GOODBYE TO ALL THAT: SEC ADOPTS RULES OVERHAULING FUNDS' USE OF DERIVATIVES; ENDS ASSET SEGREGATION

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U.S. Asset Management and Investment Funds Alert

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EXECUTIVE SUMMARY

On 28 October 2020, the U.S. Securities and Exchange Commission (SEC) adopted Rule 18f-4 (Rule or 18f-4) under the Investment Company Act of 1940, as amended (1940 Act). The Rule replaces the SEC's decades-old patchwork of guidance with a comprehensive framework for the use of derivatives transactions by registered funds. The final Rule retains the key elements of the proposal (2019 Proposal), with certain modifications in consideration of industry feedback and market disruptions surrounding the coronavirus (COVID-19) outbreak.

The Rule, which is structured as an exemption from restrictions on the issuance of "senior securities" set forth in Sections 18 and 61 of the 1940 Act, imposes several conditions on funds that make significant use of derivatives transactions (defined below), including:

- value at risk (VaR) limitations in lieu of asset segregation requirements;
- adoption of a written derivatives risk management program (DRMP);
- new oversight responsibilities on a fund's board of directors (the Board);
- an exception for funds that make limited use of derivatives;
- alternative requirements for certain leveraged/inverse funds;
- special treatment for reverse repurchase agreements (reverse repos) and similar financing transactions under the Rule;
- special treatment for unfunded commitment agreements under the Rule; and
- new reporting and recordkeeping requirements.

The Rule defines "derivatives transactions" to mean:

1. any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise;
2. any short sale or borrowing; and

3. (optionally) reverse repos and similar financing transactions.

Notably, the final definition adopted in 18f-4 provides an option for funds to consider reverse purchase agreements and similar financing transactions as either derivatives transactions for purposes of meeting the requirements set forth in the Rule or as senior securities equivalent to bank borrowings for purposes of Sections 18 of the 1940 Act.

In conjunction with the Rule, the SEC will rescind Investment Company Act Release No. 10666 (Release 10666)7, as well as subsequent SEC staff no-action letters and other guidance that together have governed the use of derivatives and certain other financing transactions in registered funds for over 40 years.

Key Dates

- Effective Date – The Rule is effective 60 days after publication in the Federal Register.8
- Compliance Date – Eighteen months after the effective date, funds (except those relying on the "limited derivatives user" exception) must implement VaR testing and a DRMP. The SEC will simultaneously rescind Release 10666 and its related guidance.

A fund may operate in reliance on 18f-4 after the effective date but prior to the compliance date, provided that the fund satisfies all conditions set forth in 18f-4.

Summary Of Key Elements

In this alert, we provide summaries and practical takeaways for the three key elements of the Rule—VaR limits, derivatives risk management, and Board responsibilities—as well as an overview of key exceptions, alternatives, and reporting requirements.

- **VaR Limits.** The Rule will entirely replace the asset segregation regime set forth in Release 10666 and subsequent SEC staff guidance with a VaR test intended to impose an "outer limit" on leverage risk in funds. The VaR test will measure the VaR of the fund relative to the VaR of a "designated reference portfolio" that reflects the markets or asset classes in which the fund invests. The designated reference portfolio can generally be either (i) an index selected by the fund's derivatives risk manager (DRM), or (ii) the fund's own securities portfolio (excluding derivatives transactions). Under the Rule, the VaR of a fund's portfolio cannot exceed 200% (250% for certain closed-end funds) of the VaR of the designated reference portfolio.9 If the fund's DRM reasonably determines that no designated reference portfolio can be identified, the Rule instead requires an "absolute VaR test," which limits the VaR of the fund's portfolio to no more than 20% (25% for certain closed-end funds) of the fund's net assets.
- **Derivatives Risk Management Program.** A formalized risk management program is a second key element of the Rule. The Rule will require funds to adopt a written DRMP that includes policies and procedures reasonably designed to manage a fund's derivatives risks.10 The Rule grants a fund the flexibility to tailor its DRMP to suit its derivatives usage, but each DRMP must include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing on at least a weekly basis, (4) weekly backtesting, (5) internal reporting and escalation, and (6) periodic reviews of the DRMP.
- **Board Responsibilities.** The Rule will require a fund Board's heightened attention to and oversight of the fund's derivatives usage and the attendant material risks. In particular, the Board must approve the

designation of an officer or officers of the fund's investment adviser as the fund's DRM, and it must review the DRM's initial and annual written report on the DRMP. In addition, the Board is expected to review periodic written reports describing information related to the implementation of the DRMP.

- **Exception for Limited Derivatives Users.** Funds that limit derivatives exposure to 10% of net assets (excluding certain currency and interest rate hedging transactions) are excepted from the VaR test, DRMP requirements, and Board oversight and reporting requirements of the Rule, provided that such funds implement written policies and procedures reasonably designed to manage their derivatives risks.
- **Other Provisions.** The Rule contains several exceptions and provisions related to specific types of funds and instruments. Money market funds are excluded from the definition of “funds” for purposes of the Rule. Consequently, under the Rule, money market funds are effectively prohibited from engaging in derivatives transactions, with the narrow exception of delayed-settlement securities.[11] The Rule also contains detailed provisions regarding the definition of “derivatives transactions” and special treatment for leveraged/inverse funds, reverse repos and similar financing transactions, delayed-settlement securities, and unfunded commitment agreements, as well as expanded reporting and recordkeeping requirements.

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