and procedures and related processes;
  - determine how any current approach to derivatives risk management will interact with the approach required by the Final Rule;
  - determine how to appropriately involve service providers, including sub-advisers, in their derivatives risk management programs; and
  - develop systems to make the required reporting to boards and the SEC, and maintain the detailed required records.

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies; Release No. IC-34078 (Oct. 28, 2020), https://www.sec.gov/rules/final/2020/ic-34084.pdf (Adopting Release). See also statements in support from Commissioner Hester M. Peirce, https://www.sec.gov/news/public-statement/peirce-statement-derivatives-102820, and Commissioner Elad L. Roisman, https://www.sec.gov/news/public-statement/roisman-statement-derivatives-102820, and dissenting statements from Commissioner Allison Herren Lee, https://www.sec.gov/news/public-statement/lee-derivatives-2020-10-28, and Commissioner Caroline Crenshaw, https://www.sec.gov/news/public-statement/crenshaw-derivatives-2020-10-28.

[2] A derivatives instrument includes any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar 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. *See* Rule 18f-4(a).

[3] *See* the Adopting Release.

[4] The SEC summarized each of these derivatives risks in the Adopting Release and noted that each are common to most types of derivatives transactions.

[5] In the Adopting Release, the SEC identified the following factors, among others, that could be considered for stress testing and would be expected to vary from fund to fund: liquidity, volatility, yield curve shifts, sector movements, or changes in the price of the underlying reference security or asset, and interest rates, credit spreads, volatility, and foreign exchange rates. *See* page 72.
[6] The SEC noted that Rule 18f-4 provides flexibility for funds to involve sub-advisers in derivatives risk management, which could include, as appropriate, officers of the sub-adviser, either alone or with officers of the investment adviser, as the derivatives risk manager or the delegation of certain activities to the sub-adviser.
[7] Rule 18f-4(c)(2) and Rule 18f-4(a) (the definition of "Value-at-Risk or VaR").
[8] *See* the Adopting Release.
[9] Note that the limit was increased from the 150% limit as set forth in the 2019 Proposal.
[10] Rule 18f-4(a) (defining "Designated Reference Portfolio").
[11] Rule 18f-4(c)(2)(i).
[12] Rule 18f-4(c)(2) and Rule 18f-4(a) (defining "Absolute VaR Test"). Note that this Absolute VaR limit was increased from the 15% Absolute VaR limit set forth in the 2019 Proposal.
[13] Rule 18f-4(a) (defining "Designated Index").
[14] *See* the Adopting Release and Rule 18f-4(a)(defining "Designated Index").
[15] *Id.*
[16] *Id.*
[17] *See* the Adopting Release and Item B.10. of Form N-PORT.
[18] Rule 18f-4(a) (defining "Relative VaR Test").
[19] Rule 18f-4(a) (defining "Securities Portfolio").
[20] Rule 18f-4(a) (defining "Value-at-Risk or VaR").
[21] *Id.*
[22] The example provided in the Adopting Release is that a fund could 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. *See* the Adopting Release.
[23] *See* the Adopting Release.
[24] *Id.*
[25] Rule 18f-4(c)(2)(ii).
[26] *Id.*
[27] Rule 18f-4(c)(2)(iii).
[28] Rule 18f-4(c)(4)(i).
[29] Rule 18f-4(a) (defining "Derivatives Exposure").
[30] Rule 18f-4(c)(4)(i)(B).
[31] Rule 18f-4(a) (defining "Derivatives Exposure").
[32] *Id.*
[33] Rule 18f-4(a) (defining "Derivatives Exposure" and "Derivatives Transaction").
[34] *See* Rule 18f-4(c)(4)(ii).
[35] *Id.*
[36] Rule 18f-4(c)(4)(ii)(A).
[37] Rule 18f-4(c)(4)(ii)(B).
[38] Item B.9. of Form N-PORT.
[39] Note that a fund is not required to comply with the board oversight and reporting requirements if it is a limited derivatives user.
[40] *See* the Adopting Release (noting that the Final Rule will not distinguish between TOB financings that are recourse and non-recourse or funds holding TOB floaters that look to a third-party to satisfy any income shortfall). The Adopting Release noted that an inverse floater issued by a TOB trust that is purchased in the secondary market would not be considered a "similar financing transaction" under the Final Rule.
[41] *See* Adopting Release.
[42] An unfunded commitment would include, for example, capital commitments to a private fund that requires investors to fund capital contributions upon the request of the private fund.
[43] *See* the Adopting Release.
[44] *See* the Adopting Release.
[45] "Leveraged/inverse fund" is defined under Rule 18f-4 as a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple (leverage multiple), or to provide investment returns that have an inverse relationship to the performance of a market index (inverse multiple), over a predetermined period of time. The term "multiple" as used in the Final Rule has the same meaning as in Rule 6c-11 under the 1940 Act – meaning that the performance amplification factor or "multiple" by which the leveraged/inverse fund seeks to provide returns relative to the index does not need to be evenly divisible by 100.
[46] These deviations are attributable to financing costs embedded in the fund's derivatives and valuation differences between the fund's portfolio and the index it tracks.
[47] What the SEC deems to be *"de minimis"* is not defined in the Adopting Release.
[48] Reporting requirements include filing Form N-RN with the SEC to report information about VaR test breaches.
[49] *See* Rule 18f-4(c)(5)(i).
[50] *See* Rule 18f-4(c)(5)(ii).
[51] *See* Rule 18f-4(c)(5)(iii).
[52] Rule 6c-11 permits certain types of ETFs to operate without first obtaining exemptive relief.
[53] *See* Order Granting a Conditional Exemption from Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10; 15c1-5; 15c1-6; and 14e-5 for Certain Exchange Traded Funds, Exchange Act Release No. 87110 (Sept. 25, 2019) [84 FR 57089 (Oct. 24, 2019)], available at https://www.govinfo.gov/content/pkg/FR-2019-10-24/pdf/2019-21515.pdf.
[54] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 FR 33318 (July 12, 2019)], available at https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf.

[55] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)], available at https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.
[56] See Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2020), available at https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28.
[57] A fund must identify whether it entered into a reverse repo or similar financing transaction under either: Rule 18f-4(d)(1)(i) and complies with the asset coverage requirements of Section 18; or Rule 18f-4(d)(1)(ii) and treats all reverse repurchase agreements or similar financing transactions as derivatives transactions under the Final Rule. *See* Form N-CEN Item C.7.iii. and iv.
[58] Because the SEC did not ultimately require all funds to report derivatives exposure information, as proposed, but instead imposed the requirement only on funds that are limited derivatives users, making this information public was unlikely to provide the market-wide insight into the levels of funds' derivatives exposure to investors and other market participants the SEC initially anticipated. Moreover, the SEC determined that making the derivatives exposure data that funds that are limited derivatives users must report publicly available could cause investors to believe that these reporting funds (which do not use derivatives extensively or largely use them for limited hedging purposes), are riskier than funds that use derivatives to a greater extent but are not required to report their exposure information.
[59] *See* Adopting Release at n. 625.
[60] *Id.*
[61] *See* Form N-RN Item E.
[62] *See* Form N-RN Item F.
[63] *See* Rule 18f-4(c)(7) and General Instruction A.(2) to Form N-RN.
[64] *See* Form N-RN Item G.
[65] *See* General Instruction A.(1) to Form N-RN.
[66] *See* Rule 18f-4(c)(6)(A).
[67] *See* Rule 18f-4(c)(6)(B).
[68] *See* Rule 18f-4(c)(6)(C).
[69] *See* Rule 18f-4(c)(6)(D).
[70] *See* Rule 18f-4(d)(2).
[71] *See* Rule 18f-4(e)(2).
[72] *See* Rule 18f-4(c)(6)(ii)(A).
[73] *See* Rule 18f-4(c)(6)(ii)(B).
[74] *See* pages 243-246 of the 2019 Proposal.
[75] *See* the Adopting Release.
[76] *See id.*
[77] *See id.*
[78] *See id.*
[79] *See id.*
[80] *See id.*

For more information, contact:

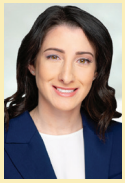
Nicole Simon
Partner
212.812.4137
nsimon@stradley.com

Christopher J. Zimmerman
Partner
202.419.8402
czimmerman@stradley.com

Matthew R. DiClemente
Co-Chair, Investment Management
215.564.8173
mdiclemente@stradley.com

David W. Grim
Partner
202.507.5164
dgrim@stradley.com

Joel D. Corriero
Partner
215.564.8528
jcorriero@stradley.com



Jamie M. Gershkow
Associate
212.404.0654
jgershkow@stradley.com

Shawn A. Hendricks
Associate
215.564.8778
shendricks@stradley.com

Exhibit A: SEC's Derivatives Rule Proposal Highlight of Some of Common Suggestions vs. Result in Final Rule	
Suggestions in the Comments	**Final Rule**
Leverage Limits	
Commenters suggested **increasing the limits for the relative VaR and absolute VaR tests.** As proposed, the rule would have imposed a 150% relative VaR limit and 15% absolute VaR limit (200% and 20%, respectively, for closed-end funds)	**VaR limits were increased** to 200% relative VaR and 20% absolute VaR (250% and 25%, respectively, for closed-end funds).
Commenters highlighted **difficulties in finding an appropriate designated reference index** for certain funds. Some suggested adjusting the definition to focus on strategy rather than asset class.	The definition of a designated reference index still requires that the index reflects the markets or asset classes in which the fund invests (it was not changed to be strategy-focused). However, active funds now have the **alternative option of measuring VaR against their own securities portfolio** (ex-derivatives).
As proposed, a fund that exceeded its VaR limit would have only a three-day grace period to come back into compliance, after which they would be barred from using derivatives until meeting certain conditions. Commenters suggested **extending the three-day grace period and removing the time-out rule**.	The grace period **was extended to five business days**. The five-day grace period would be followed by board reporting and other requirements, but **no time-out** on using derivatives. Instead, the fund must promptly come back into compliance in a manner that is in the best interests of the fund and its shareholders.
Derivatives Risk Management Program	
Commenters asked that the **weekly stress testing** requirement set forth in the proposal be changed to a **less frequent** (e.g., monthly) requirement, given that these are data-intensive calculations.	The SEC **held firm on the weekly stress testing** requirement, noting that they believe it strikes an appropriate balance of costs and benefits.
Commenters asked that the **daily back testing** requirement set forth in the proposal be changed to a **less frequent** (e.g., weekly or monthly) requirement. They noted that derivatives risk managers need to look at an appropriate trailing period for this to be meaningful.	The SEC changed this requirement to require back testing on a **weekly, rather than a daily, basis** (taking into account the fund's gain and loss on each business day that occurred during the weekly back testing period). The SEC specifically declined to make this a monthly requirement.
Regarding the **role of sub-advisers** in program administration, commenters supported permitting the derivatives risk manager to delegate certain responsibilities to sub-advisers.	The SEC provided some further detail on this point in the final release. As noted above, the final rule permits officers of a fund's sub-advisers to be **derivatives risk managers**, and where a sub-

	adviser is responsible for a fund's entire portfolio, an officer or officers of the sub-adviser may be the sole derivatives manager(s). The SEC also clarified that certain activities not specifically assigned to the derivatives risk manager in the final rule could be **delegated** to a fund's sub-advisers (subject to **appropriate oversight** policies), and that a fund's derivatives risk manager may **reasonably rely on information provided by sub-advisers**. The SEC noted that certain risk management activities (e.g., portfolio level stress testing) would not be appropriately delegated to an officer of a sub-adviser that manages only a sleeve of a fund's portfolio.
Commenters suggested that a fund's investment **adviser should be permitted to serve as the derivatives risk manager**. They highlighted concerns around selecting individuals to serve in this role.	The SEC **held firm on this point,** and the final rule does not allow the adviser to serve as a derivatives risk manager; instead, the rule requires **one or more individuals** to serve as a derivatives risk manager. They must be an officer or officers (or person(s) with sufficient authority to be considered an officer for this purpose) of the adviser (or, where a sub-adviser manages an entire sleeve, the sub-adviser).
Commenters asked for **clarification on what "relevant experience" means** in the context of designating a derivatives risk manager. They pointed out that this was not a requirement for liquidity risk managers.	The SEC **declined to address this in the text of the rule** but noted in the release that different funds may appropriately seek out different types of experience.
Board Oversight	
Commenters asked that the requirement for the **board to specifically consider the relevant experience of a derivatives risk manager** be removed, noting that the board may not be in the best position to evaluate that experience and that there is ambiguity in what experience should be required.	The SEC **removed the requirement that the board specifically consider** the relevant experience of a derivatives risk manager but **maintained that relevant experience is required for a person serving in such role**. Accordingly, this is now part of the overall assessment of a derivatives risk manager rather than a specific point.
Commenters pointed out that the proposal inappropriately blurs the line between oversight and day to day operation of the fund, the latter of which should not be the board's role (instead, their **role should be one of oversight**).	The adopting release clarified that the SEC "believe[s] the **role of the board under the rule is one of general oversight**, and consistent with that obligation, [they] expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors." The release also noted, "Effective board oversight depends on the board **receiving sufficient information** on a **regular 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**."
Commenters requested that **reporting to the board be permitted on a summary level** (e.g., with respect to VaR exceedances, as well as stress testing and back testing results).	The SEC **addressed this comment to allow for summary analyses** and does not need to be an itemization. They clarified in the final rule that the board is not required to receive a report of "any" exceedance but rather should get an analysis of exceedances during the period covered, as well as stress testing and back testing.
Commenters highlighted the proposal's reference to board oversight being an **"iterative process,"** which suggests more day-to-day involvement beyond the level of oversight.	The adopting release clarified that "[t]he use of the word "iterative" is **not intended to imply that the board is responsible for the day-to-day management** of the fund's derivatives risk, but is instead intended to clarify that the board's oversight role requires regular engagement with the derivatives risk management program rather than a one-time assessment."
Definition of Derivatives; Specific Instruments	
Under the proposal, reverse repos would be treated as bank borrowings and subject to 300% asset coverage. Commenters suggested that funds be **permitted to treat reverse repos as derivatives under the rule** or follow a modified asset segregation approach for reverse repos.	Under the final rule, a fund **may either elect to treat reverse repurchase agreements** and similar financing transactions **as derivatives** transactions under the rule **or** elect to subject such transactions to the **asset coverage requirements of section 18**.
Commenters suggested that **permissible cash collateral from securities lending** should be expanded beyond cash and cash equivalents.	The SEC **declined to make this change**. They did, however, clarify that cash equivalents include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.
Commenters asked the SEC to **exclude certain firm and standby commitments** (delayed delivery, when-issued, or other forward settling securities) from the definition of derivatives.	The final rule **excludes these instruments** from the definition of derivatives so long as the fund **intends to physically settle**, and settlement occurs **within 35 days**. This impacts MMFs, which, under the final rule, would be able to use these instruments if they meet the above conditions.
Prior to the rule proposal, there had been uncertainty about **how unfunded commitments should be treated** under Section 18.	The final rule allows funds to enter into unfunded commitment agreements to make certain loans or investments **if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to**

	meet its obligations with respect to its unfunded commitment agreements, in each case as they come due.
Money Market Funds	
Commenters focused on the **implications of money market funds (MMFs)**. They are not included in the definition of "funds" under Rule 18f-4 and would be left without an avenue to invest in derivatives, like when-issued and delayed delivery securities, unfunded commitments and instruments with longer than typical settlement periods (which would arguably fall within the definition of derivatives). That would affect their ability to invest in Treasuries.	As noted above, the final rule **excepts certain instruments commonly used by MMFs** from the definition of derivatives, thus preserving their ability to use them.
Commenters suggested that MMFs should be allowed to **invest in any 2a-7 instrument**, even if it would be a derivative under 18f-4 because 2a-7 provides sufficient protection/oversight.	The SEC **declined to modify** the rule to provide an exemption in rule 18f-4 for any eligible security as defined in rule 2a-7, noting that **Rule 2a-7 is not designed to address senior security concerns**.
Limited Derivatives Users	
Commenters suggested that **basic netting principles should apply** (e.g., for offsetting contracts to close-out positions).	The SEC modified the "derivatives exposure" definition in the final rule to allow a fund to **exclude from its derivatives exposure any closed-out positions**.
Commenters suggested that funds should be able to **carve-out currency hedging from the 10% threshold** (as proposed, a fund would choose currency hedging or 10% user).	The final rule **allows a fund to exclude** certain currency and interest rate hedging transactions from the 10% derivatives exposure threshold.
Commenters suggested **expanding the types of hedging exceptions permitted** (e.g., interest rate hedging, credit protection on a security held by the fund, written calls on securities a fund holds, FX rolls).	The final rule **allows currency and interest rate hedging derivatives to be excluded**; the SEC **declined to expand that to additional instruments**, noting the difficulty of distinguishing hedging transactions from speculative transactions.

Exhibit B:
Summary of New Reporting Requirements

Annual Reporting – Form N-CEN				
Who Must File	**When Filing Must be Made**	**What Must be Disclosed**	**Access to Information**	**Authority**
All registered funds relying on Rule 18f-4 (including money market funds, excluding BDCs)	With annual Form N-CEN filing	Whether the fund is a "limited derivatives user" and excepted from the Rule 18f-4 derivatives risk management program requirement and limit of fund leverage risk under rule 18f-4(c)(4).	Public	Form N-CEN Item C.7.i.
"	"	Whether the fund is a leveraged/inverse fund under rule 18f-4(c)(5) and excepted from complying with the limit on fund leverage risk described in rule 18f-4(c)(2).	Public	Form N-CEN Item C.7.ii.
"	"	Whether the fund has entered into reverse repurchase agreements or similar financing transactions under rule 18f-4(d)(1)(i) or (ii).	Public	Form N-CEN Item C.7.iii. and iv.
"	"	Whether the fund has entered into unfunded commitment agreements under rule 18f-4(e).	Public	Form N-CEN Item C.7.v.
"	"	Whether the fund has invested securities on a when-issued or forward-settling, or with non-standard settlement cycles, in reliance on rule 18f-4(f).	Public	Form N-CEN Item C.7.vi.

Quarterly Reporting – Form N-PORT				
Who Must File	**When Filing Must be Made**	**What Must be Disclosed**	**Access to Information**	**Authority**
All registered open-end funds.	With quarterly Form N-PORT filing.	The percentage of the fund's Highly Liquid Investments pledged as margin or collateral in connection with derivatives transactions, as classified in the applicable categories under Rule 22e-4.	SEC only	Form N-PORT Item B.8.
Funds subject to the limit on fund leverage risk described in Rule 18f-4(c)(2)	With quarterly Form N-PORT filing.	The fund's median daily VaR, during the monthly reporting period, reported as a percentage of the fund's net asset value.	SEC only	Form N-PORT Item B.10.a.
"	"	The number of exceptions the fund identified during the reporting period arising from back-testing the fund's VaR calculation model.	SEC only	Form N-PORT Item B.10.c.
Funds subject to the limit on fund leverage risk described in Rule 18f-4(c)(2) *and* subject to the **relative** VaR test during the reporting period.	With quarterly Form N-PORT filing.	The name of the fund's designated reference index or a statement that the fund's designated reference portfolio is the fund's securities portfolio; as applicable.	Public – Report for third month of each fiscal quarter (60 days after the end of the fiscal quarter). SEC only – All other periods.	Form N-PORT Item B.10.b.i.
"	"	The index identifier for the fund's designated reference index, as applicable.	Public – Report for third month of each fiscal quarter (60 days after the end of the fiscal quarter). SEC only – All other periods.	Form N-PORT Item B.10.b.ii.
"	"	The fund's median VaR ratio, during the monthly reporting period, reported as a percentage of the VaR of the fund's designated reference portfolio.	SEC only	Form N-PORT Item B.10.b.iii.

Quarterly Reporting – Form N-PORT (continued)				
Who Must File	**When Filing Must be Made**	**What Must be Disclosed**	**Access to Information**	**Authority**
Rule 18f-4 "limited derivatives users"	With quarterly Form N-PORT filing.	The fund's derivatives exposure (as defined in rule 18f-4(a)), reported as a percentage of the fund's net asset value.	SEC only	Form N-PORT Item B.9.a.
"	"	The fund's derivatives exposure attributable to currency or interest rate derivatives entered into and maintained by the fund for hedging purposes as provided in Rule 18f-4(c)(4)(i)(B), reported as a percentage of the fund's net asset value.	SEC only	Form N-PORT Item B.9.b. and c.
"	"	The number of business days beyond the five-business-day remediation period, described in Rule 18f-4(c)(4)(ii), that its derivatives exposure exceeded 10% of its net assets during the reporting period.	SEC only	Form N-PORT Item B.9.d.

Current Reporting – Form N-RN (formerly Form N-LIQUID)				
Who Must File	**When Filing Must be Made**	**What Must be Filed**	**Access to Information**	**Authority**
All registered funds, including closed-end funds and BDCs, subject to the relative VaR test under Rule 18f-4(c)(2)(i).	Within one business day following the fifth business day the fund has determined its portfolio VaR exceeded, as applicable, 200% or 250% of the VaR of its designated reference portfolio for the preceding five business days.	The dates on which the fund portfolio's VaR exceeded 200% or 250% of the VaR of its designated reference portfolio.	SEC only	Form N-RN Item E.1.
"	"	The VaR of the fund's portfolio for each of these days.	SEC only	Form N-RN Item E.2.
"	"	The VaR of its designated reference portfolio for each of these days	SEC only	Form N-RN Item E.3.
"	"	The name of the designated index, or a statement that the fund's designated reference portfolio is its securities portfolio, as applicable.	SEC only	Form N-RN Item E.4.
"	"	The index identifier for the fund's designated index, as applicable.	SEC only	Form N-RN Item E.5.
All registered funds, including closed-end funds and BDCs, subject to the absolute VaR test under Rule 18f-4(c)(2)(i).	Within one business day following the fifth business day the fund has determined the portfolio VaR of the fund exceeded, as applicable, 20% or 25% of the VaR of its net assets for preceding five business days.	The dates on which the fund portfolio's VaR exceeded 20% or 25% of the value of its net assets.	SEC only	Form N-RN Item F.1.
"	"	The VaR of the fund's portfolio for each of these days.	SEC only	Form N-RN Item F.2.
"	"	The value of the fund's net assets for each of these days.	SEC only	Form N-RN Item F.3.
All registered funds, including closed-end funds and BDCs, subject to the relative or absolute VaR test under Rule 18f-4(c)(2)(i).	The fund is back in compliance with the relative VaR test or the absolute VaR test, as applicable.	The dates on which the fund was not in compliance with the applicable VaR test.	SEC only	Form N-RN Item G.1.
"	"	The current VaR of the fund's portfolio on the date the Form N-RN is filed.	SEC only	Form N-RN Item G.2.