SEC Adopts New Rule Governing Registered Funds' Use of Derivatives

December 18, 2020

Under Rule 18f-4, a "derivatives transaction" means: (1) 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 of delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing and (3) if a registered fund chooses to rely on paragraph (d)(1)(ii) of Rule 18f-4 to treat all reverse repurchase agreements or similar financing transactions as derivatives transactions, any reverse repurchase agreement or similar financing transaction. Rule 18f-4 permits a registered fund to enter into reverse repurchase agreements and similar financings provided that the registered fund: (1) treats the transaction as a borrowing and meets the asset coverage requirements under Section 18 or (2) in a change from the proposed rule, treats all reverse repurchase agreements or similar financings as derivatives transactions under the rule.

Summary

In a **release** dated November 2, 2020 (the "**Adopting Release**"), the Securities and Exchange Commission (the "**SEC**") adopted new Rule 18f-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), which was originally proposed by the SEC on December 11, 2015 (the "**2015 Proposal**") and re-proposed on November 25, 2019 (the "**Proposing Release**"). According to the Adopting Release, Rule 18f-4 applies to the use of **derivatives transactions** and certain other transactions by registered investment companies (other than money market funds and UITs) and business development companies ("**registered funds**"), and is designed to promote the ability of registered funds to use derivatives in a broad variety of ways that serve investors, while still addressing the investor protection concerns underlying Section 18 of the Investment Company Act. The SEC adopted most elements of the proposed rule described in the Proposing Release, with certain modifications as further described below. Most notably, the final rule did not adopt the proposed alternative requirements for **leveraged/inverse funds**, which in most cases, because of their extensive use of derivatives, would be unable to meet the fund leverage risk limits under Rule 18f-4. The alternative framework proposed in the Proposing Release would have excluded certain leveraged/inverse funds from the fund leverage risk limits, and would have imposed new sales practices rules under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), and the Investment Advisers Act of 1940, as amended (the "**Investment Advisers Act**"), with respect to the purchase and sale of leveraged/inverse funds for retail investor accounts. In response to commenters' concerns, the SEC did not adopt the proposed alternative framework and sales practice rules for leveraged/inverse funds, and Rule 18f-4, as adopted, provides an exception to the fund leverage risk limit only for certain leveraged/inverse funds that were in operation as of October 28, 2020.

The SEC also adopted amendments to Forms N-PORT, N-LIQUID (re-titled "Form N-RN") and N-CEN, which require a registered fund to report, among other things, certain information regarding testing of its fund leverage risk and, for a registered fund relying on the limited derivatives user exception, its derivatives exposure.

A "leveraged/inverse fund" is defined in Rule 18f-4 as a registered 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."

Key Takeaways

The elements of Rule 18f-4 are discussed in greater detail below. Some key takeaways include:

- Modifications from the proposed rule to provide greater flexibility in the application of the relative VaR test under the rule, including increasing the fund leverage risk limit to 200% from 150%, as originally proposed, and permitting an actively managed fund to use its securities portfolio (excluding derivatives transactions) as its designated reference portfolio for purposes of the test.
- Adoption of the proposed rule's lighter approach for board oversight of registered funds' derivatives risk management programs, as compared to the extensive board oversight responsibilities originally proposed in the 2015 Proposal.
- Rejection of the alternative regulatory framework and sales practice requirements originally proposed in the Proposing Release for leveraged/inverse funds.
- In dissenting opinions, Commissioners Lee and Crenshaw expressed their concern that the final version of Rule 18f-4 deviated significantly from the original purpose of the proposed rule and did not go far enough to protect retail investors from leverage and derivatives risks in registered funds. Commissioner Lee noted that the final rule "underwent a substantial overhaul – increasing risk, reducing transparency around that risk, and dropping the basic sales practice rules for extremely complex products – all to the detriment of retail investors."[1]

Background

Section 18 of the Investment Company Act is a protective measure designed to limit the leverage a registered fund can incur through the issuance of "senior securities," which broadly include instruments that evidence indebtedness. In a 1979 release ("**Release 10666**"),[2] and in no-action letters and comment letters issued since then, the SEC and its staff provided guidance on the application of Section 18 limits to reverse repurchase agreements, firm and standby commitment agreements, various derivative instruments and short sale transactions. Under such guidance, which will be rescinded with the adoption of Rule 18f-4, a

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[1] Commissioner Allison Herren Lee, "Statement on the Final Rule on Funds' Use of Derivatives" (Oct. 28, 2020), **SEC.gov | Statement on the Final Rule on Funds' Use of Derivatives**; Commissioner Caroline A. Crenshaw, "Statement on Funds' Use of Derivatives" (Oct. 28, 2020), **SEC.gov | Statement on Funds' Use of Derivatives**.

[2] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25, 128 (Apr. 27, 1979).

registered fund was generally permitted to engage in derivatives transactions and financial commitment transactions without being subject to a limit on the level of those transactions, provided that the fund segregated liquid assets sufficient to cover its risk of loss under those transactions.

As noted in the Proposing Release and Adopting Release, the SEC continues to believe that Section 18 serves the Investment Company Act's fundamental purpose of protecting investors against the potential adverse effects of excessive leverage, which could unduly increase the speculative nature of a registered fund's common shares, and increase the risk that a registered fund may be operating without sufficient assets or reserves to meet its obligations. However, the SEC also expressed its concern, as it did at the time of the 2015 Proposal, that current market practices among registered funds with respect to the use of derivatives may not adequately address the undue speculation and asset sufficiency concerns underlying Section 18.[3] In addition, the SEC noted that different interpretations of SEC staff guidance in this area have led to varying practices among registered funds regarding the amounts and types of assets segregated for the same types of transactions. In the SEC's view, disparate market practices may have created unfair disadvantages for certain registered funds, and made it more difficult for registered funds and SEC staff to evaluate funds' compliance with Section 18.

To address these concerns, the SEC initially issued the 2015 Proposal, which took a more rigid approach to limiting derivatives use by imposing restrictive asset segregation requirements and limits on a registered fund's notional exposure to derivative transactions and other Section 18 senior securities. Commenters were largely critical of the 2015 Proposal and noted in particular that such requirements could limit the ability of registered funds to use derivatives for nonspeculative purposes that benefit investors, such as risk mitigation.[4] In response, the SEC proposed and adopted the current version of Rule 18f-4, which replaces the prescriptive approach of the 2015 Proposal with a more flexible approach that recognizes the valuable role that derivatives can play in helping a registered fund to manage risks and achieve its investment objectives efficiently.

The SEC also rescinded prior guidance provided in Release 10666 regarding the application of Section 18 to reverse repurchase agreement transactions and firm and standby commitment transactions. Consistent with its approach in other areas of the securities laws, including within the Division of Investment Management, the SEC staff has also reviewed previously issued no-action letters regarding the use of derivatives by registered funds to determine which no-action letters should be withdrawn in connection with the adoption of Rule 18f-4. The withdrawal of such no-action letters and Release 10666 will be effective 18 months after the effective date of Rule 18f-4.

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[3] For example, the Proposing Release noted that for cash-settled derivatives, registered funds commonly segregate their mark-to-market liability, as opposed to the notional amount of their potential obligation, which may not reflect the full investment exposure of such positions.

[4] Commissioner Hester M. Peirce and Commissioner Elad L. Roisman, "Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices" (Nov. 26, 2019), **https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices**.

Rule 18f-4 Requirements

Rule 18f-4 generally permits registered funds (including business development companies, but not money market funds or UITs) to enter into derivatives transactions, notwithstanding the restrictions under Section 18 of the Investment Company Act, subject to certain conditions as described below.

Adoption of Derivatives Risk Management Program

Under Rule 18f-4, a registered fund is required to adopt a written derivatives risk management program reasonably designed to manage a registered fund's derivatives risks while, as recently seen in other SEC rulemakings, allowing principles-based tailoring to the registered fund's particular risks. The rule requires one or more officers of a registered fund's adviser (including any subadviser) to administer the derivatives risk management program as the fund's derivatives risk manager. According to the Adopting Release, this requirement is intended to centralize the fund's derivatives risk management function and promote accountability, while allowing the flexibility for a group or committee of officers to serve as a fund's derivatives risk manager, as opposed to a single officer as was required under the 2015 Proposal. The derivatives risk management program must also be designed to reasonably segregate the registered fund's derivatives risk management function from its portfolio management, based on the view that such segregation promotes objective and independent risk assessment, and serves as a check and balance on the fund's portfolio management function. Commenters generally supported a segregation requirement but noted that portfolio managers' expertise and input with respect to derivatives may be needed for a registered fund to be able to react to market events. In the Adopting Release, the SEC recognized the value of such input and noted that the rule would not require strict communications barriers between the derivatives risk management and portfolio management functions, and would permit a group or committee serving as a registered fund's derivatives risk manager to include the fund's portfolio managers. However, a single portfolio manager for a registered fund is not permitted to serve as the fund's derivatives risk manager, and if a group or committee serves as the fund's derivatives risk manager, the fund's portfolio managers are not permitted to be a majority of such group or committee.

The rule also requires a registered fund's derivatives risk management program to include the following elements:

- Identification and assessment of the registered fund's derivatives risks, including leverage risk, market risk, counterparty risk, liquidity risk, operational risk, legal risk and any other risks that are deemed material by the registered fund's derivatives risk manager (or investment adviser, in the case of a limited derivatives user that is exempt from the requirement to appoint a derivatives risk manager),
- Establishment, maintenance and enforcement of risk guidelines that provide for quantitative or otherwise measurable criteria, metrics or thresholds, and that specify the levels that the registered fund does not normally expect to exceed and the measures to be taken if exceeded,

- Stress testing to be conducted at least weekly to evaluate potential losses to a registered fund's portfolio due to "extreme but plausible market changes" or changes in market risk factors that would significantly adversely affect the fund's portfolio, taking into account correlations of market risk factors, and resulting payments to derivatives counterparties,
- Backtesting, to be conducted no less frequently than weekly, of the VaR calculation model used by the registered fund to conduct the fund leverage risk limit tests,
- Internal reporting to persons responsible for a registered fund's portfolio management under circumstances that must be specified in the fund's derivatives risk management program, including the results of stress tests conducted under the program and breaches of the risk guidelines established under the program,
- Escalation of material risks arising from a registered fund's derivatives transactions in a timely manner to persons responsible for a registered fund's portfolio management and, if the derivatives risk manager deems it appropriate, to the board of directors, and
- Periodic review of the derivatives risk management program at least annually by a registered fund's derivatives risk manager to evaluate the program's effectiveness and to reflect changes in risk over time, including a review of the VaR calculation model (and its backtesting), and any designated reference portfolio, used by the registered fund to conduct the fund leverage risk limit tests.

Fund Leverage Risk Limits

Use of VaR

For purposes of Rule 18f-4, VaR means an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's assets (or net assets when computing a registered funds's VaR), over a specified time horizon and at a given confidence level.

As described in the Proposing Release and Adopting Release, Rule 18f-4 replaces the 2015 Proposal's asset segregation requirement and general notional exposure limits with a fund leverage risk limit based on a registered fund's **VaR**. The SEC eliminated the 2015 Proposal's asset segregation requirement because, in the SEC's view, such requirement would be more restrictive and less risk-sensitive than Rule 18f-4's VaR tests as a means to limit fund leverage risk, and may limit a registered fund's ability to enter into derivative transactions that do not raise the concerns underlying Section 18. Similarly, the SEC noted that requiring a notional exposure limit would be a relatively blunt tool that would not differentiate between derivatives transactions that may have the same notional amount but different underlying reference assets with varying levels of risk. Therefore, Rule 18f-4 adopted a VaR test (as described below), which the SEC viewed as a more effective means to analyze whether a registered fund uses derivatives for leverage, as opposed to other purposes that do not raise the concerns underlying Section 18.

According to the Adopting Release, some commenters expressed concerns with the use of VaR, including a concern that VaR does not reflect the size of losses occurring on trading days on which the greatest losses occur ("**tail risks**") and may underestimate the risk of loss under stressed market conditions. However, the SEC stated in the Adopting Release that it continues to believe that the VaR tests are an appropriate means to limit fund leverage risks as part of Rule 18f-4, noting that it "believe[s] that the final rule's derivatives risk management program provides an effective complement to the VaR tests and, in particular, that the stress testing component of the program will require [registered] funds to evaluate the 'tail risks' that VaR by its nature does not capture. A [registered] fund's compliance with its VaR test would satisfy the final rule's outside limit on fund leverage risk but is not a substitute for an effective derivatives risk management program."

Rule 18f-4 requires that any VaR model used by a registered fund to test its compliance with the rule's fund leverage risk limit (as described below) take into account all significant, identifiable market risk factors associated with the fund's investments, including (as relevant):

- equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
- material risks arising from nonlinear price characteristics of the fund's investments, including options and positions with embedded optionality; and
- the sensitivity of the market value of the fund's investments to changes in volatility.

The rule also requires such VaR model to use a 99% confidence level and a time horizon of 20 days, and to be based on at least three years of historical market data.

Default Test: Relative VaR

Under the rule, registered funds that use derivative transactions are required to comply with a relative VaR test whereby the VaR of the registered fund's portfolio may not exceed 200% of the VaR of a designated reference portfolio (250% in the case of a closed-end registered fund or BDC with outstanding shares of a class of senior security that is stock), which may be: (i) an unleveraged index approved by the registered fund's derivatives risk manager that reflects the markets or asset classes in which the registered fund invests, provided that a registered fund whose investment objective is to track the performance (including a leveraged multiple or inverse multiple) of an unleveraged index must use that index as its designated reference portfolio or (ii) the registered fund's securities portfolio, excluding any derivatives transactions, approved by the registered fund's derivatives risk manager for purposes of the relative VaR test.[5] The designated reference portfolio is intended to represent a baseline VaR that approximates the VaR of a registered fund's unleveraged portfolio. By comparing the fund's VaR to the baseline VaR of the designated reference portfolio, the VaR test was designed to limit the extent to which the fund increased its leverage risk through the use of derivatives.

The SEC modified this test from the relative VaR test as proposed in the Proposing Release by, among other things: (i) increasing the fund leverage

[5] According to the Adopting Release, the final rule requires the designated index to be "approved" by the derivatives risk manager as opposed to "selected," as originally proposed, to clarify that the designated index may be recommended by advisory personnel for the derivatives risk manager's approval.

risk limit to 200% (250% in the case of certain closed-end registered funds and BDCs as described above) from 150% as originally proposed and (ii) permitting an actively managed fund to use its securities portfolio, excluding derivative transactions, as its designated reference portfolio, as opposed an index.

Alternative Test: Absolute VaR

Under the Proposing Release, if a registered fund's derivatives risk manager is unable to identify an appropriate designated reference index, the registered fund would have been required to comply with an absolute VaR test whereby the VaR of the registered fund's portfolio could not exceed 15% of the value of its net assets. Under the final version of Rule 18f-4, a registered fund would be required to comply with the absolute VaR test if its 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." According to the Adopting Release, the SEC made this modification to make clear that the derivatives risk manager's determination must be made "after reasonable inquiry and analysis regarding the feasibility of applying a relative VaR test to a fund and the appropriate reference portfolio for that purpose." The final rule also increased the limit for the absolute VaR test to 20% of the value of the registered fund's net assets (25% in the case of a closed-end registered fund or BDC with outstanding shares of a class of senior security that is stock).

Implementation

The SEC recognized the concerns regarding operational complexities raised under the 2015 Proposal, which required testing of the applicable limits immediately after a registered fund entered into a senior securities transaction. To address these concerns, the SEC modified Rule 18f-4, as adopted, to require testing of the applicable VaR test at least once each business day. Under the proposed version of Rule 18f-4, in the event that a registered fund did not meet the required fund leverage risk limit, the fund would have been required to come into compliance within three business days, and if the fund was not in compliance within three business days, then the derivatives risk manager would have been required to comply with certain board reporting requirements and review the fund's derivatives risk management program to make updates to the program as necessary. In addition, the fund would have been prohibited from entering into any derivatives transactions (other than derivatives designed to reduce the fund's VaR) until the fund had complied with the applicable VaR test for three consecutive business days.

According to the Adopting Release, commenters expressed concern that such remediation requirements under the proposed rule could cause funds to enter into fire sales and realize trading losses, which could result in greater harm to investors than noncompliance with fund leverage risk limits. In response, the SEC loosened such requirements in the final rule so that if a registered fund determines that it does not meet the required fund leverage risk limit, the fund must come back into compliance "promptly after such determination, in a manner that is in the best interests of the fund and its shareholders," eliminating the three business day time limit. The SEC also: (i) eliminated the proposed prohibition on a registered fund's ability to enter into derivatives transactions if the fund does not come back into compliance with its VaR test within three business days, (ii) extended from three business days to five business days the time period during which a registered fund may be in violation of its VaR test before having to comply with certain board reporting requirements (which, in a change from the proposed rule, must be in writing) and review of the fund's derivatives risk management program and (iii) added a requirement for the derivatives risk manager to provide a written report to the registered fund's board within 30 calendar days of the exceedance, explaining how the fund came back into compliance with its VaR test, and the results of the required review of the fund's derivatives risk management program. If the registered fund remains out of compliance with its VaR test at the time of the report, such report must update the board on when the derivatives risk manager reasonably expects the fund to come into compliance, and the derivatives risk manager must also update the board on the fund's progress at regularly scheduled intervals at a frequency determined by the board.

Board Oversight and Reporting

As adopted, Rule 18f-4 eliminated the 2015 Proposal's extensive requirements for board approval and oversight of a registered fund's use of derivative transactions and derivatives risk management program. Instead, the final rule requires a registered fund's board to approve the designation of the fund's derivatives risk manager, and the derivatives risk manager is required to provide a written report, at least annually, to the board regarding the implementation and effectiveness of the fund's derivatives risk management program. The derivatives risk manager is required to include in such report a representation that the derivatives risk management program was reasonably designed to manage the fund's derivatives risks and complies with the requirements of the rule. Such representation may be based on the derivative risk manager's reasonable belief after due inquiry, which basis must be included in the written report to the board, along with such information as may be reasonably necessary to evaluate the program. The SEC proposed such representation because it believes that a fund's derivatives risk manager is in the best position to make such determination, as opposed to the fund's board, and that management of a fund's derivatives risks is primarily the responsibility of the fund and the fund's adviser, with board oversight.

Rule 18f-4 also requires the derivatives risk manager to provide written reports to the board, at a frequency determined by the board, regarding its analysis of breaches of the risk guidelines set forth in the derivatives risk management program, and results of the stress testing and backtesting conducted under the program.

In connection with the Proposing Release, Commissioners Robert J. Jackson Jr. and Allison Herren Lee commented on the change from the 2015 Proposal, stating that they were "unpersuaded that hiring the risk manager is enough board-level engagement on the risks presented by derivatives use."[6] Nevertheless, the board oversight and reporting

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[6] Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee, "Statement on Proposed Rules on Funds' Use of Derivatives" (Nov. 26, 2019), **https://www.sec.gov/news/public-statement/jackson-lee-statement-proposed-rules-funds-derivatives**.

requirements of Rule 18f-4 were adopted largely as proposed in the Proposing Release, except for the following modifications:

- The final rule clarified that the scope of the derivatives risk manager's written reports to the board need not report every single breach of the risk guidelines. According to the Adopting Release, the derivatives risk manager's report must include an analysis of the exceedances, which could be in summary form,
- The final rule eliminated the specific reference to the board's taking into account, when approving the designation of a derivatives risk manager, the derivatives risk manager's relevant experience regarding management of derivatives risk. According to the Adopting Release, such specific reference is unnecessary, as the board's consideration of a candidate would necessarily take into account the candidate's relevant experience, as well as all other relevant factors.
- The final rule clarified that the derivatives risk manager's written reports to the board on the implementation and effectiveness of the derivatives risk management program must include the basis for any change in the designated reference portfolio, in addition to the basis for approval of a designated reference portfolio.

Exception for Limited Derivatives Users

Rule 18f-4 provides exceptions from the VaR-based limit on fund leverage risk, the required elements of the derivatives risk management program and the related board oversight and reporting provisions for a registered fund that uses derivatives in a limited manner. A registered fund may rely on such exceptions if the fund:

- adopts and implements policies and procedures reasonably designed to manage the registered fund's derivatives risks, and
- limits its notional derivatives exposure (including the value of assets sold short) to 10% of its net assets.

As adopted, the limited derivatives user exception in the final rule included certain modifications from the proposed rule, including a clarification that a registered fund's derivatives exposure: (i) can exclude any closed-out positions, if such positions were closed out with the same counterparty and result in no credit or market exposure to the fund, and (ii) must include, for a registered fund that chooses to treat its reverse repurchase agreements or similar financing transactions as derivative transactions under the rule, the proceeds that the fund has received but has not yet repaid, or for which the associated liability has not been extinguished, in connection with each such transaction.

In a change from the proposed rule, the final rule permits a fund to exclude certain currency and interest rate hedges from the 10% derivatives exposure threshold. In addition, the SEC responded to commenters' concerns by including provisions in the final rule to address exceedances of the 10% derivatives exposure threshold. Under the final rule, if the derivatives exposure of a registered fund relying on the limited derivatives user exception exceeds the 10% threshold for five business days, the fund's investment adviser must provide a written report to the fund's board stating whether the investment adviser intends to reduce the fund's derivatives exposure to under 10% of net assets promptly (and within 30 days) or, as soon as reasonably practicable, comply with the final rule's VaR-based limit on fund leverage risk, the required elements of the derivatives risk management program and the related board oversight and reporting provisions.

Recordkeeping

Rule 18f-4 requires a registered fund to maintain certain records that are designed to provide SEC staff, the registered fund's board and its compliance staff the ability to evaluate compliance with the rule. Specifically, the rule requires a registered fund to maintain:

- The written policies and procedures of its derivatives risk management program, along with results of the stress testing and backtesting required under the rule, and records documenting any internal reporting, escalation of material risks and periodic reviews of the program, as required under the rule.
- Copies of materials provided to the fund's board of directors in connection with approval of the derivatives risk manager and other reports required to be made to the board under the rule.
- Determinations or actions taken by the fund under the rule's fund leverage risk limit requirements.
- The written policies and procedures, and reports to the board, required for limited derivatives users under the rule.
- Written records documenting whether the fund treats reverse repurchase agreements or similar financing transactions as derivatives transactions or senior securities subject to the asset coverage requirements of Section 18.

These records would be required to be kept for not less than five years, with the first two years in an easily accessible place.

Reverse Repurchase Agreements and Unfunded Commitments

Rule 18f-4 permits a registered fund to enter into reverse repurchase agreements and similar transactions provided that the registered fund treats the transaction as a borrowing and meets the asset coverage requirements under Section 18 of the Investment Company Act. In a change from the proposed rule, the final rule also provides that a registered fund may instead choose to treat all reverse repurchase agreements or similar financings as derivatives transactions under the rule.

Rule 18f-4 also permits a registered fund to enter into unfunded commitment agreements (e.g., agreements to make a loan to a company or to invest in the equity of a company in the future) subject to certain conditions, including the registered fund's reasonable belief that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements.

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

Commenters noted that certain securities transactions customarily settle on a delayed basis, and that registered funds may engage in such transactions for the purpose of purchasing the securities, and not for the purpose of obtaining an unfunded investment exposure to such securities. In the Adopting Release, the SEC agreed with commenters that the potential for leverage in such transactions is limited because of the short period of time between trade date and settlement, and the fund's intention to physically settle such transactions rather than enter into offsetting transactions. To address this, the SEC added a new provision to the final rule to clarify that such transactions would not be deemed to involve a senior security, provided that the fund intends to physically settle the transaction and the transaction settles within 35 days of its trade date. Such provision would also apply to money market funds, in addition to the registered funds that are subject to Rule 18f-4.

Leveraged/Inverse Funds

In the most significant departure from the proposed rule, the SEC determined not to adopt the proposed alternative framework for leveraged/inverse funds, which generally use derivatives extensively to pursue their investment strategies. In the Proposing Release, the SEC expressed concerns with retail investors' investment in such leveraged/inverse funds, which are generally intended as short-term trading tools and can result in large and unexpected losses for longer-term investors (noting in particular FINRA sanctions against broker-dealers for unsuitable sales of leveraged/inverse ETFs). However, the SEC also noted that investors who are sophisticated enough to be able to evaluate the risks of such investments may want to be able to use such investments for short-term investment needs. The SEC therefore proposed in the Proposing Release an alternative regulatory framework to address investor protection concerns, while still preserving the availability of leveraged/inverse funds as an investment choice for certain retail investors.

Specifically, as described in the Proposing Release, Rule 18f-4 would have provided for an exception to the VaR-based limit on fund leverage risk for a leveraged/inverse fund that:

- Discloses in its prospectus that it is not subject to such limit on fund leverage risk, and
- Does not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse return) of its underlying index.

As a counterweight to this exception, the Proposing Release also proposed sales practice rules under the Exchange Act and Investment Advisers Act, which were designed to ensure that retail investors making investments in leveraged/inverse funds were capable of evaluating the risks of such investments.

As noted in the Adopting Release, most commenters "categorically opposed" the adoption of the proposed sales practice rules, citing that such rules would, among other things: overlap with existing broker-dealers' obligations under Regulation Best Interest and investment advisers' fiduciary duties; increase operational burdens and costs, which may cause broker-dealers and investment advisers to stop offering such investments and restrict investment options available to investors; and fail to achieve the SEC's investor protection goals because such rules would not apply to other leveraged/inverse products, such as ETNs. In response to these comments, the SEC abandoned the proposed alternative framework and sales practice rules for leveraged/inverse funds described in the Proposing Release. As adopted, Rule 18f-4, including the fund leverage risk limit, applies to all leveraged/inverse funds, with a narrowed exception to the fund leverage risk limit only for any existing leveraged/inverse fund (in operation as of October 28, 2020) that cannot comply with such limit and:

- Has outstanding shares issued in one or more public offerings and discloses in its prospectus a leverage multiple or inverse multiple that exceeds 200% of its underlying index;
- Does not change the underlying index or increase the level of the leveraged or inverse exposure that the fund seeks to provide; and
- Discloses in its prospectus that it is not subject to such limit on fund leverage risk.

The SEC noted in the Adopting Release that the combination of Rule 18f-4 and Regulation Best Interest may not be sufficient to address all investor protection concerns raised by complex products, such as where a retail investor invests through a self-directed account in ETNs or other products that use leveraged/inverse strategies. The SEC therefore directed its staff to review the effectiveness of existing regulatory requirements with respect to complex products, and consider recommendations to the SEC for additional rulemaking or other policy action to promote retail investors' understanding of such products and their risks.

The SEC also adopted amendments to Rule 6c-11 to remove the provision that currently excludes ETFs that are leveraged/inverse investment funds from relying on the rule, and to require such ETFs to comply with Rule 18f-4.

Reporting Requirements

Amendments to Forms N-PORT, N-LIQUID (re-titled as "Form N-RN") and N-CEN require a registered fund to provide information to the SEC regarding: (1) only for a fund relying on the limited derivatives user exception, its exposure to derivatives and exceedances of the 10% threshold, (2) its median daily VaR and backtesting results, (3) if applicable, its designated reference portfolio, (4) VaR test breaches (to be reported to the SEC in a nonpublic current report) and (5) certain identifying information regarding the Rule 18f-4 provisions relied on by the registered fund such as, among other things, whether the fund is a limited derivatives user or leveraged/inverse fund excepted from certain requirements under the rule, and whether the fund has treated its reverse repurchase agreements or similar financing transactions as derivatives transactions under the rule or subject to Section 18 asset coverage requirements. In a change from the proposed rule, such information generally would not be made public, except for the information regarding a registered fund's designated reference portfolio and the identifying information described above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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Transition Period

The SEC provided a transition period of 18 months from the effective date of Rule 18f-4 to provide time for affected registered funds to prepare for compliance with the final rule.