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

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On October 28, 2020, the Securities and Exchange Commission ("SEC") approved new Rule 18f-4 ("Final Rule") under the Investment Company Act of 1940 ("1940 Act") and further amended other rules and forms relating to the use of derivatives and certain other transactions by registered open-end funds, closed-end funds and business development companies (collectively referred to herein as "funds").[1]

The Final Rule ushers in a new era of derivatives regulation for funds 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 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 ("2019 Proposal"), including its centerpiece, new Rule 18f-4, which sets forth the conditions under which funds can enter into derivatives transactions. However, the Final Rule contains several important revisions in response to industry comments.

The Final Rule will become effective 60 days after its publication in the Federal Register ("Effective Date"), which has not yet occurred as of the date of this article. The compliance date for the Final Rule will be 18 months after the Effective Date. While the exact date of publication in the Federal Register is not yet certain, it is anticipated that the compliance date for the Final Rule will be mid-2022. Below is a summary of the key components of the Final Rule.

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 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 discussed below. 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. 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.

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").
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.

- *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.[4]

- *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 transactions, including exceeding the risk guidelines or the results of the stress testing.

- *Periodic review* 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. 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, personnel of the adviser who might not be formally designated as 'officers' of the adviser but who have a comparable degree of seniority and authority within the organization can be treated as an officer for purposes of the Final Rule. The SEC, in the Adopting Release, also provided guidance on the program administration in the context of sub-advised funds.[5]

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 below) 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.[6] The VaR-based limit will

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4. 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.
5. 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.
6. Rule 18f-4(c)(2) and Rule 18f-4(a) (defining "Value-at-Risk" or "VaR").

replace the current regime of asset segregation for purposes of limiting leverage-related risks in registered funds.[7]

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 ("Relative VaR Test").[8] 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).[9] 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 such purpose, 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 ("Absolute VaR Test").[10] 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.[11] The SEC estimates that few existing funds will fail the VaR tests.

Selecting a Designated Reference Portfolio—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.[12] The index must not be administered by 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.[13] A fund may use a blended index as its designated index, provided that each constituent index meets the rule's requirements.[14] Notwithstanding the foregoing, if the fund's investment objective is to track the performance (including a leverage 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 under the Final Rule.[15]

As an alternative to using a designated index, a fund may calculate the Relative VaR Test of its portfolio against that of its own portfolio of securities and other investments (excluding derivatives transactions), subject to certain additional requirements.[16] The use of a fund's securities portfolio for this purpose must be approved by the derivatives risk manager, and the securities portfolio must reflect the markets or asset classes in which the fund as a whole (including through derivatives) invests.[17]

VaR Model Requirements—Any VaR model that a fund selects must take into account and incorporate all significant, identifiable market risk factors associated with the 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.[18]

7. *See* the Adopting Release.
8. Note that the limit was increased from the 150% limit as set forth in the 2019 Proposal.
9. Rule 18f-4(a) (defining "Designated Reference Portfolio").
10. Rule 18f-4(c)(2)(i).
11. 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.
12. Rule 18f-4(a) (defining "Designated Index").
13. *Id.*
14. *See* the Adopting Release and Rule 18f-4(a)(defining "Designated Index").
15. *Id.*
16. Rule 18f-4(a) (defining "Relative VaR Test").
17. Rule 18f-4(a) (defining "Securities Portfolio").
18. Rule 18f-4(a) (defining "Value-at-Risk or VaR").

VaR Calculations—A fund's VaR model must use a 99% confidence level and a time horizon of 20 trading days (which may be calculated on an overlapping or non-overlapping basis). All VaR calculations must be based on at least three years of historical data, rather than historical simulation.[19] Under the Final Rule, a fund is not required 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. Its VaR calculations must, however, comply with the same proposed VaR definition and specified model requirements.[20]

Considerations for Funds of Funds—Funds of funds that do not use derivatives directly will not be required to look through to the exposure of the underlying funds in which they invest. For purposes of calculating its own VaR, a fund of funds would be permitted to use the historic returns of the underlying funds and would not require daily transparency into the holdings of underlying funds.[21]

Compliance Testing—A fund must 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 morning before market open or in the evening after market close.[22]

Remediation— If a fund 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.[23]

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 the derivatives risk manager must (1) 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) 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) provide a written report within 30 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 on the fund's progress in coming back into compliance at regularly scheduled intervals at a frequency determined by the board.[24]

III. Exceptions for Limited Derivatives Users

A.10% Notional Test

Under Rule 18f-4, if a fund is considered a "limited derivatives user," it will not be required to adopt a derivatives risk management program meeting the requirements above, nor will it be required to comply with the VaR limits, related board oversight, and reporting requirements. A fund will be deemed a "limited derivatives user" if the fund: (1) adopts and implements policies

19. *Id.*
20. *See* the Adopting Release.
21. *Id.*
22. Rule 18f-4(c)(2)(ii).
23. *Id.*
24. Rule 18f-4(c)(2)(iii).

and procedures reasonably designed to manage the fund's derivative risks and (2) limits its derivatives exposure to 10% of its net assets.[25]

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.[26] For purposes of calculating whether a fund qualifies as a limited derivatives user, a fund will be permitted to exclude derivatives transactions that it uses to hedge certain currency and interest rate risks[27] and positions closed out with the same counterparty.[28] A fund electing to treat reverse repurchase agreements as derivatives under Rule 18f-4 (as explained 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.[29] 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.[30]

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.[31] The SEC explained 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 or a Form N-PORT reporting requirement. 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.[32]

If a fund's derivatives exposure exceeds the 10% threshold for five business days, the fund's investment adviser must provide a written report to the fund's board 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;[33] or (2) establish a derivatives risk management program, comply with the VaR-based limit, and comply with the related board oversight and reporting requirements as soon as reasonably practicable.[34] 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.[35]

25. Rule 18f-4(c)(4)(i).
26. Rule 18f-4(a) (defining "Derivatives Exposure").
27. Rule 18f-4(c)(4)(i)(B).
28. Rule 18f-4(a) (defining "Derivatives Exposure").
29. *Id.*
30. Rule 18f-4(a) (defining "Derivatives Exposure" and "Derivatives Transaction").
31. *See* Rule 18f-4(c)(4)(ii).
32. *Id.*
33. Rule 18f-4(c)(4)(ii)(A).
34. Rule 18f-4(c)(4)(ii)(B).
35. Item B.9. of Form N-PORT.

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.

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.

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.[36] As funds prepare for implementation of the Final Rule, chief compliance officers and risk officers should consider the types of monitoring and reporting they are currently presenting to the board, and how that will fit together with, or be supplanted by, reports of the derivatives risk manager under the new regime. For those fund complexes with a separate derivatives risk manager, it will be important to delineate reporting lines and responsibilities and to avoid duplicative reporting responsibilities.

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.

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 noted in the Adopting Release that it believed tender option bond (TOB) financing was economically similar to reverse repos and therefore a "similar financing transaction" under the Final Rule.[37]

36. Note that a fund is not required to comply with the board oversight and reporting requirements if it is a limited derivatives user.
37. *See* the Adopting Release.

Securities Lending Transactions. 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 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 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.[38] Such commitments would not be included in or subject to the asset coverage requirements under the 1940 Act.

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

Under the Final Rule, 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. 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. 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.[39]

VIII. Special Rules for Leveraged/Inverse Funds 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

38. 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.
39. *See* the Adopting Release.

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. Because leveraged/inverse funds will generally be subject to Rule 18f-4, 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.

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 (e.g., due to embedded financing costs and valuation differences) between the VaR of the fund and 200% of the VaR of its designated index, 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.[40] The SEC would not view these de minimis deviations as exceedances of the Relative VaR Test.[41]

Grandfathered Exchange-Traded Funds (ETFs) Seeking Exposure Exceeding 200% of the Returns or Inverse Returns of an Index. The Final Rule excludes from the requirement to comply with the limit on fund leverage risk leveraged/inverse funds that, as of October 28, 2020: (1) are in operation; (2) have outstanding shares issued in one or more public offerings to investors; and (3) 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.[42] These funds must comply with all of the other provisions of Rule 18f-4 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.[43] 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.[44]

B. Amendments to Rule 6c-11

As of the Compliance Date, the Final Rule will amend Rule 6c-11 under the 1940 Act ("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.[45] Also effective on the Compliance Date, the SEC will rescind exemptive orders previously issued to sponsors of leveraged/inverse ETFs. Thereafter, new and existing leveraged/inverse ETFs would instead rely upon the conditions of the ETF Rule and Rule 18f-4 instead of existing exemptive orders.

C. No Adoption of Sales Practices Rules

The SEC determined not to adopt the sales practices rules included in the 2019 Proposal in light of the overwhelming opposition by commentators. The SEC has instead directed its staff

40. What the SEC deems to be "*de minimis*" is not defined in the Adopting Release.
41. Reporting requirements include filing Form N-RN with the SEC to report information about VaR test breaches.
42. *See* Rule 18f-4(c)(5)(i).
43. *See* Rule 18f-4(c)(5)(ii).
44. *See* Rule 18f-4(c)(5)(iii).
45. Rule 6c-11 permits certain types of ETFs to operate without first obtaining exemptive relief.

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.[46]

IX. New Reporting and Recordkeeping Requirements

As part of the Final Rule, the SEC adopted amendments to Forms N-CEN, N-PORT and N-LIQUID (to be renamed Form N-RN), the latter of which will be expanded to require reporting not only by open-end funds but also by closed-end funds and BDCs that are subject to the Final Rule's limit on fund leverage risk.[47] In a significant divergence from the 2019 Proposal, the Adopting Release limits the amount of new information that must be disclosed publicly; only the information reported on Form N-CEN and limited information on Form N-PORT will be made publicly available. More detailed information about these new reporting and disclosure requirements is set forth in the Adopting Release.

The Final Rule has also imposed certain recordkeeping requirements that are substantially consistent with those included in the 2019 Proposal and which are outlined in Rule 18f-4(e)(2). 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.[48] 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.[49]

X. Effective and Compliance Dates

The Effective Date of the Final Rule is 60 days after its publication in the Federal Register, and the Compliance Date is 18 months after the Effective Date. Funds may voluntarily comply with Rule 18f-4 after the Effective Date but prior to the Compliance Date, if the Final Rule's conditions are satisfied, subject to certain additional conditions outlined in the Adopting Release.

This 18 month compliance period will force funds to adopt an aggressive timeline in order to come into compliance with the various 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 requirements of 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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46. *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.
47. *See* Adopting Release Section II.G. for a full discussion on these amendments to fund reporting requirements.
48. *See* Rule 18f-4(c)(6)(ii)(A).
49. *See* Rule 18f-4(c)(6)(ii)(B).