



# FUND BOARD VIEWS

## Viewpoints

### **New derivatives rule: A fund board's responsibilities**

*April 6, 2022*

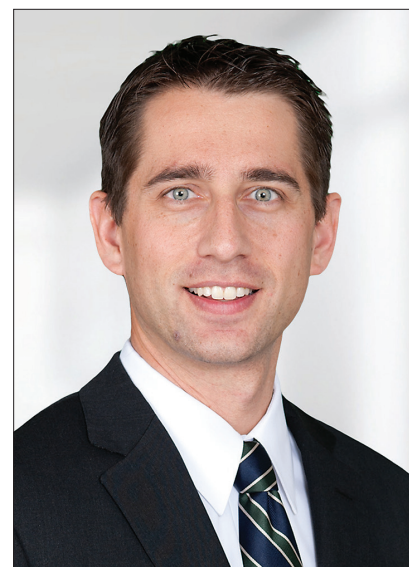
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In late 2020, the Securities Exchange adopted new rule 18f-4 under the Investment Company Act of 1940, which provides for an updated and comprehensive regulatory approach to the use of derivatives and certain other transactions by registered investment companies.<sup>1</sup> More so than the prior regulatory approach, the new derivatives rule is intended to focus on the economic realities and specific risks of funds' use of derivatives, including with respect to leverage, markets, operations, liquidity, counterparty, and legal risks. With the adoption of the derivatives rule, the SEC has also formalized the fund board's role with respect to funds' use of derivatives by including requirements that are designed to facilitate board oversight of derivative risk management.

The compliance date for the new derivatives rule is Aug. 19, 2022. On or prior to the compliance date, a board of a fund that is subject to the full requirements under the derivatives rule should be prepared to specifically: (1) approve the designation of a derivatives risk manager, who is responsible for the administration of a derivatives risk management program for



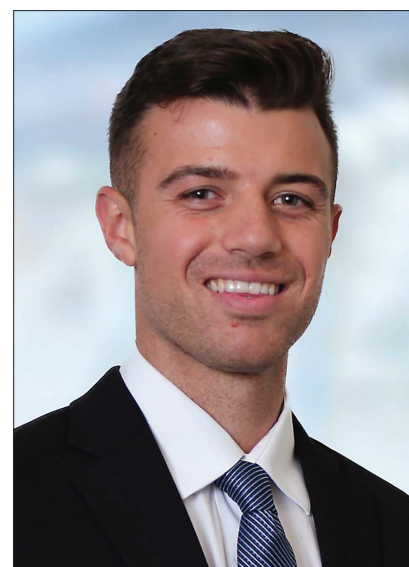
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a fund; (2) receive reports from the DRM in connection with the board's oversight responsibilities; and (3) approve compliance policies and procedures adopted pursuant to rule 38a-1 under the 1940 Act for purposes of compliance with the derivatives rule.<sup>2</sup>

After providing an overview of the derivatives rule, this article identifies and reviews the key responsibilities of a board under the rule.

## Overview

The derivatives rule requires that a fund that enters into derivative transactions (other than a fund that qualifies as a "limited derivatives user," as discussed further below) adopt and implement a written DRMP, 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 DRMP from the portfolio management of the fund. Under the derivatives rule, a "derivatives transaction" is defined as any instrument under which a fund has or may have a future payment or delivery obligation. The definition includes futures, forwards, options, swaps (or any combination thereof or any similar instrument), and short sale borrowings.<sup>3</sup>

- The DRMP must be administered by the DRM, whose designation is approved by the board, and the DRMP must include the following elements:
- Risk identification and assessment of the fund's derivatives risks;
- Risk guidelines that provide for quantitative or otherwise measurable criteria, metrics or thresholds of the fund's derivatives risks;
- Stress testing, at least weekly, to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes taking into account a number of factors;
- Backtesting, at least weekly, of the results of the fund's value-at-risk calculation model by comparing the fund's daily gain and loss to the estimated VaR each business day in the week;
- Internal reporting requirements, including providing for the escalation of material risks arising from the fund's derivatives transactions to portfolio management of the fund and to the board as appropriate; and
- Periodic review of the DRMP by the DRM.

An integral component of the derivatives rule is the requirement that a fund must comply with an outer limit on fund leverage risk based upon VaR, which is the estimate of potential losses on an instrument or portfolio, as expressed as a percentage of the value of the portfolio's assets (or net assets when computing a fund's VaR), over a specified time horizon and confidence level. A fund may choose a specific VaR model based on a number of criteria set forth under the derivatives rule.

Under the relative VaR test, a fund's VaR must not exceed 200% (250% for certain closed-end funds) of the VaR of the designated reference portfolio. Alternatively, if the DRM determines that a designated reference portfolio would not provide an appropriate reference portfolio for the purposes of the relative VaR test, the fund must instead comply with the absolute VaR test. Under the absolute VaR test, a fund's VaR must not exceed 20% (25% for certain closed-end funds) of the value of the fund's assets. Under either test, VaR is tested once a day (same time each business day). If the fund exceeds the VaR test, the fund must come

back into compliance promptly in a manner that is in the best interest of the fund and its shareholders. VaR exceedances of more than five business days trigger specific reporting obligations to the board (as further discussed below) and the SEC.

The derivatives rule provides an exemption to most of its provisions for funds that meet the qualifications of limited derivative users. Limited derivative users will not have a DRMP, a DRM, VaR limits, or related board oversight reporting requirements, but will be required to adopt and implement policies and procedures designed to manage a fund's derivatives risk. In order to be considered a limited derivative user, a fund's notional derivatives exposure cannot exceed 10% of the fund's net assets, subject to certain qualifications.

### **The Board's Role**

Boards have certain key responsibilities under the derivatives rule, which are designed to facilitate oversight by a board of a fund's derivatives risk management. These are summarized above as the board approval requirements and reviewed in further detail below. In providing oversight of derivatives risk management, the SEC believes that boards should, among other things: (i) understand the DRMP and the derivatives risks it is designed to manage; (ii) participate in determining who should administer the program as the DRM; (iii) ask questions and seek relevant information regarding the adequacy of the DRMP and the effectiveness of its implementation; (iv) inquire into materials risks arising from the fund's derivatives transactions; and (v) provide follow-up when appropriate and take reasonable steps to ensure that matters identified are addressed.

Approval of the Derivatives Risk Manager: The derivatives rule requires that a board, including a majority of the independent directors, approve the designation of the DRM. The SEC envisions an effective relationship and a direct line of communication between a board and the DRM. While a board would approve the "designation" of the DRM, the SEC has acknowledged that boards would generally request that the adviser carry out the due diligence and articulation of the qualification of the DRM.

The DRM may be either a single officer of the adviser or a group of officers of the adviser. The SEC rejected the proposal that the adviser itself may serve as the DRM in order to promote independence, objectivity, and accountability of the DRM to the board. The DRM may not be a portfolio manager of the fund, or if a group of officers serve as DRM, a majority of such officers must not be portfolio managers of the fund. A DRM is also required to have relevant experience regarding the management of derivatives risks, including with respect to leverage, markets, operations, liquidity, counterparty, and legal risks.

The relationship between a board and the DRM is different and distinct from that of the board and the chief compliance officer. For example, the CCO must be fund officer, and the board must approve the CCO's compensation. The CCO must also meet, at least annually, in executive session with the independent directors. There are no related requirements for the DRM.

Approval of Compliance Policies and Procedures: While a board will not be requested to approve the DRMP, which is a risk management program, it will be requested to approve the compliance policies and procedures in connection with the derivatives rule. The SEC stated that a board is responsible for overseeing the fund's compliance with the derivatives rule and must approve, pursuant to Rule 38a-1 under the 1940 Act, policies and procedures that are reasonably designed to prevent violations of the derivatives rule. All funds that engage in derivatives transactions in reliance on the derivatives rule, including limited derivatives users, are required to adopt such compliance policies and procedures.

Board Reporting and Oversight: The derivatives rule requires that the DRM provide various reports to the board at varying frequencies:

- *Annual Report*—The DRM must provide a written annual report to the board (which also must be provided at the implementation of the DRMP, on or prior to the compliance date), which includes a representation that the DRMP is reasonably designed to manage the fund’s derivatives risks and that it incorporates the required elements of the derivatives rule, as well as provide the basis for these representations. The annual report also must provide information reasonably necessary for the board to evaluate the adequacy and effectiveness of the implementation of the DRMP. Information in the annual report must also include, as applicable, the basis for the DRM’s approval of a fund’s designated reference portfolio or any change to a fund’s designated reference portfolio for purposes of the relative VaR test, or if a fund uses the absolute VaR test, an explanation of the basis for the DRM’s determination to use such test.
- *Regular Reports*—The DRM must provide written reports to the board, at the frequency determined by the board, on the results of the fund’s stress testing and backtesting, as well as exceedances of the fund’s risk guidelines. These regular reports must include such information as reasonably necessary for the board to evaluate the fund’s responses. The SEC indicated that these reports should not be a listing of test results, but rather a summary report that provides context and analysis of the testing results.
- *Ad Hoc Reports*—A board should further expect ad hoc reporting due to triggering events in the DRMP. The DRM must directly inform the board of material risks arising from the fund’s derivatives transactions, including risks identified by fund exceedances under the DRMP’s risk guidelines or stress testing. Also, if a fund is not in compliance with its applicable VaR test within five business days, the DRM must provide a written report to the board analyzing the exceedance and discussing how and by when the DRM reasonably expects the fund to come back into compliance, and provide a further written report within 30 calendar days that includes additional detail for the board.

Although a fund that is a limited derivatives user is not required to provide annual or regular reports to its board, it is required to report to its board if the fund exceeds the exposure threshold that allows the fund to be categorized as a limited derivatives user under the derivatives rule.

The role of the board under the derivatives rule is primarily one of oversight. Effective oversight does not require an expertise in investing in derivatives, but rather it is important to be informed, inquisitive, and appropriately responsive to the information presented. A board should be conversant with the general framework of the derivatives rule as specifically related to the funds that the board oversees, including understanding a fund’s use of derivatives and the DRMP and the derivatives risks it is designed to address. Boards may continue to rely on the recommendations of others in fulfilling their oversight responsibilities, including from the DRM, portfolio management, and compliance and legal personnel.

In preparation for the upcoming compliance date, boards should continue to request information from the adviser, including with respect to the specific funds that are within the scope of the derivatives rule, the process for determining the person(s) that will serve as the DRM, the development of the DRMP (including

incorporating any role of a sub-adviser), and any necessary board or SEC reporting. In addition, boards can seek information on the level of support that the DRM or the adviser will receive, including with respect to VaR calculations, backtesting, and stress testing.

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1. Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34078 (Oct. 28, 2020) (Adopting Release).
  2. Related requirements for limited derivatives users are less extensive, and reviewed throughout this article.
  3. A fund also may (but is not required to) consider reverse repurchase agreements or similar financing transactions and unfunded commitments as "derivatives transactions" under the Derivatives Rule for purposes of meeting the requirements of Section 18 of the 1940 Act.