

New York, December 21, 2020

## Summary of Rule 18f-4\*

(click [here](#) to launch adopting release and final rule)

The Investment Company Act limits the ability of registered funds and business development companies to engage in transactions that involve potential future payment obligations, including obligations under derivatives such as forwards, futures, swaps and written options. The Securities and Exchange Commission (“Commission” or “SEC”) voted to adopt new rules, and rule and form amendments, designed to provide an updated, comprehensive approach to the regulation of funds’ use of derivatives and certain other transactions. New rule 18f-4, an exemptive rule under the Investment Company Act of 1940 (the “Act”), permits mutual funds (other than money market funds), exchange-traded funds (“ETFs”), registered closed-end funds, and business development companies (collectively, “funds”) to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under section 18 of the Act. In connection with these new rules, the Commission amended rule 6c-11 under the Act to allow leveraged or inverse ETFs to operate without obtaining an exemptive order. Finally, the Commission adopted new reporting requirements and amendments to certain disclosure forms. **The new rule, and related rule and form amendments will be effective 60 days after publication in the Federal Register with a compliance date 18-months thereafter.**

The new rule permits funds to enter into these transactions if they comply with certain conditions designed to protect investors. These conditions include adopting a derivatives risk management program and complying with a limit on the amount of leverage-related risk that the fund may obtain based on value-at-risk, or “VaR.”

A streamlined set of requirements will apply for funds that use derivatives in a limited way. The rule also permits a fund to enter into reverse repurchase agreements and similar financing transactions, as well as “unfunded commitments” to make certain loans or investments, subject to conditions tailored to these transactions. Funds, including money market funds, will now be permitted under the rule to invest in securities on a forward-settling basis. Funds also will be subject to reporting and recordkeeping requirements regarding their derivatives use.

## Rule 18f-4 under the Investment Company Act

Rule 18f-4 provides certain exemptions from the Act subject to conditions. The conditions and other elements of the rule include the following, all of which are described in detail in the adopting release for the rule (click [here](#) to launch the SEC Press release):

**Derivatives Risk Management Program.** The new rule generally requires a fund to implement a written derivatives risk management program. The program will institute a standardized risk management framework for funds, while also permitting principles-based tailoring by each fund to the fund’s particular risks. The program must include risk guidelines as well as stress testing, backtesting, internal reporting and escalation, and program review elements. A derivatives risk manager approved by the fund’s board of directors will administer the program. The fund’s derivatives risk manager will have

to report to the fund's board on the derivatives risk management program's implementation and effectiveness to facilitate the board's oversight of the fund's derivatives risk management.

**Limit on Fund Leverage Risk.** A fund relying on the rule generally must comply with an outer limit on fund leverage risk based on value-at-risk, or "VaR." This outer limit is based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference portfolio" for that fund. A fund generally can use either an index that meets certain requirements or the fund's own securities portfolio (excluding derivatives transactions) as its designated reference portfolio. If the fund's derivatives risk manager reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund would be required to comply with an absolute VaR test. The fund's VaR generally is not permitted to exceed 200% of the VaR of the fund's designated reference portfolio under the relative VaR test or 20% of the fund's net assets under the absolute VaR test.

**Exception for Limited Users of Derivatives.** The rule provides an exception from the program and VaR test requirements provided that the fund adopts and implements written policies and procedures reasonably designed to manage its derivatives risks. A fund may rely on this exception if the fund's derivatives exposure is limited to 10% of its net assets, excluding certain currency and interest rate hedging transactions.

**Alternative Requirements for Certain Leveraged /Inverse Funds.** Leveraged/inverse funds will generally be subject to rule 18f-4 like other funds, including the requirement to comply with the VaR-based limit on fund leverage risk. This will effectively limit leveraged or inverse funds' targeted daily return to 200% of the return (or inverse of the return) of the fund's underlying index. The final rule provides an exception from the VaR requirement for leveraged or inverse funds currently in operation that seek an investment return above 200% of the return (or inverse of the return) of the fund's underlying index and satisfy certain conditions.

**Reverse Repurchase Agreements and Unfunded Commitment Agreements.** The rule permits a fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions.

**When-Issued, Forward-Settling, and Non-Standard Settlement Cycle Securities.** The rule permits funds, as well as money market funds, to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, subject to conditions.

**Recordkeeping.** The rule requires that the fund comply with certain recordkeeping requirements.

## Other aspects of the Rulemaking

**Form Changes:** The amendments to Forms N-PORT, N-LIQUID (becoming Form N-RN), and N-CEN will require each fund to provide information regarding its compliance with rule 18f-4, with certain of the newly required data elements being non-public. Certain aspects of these changes are described in more detail below.

This newly required information includes: (1) certain identifying information about the fund (e.g., identifying the provisions of rule 18f-4 that the fund is relying on to engage in derivatives transactions and the other transactions that the rule addresses); (2) as applicable, information regarding a fund's VaR and designated reference portfolio, and VaR backtesting results; (3) VaR test breaches, to be reported to the Commission in a non-public current report; and (4) for a fund that is operating as a limited derivatives user, information about the fund's derivatives exposure and the number of business days that its derivatives exposure exceeded 10% of its net assets.

### Amendments to Rule 6c-11

As part of the rule making package on rule 18f-4, the Commission adopted amendments to rule 6c-11 under the Investment Company Act. Rule 6c-11 generally permits ETFs to operate without obtaining a Commission exemptive order, subject to certain conditions. Rule 6c-11 has not been available to leveraged/inverse ETFs. The amended rule 6c-11 will permit leveraged/inverse ETFs to rely on rule 6c-11 if they comply with all applicable provisions of rule 18f-4. As noted by the Commission, this will permit new leveraged/inverse funds that can satisfy the requirements of rule 18f-4 to come to market under rule 6c-11 without first being required to receive a separate ETF exemptive order. Exemptive orders previously issued to sponsors of leveraged/inverse funds permitting these funds to operate as ETFs will be superseded.

### Rescission of Release 10666

The adopting release for rule 18f-4 also noted that Release 10666 and certain no-action letters and other guidance issued by the Division of Investment Management addressing derivatives transactions and other transactions covered by rule 18f-4 will be moot, superseded, or otherwise inconsistent with the final rule and, therefore, will be withdrawn. Affected funds will have an eighteen-month transition period while they prepare to come into compliance with rule 18f-4 before Release 10666 is withdrawn.

## New Reporting Requirements

Funds will be required to report confidentially to the Commission on a current basis on Form N-RN if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than five business days. (Note: Form N-RN requirements are not included in this document) Funds currently required to file reports on Forms N-PORT and N-CEN will be required to provide certain information regarding a fund's derivatives use. This will include information regarding the fund's VaR, as applicable, and information about the fund's derivatives exposure (for funds that rely on the limited derivatives user exception in rule 18f-4).

## Amendments to Form N-PORT

The new Rule amends Form N-PORT to add new items to Part B (“Information About the Fund”), as well as to make certain amendments to the form’s General Instructions.

**a. Derivatives Exposure.** According to the adopting release, a fund that relies on the limited derivatives exception will include information about its derivatives exposure on Form N-PORT. This information will include certain segmentation of derivatives exposures and the number of business days a fund’s derivatives exposure exceeded 10% of its net assets. Derivatives exposure information reported in response to Item B.9 of N-PORT will not be made public.

**b. VaR Information.** Also, the adopting release states that Form N-PORT will include a new reporting item related to the new VaR tests for funds that are subject to the VaR-based limit on fund leverage risk during the relevant reporting period. Information that a fund will report under this new reporting item would be made public for the third month of each fund’s quarter. Funds that are subject to the new VaR-related N-PORT item will have to report their median daily VaR and, for funds subject to the relative VaR test, the fund’s median VaR ratio, for the monthly reporting period. Funds subject to the relative VaR test during the reporting period will report the name of the fund’s designated reference index, and index identifier. According to the adopting release, these requirements will assist the SEC’s monitoring efforts and are designed to help identify changes in a fund’s VaR over time, and to help identify trends involving a single fund or group of funds regarding their VaRs. The requirement that a fund report information about its designated reference index is designed to help analyze whether funds are using designated reference indexes that meet the rule’s requirements, and also to assess any trends in the designated reference indexes that funds select. A fund also will have to report the number of exceptions the fund identified during the reporting period arising from backtesting the fund’s VaR calculation model. The SEC stated that this requirement is designed to help analyze whether a fund’s VaR model is effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund’s investments, as required by the rule and will assist the SEC in monitoring for compliance with the VaR tests.

### FORM REVISIONS FROM ADOPTING RELEASE:

#### **Form N-PORT MONTHLY PORTFOLIO INVESTMENTS REPORT**

##### **E. Definitions**

References to sections and rules in this Form N-PORT are to the Act, unless otherwise indicated. Terms used in this Form N-PORT have the same meanings as in the Act or related rules (including rule 18f-4 solely for Items B.9 and 10 of the Form), unless otherwise indicated.

**“Absolute VaR Test”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Derivatives Exposure”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Designated Index”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Designated Reference Portfolio”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Relative VaR Test”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Securities Portfolio”** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“Value-at-Risk” or VaR** has the meaning defined in rule 18f-4(a) [17 CFR 270.18f-4(a)].

**“VaR Ratio”** means the value of the Fund’s portfolio VaR divided by the VaR of the Designated Reference Portfolio.

## F. Public Availability

Information reported on Form N-PORT for the third month of each Fund’s fiscal quarter will be made publicly available 60 days after the end of the Fund’s fiscal quarter.

The SEC does not intend to make public the information reported on Form N-PORT for the first and second months of each Fund’s fiscal quarter that is identifiable to any particular fund or adviser, or any information reported with respect to a Fund’s Highly Liquid Investment Minimum (Item B.7), derivatives transactions (Item B.8), Derivatives Exposure for limited derivatives users (Item B.9), median daily VaR (Item B.10.a), median VaR Ratio (Item B.10.b.iii), VaR backtesting results (Item B.10.c), country of risk and economic exposure (Item C.5.b), delta (Items C.9.f.v, C.11.c.vii, or C.11.g.iv), liquidity classification for portfolio investments (Item C.7), or miscellaneous securities (Part D), or explanatory notes related to any of those topics (Part E) that is identifiable to any particular fund or adviser. However, the SEC may use information reported on this Form in its regulatory programs, including examinations, investigations, and enforcement actions.

## PART B

### Item B.8 -- Derivatives Transactions.

For portfolio investments of open-end management investment companies, provide the percentage of the Fund’s Highly Liquid Investments that it has pledged as margin or collateral in connection with derivatives transactions that are classified among the following categories as specified in rule 22e-4 [17 CFR 270.22e-4]:

1. Moderately Liquid Investments
2. Less Liquid Investments
3. Illiquid Investments

For purposes of Item B.8, when computing the required percentage, the denominator should only include assets (and exclude liabilities) that are categorized by the Fund as Highly Liquid Investments.

### Item B.9 -- Derivatives Exposure for limited derivatives users.

If the Fund is excepted from the rule 18f-4 [17 CFR 270.18f-4] program requirement and limit on fund leverage risk under rule 18f-4(c)(4) [17 CFR 270.18f-4(c)(4)], provide the following information:

- a. Derivatives exposure (as defined in rule 18f-4(a) [17 CFR 270.18f-4(a)]), reported as a percentage of the Fund’s net asset value.



- b.** Exposure from currency derivatives that hedge currency risks, as provided in rule 18f-4(c)(4)(i)(B) [17 CFR 270.18f-4(c)(4)(i)(B)], reported as a percentage of the Fund's net asset value.
- c.** Exposure from interest rate derivatives that hedge interest rate risks, as provided in rule 18f-4(c)(4)(i)(B) [17 CFR 270.18f-4(c)(4)(i)(B)], reported as a percentage of the Fund's net asset value.
- d.** The number of business days, if any, in excess of the five-business-day period described in rule 18f-4(c)(4)(ii) [17 CFR 270.18f-4(c)(4)(ii)], that the Fund's derivatives exposure exceeded 10 percent of its net assets during the reporting period.

**Item B.10 -- VaR information.**

For Funds subject to the limit on fund leverage risk described in rule 18f-4(c)(2) [17 CFR 270.18f-4(c)(2)], provide the following information, as determined in accordance with the requirement under rule 18f-4(c)(2)(ii) to determine the fund's compliance with the applicable VaR test at least once each business day:

- a.** Median daily VaR during the reporting period, reported as a percentage of the Fund's net asset value.
- b.** For Funds that were subject to the Relative VaR Test during the reporting period, provide:
  - i.** As applicable, the name of the Fund's Designated Index, or a statement that the Fund's Designated Reference Portfolio is the Fund's Securities Portfolio.
  - ii.** As applicable, the index identifier for the Fund's Designated Index.
  - iii.** Median VaR Ratio during the reporting period, reported as a percentage of the VaR of the Fund's Designated Reference Portfolio.
- c.** Backtesting Results. Number of exceptions that the Fund identified as a result of its backtesting of its VaR calculation model (as described in rule 18f-4(c)(1)(iv) [17 CFR 270.18f-4(c)(1)(iv)]) during the reporting period.

## Amendments to Form N-CEN

Form N-CEN currently includes an item that requires a fund to indicate—in a manner similar to “checking a box”—whether the fund has relied on certain Investment Company Act rules during the reporting period. As adopted, the rule will require a fund to identify whether it relied on proposed rule 18f-4 during the reporting period. Also, the rule will require a fund to identify whether it relied on any of the exceptions from various requirements under the rule, specifically:

- Whether the fund is a limited derivatives user excepted from the rule's program requirement and VaR tests; or
- Whether the fund is a leveraged/inverse fund that would be excepted from the limit on fund leverage risk.

Further, a fund would have to identify whether it has entered into reverse repurchase agreements or similar financing transactions and whether it entered into such transactions either under (1) the

provision of rule 18f-4 that requires compliance with section 18's asset coverage requirements; or (2) the provision that allows funds to treat these transactions as derivatives transactions for all purposes under the rule. A fund will also have to identify whether it has entered into unfunded commitment agreements, as provided under the rule and whether it is relying on the provisions of the rule that address investments in securities on a when-issued or forward settling basis, or with a non-standard settlement cycle. All new information reported on Form N-CEN will be publicly available.

## FORM REVISIONS FROM ADOPTING RELEASE:

### **FORM N-CEN ANNUAL REPORT FOR REGISTERED INVESTMENT COMPANIES**

#### **Item C.7.n -- Rule 18f-4 (17 CFR 270.18f-4):**

- i. Is the Fund excepted from the rule 18f-4 (17 CFR 270.18f-4) program requirement and limit on fund leverage risk under rule 18f-4(c)(4) (17 CFR 270.18f-4(c)(4))?
- ii. Is the Fund a leveraged/inverse fund that, under rule 18f-4(c)(5) (17 CFR 270.18f-4(c)(5)), is excepted from the requirement to comply with the limit on fund leverage risk described in rule 18f-4(c)(2) (17 CFR 270.18f-4(c)(2))?
- iii. Did the Fund enter into any reverse repurchase agreements or similar financing transactions under rule 18f-4(d)(i) (17 CFR 270.18f-4(d)(i))?
- iv. Did the Fund enter into any reverse repurchase agreements or similar financing transactions under rule 18f-4(d)(ii) (17 CFR 270.18f-4(d)(ii))?
- v. Did the Fund enter into any unfunded commitment agreements under rule 18f-4(e) (17 CFR 270.18f-4(e))?
- vi. Did the Fund invest in a security on a when-issued or forward-settling basis, or with a non-standard settlement cycle, in reliance on rule 18f-4(f) (17 CFR 270.18f-4(f))?

## Note to CAPS Users

Changes to CAPS functionality relating to Rule 18f-4 is limited to the N-PORT and N-CEN modules. Command Financial monitors the SEC website daily for updates to rules, regulations, announcements, as well as changes to EDGAR technical specifications and manuals. When the SEC publishes the technical specifications related to Rule 18f-4, Command will communicate with our customers the SEC's requirements along with any needed changes to CAPS to adopt the specifications. Command will then have a follow up communication of our planned CAPS Release schedule to conform with the updated EDGAR technical specifications.

## **\*Disclosures**

**This summary is based on the information contained in Securities and Exchange Commission Release No. IC-34084, and is not intended as legal advice or a comprehensive analysis of the rule. You should consult with your counsel as you develop your compliance strategy.**