Dealing with the New Derivatives Rule: A Guide for Legal and Compliance Professionals

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In October 2020, the U.S. Securities and Exchange Commission (the "SEC") adopted Rule 18f-4 under section 18 of the Investment Company Act of 1940 (the "1940 Act") to regulate the use of derivatives by open-end registered investment companies other than money market funds, business development companies ("BDCs"), and closed-end investment companies ("Funds"). This Compliance Corner article provides an overview of the requirements of Rule 18f-4 and practical considerations related to the design of compliance programs under that rule. More in-depth discussions of Rule 18f-4 are available at our blogs: Asset Management ADVocate (assetmanagementadvocate.com) and Derivatives & Repo Report (derivativesandreporeport.com).

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Background: Limitations on Senior Securities

The 1940 Act restricts the ability of a Fund to issue "senior securities" unless it maintains a minimum level of "asset coverage." Section 18(g) defines "senior security" to mean "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness." Section 18(h) defines "asset coverage" as the ratio which the value of the Fund's assets minus liabilities other than liabilities for the relevant senior securities bears to the aggregate amount of such senior securities.

In particular, section 18 prohibits an open-end Fund from issuing or selling any "senior security," other than a borrowing from a bank, unless it maintains a 300% asset coverage ratio. Closed-end Funds must also maintain a 300% asset coverage ratio for indebtedness, although their indebtedness is not limited to bank loans. Closed-end Funds may also issue senior securities that are preferred stock, subject to only a 200% asset coverage ratio. Section 61 subjects BDCs to the limitations applicable to closed-end funds under section 18, although BDCs may decrease their asset coverage ratio to 150% if certain conditions are met.

In Investment Company Act Release 10666 (April 1979), the SEC staff took the position that purchases of to-be-announced securities and other forward contracts, as well as puts to a Fund, were senior securities for purposes of the 1940 Act, but permitted Funds to engage in these transactions if the Fund's obligation was covered by segregated assets. Subsequent no-action letters and staff guidance expanded this position to cover other derivatives transactions. Starting on August 19, 2022, Release 10666 and these no-action letters will be rescinded, and Funds will be required to comply with Rule 18f-4. Compliance with Rule 18f-4 is optional prior to August 19, 2022.

What Rule 18f-4 Does

Rule 18f-4 primarily permits funds to engage in "derivatives transactions" that would otherwise be subject to the restrictions of Section 18 of the 1940 Act. The rule's definition of a "**derivatives transaction**" includes a list of specific "derivatives instruments," borrowing assets for short sales, and a catchall for:

> ***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***

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as margin or settlement payment or otherwise."

Additionally, Rule 18f-4 regulates the application of section 18 to reverse repurchase agreements and unfunded commitment agreements. The final rule also provides that certain "non-standard settlement transactions" are not senior securities. These aspects of Rule 18f-4 are beyond the scope of this article, which focuses on how Rule 18f-4 impacts the use of derivatives by Funds.

Rule 18f-4: The Big Picture

At its most basic level, Rule 18f-4 will require a Fund to either:

- *Operate as a Limited Derivatives Fund* - Limit the way and extent to which the Fund engages in derivatives transactions; or
- *Operate as a VaR Fund* - Adopt a Derivatives Risk Management Program (a "DRM Program") that, among other requirements, limits the Fund's value-at-risk ("VaR") relative to (i) an index, (ii) its non-derivatives portfolio or (iii) its net assets. Rule 18f-4 defines VaR as an estimate of potential losses based on at least three years of historical market data expressed as a percentage of the value of a Fund's net assets over a 20 trading day time horizon and at a 99% confidence level, taking all significant, identifiable market risk factors into account.

A Fund may opt to be a VaR Fund even if it could qualify as a Limited Derivatives Fund. If a Fund's adviser already uses VaR models in its risk management program, the VaR Fund approach may be a viable alternative. But we anticipate that advisers that do not currently employ VaR models, and do not have an independent reason to start, will try to operate their Funds as Limited Derivatives Funds.

"[For VAR Funds, t]he DRM Program must specify in what circumstances the Risk Manager will provide VaR Fund portfolio managers with stress testing results and notify them of violations of the risk guidelines or other material risks arising from the Fund's derivatives transactions."

Limited Derivatives Funds: Key Concepts and Considerations

To qualify as a Limited Derivatives Fund, a Fund must satisfy three principal requirements:

1) Adopt and implement written policies and procedures reasonably designed to manage the Fund's derivatives risks, including idiosyncratic risks;

2) Limit its "derivatives exposure" to no more than 10% of its net assets; and

3) Should its derivatives exposure exceed this 10% threshold for more than five business days, either: (a) promptly (within no more than 30 calendar days) reduce that exposure to 10%, in a manner that is in the best interests of the Fund and its shareholders; or (b) adopt and comply with a DRM Program as soon as reasonably practicable.

Accordingly, calculating derivatives exposure can be described as the cornerstone of a Limited Derivatives Fund's compliance program. The following is a six-step process for calculating derivatives exposure.

Step #1 - Identify Derivatives Transactions - A Fund must first identify all of its "derivatives transactions". The touchstone of this analysis is whether the transaction creates a future payment obligation for the Fund. *Table 1* summarizes what is, is not, and may be a "derivatives transaction" in light of this touchstone consideration and the literal definition of "derivatives transaction" under Rule 18f-4.

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Table 1: Identifying Derivatives Transactions

Not Derivatives Transactions	May Be Derivatives Transactions	Are Derivatives Transactions
Non-standard settlement trade Unfunded commitment agreement Purchased option Prepaid swap Non-recourse structured investment product	Reverse repurchase agreement or similar transaction **Note:** A Fund can choose to treat reverse repos as derivatives transactions. Limited Derivatives Funds should not treat reverse repurchase agreements as derivatives transactions, since this would increase their derivatives exposure.	"Derivatives instrument" under which the Fund is obligated to make a future payment or delivery, including a: • Periodic-payment swap or security-based swap, • Futures contract, • Forward contract, • Written option, • Firm or standby commitment that is not an unfunded commitment agreement (*e.g.*, a to-be-announced ("TBA") trade), and any combination thereof. Short-sale borrowing.

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Table 2: Calculating Derivatives Exposure	
Type of Derivatives Transaction	**Exposure Amount**
Options	Delta adjusted gross notional amount
Interest rate derivatives	10-Year bond equivalent of the gross notional amount
Short sale borrowings	Market value of assets sold short
All other derivatives transactions	Gross notional amount

Step #2 - Quantify Derivatives Transactions - A Fund should quantify the amount of each transaction's exposure (its "Exposure Amount"). *Table 2* shows how Exposure Amount should be quantified for different types of derivative transactions.

You will find a more detailed discussion of issues related to this calculation in our blog post, *Derivatives Exposure: A Circuitous Path to "Gross Notional Amounts"* (June 3, 2021) at Asset Management ADVocate.

Step #3 - Identify Hedges Excluded from Exposure - Rule 18f-4 excludes from a fund's derivatives exposure currency or interest rate derivatives transactions that:

- are entered into and maintained by the fund for hedging purposes;
- hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the fund, or a fund's borrowings (*i.e.,* the hedge must be "directly matched" to the particular investment or borrowing); and
- have a notional amount that does not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10 percent.

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A Fund should identify these "Excluded Hedges," which are narrowly defined. For example, derivatives used by a Fund to manage its portfolio duration will not qualify as Excluded Hedges. Our blog posts, *Trimming Hedges - Hedges Included in Derivatives Exposure* (August 3, 2021) and *Trimming Hedges - Hedges Excluded From Derivatives Exposure* (July 29, 2021), at Asset Management ADVocate discuss Excluded Hedges in more detail.

Step #4 - Identify "Closed-Out" Positions - A Fund should identify derivatives that directly close-out a derivatives transaction with the same counterparty. A Fund can use a derivative that is not a derivative transaction to close-out a derivative transaction. For example, an option purchased by a Fund (which would not be a derivative transaction) can offset an option written by the Fund (which would be).

Step #5 - Calculate a Fund's Derivative Exposure - The Fund should sum its Exposure Amounts after excluding transactions identified in Steps 3 and 4. The result is the Fund's derivatives exposure. For those mathematically inclined, our blog post, *The Derivatives Exposure Equation* (April 21, 2021), at Asset Management ADVocate, provides an equation for calculating derivatives exposure.

Step #6 - Determine Whether the Fund is a Limited Derivatives Fund - A Fund will be a Limited Derivatives Fund if its derivatives exposure does not exceed 10% of its net assets.

DRM Program: Key Concepts and Considerations

A Fund that does not qualify as a Limited Derivatives Fund (*i.e.,* a VaR Fund) must adopt a DRM Program, a key characteristic of which is the daily testing of the Fund's VaR. Rule 18f-4 identifies three varieties of VaR Funds:

- *Grandfathered Leveraged/Inverse Funds* - Open-end funds that, as of October 28, 2020, disclosed in their prospectus that they seek to provide investment returns that exceed 200% of the performance or the inverse performance of a market index over a predetermined period;
- *Closed-End with Preferred Funds* - Closed-End Funds that have already leveraged themselves by issuing preferred stock in compliance with section 18 or 61; and
- *Other VaR Funds* - All other VaR Funds.

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	Table 3: VaR Test Limits		
	VaR Test Limit		
	Relative		**Absolute**
Type of VaR Fund	**Index**	**Portfolio**	
Grandfathered Leveraged/ Inverse Fund	As disclosed in Prospectus	N/A	N/A
Closed-End with Preferred Fund	250%	250%	25%
Other VaR Fund	200%	200%	20%

Each variety of VaR Fund has to comply with one of the VaR Test Limits shown on *Table 3*.

A relative VaR Test Limit is the percentage of the VaR of the referenced index or non-derivatives portfolio; the Absolute VaR Test Limit is the percentage of the Fund's net assets.

In addition, Rule 18f-4 requires every DRM Program to have five key elements.

Element #1 - Derivatives Risk Manager

A VaR Fund's board of directors, including a majority of independent directors (its "Board"), must approve the designation of an officer (or committee of officers) of the Fund's investment adviser to act as the "derivatives risk manager" (the "Risk Manager"). The Risk Manager administers the DRM Program, including making certain determinations and reports to the Board required by Rule 18f-4. The Risk Manager cannot be a portfolio manager or, if a committee is designated, a majority of its members cannot be portfolio managers.

Element #2 - Internal and Board Reporting

Before implementing the DRM Program and at least annually thereafter, the Risk Manager must represent in a written report to the Board that the DRM Program is reasonably designed to manage the Fund's derivatives risks and to incorporate all required elements of Rule 18f-4. The DRM Program must specify in what circumstances the Risk Manager will provide VaR Fund portfolio managers with stress testing results and notify them of violations of the risk guidelines or other material risks arising from the Fund's derivatives transactions. The program must also specify the (presumably more significant) circumstances in which the Risk Manager will notify the Board of such matters. At intervals established by the Board, the Risk Manager must report to the Board the results of stress and back testing and any violations of the risk guidelines.

Element #3 - Risk Identification and Guidelines

A VaR Fund must identify and assess its derivatives risks, and establish, maintain, and enforce guidelines that: (i) provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the Fund's risks; and (ii) specify levels of the given criterion, metric, or threshold that a Fund does not normally expect to exceed and the measures to be taken if they are exceeded. *Table 4* sets forth derivative risks explicitly identified in Rule 18f-4, which must also be addressed in the policies of a Limited Derivatives Fund.

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Table 4: Risks Commonly Associated with Derivatives	
Type of Risk	**Description**
Leverage	Derivatives can magnify gains and losses
Market	Adverse market movements related to a Fund's derivatives positions; change in market volatility adversely impacts fund returns, obligations and exposures
Counterparty	The risk that a counterparty to a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty
Liquidity	Liquidity demands may result from the Fund's obligations to make margin, collateral or settlement payments to counterparties
Operational	Potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human errors
Legal	Insufficient derivatives documentation, insufficient capacity or authority of counterparty, or legality or enforceability of derivatives contract

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In developing and implementing these guidelines, a VaR Fund should consider the composition of its investment portfolio and disclosures to investors.

Element #4 - Stress Testing

At least weekly, a VaR Fund must conduct stress tests that evaluate potential losses 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. These tests must account for correlations of relevant market risk factors and resulting payments to derivatives counterparties.

Element #5 - Back Testing

At least weekly, a VaR Fund must compare the result of its VaR model with its actual gains or losses that occurred on each business day during the prior test period (*e.g.,* the prior week), and identify any exceptions in excess of estimated losses under the VaR calculation model. In the adopting release, the SEC observed that, "[If] 10 or more exceptions are generated in a year from backtesting ..., it is statistically likely that such exceptions are a result of a VaR model that is not accurately estimating VaR."

Closing Thoughts

As noted earlier, Funds will have to comply with Rule 18f-4 beginning on August 19, 2022. In light of that pending deadline, many Funds and their advisers are presently focused on the design of the compliance programs required by that rule.

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