CLIENT ALERT

The SEC Adopts Derivatives Rule for Registered Investment Companies and BDCs

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On October 28, 2020, the Securities and Exchange Commission ("SEC" or "Commission") adopted Rule 18f-4 (the "Rule") under the Investment Company Act of 1940 (the "Investment Company Act"),[1] to regulate the use of derivatives and other transactions involving leverage by registered open-end funds (including mutual funds and exchange-traded funds ("ETFs"), but excluding money market funds),[2] registered closed-end funds ("Closed-End Funds") and business development companies ("BDCs") (together, "funds"). The Rule, including its recordkeeping provisions, as well as related reporting rule and form changes (the "Reporting Rules") and conforming amendments to Investment Company Act Rule 6c-11 (exchange-traded funds) and Rule 22e-4 (liquidity risk management programs), will become effective February 19, 2021. Funds will have until August 19, 2022 to come into compliance with Rule 18f-4, the Reporting Rules and the changes resulting from amendments to Rules 6c-11 and 22e-4.

Rule 18f-4, which takes the form of an exemption from Section 18 and (for BDCs) Section 61 of the Investment Company Act, represents a change from the existing "asset segregation" approach currently relied on by funds to enter into

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1 *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-34084 (Nov. 2, 2020), 85 Fed. Reg. 83162 (Dec. 21, 2020), *available* here (the "Adopting Release"). The Rule was adopted by a 3-2 vote, with Commissioners Allison Herren Lee and Caroline Crenshaw dissenting. *See* Statement on the Final Rule on Funds' Use of Derivatives, Commissioner Allison Herren Lee (Oct. 28, 2020) ("Statement of Commissioner Lee"); and Statement on the Final Rule on Funds' Use of Derivatives, Commissioner Caroline A. Crenshaw (Oct. 28, 2020) ("Statement of Commissioner Crenshaw").

2 The Rule is not applicable to registered money market funds ("Money Market Funds"), with the exception of a provision that permits them to engage in certain delayed-settlement transactions, subject to conditions. The Rule is not applicable in any respect to unit investment trusts ("UITs").

derivatives and other leveraged transactions not structured as borrowings. The existing approach, which is interpretive in nature, derives from a General Statement of Policy published by the SEC in 1979 ("SEC Release 10666"), which recognized that certain types of leveraged transactions entered into by funds "raise serious questions as to whether [they] involve the issuance of senior securities . . . and, thus, are either prohibited by, or subject to the asset coverage requirement of, Section 18(f)(1) [of the Investment Company Act]."[3] SEC Release 10666 indicates that entry by funds into transactions described in the release would not violate Section 18(f)(1) so long as the funds "segregated" certain types of liquid assets sufficient to "cover" their obligations under the transactions. In a number of no-action letters issued over the years, the SEC staff extended this approach to other types of leveraged transactions beyond those discussed in SEC Release 10666, clarified the types of assets that could be "segregated" and that earmarking such assets on the custodian's books would constitute "segregation," and provided that in lieu of "segregation," "cover" could alternatively be achieved through entry by funds into specified types of offsetting transactions.

The Rule reflects industry feedback on a 2015 rule proposal regarding the use of derivatives and other leveraged transactions by funds (the "2015 Proposal")[4] as well as on a re-proposal of the 2015 Proposal in 2019 (the "2019 Proposal").[5] The SEC indicates in the Adopting Release that it seeks to "address investor protection concerns related to funds' derivatives use," and to provide an "updated and more comprehensive approach" to the regulation of funds' use of derivatives and other leveraged transactions.[6] The Adopting Release also states that the existing asset segregation approach has created an "un-level competitive landscape," based on the varying interpretations of the standard by different fund families, and, as a result, the SEC has found it difficult to evaluate funds' compliance with Section 18.[7]

The Adopting Release notes that greater reporting of derivatives transactions by funds is necessary to allow the SEC more effectively to monitor funds' use of derivatives and compliance with Rule 18f-4.[8] Consistent with that concern, the SEC adopted the Reporting Rules, which incorporate changes to Form N-PORT, Form N-CEN and Form N-LIQUID (renamed Form RN).

In conjunction with adoption of Rule 18f-4 and the Reporting Rules, SEC Chairman Jay Clayton and the Directors of the Divisions of Investment Management, Corporation Finance and Trading and Markets issued the Joint Statement

[3] General Statement of Policy, SEC Rel. No. IC-10666, 44 Fed. Reg. 25128 (Apr. 27, 1979) at 25128.

[4] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), 80 Fed. Reg. 80994 (Dec. 28, 2015).

[5] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, SEC Rel. Nos. 34-87607, IA-5413, IC-33704 (Nov, 25, 2019), 85 Fed. Reg. 4446 (Jan. 24, 2020).

[6] Adopting Release at 83163.

[7] *Id.* at 83163-83164.

[8] *Id.* at 83171.

Regarding Complex Financial Products and Retail Investors (the "Joint Statement").[9] The Joint Statement directed the SEC staff in the Divisions of Investment Management, Corporation Finance, and Trading and Markets to review "the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex products [and] . . . make recommendations . . . for potential new rulemakings, guidance, or other policy actions, if appropriate." Depending upon the results of the staff review referenced in the Joint Statement, the SEC may decide to take additional actions with respect to funds that use derivatives and, in particular, in regard to sales practice concerns around funds that employ leverage as part of their stated investment strategy.

I. Executive Summary

The rules changes and adoptions by the SEC include the following key features, which we discuss in more detail below:

- **Derivatives Transactions and Other Leveraged Transactions entered into by Funds as Senior Securities—**The Adopting Release indicates that, in the view of the SEC, all derivatives transactions that create future payment obligations, as well as transactions described in SEC Release 10666, are senior securities for purposes of Section 18 of the Investment Company Act and may not be entered into by funds absent compliance with the requirements of Section 18 (as modified by Section 61 for BDCs)[10] or compliance with the Rule.[11] The Rule provides an exemption, subject to satisfaction of the conditions of the Rule, to permit funds to enter into derivatives transactions, notwithstanding the requirements of Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the Investment Company Act, and further provides that derivatives transactions entered into by a fund in

[9] Joint Statement Regarding Complex Financial Products and Retail Investors, Chairman Jay Clayton, Dalia Blass, Director, Division of Investment Management, William Hinman, Director, Division of Corporation Finance and Brett Redfearn, Director, Division of Trading and Markets (Oct. 28, 2020) *available* here. *See also* Adopting Release at 83164 noting that the SEC has directed the staff to "to review the effectiveness of the existing regulatory requirements in protecting investors who invest in leveraged/inverse funds and other complex investment products."

[10] Section 18 is designed to limit the leverage that a fund may obtain or incur through the issuance of senior securities. Section 18(f)(1) prohibits an open-end fund from issuing or selling any "senior security," other than borrowing from a bank, subject to a requirement to maintain 300% "asset coverage." "Asset coverage" of a class of senior securities representing indebtedness of a fund is defined in Section 18(h) as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." Section 18(a) prohibits a Closed-End Fund from issuing or selling any "senior security [that] represents an indebtedness" unless it has at least 300% "asset coverage" immediately after such issuance or sale, although Closed-End Funds' ability to issue senior securities representing indebtedness is not limited to bank borrowings. Closed-End Funds also may issue or sell senior securities that are equities, subject to the limitations of Section 18 (including required asset coverage of at least 200% immediately after such issuance or sale). Section 61 of the Investment Company Act makes the provisions of Section 18, which are applicable to Closed-End Funds, applicable as well to BDCs, with certain modifications. *See* Adopting Release at 83165-83166.

[11] *Id.* at 83167. As noted above, the Rule does not apply to UITs, which are not subject to Section 18. The Adopting Release notes that derivatives transactions might raise regulatory issues for UITs. *Id.* at 83171 at n.79 ("As the Commission has noted, derivatives transactions generally require a significant degree of management, and a UIT engaging in derivatives transactions therefore may not meet the Investment Company Act requirements applicable to UITs.").

compliance with the Rule will not be considered for purposes of defining "asset coverage," as defined in Section 18(h) of the Investment Company Act.[12] The SEC's view, expressed in the Adopting Release, represents a significant change from its interpretation reflected in SEC Release 10666.

- **VaR-Based Limits on Fund Leverage—**The Rule establishes an exemption from the restrictions of Section 18 for funds (and Section 61 for BDCs) entering into derivatives transactions if a fund complies with specific limits calculated based on a value-at-risk ("VaR")-based test and implements a risk management program.[13] Under the Relative VaR Test (as defined below), a fund entering into derivatives transactions must ensure each business day that the VaR of its portfolio does not exceed 200% of the VaR of a "designated reference portfolio." If a fund's Derivatives Risk Manager (as defined below) is unable to identify an appropriate designated reference portfolio, the fund must comply with an Absolute VaR Test (as defined below), under which the VaR of the fund's portfolio may not exceed 20% of the value of the fund's net assets. The Rule provides a second, higher set of VaR limits of 250%, under the Relative VaR Test, and 25%, under the Absolute VaR Test, for Closed-End Funds and BDCs that have issued to investors and have outstanding shares of a senior security that is a stock. The Rule excepts from the VaR limit requirements funds that qualify as "Limited Derivatives Users" and Leveraged/Inverse Funds (each as defined below) that were in operation as of October 28, 2020 and that seek an investment return above 200% of the return (or inverse of the return) of the fund's underlying index.[14] In a change from the 2019 Proposal, the Rule does not require a fund that is out of compliance with the applicable VaR limits to exit its derivatives transactions, make other portfolio adjustments or refrain from entering into new derivatives transactions. Instead, as discussed below, the Rule requires funds that have exceeded applicable VaR limits for five business days to report the exceedance to the SEC and to the fund's board of directors or board of trustees (the "Fund Board").

- **Derivatives Risk Management Program—**A fund (other than a Limited Derivatives User) that engages in derivatives transactions will be required to adopt a risk management program (the "Program") that includes the following elements: risk identification and assessment, risk guidelines, stress testing, back-testing, internal reporting and escalation, and Program review. The fund must appoint an individual or committee to act as the derivatives risk manager (the "Derivatives Risk Manager") in seeking to implement and oversee the Program. The Derivatives Risk Manager must have experience with derivatives and must be approved by and have a reporting line to the Fund Board.

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12 Rule 18f-4(b).

13 The Rule defines "VaR" or "Value-at-Risk" as "an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets (or net assets when computing a fund's VaR), over a specified time horizon and at a given confidence level . . . ." *See* Rule 18f-4(a).

14 Limited Derivatives Users but not Leveraged/Inverse Funds are also excluded from the requirement under the Rule that the fund establish a Program.

- **Limited Derivatives User Exception—**A fund that limits its "derivatives exposure,"[15] excluding certain currency and interest rate hedges, to 10% of its net assets (a "Limited Derivatives User"), is not required to comply with the VaR-based limits or to test for compliance with those limits. In addition, such a fund is not required to adopt a Program or to appoint a Derivatives Risk Manager. A Limited Derivatives User, however, must adopt and implement policies and procedures that are reasonably designed to manage the fund's derivatives risks.

- **Role of the Fund Board—**The Fund Board is responsible for actively overseeing a fund's compliance with the Rule. Responsibilities include approval of the designation of a Derivatives Risk Manager, establishment of a reporting schedule regarding the Program, evaluation of regular reports regarding the implementation and effectiveness of the Program, and oversight of compliance by the fund with the Program, including oversight of remediation by the fund's investment adviser of exceedances of VaR-based limits and the results of the fund's stress testing.

- **Reverse Repurchase Agreements—**The Rule provides an exemption from Sections 18(c) and 18(f)(1) of the Investment Company Act[16] for reverse repurchase agreements and similar financing transactions, including securities lending transactions that are viewed as increasing leverage for a fund.[17] Specifically, to avail itself of this exemption, a fund may comply with one of two alternatives with respect to these transactions: it may either comply with the asset coverage requirements of Section 18 of the Investment Company Act and include the aggregate amount of indebtedness associated with all reverse repurchase agreements and similar financing transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio, or it may treat reverse repurchase agreements and similar financing transactions as derivatives transactions for all purposes of Rule 18f-4, including the VaR limits.[18]

- **Treatment of Unfunded Commitment Agreements—**Unfunded commitment agreements (*i.e.*, contracts under which a fund commits, conditionally or unconditionally, to make loans to or to invest equity in an entity in the

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15 "Derivatives exposure" is defined as "the sum of: (1) the gross notional amounts of a fund's derivatives transactions such as futures, swaps, and options; and (2) in the case of short sale borrowings, the value of any asset sold short."

16 Section 18(c) limits a Closed-End Fund to issuing only one class of senior security representing indebtedness and one class of senior security that is stock. Section 18(f)(1) provides that an open-end fund may not issue any senior securities, but may borrow from a bank. BDCs are exempt from Section 18(c) by virtue of Section 61(a)(3).

17 According to the Adopting Release, securities lending transactions should not be viewed as a "similar financing transaction" so long as the fund that lent out its securities reinvests cash collateral received in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, or, if the fund receives non-cash collateral, the fund does not sell or otherwise use the non-cash collateral to leverage itself. *See* Adopting Release at 83229.

18 As noted above, BDCs are not subject to Section 18(c) (as to which Rule 18f-4(d) provides an exemption), and may issue more than one class of senior security representing indebtedness by virtue of Section 61(a)(3). Nevertheless, because the alternative treatment of reverse repurchase agreements in Section 18f-4(d) applies to all "funds," which include BDCs, the alternatives included in Rule 18f-4 appear to be available to BDCs as well as to other types of funds.

future) are not treated as derivatives transactions under the Rule. Instead, the Rule permits a fund to enter into unfunded commitment agreements so long as the fund reasonably believes, at the time it enters into any such agreement, that it will have sufficient cash and cash equivalents to meet its obligations under its unfunded commitment agreements as they come due. In establishing its reasonable belief regarding the sufficiency of the fund's assets to meet future obligations with respect to unfunded commitment agreements, a fund will be required to consider the extent of its obligations and not count as available to satisfy those obligations: (i) any proceeds of investment liquidations at prices that significantly differ from the market value of the investments; or (ii) funding to be obtained by issuing additional equity.

- **Delayed Settlement Transactions—**The Rule excludes from treatment as a senior security, delayed settlement transactions (including when-issued and forward settlement transactions) that are intended to be physically settled and that are subject to settlement within 35 days (the "Delayed Settlement Transactions Exception").[19] Although the Rule is not otherwise applicable to Money Market Funds, the Delayed Settlement Transactions Exception applies to Money Market Funds as well as other funds.

- **New Reporting, Disclosure, Recordkeeping and Policy and Procedure Requirements—**A fund will be required to report confidentially to the SEC on a current basis on Form N-RN (formerly named Form N-LIQUID) if the fund has been out of compliance with the VaR-based limit on fund leverage for more than five business days. A fund that is currently required to file reports on Forms N-PORT and N-CEN will be required to provide information regarding the fund's derivatives use. The fund will need to report information regarding the fund's VaR, when applicable, and, in the case of Limited Derivatives Users, information about the fund's derivatives exposure. The Rule requires a fund to keep records relating to its compliance with the Rule and to maintain policies and procedures regarding its obligations under the Rule, including specific policies and procedures required in connection with the Program and, for a Limited Derivatives User, relating to its derivatives activities.

- **Leveraged/Inverse Funds—**In a significant shift from the 2019 Proposal, the SEC did not adopt proposed sales practice rules relating to funds that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a pre-determined period of time ("Leveraged/Inverse Funds"). Similarly, the SEC did not provide a general exception for Leveraged/Inverse Funds from application of the VaR-based limits. Instead, a Leveraged/Inverse Fund will be subject to the Rule to the same extent as other funds, including the obligation to comply with the VaR-based limits. As a result, a Leveraged/Inverse Fund's targeted daily return will effectively be limited to 200% of the return (or inverse of the return) of the fund's

[19] Transactions covered by the Delayed Settlement Transactions Exception would include, among others, "to be announced" or "TBA" transactions. TBA transactions would, however, fall within the definition of derivatives transactions and be fully subject to the Rule if they do not satisfy the conditions of the Delayed Settlement Transactions Exception. Adopting Release at 83175.

underlying index. The SEC excepted from the 200% cap under the VaR-based limits, subject to certain conditions, Leveraged/Inverse Funds that have a cap in excess of 200% and that were in operation as of October 28, 2020.

- **Conforming Rule Changes—**The SEC amended Rule 6c-11 under the Investment Company Act, which permits ETFs to operate under the Investment Company Act, in order to make that rule applicable to Leveraged/Inverse Funds. The SEC is also rescinding the ETF exemptive orders applicable to Leveraged/Inverse Funds that operate as ETFs and comply with Rule 18f-4. The SEC amended Rule 22e-4, the rule that requires open-end funds to establish a liquidity risk management program, and related reporting requirements to eliminate references to “assets segregated” to cover derivatives transactions. As a result, funds will need to amend their liquidity risk management programs adopted under Rule 22e-4 to reflect these changes. These amendments are subject to the August 19, 2022 compliance date applicable to Rule 18f-4 and the Reporting Rules.

- **Elimination of Asset Segregation Guidance and Rescission of SEC Release 10666; Transition Periods—** In connection with adoption of the Rule, the SEC is rescinding its prior guidance regarding entry by funds into specified types of leveraged transactions that may involve the issuance of a “senior security” in reliance on asset segregation, as set out in SEC Release 10666. The SEC staff is reviewing related no-action letters with a view to withdrawing them. The SEC has provided an 18-month transition period for funds to come into compliance with Rule 18f-4 and the Reporting Rules.

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II. General Discussion

1. Derivatives Transactions and Other Leveraged Transactions Entered into by Funds as Senior Securities.

The Rule provides an exemption, subject to satisfaction of the conditions of the Rule, to permit funds to enter into derivatives transactions, notwithstanding the requirements of Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the Investment Company Act. The Rule further provides that derivatives transactions entered into by a fund in compliance with the Rule will not be considered for purposes of defining "asset coverage," as defined in Section 18(h) of the Investment Company Act.[20]

The Adopting Release characterizes derivatives transactions as "senior securities" and requires a fund entering into such transactions to comply with the Rule for those transactions to be exempt from the requirements of Sections 18 and 61 of the Investment Company Act. The types of derivatives transactions that are described as implicating the "senior security" definition are those "that create future payment obligations."[21] Prior SEC guidance, including that contained in SEC Release 10666, was less conclusive regarding the status of leveraged transactions as constituting "senior securities." The SEC and SEC staff in the past indicated that derivatives and similar transactions incorporated "evidences of indebtedness" of the type referenced in Sections 18 and 61,[22] but, prior to proposing the Rule, did not articulate the view expressly that entry into these transactions would implicate the statutory provisions of Sections 18 or 61 of the Investment Company Act.

<u>Definition of "Derivatives Transaction</u>"

The Rule defines the term "derivatives transaction" to mean:

- Any swap, security-based swap, futures contract, forward contract, or option, or 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 margin or settlement payment or otherwise;

- Any short sale borrowing; and

20 Rule 18f-4(b).

21 Adopting Release at 83167 ("As was the case for trading practices that [SEC] Release 10666 describes, where the fund has entered into a derivatives transaction and has such a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18.").

22 *See* SEC Release 10666 at 25128.

- Any reverse repurchase agreement or similar financing transaction, if a fund elects to treat all reverse repurchase agreements or similar financing transactions as derivatives transactions for all purposes under the Rule.

The SEC limited the types of derivatives to which the Rule applies to those that "involve the issuance of a senior security, because they involve a contractual future payment obligation."[23] Consistent with this approach, but unlike in the SEC's 2015 Proposal, the Rule's definition of derivatives transaction includes short sale borrowings. The Adopting Release explains the characterization of a "short sale" as a derivatives transaction as follows: "[t]he value of a short position is . . . derived from the price of another asset, *i.e*., the asset sold short," and "[a] short sale of a security provides the same economic exposure as a derivatives instrument, like a future or swap, that provides short exposure to the same security."[24] In a revision to the 2019 Proposal, the Rule includes reverse repurchase agreements and similar financing transactions in the definition of derivatives transaction if a fund elects to treat them as such for all purposes under the Rule. Otherwise, reverse repurchase agreements and similar financing transactions are subject to the asset coverage requirements of Section 18 of the Investment Company Act.[25] The Adopting Release states that the definition of derivatives transaction is intended to include firm and standby commitment agreements, subject to the Delayed Settlement Transactions Exception, which allows funds (and Money Market Funds) to invest in securities on a when-issued or forward settling basis, or with a non-standard settlement cycle.[26] The Adopting Release suggests that when-issued securities, TBAs, dollar rolls, and bond forwards are potentially covered by the Delayed Settlement Transactions Exception.[27]

2. VaR-Based Limits on Fund Leverage.

Limits on Fund Leverage Risk

A fund that engages in derivatives transactions will be required to comply with the Rule, including its VaR limits, unless the fund qualifies as a Limited Derivatives User or, with respect to the 200% VaR limit only, the fund is excepted because it is a Leveraged/Inverse Fund that was in operation as of October 28, 2020. In the case of a fund-of-funds arrangement, the acquiring fund will generally not be required to comply with the Rule with respect to derivatives entered into by the

[23] Adopting Release at 83172. The Adopting Release notes, by way of example, that purchased call options are among the type of derivatives transactions not intended to be covered by the Rule - although they "provide the economic equivalent of leverage because they can magnify the fund's exposure beyond its investment … [they] do not impose a payment obligation on the fund beyond its investment." *Id*. at 83165. The SEC declined to exclude from the definition of a "derivatives transaction," as requested by commenters on the 2019 Proposal, foreign currency derivatives, such as foreign currency forwards and swaps, or purchased option spread transactions. *Id.* at 83173.

[24] *See id.* at 83173.

[25] Rule 18f-4(d)(1).

[26] Adopting Release at 82174.

[27] *Id.*

acquired funds.[28] In the case of a fund that holds derivatives through a controlled foreign corporation (*e.g.*, a wholly-owned Cayman subsidiary), the fund would be required to comply with the Rule with respect to derivatives held by the controlled foreign corporation because those derivatives transactions are treated as direct investments of the fund for regulatory and other purposes, including for purposes of Section 18.[29]

The principal VaR limit, and the test that is designated for purposes of the Rule as the "default test," compares the VaR of a fund to the VaR of an appropriate "designated reference portfolio" selected by the fund's Derivatives Risk Manager (the "Relative VaR Test"). The "designated reference portfolio" can be either an index or, in the case of an actively managed fund (but not an index-tracking fund), the fund's own securities portfolio (excluding derivatives transactions). Under the Relative VaR Test, a fund's VaR is measured as a percentage of the value of the fund's net assets, whereas the VaR of a fund's designated index (or securities portfolio) is measured as a percentage of the value of the portfolio. The Relative VaR Test is designed to limit the extent to which a fund increases its market risk by leveraging its portfolio through derivatives, while not restricting the fund's ability to use derivatives for other purposes.[30]

Under the Rule, if a 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 must, in the alternative, comply with an absolute VaR test (the "Absolute VaR Test") under which the fund needs to compare the VaR of the fund's portfolio to its own net assets. The Relative VaR Test or, if applicable, the Absolute VaR Test must be calculated daily.[31] Notably, the Rule, as adopted, reflects an increase from the 2019 Proposal in both the relative and absolute VaR limits from 150% to 200%, and 15% to 20%, respectively, and the inclusion of separate, higher relative and absolute VaR limits for Closed-End Funds and BDCs that have issued and have outstanding senior securities that are stock, of 250% and 25%, respectively.[32]

As discussed below, subject to compliance with specified conditions, Limited Derivatives Users are not subject to the VaR-based limits.

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[28] *Id.* at 83203.

[29] *Id.*

[30] *Id.* at 83191.

[31] The Adopting Release does not provide guidance on how a fund should comply with the requirement to select a designated index, or how a fund should apply the VaR-based limits, where the fund is a multi-manager fund and multiple independent investment advisers manage separate sleeves of the fund pursuant to different strategies. By contrast, however, the Adopting Release notes that stress testing must be carried out on a portfolio-wide basis and not at the level of a sleeve. *Id.* at 83179.

[32] Under the 2019 Proposal the VaR limits established for all funds, including all Closed-End Funds and BDCs, were 150% and 50%, respectively.

Relative VaR Test – Designated Index

A fund will satisfy the Rule's Relative VaR Test if the VaR of the fund's portfolio does not exceed 200% of the VaR of its designated reference portfolio (or, in the case of a Closed-End Fund or BDC that has issued and has outstanding senior securities that are stock, 250% of the VaR of its designated reference portfolio). A "designated reference portfolio" is defined as a designated index or, in the case of actively managed funds,[33] the fund's securities portfolio. A "designated index" must (i) be "unleveraged"[34] and (ii) reflect the markets or asset classes in which the fund invests. Unless the index is widely recognized and used, the designated index may not be one that is administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser (an "excluded index"). Notwithstanding the excluded index prohibition, the Rule requires an index-tracking fund whose investment objective is to track an excluded index to use the excluded index as its designated index. A fund may also use a blended index as its designated index so long as each constituent index meets the requirements of the Rule. Closed-End Funds and BDCs are subject to the same "unleveraged index" requirement as open-end funds.

The designated index must be approved by the Derivatives Risk Manager and reviewed by the Derivatives Risk Manager periodically. The Fund Board must be provided with a written report by the Derivatives Risk Manager explaining his or her (or, in the case of a committee, their) basis for approving the designated index. A fund is required to disclose its designated index on Form N-PORT, and not, as proposed in the 2019 Proposal, in its annual report, or, in the case of a BDC, its Form 10-K.

Relative VaR Test – Securities Portfolio

The SEC, in a change from the 2019 Proposal, added an alternative benchmark to the Rule's Relative VaR Test for an actively managed fund. Under the Rule, an actively managed fund is permitted to compare the VaR of the fund to that of the fund's "securities portfolio." The "securities portfolio" of a fund is defined to mean its securities and other investments, excluding derivatives transactions. Use by a fund of its "securities portfolio" to calculate the fund's compliance with limits under the Relative VaR Test must be approved by the fund's Derivatives Risk Manager, and in selecting this approach, the Derivatives Risk Manager must conclude that the "securities portfolio" "reflects the markets or asset classes in which the fund invests."[35] Use of the "securities portfolio" as the designated reference portfolio does not require that a fund

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33 If the fund's investment objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its designated reference portfolio. Rule 18f-4(a) (definition of "designated reference portfolio").

34 The Rule does not define "unleveraged." The Adopting Release states that the determination of whether an index will be considered to be leveraged will depend upon "the economic characteristics of the index's constituents, and not just on whether some or all of the constituents are derivatives. An index would be leveraged if, for example, the derivatives included in the index multiply the returns of the index or index constituents, as suggested by these commenters." Adopting Release at 83192.

35 *Id.* at 83194. *See* the discussion under "Absolute VaR Test" for a discussion of when a "securities portfolio of a fund might not reflect the markets or asset classes in which a fund invests."

"scale down" the VaR of its securities portfolio (*i.e.*, reduce the VaR of its portfolio to a specified level) if the fund also has issued senior security debt borrowings that are not represented by the fund's derivatives transactions.[36] The Adopting Release indicates that the SEC does not believe that a reduction to take into account such borrowings would be required for a fund's securities portfolio to represent an "unleveraged" reference portfolio. The Adopting Release notes that the Rule "provides that VaR must be expressed as a percentage of the value of the relevant portfolio" and, as a result, "the scale of the fund's securities portfolio, even if increased by borrowings, would not change the portfolio's VaR when expressed as a percentage." [37]

Similar to the requirements under the Relative VaR Test using a designated index, reliance on the securities portfolio approach to the Relative VaR Test requires periodic review of the appropriateness of the securities portfolio by the Derivatives Risk Manager and reporting to the Fund Board. In addition, a fund subject to the Relative VaR Test during a monthly reporting period must report to the SEC on Form N-PORT, as applicable, the name of the fund's designated index (and index identifier), or a statement that the fund's designated reference portfolio is the fund's securities portfolio.

<u>Absolute VaR Test</u>

If a 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 must comply with the Absolute VaR Test. The Adopting Release contemplates that this result might occur, for example, for a long/short or market neutral fund, when the fund's strategy does not involve the kind of risk associated with the market risk of an index and the fund's securities portfolio does not reflect the overall markets or asset classes in which the fund invests or involve the kind of market risk associated with the fund's strategy.[38] Under the Absolute VaR Test, a fund must ensure that the VaR of its entire portfolio not exceed 20% of the value of the fund's net assets (or 25% in the case of a Closed-End Fund or BDC that has issued and has outstanding senior securities that are stock).

<u>Model and Parameters for All VaR Testing</u>

The Rule requires that the VaR-based limits be calculated using a VaR model having a 99% confidence level and a time horizon of 20 trading days and be based on at least three years of historical market data. The Adopting Release indicates that a fund could determinate a 99% confidence level VaR by rescaling a calculation initially performed at a 95% confidence level. The Adopting Release notes that this technique may be beneficial by allowing a fund's VaR calculation

36 *Id.* at 83195.

37 *Id.* at 83195.

38 *Id.* at 83191.

to take into account additional observations while still complying with the Rule's VaR tests calibrated to a 99% confidence level and a time horizon of 20 trading days.[39]

The Rule requires that the VaR model incorporate all significant, identifiable market risk factors associated with a fund's investments, including the following:

- equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
- material risks arising from the 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.

A fund is not required under the Rule to use the same VaR model when calculating the VaR of its portfolio and the VaR of its designated reference portfolio, although each model is required to comply with the parameters set out in the Rule. The Adopting Release explains that these provisions are designed to provide funds with the ability to make use of less costly approaches.[40] By way of example, the Adopting Release notes that a fund that invests significantly in options likely would use Monte Carlo simulation, which is more computationally and time intensive than parametric and other simpler models. The Adopting Release indicates that in this situation, the fund should not be required to use the same complex Monte Carlo simulation model it uses to calculate the VaR of its portfolio in order to calculate the VaR of its unleveraged designated index or securities portfolio (to which the fund will compare its total portfolio VaR for purposes of the VaR tests) in lieu of an appropriate simpler model.[41]

In addition, the Rule does not require a fund to apply its VaR model consistently (*i.e.*, the same VaR model may be applied in different ways, such as by time-scaling) when calculating (i) the VaR of its portfolio and (ii) the VaR of its designated reference portfolio. The Rule requires, however, that each application complies with parameters set out in the Rule.[42]

[39] *Id.* at 83201-83202.

[40] *Id.* at 83200.

[41] *Id.* at 83202 at n.447.

[42] *Id.* at 83202.

The Adopting Release notes that, if a fund believes that an alternative means of estimating and limiting its leverage risk would be more effective in accomplishing the SEC's stated goals with respect to the Rule, the fund may apply for exemptive relief to use a different type of risk model.[43]

Testing and Remediation

Under the Rule, a fund must analyze its compliance with the applicable VaR test at least once each business day. The Rule does not require that a fund perform its calculation at a particular time, but the Adopting Release suggests that a fund should calculate its VaR at a consistent time each day.[44]

If a fund determines that it is not in compliance with the VaR test it has selected, the fund must come back into compliance promptly and within no more than five business days after such determination.[45] In the event that a fund is not in compliance with the applicable VaR test within five business days, then:

- the fund's Derivatives Risk Manager must provide a written report on the non-compliance to the Fund Board explaining how and by when (*i.e.*, within what number of business days) the Derivatives Risk Manager reasonably expects the fund to come back into compliance (the "Non-Compliance Report");

- the Derivatives Risk Manager must analyze the circumstances that caused the fund to be out of compliance for more than five business days and update any Program elements as appropriate to address those circumstances ("Analysis and Program Update"); and

- the Derivatives Risk Manager must provide a written report within 30 calendar days of the exceedance to the Fund Board explaining how the fund came back into compliance and the results of the Analysis and Program Update. If the fund remains out of compliance with the applicable VaR test at that time, the Derivatives Risk Manager's written report must update the previously provided Non-Compliance Report, and update the Fund Board on the fund's progress in coming back into compliance at regularly scheduled intervals at a frequency determined by the Fund Board.[46]

Unlike the 2019 Proposal, the Rule does not require a fund that did not come back into compliance within five business days to exit its derivatives transactions or make other portfolio adjustments, and the Rule does not include the requirement from the 2019 Proposal that restricted a fund from entering into new derivatives transactions (with certain

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43 *Id.* at 83189 ("A fund that believes an alternative means of estimating and limiting its leverage risk would be more effective in accomplishing the Commission's stated goals in adopting the final rule given [its] idiosyncratic circumstances, including addressing the concerns underlying section 18, may raise such issues via the exemptive application process.").

44 *Id.* at 83203.

45 The SEC increased this from the three-business-day period included in the 2019 Proposal.

46 *See* Rule 18f-4(c)(2)(iii)(A)-(C).

exceptions) after an exceedance until the fund was in compliance with its VaR limit for three consecutive business days. The Rule requires that a fund comes back into compliance with the applicable VaR test promptly and in a manner that is in the best interests of the fund and its shareholders. The Adopting Release explains that these requirements are designed to require a fund to reduce its VaR exceedance on a timely basis but without compelling the fund to resort to a "fire sale" or otherwise incur reasonably avoidable trading losses.

A fund that is unable to come back into compliance with its applicable VaR test within five business days must file a report with the SEC (on a non-public basis) on Form N-RN on the first business day after the five-day remediation period and again after the fund is back in compliance. The Adopting Release states that a fund engaging in a "fire sale" to avoid filing a report on Form N-RN would violate the Rule.[47]

3. Derivatives Risk Management Program.

The Rule requires every fund that engages in derivatives transactions, other than a fund that qualifies as a Limited Derivatives User, to implement a written Program.[48] The Program must include policies and procedures tailored to a fund's specific derivatives risks,[49] including leverage, market, counterparty, liquidity, operational and legal risks, and other risks that the fund's Derivatives Risk Manager deems material.[50] A fund's Program also needs to take into account how the fund's derivatives use affects its investment portfolio and strategy, including whether derivatives are used to increase or decrease portfolio risks or facilitate efficient portfolio management.[51] As part of developing the Program, a fund must consider risks that VaR does not capture (such as counterparty risk and liquidity risk).[52] The Program would be part of an investment adviser's overall management of portfolio risk and would complement a fund's other risk management policies and procedures, such as a fund's liquidity risk management program adopted under Rule 22e-4.[53]

The Rule includes some degree of flexibility to apply a Program to different sleeves of a fund in the case of a multi-strategy fund having separate managers or sub-advisers for the different sleeves. Certain elements of a Program, however, such as stress testing, must be evaluated at the portfolio level and not at the level of a sleeve of a fund.[54]

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[47] *See* Adopting Release at 83206.

[48] Rule 18f-4(c)(6)(i)(D) requires a fund that is a Limited Derivatives User to maintain a written record of its policies and procedures that are reasonably designed to manage its derivatives risk, even though the fund is not required to implement a written Program.

[49] Rule 18f-4(c)(1).

[50] Rule 18f-4(a) (definition of "derivatives risks").

[51] *See* Adopting Release at 83175.

[52] *Id.* at 83188.

[53] *Id.* at 83175.

[54] *Id.* at 83179, *but see supra* n.31.

The Rule does not require that the Fund Board approve a fund's Program.[55] Instead, it is contemplated that the Fund Board will "engage with the derivatives risk management program, through its appointment of the derivatives risk manager, who is responsible for administering the program and reporting to the board on the program's implementation and effectiveness."[56]

<u>Administration by the Derivatives Risk Manager</u>

An officer or officers of the fund's investment adviser must serve as the fund's Derivatives Risk Manager.[57] The Rule requires that this individual or committee of individuals must have relevant experience regarding risk management of derivatives. Unlike Rule 22e-4 under the Investment Company Act, the Rule specifies that a fund's investment adviser may not serve as Derivatives Risk Manager. The Derivatives Risk Manager must be approved by the Fund Board (including by a majority of the independent directors) and have a direct reporting line to the Fund Board.[58]

If a single individual is appointed to act as a fund's Derivatives Risk Manager, he or she may not be a portfolio manager of the fund, and if multiple individuals are appointed to the position, portfolio management personnel of the fund may not represent a majority of the committee.[59] Moreover, all functions performed by the Derivatives Risk Manager must be reasonably segregated from the fund's portfolio management functions.[60] The Adopting Release states that the officer(s) of a sub-adviser for a fund may be appointed Derivatives Risk Manager for that fund without the concurrent appointment of one or more officers of the primary adviser to the role, if the sub-adviser "manages the entirety of the fund's portfolio (as opposed to a portion, or 'sleeve' of the fund's assets)."[61] If the sub-adviser manages only a portion of the fund's assets,

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55 *See id.* at 83177 ("Unlike rule 22e–4, where the board is required to approve a fund's liquidity risk management program that contains certain specific program elements, the board is not required to approve the derivatives risk management program.").

56 *Id.*

57 The Rule specifies that the individual(s) appointed as Derivatives Risk Manager must be an "officer" of the fund's investment adviser, since the "person(s) serving in this role must have sufficient authority within the investment adviser to carry out these responsibilities." Adopting Release at 83176. The Adopting Release clarifies that a person who does not have an officer title, but who has a degree of seniority and authority within the adviser's organization that is comparable to that of an officer, and who has the qualifications to serve as Derivatives Risk Manager under the Rule, may be treated as an officer for purposes of the Rule and may serve as the Derivatives Risk Manager if approved by the Fund Board. *Id.* at 83176-83177.

58 Rule 18f-4(c)(3).

59 *See* Rule 18f-4(a) (definition of "derivatives risk manager").

60 The Adopting Release states that portfolio managers may be conflicted when addressing risk management issues because their compensation may be based in part on the fund's returns. The Adopting Release clarifies, however, that this requirement is not meant to impose a communications "firewall" between the Derivatives Risk Manager and portfolio management and acknowledges the importance of open communication between the Derivatives Risk Manager and portfolio management. *See* Adopting Release at 83178.

61 *Id.* at 83173.

one or more of its officers may be included among a group of individuals that serve as the Derivatives Risk Manager together with one or more officers of the primary adviser.[62]

A fund's Derivatives Risk Manager may delegate to third-party vendors (including sub-advisers) functions relating to the administration of a fund's Program, such as responsibility for calculating the VaR of the fund's designated reference portfolio, but third-party vendors (other than officers of sub-advisers) are not be permitted to act as a fund's Derivatives Risk Manager. When a fund delegates derivatives risk management activities to a sub-adviser, the fund's policies and procedures are expected to address the oversight of the delegated activities, including the scope of, and conditions on, activities delegated to the sub-adviser as well as oversight of the sub-adviser.[63]

The primary responsibilities of the Derivatives Risk Manager are: administering and maintaining the Program, recommending the appropriate VaR test for each fund and addressing exceedances of the applicable limits. The specific duties are listed on <u>Annex A</u>.

A fund's Program is required to include the following elements:

- *Risk identification and assessment* of a fund's derivatives risks, taking into account the fund's derivatives transactions and other investments.[64] Derivatives risks that must be identified and managed include leverage, market, counterparty, liquidity, operational and legal risks, as well as any other risks the Derivatives Risk Manager deems material to the fund.[65]

- *Risk guidelines*, providing for quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks. The Rule imposes no specific risk limits for these guidelines, but does require a fund to adopt guidelines that provide for quantitative thresholds tailored to the fund. The risk guidelines must 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 any of them is exceeded.[66] The guidelines relating to exceedances must provide the Derivatives Risk Manager with a clear basis from which to determine whether to involve other persons, such as the fund's portfolio managers or the Fund Board, in addressing derivatives risks appropriately.[67] The Adopting Release notes that a fund may want to consider establishing investment size limits or lists of approved transactions.[68]

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62 *Id*. at 83178.

63 *Id*.

64 Rule 18f-4(c)(1)(i).

65 Rule 18f-4(a).

66 Rule 18f-4(c)(1)(ii).

67 Adopting Release at 83180.

68 *Id.* at 83180.

- *Stress testing* of derivatives risks to evaluate potential losses to a fund's portfolio under stressed conditions.[69] A fund's stress tests must 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. Stress tests must take into account correlations of market risk factors and resulting payments to derivatives counterparties. A fund must conduct stress tests at least weekly. Frequency of the stress testing must take into account the fund's strategy, investments, and current market conditions. The Adopting Release notes that stress testing may "identify risks that may not result in a VaR [limit] breach, yet may not be appropriate in light of the fund's investment strategy."[70]

- *Back-testing* the results of the VaR calculation model used by the fund in connection with the Relative VaR Test or the Absolute VaR Test.[71] In meeting this requirement, a fund will need to compare its gain or loss for each business day with the VaR that the fund calculated for that day using its VaR model, and identify as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss. A fund must perform this analysis weekly (rather than daily as proposed by the SEC in 2019), comparing the fund's daily gain and loss to the estimated VaR for each business day during the testing period. According to the SEC, the back-testing should incorporate elements that the Derivatives Risk Manager may find important when assessing whether the fund's VaR model should be adjusted.[72]

- *Internal reporting and escalation* of material risks arising from the fund's derivatives transactions.[73] The Program must identify the circumstances when portfolio management personnel must be informed about the operation of the Program, including guidelines exceedances and stress testing results. The Rule also specifies that the Derivatives Risk Manager must directly inform the Fund Board of material risks arising from the fund's derivatives use, including risks indicated by exceedances of guidelines or stress testing results.

- *Periodic review of the Program* by the Derivatives Risk Manager at least annually. The purpose of the review is for the Derivatives Risk Manager to evaluate the Program's effectiveness and to reflect changes in the fund's derivatives risks over time.[74] The Derivatives Risk Manager must review the Program overall, including each of the specific Program elements. The Rule also specifically requires that the review include the VaR calculation model used by the fund, and the required back-testing, along with any designated reference portfolio to evaluate whether it remains appropriate. The Adopting Release states that a Derivatives Risk Manager generally should implement periodic review procedures for evaluating regulatory, market-wide, and fund-specific developments

69 Rule 18f-4(c)(1)(iii).

70 Adopting Release at 83182.

71 Rule 18f-4(c)(1)(iv).

72 Adopting Release at 83182.

73 Rule 18f-4(c)(1)(v).

74 Rule 18f-4(c)(1)(vi).

affecting the fund's Program so that the Derivatives Risk Manager is well-positioned to evaluate the Program's effectiveness.[75]

4. Role of a Fund Board.

Under the Rule, a Fund Board is responsible for overseeing the Program, including by appointing the Derivatives Risk Manager, receiving regular written reports regarding the Program's implementation and effectiveness, and reviewing exceedances of the fund's guidelines and the results of stress testing. The Adopting Release discusses the role of the Fund Board in response to commenters who asked for guidance as follows:

We believe the role of the board under the [R]ule is one of general oversight, and consistent with that obligation, we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors.

We continue to believe that the [Fund Board] should view oversight as an iterative process. . . . The use of the word "iterative" is not intended to imply that the board is responsible for the day-to-day management of the fund's derivatives risk, but is instead intended to clarify that the [Fund Board's] oversight role requires regular engagement with the derivatives risk management program rather than a one-time assessment. We continue to believe that the [Fund Board's] role should be an active one that involves inquiry into material risks arising from the fund's derivatives transactions and follow-up regarding the steps the fund has taken to address such risks, including as those risks may change over time. Effective [Fund Board] oversight depends on the [Fund Board] receiving sufficient information on a regular basis to remain abreast of the specific derivatives risks that the fund faces. [Fund] Boards should request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed. Whether a [Fund Board] requests follow-up information, however, will depend on the facts and circumstances.[76]

<u>Fund Board Approval of the Derivatives Risk Manager</u>

The Fund Board (including a majority of its independent directors or trustees) must approve the designation of the Derivatives Risk Manager, taking into consideration the relevant experience of the individual(s) regarding management of derivatives risk. According to the SEC, the person(s) selected to serve as Derivatives Risk Manager must have "relevant experience regarding derivatives risk management" to ensure that the Derivatives Risk Manager is "well-positioned to manage" the "potential complex and unique risks that derivatives can pose to funds."[77] The fund's investment adviser may play a role by reviewing the qualifications of candidates for the position and by recommending one or more candidates for the Fund Board's consideration and approval.[78] The SEC has indicated that it anticipates that the Fund

[75] *See* Adopting Release at 83184.

[76] *Id*.

[77] *Id.* at 83178.

[78] *See id.* at 83185.

Board will request that the investment adviser conduct due diligence on the Derivatives Risk Manager and summarize for the Fund Board the qualifications of the candidates that it puts forward.

Fund Board Reporting

The Derivatives Risk Manager is required to provide to the Fund Board, on or before the implementation of the Program and at least annually thereafter, a written report regarding the Program. The annual report provided by the Derivatives Risk Manager to the Fund Board must include a representation that the Program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the Program. The annual report must also state the bases for the Derivatives Risk Manager's conclusions along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program and, for reports following the Program's initial implementation, the effectiveness of its implementation..[79] The Rule provides that the representation may be based on the Derivatives Risk Manager's reasonable belief after due inquiry. The Derivatives Risk Manager must also include in the report an explanation of the basis for selecting the designated reference portfolio, any change in the designated reference portfolio during the review period, or an explanation as to why a designated reference portfolio was not appropriate for the fund's VaR test.

In addition to the annual report, the Derivatives Risk Manager must provide regular written reports to the Fund Board, at a frequency to be determined by the Fund Board. These reports must analyze, among other things, exceedances of the fund's risk guidelines and the results of the fund's stress tests and back-testing.[80] The purpose of these reports is to give the Fund Board information reasonably necessary to evaluate the fund's response to exceedances and the results of the fund's stress testing and to facilitate the Fund Board's oversight of the fund and the operation of the Program.[81] In a change from the 2019 Proposal, the report is not required to include a description of every exceedance of the risk guidelines.

5. Limited Derivatives User Exception.

The Rule excepts funds that qualify as Limited Derivatives Users from the Program requirement, VaR-based limits, and related Fund Board oversight and reporting provisions.[82] To rely on the exception, a fund must limit its derivatives exposure to 10% of its net assets. A fund may exclude from the 10% threshold derivatives transactions that are used to hedge certain currency and/or interest rate risks. Specifically, a fund may exclude currency or interest rate derivatives that hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the fund (which must be foreign-currency-denominated in the case of foreign currency derivatives), or the fund's

[79] Rule 18f-4(c)(3)(ii).

[80] Rule 18f-4(c)(5)(iii).

[81] *See* Adopting Release at 83187.

[82] Rule 18f-4(c)(4).

borrowings, provided that the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes and the notional amounts of such derivatives do not exceed the value of the hedged investments (or the par value in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10%.[83]

For purposes of the Limited Derivatives User exception, "derivatives exposure" is defined as the sum of the gross notional amount of a fund's derivatives transactions and, in the case of short sale borrowings, the value of the asset sold short.[84] The Rule permits a fund to treat reverse repurchase agreements or similar financing transactions as derivatives transactions under certain circumstances, and, as a result, a fund treating these transactions as derivatives transactions must also include in its derivatives exposure the proceeds that the fund received but has not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with each such transaction. In determining its derivatives exposure, a fund may convert the notional amount of an interest rate derivative to the 10-year bond equivalent. In addition, a fund may delta adjust the notional amounts of options contracts in connection with its calculation of derivatives exposure.[85] In calculating derivatives exposure, a fund may exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund.

A fund relying on the Limited Derivatives User exception is required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risk.[86] In the Adopting Release, the SEC notes that the policies and procedures must be tailored to the fund's derivatives use.[87] The Rule does not prescribe the frequency with which a fund must calculate its derivatives exposure to evaluate its continued eligibility for the exception or the content of the policies and procedures a Limited Derivatives User must adopt to manage it derivatives risks.[88]

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83 Rule 18f-4(c)(4)(B).

84 Rule 18f-4(a) (definition of "derivatives exposure").

85 *See* Adopting Release at 83207. Although the Adopting Release does not explain how the notional amount of an interest rate derivative would be converted to a 10-year bond equivalent it notes that: "[p]ermitting funds to convert . . . interest rate derivatives to 10-year bond equivalents is designed to result in adjusted notional amounts that better represent a fund's exposure to interest rate changes." The Adopting Release also notes that the reference to "delta" means the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. The Adopting Release notes that a fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta. *Id.* at n.500.

86 *See* Rule 18f-4(c)(4)(i)(A).

87 *See* Adopting Release at 83211-83212. The SEC notes the following by way of example: ". . . a fund that uses derivatives only occasionally and for a limited purpose, such as to equitize cash, is likely to have limited policies and procedures commensurate with this limited use. A fund that uses more complex derivatives with derivatives exposure approaching 10% of net asset value, in contrast, should have more extensive policies and procedures."

88 *Id.* at 83212 ("[A]lthough a more prescriptive approach regarding a fund's policies and procedures, such as a minimum frequency of testing as one commenter suggested, would provide clearer guidelines to facilitate compliance, this approach may be over or under-inclusive considering the breadth of funds' use of derivatives and the derivatives' particular risks.").

The Rule contains remediation provisions to address instances in which a Limited Derivatives User exceeds the 10% threshold.[89] If a Limited Derivatives User's derivatives exposure exceeds the 10% derivatives exposure threshold for five business days, the fund's investment adviser must provide a written report to the Fund Board. The investment adviser's report to the Fund Board must inform the Fund Board whether the adviser intends either to: (i) promptly, within 30 calendar days of the exceedance, reduce the fund's derivatives exposure to be in compliance with the 10% threshold; or (ii) establish a Program, comply with the VaR-based limit on fund leverage risk, and comply with the related Fund Board oversight and reporting requirements as soon as reasonably practicable. In either case the fund is required to specify the number of business days, in excess of the five-business-day remediation period, that the fund's derivatives exposure exceeded 10% of its net assets during the applicable reporting period. The Adopting Release indicates that the inclusion of the five-business-day period is intended "to provide funds with some flexibility in coming back into compliance with the limited derivatives user exception without triggering an obligation to inform the fund's board of directors or a Form N-PORT reporting requirement."[90]

6. Reverse Repurchase Transactions and Similar Transactions.

The Rule permits funds to enter into reverse repurchase agreements and similar financing transactions, notwithstanding Sections 18(c) and 18(f)(1) of the Investment Company Act, so long as they meet the relevant asset coverage requirements of Section 18 of the Investment Company Act.[91] In such an event, a fund is required to combine the aggregate amount of indebtedness associated with all reverse repurchase agreements and similar financing transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.[92]

In a change from the 2019 Proposal, the Rule permits a fund to choose to treat reverse repurchase agreements or similar financing transactions as derivatives transactions, instead of including them in the fund's asset coverage calculations for purposes of Section 18.[93] A fund that chooses this course of action would need to treat all reverse repurchase agreements and similar transactions as derivatives for all purposes under the Rule. The Adopting Release explains that this change is intended to provide a fund with flexibility to choose the approach that is best suited to its investment strategy or operational needs while still addressing Section 18's asset sufficiency and leverage concerns.[94]

89 *See* Rule 18f-4(c)(4)(ii).

90 Adopting Release at 83212-83213.

91 Rule 18f-4(d)(1)(i). For a general discussion of the asset coverage requirements of Section 18 and the provisions of Sections 18(c) and 18(f)(1), *see supra* n.10 and n.16, respectively.

92 Adopting Release at 83294.

93 Rule 18f-4(d)(1)(ii).

94 *See* Adopting Release at 83225.

A fund must treat all of its reverse repurchase agreements and similar financing transactions in the same way for purposes of the Rule and the asset coverage requirements of Section 18.[95] A fund must record the approach it is using to manage its reverse repurchase agreements and similar financing transactions in its books and records and must maintain those books and records for at least five years (the first two years in an easily accessible place) following the determination of approach.[96] The Adopting Release indicates that these records should provide supporting detail for a fund's disclosure on Form N-CEN regarding the Rule's provision upon which it relied in entering into reverse repurchase agreements and similar financing transactions.[97]

The Adopting Release notes the SEC's view that securities lending arrangements could be deemed to be "similar financing transactions" and, therefore, senior securities, if they are used to leverage a fund's portfolio. The Adopting Release also notes that securities lending transactions are not to be viewed as similar to a reverse repurchase agreement if the fund lending securities receives cash collateral from the borrower and invests the cash collateral solely in "highly liquid, short-term investments, such as money market funds or other cash or cash equivalents," or receives non-cash collateral that it does not sell or otherwise use to leverage the fund's portfolio.[98] The Adopting Release does not expand the types of investments in which a fund may invest its securities lending cash collateral beyond those discussed in the 2019 Proposal without treating the arrangements as "similar financing transactions" under the Rule.

7. Unfunded Commitment Agreements.

The Rule defines an "unfunded commitment agreement" as "a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."[99] Unfunded commitment agreements do not include firm and standby commitments, which the SEC views as "similar financing transactions" to derivatives.[100]

The Rule permits a fund to enter into unfunded commitment agreements to extend loans or invest capital so long as the fund reasonably believes, at the time it enters into the agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due.[101] In forming a reasonable belief, a fund must take into account its reasonable expectations with respect to any other obligations (including any obligations with respect to senior securities and redemptions). In making this determination, a fund may

[95] *Id.* at 83243.

[96] Rule 18f-4(d)(2). *See infra* n.103.

[97] *See* Adopting Release at 83227.

[98] *See id.* at 83228.

[99] Rule 18f-4(a).

[100] *See* Adopting Release at 83174.

[101] Rule 18f-4(e).

not include any proceeds of investment liquidations at prices that significantly differ from the market value of the investments, or funding to be obtained by issuing additional equity. A fund that enters into unfunded commitment agreements in compliance with the Rule need not include them in computing its asset coverage for purposes of Section 18.

A fund that enters into unfunded commitment agreements must maintain records documenting its basis for concluding that its assets are sufficient to meet its obligations with respect to all unfunded commitment agreements.[102] The fund must maintain such records for at least five years, the first two years in an easily accessible place.

8. Delayed Settlement Transactions.

In a change from the 2019 Proposal, the Rule adopted the Delayed Settlement Transactions Exception to allow a fund to engage in a securities transaction on a when-issued or forward-settling basis, or with a non-standard settlement cycle, without treating the transaction as a senior security. The ability to treat such a transaction as not involving a senior security is conditioned upon: (i) the fund intending to physically settle the transaction; and (ii) the transaction settling within 35 days of the trade date. The ability for funds to engage in these transactions without giving rise to a senior security applies not only to funds subject to the Rule but also to Money Market Funds. According to the SEC, the “potential for leveraging is limited in these transactions, particularly because of the short period of time between trade date and settlement date and the fund’s intention to physically settle the transaction rather than to engage in an offsetting transaction.”[103]

9. New Fund Reporting, Disclosure, Recordkeeping and Policy and Procedure Requirements.

Reporting and Disclosure Requirements

The SEC amended the reporting requirements for funds that rely on the Rule. The amendments affect Forms N-PORT, N-LIQUID (which the SEC renamed “Form N-RN,” to reflect the fact that funds will use that form to file risk notices with the SEC along with certain liquidity reports related to compliance with Rule 22e-4), and Form N-CEN. The amendments are intended to enhance the SEC’s ability to oversee funds’ use of derivatives and other leveraging transactions and funds’ compliance with the Rule. The disclosure requirements are also intended to provide the SEC and (in some cases) the public additional information regarding funds’ use of derivatives and other leveraging transactions.

Amendments to Form N-PORT

The SEC amended Form N-PORT to include new Item B.9, which requires a fund that is a Limited Derivatives User (but not funds operating outside the Limited Derivatives User exception) to disclose information relating to its derivatives

[102] Rule 18f-4(e)(2).

[103] Adopting Release at 83174.

exposure. A Limited Derivatives User will also be required to report the number of business days during the reporting period, if any, in excess of the five-business-day remediation period that is provided in the Rule that the fund's derivatives exposure exceeded 10% of its net assets. The information reported in response to Item B.9 of Form N-PORT will not be made publicly available.

The SEC also amended Form N-PORT to add new Item B.10, which will require a fund that is not a Limited Derivatives User to report information relating to the VaR tests. Such a fund will report its median daily VaR for the monthly reporting period and the name of the fund's designated index and its index identifier or a statement that the fund's designated reference portfolio is the fund's securities portfolio. Funds will also report their median daily VaR ratio for the reporting period. Disclosure of a fund's median VaR information will not be made publicly available.

A fund will have to report the number of exceptions it identified during the reporting period arising from back-testing its VaR calculation model.[104] This information will also not be made publicly available.

Amendments to Form N-LIQUID (renamed Form N-RN)

The SEC adopted new current reporting requirements for funds that rely on the Rule. The SEC renamed Form N-LIQUID "Form N-RN" and amended the form to include new reporting events for a fund that is subject to the VaR-based limits on fund leverage risk. Such a fund must determine its compliance with the applicable VaR test on at least a daily basis, and the amendments require a fund to file Form N-RN to report information about its VaR limit breaches.

Currently, only registered open-end funds (other than Money Market Funds) are required to file reports on Form N-LIQUID. Under the Rule, any fund that is subject to the Rule's limits on fund leverage risk (*e.g.*, Closed-End Funds) will be required to file current reports on Form N-RN regarding VaR limit breaches. A fund's reports on Form N-RN regarding VaR limit breaches will not be made available to the public.

Under the Rule, a fund must report the required information regarding a VaR limit breach within one business day following the fifth business day after the fund has determined that its portfolio VaR exceeds the Relative VaR Test or Absolute VaR Test limit, as applicable. The fund will also be required to file a second report on Form N-RN when it comes back into compliance with its applicable VaR test after a breach.

Amendments to Form N-CEN

The SEC adopted in connection with the Rule a number of changes to Form N-CEN. Fund responses to these new reporting items will be publicly available. A fund is required, among other things, to identify whether or not it has relied on

[104] *See* Item B.10c of Form N-PORT.

the Rule during the reporting period; whether it is a Limited Derivatives User; and whether it is a Leveraged/Inverse Fund that is excepted from the requirement to comply with the limit on fund leverage risk described in Rule 18f–4(c)(2).

In meeting the Rule's requirements, a fund will have to identify whether it has entered into reverse repurchase agreements or similar financing transactions pursuant to the Rule and, if so, whether it entered into such transactions either under: (i) the provision of the Rule that requires compliance with Section 18's asset coverage requirements; or (ii) the provision that allows a fund to treat these transactions as derivatives transactions for all purposes under the Rule. In addition, a fund will have to identify whether it has entered into unfunded commitment agreements under the Rule, and whether it is relying on the Delayed Settlement Transactions Exception.

Amendment to Form N-2[105]

Form N-2 was amended in connection with adoption of the Rule to provide that funds relying on the Rule should exclude their derivatives transactions and unfunded commitment agreements from the senior securities table on Form N-2.

Recordkeeping and Policy and Procedure Requirements

The Rule requires funds to create and maintain records relating to their compliance with the Rule for five years.[106]

Specifically, a fund subject to the Program requirements must retain the following:

- a written record of its policies and procedures designed to manage the fund's derivatives risks as well as the results of stress tests and back-testing;
- any internal reporting or escalation of material risks under the Program;
- records reflecting periodic reviews of the Program;
- written reports and materials provided to the Fund Board in connection with the Program, including exceedances, and appointment of the Derivatives Risk Manager;

105 This form is used to register Closed-End Funds (as well as funds that elect to be regulated as BDCs) under the Investment Company Act and their securities under the Securities Act of 1933.

106 Rule 18f-4(c)(6)(ii)(A) requires a fund to maintain written policies and procedures under the Rule that are currently in effect, or were in effect at any time within the past five years, in an easily accessible place. In addition, a fund will have to maintain all other records and materials that the Rule would require the fund to maintain for at least five years (the first two years in an easily accessible place). *See* Rule 18f-4(c)(6)(ii)(B); 18f-4(d)(2) and 18f-4(e).

- records documenting the fund's determination of compliance with the applicable VaR limits, updates to the VaR calculation models used by the fund and the basis for changes made to the models;
- for a fund that enters into unfunded commitment agreements, records documenting the basis for the fund's reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements;
- for a fund that enters into reverse repurchase agreements or similar financing transactions, written records documenting whether the fund is treating these transactions under the Section 18 asset coverage requirements or all of the Rule's requirements applicable to derivatives transactions; and
- for a fund that is a Limited Derivatives User, the fund must maintain the fund's policies and procedures required under the Rule, along with copies of any written reports provided to the Fund Board with respect to exceedances of the 10% threshold.[107]

10. Leveraged/Inverse Funds.

The 2019 Proposal would have excluded certain Leveraged/Inverse Funds from the obligation to comply with the Relative VaR Test or the Absolute VaR Test but subjected all such funds to proposed sales practices requirements when selling shares of those funds to retail investors. The SEC did not adopt the proposed sales practices requirements for Leveraged/Inverse Funds and instead subjected Leveraged/Inverse Funds to all of the provisions of Rule 18f-4, including the VaR limits.

The Rule provides an exception from the limit on fund leverage risk for Leveraged/Inverse Funds that were in operation as of October 28, 2020 and that seek an investment result above 200% of the return (or inverse of the return) of an underlying index.[108] Such funds must comply with all provisions of the Rule other than the VaR-based limit on fund leverage risk and disclose in their prospectuses that they are not subject to the condition of the Rule limiting fund leverage risk. They are not permitted to change their underlying market index or to increase the level of leveraged or inverse market exposure that they seek.

11. Conforming Rule Changes.

The SEC, in adopting the Rule, also adopted amendments to Rule 6c-11 under the Investment Company Act, which is the rule that allows ETFs to operate without seeking individual exemptions under the Investment Company Act. These amendments permit Leveraged/Inverse Funds that operate as ETFs to operate within the scope of Rule 6c-11 provided that they comply with the Rule. Rule 6c-11, when adopted in 2019, excluded Leveraged/Inverse Funds from relying on

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107 Rule 18f-4(c)(6)(i)(D). *See* Rule 18f-4 (c)(6)(ii)(A) and (B) for retention periods for these records.

108 Rule 18f-4(c)(5).

the rule in order "to allow the Commission to consider the section 18 issues raised by these funds' investment strategies as part of a broader consideration of derivatives use by registered funds and BDCs."[109] In light of the adoption of Rule 18f-4, the SEC amended Rule 6c-11 to permit new Leveraged/Inverse Funds, which are able to comply with Rule 18f-4, to operate under Rule 6c-11.

In a change from the 2019 Proposal, the SEC amended Rule 22e-4 relating to liquidity risk management programs for registered open-end funds (other than Money Market Funds) and the reporting requirements on Form N-PORT to remove references to assets "segregated to cover" derivatives transactions. The SEC also amended Form N-PORT's general instructions to make clear that the term "derivatives transactions" has the same meaning as it does in Rule 18f-4 solely with respect to N-PORT items that relate specifically to the Rule. As a result, funds will need to amend their liquidity risk management programs adopted under Rule 22e-4 to reflect these changes.

12. Elimination of Asset Segregation Guidance and Rescission of SEC Release 10666; Transition Periods.

Elimination of Asset Segregation Guidance and Rescission of SEC Release 10666

The SEC announced that it is rescinding SEC Release 10666 and the SEC staff is reviewing, with a view to withdrawing, its no-action letters and guidance regarding funds' use of derivatives. The SEC is also rescinding the ETF exemptive orders previously issued to sponsors of Leveraged/Inverse Funds that comply with the Rule (since they will be able to rely on Rule 6c-11).[110]

The Rule does not include an asset segregation requirement for funds entering into derivatives transactions. The Adopting Release explains that, after considering comments on the matter, the SEC "continue[s] to believe that a general asset segregation requirement is not necessary in light of the final rule's requirements, including the requirements that funds must establish derivatives risk management programs and comply with the VaR-based limit on fund leverage risk."[111]

Transition Periods

The SEC is allowing an 18-month transition period—ending August 19, 2022—before the rescission of SEC Release 10666 will become effective and funds must come into compliance with Rule 18f-4. The Rule will become effective on February 19, 2021, and a fund may rely on the Rule from and after that date, provided that the fund satisfies all of the Rule's conditions.

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[109] Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019), 84 Fed. Reg. 57162 (Oct. 24, 2019) at nn.72-74 and accompanying text.

[110] *See* Adopting Release at 83171.

[111] *Id.* at 83190.

III. Conclusion

The Rule represents a change of approach from the regulatory framework in place today governing funds' use of derivatives and other types of leveraged transactions that are not structured as borrowings. Historically, the SEC and its staff have followed the approach outlined in SEC Release 10666 in regulating the use of these instruments by funds. In seeking to act in accordance with SEC Release 10666, funds have addressed potential senior security concerns regarding exposure and leverage by segregating liquid assets sufficient to "cover" their obligations under the particular instruments or by entering into certain offsetting transactions. The Rule replaces the historical approach with a uniform set of limits on fund leverage risk and a variety of compliance conditions imposed on the use of derivatives and similar transactions as well as enhanced reporting, irrespective of whether a transaction is for risk management, asset class exposure or enhanced return. Implementation of the Rule will likely impose potentially significant compliance and other costs on funds, including funds that are eligible to rely on the exception for Limited Derivatives Users. Compliance with the Rule may also present particular complexity for multi-manager and sub-advised funds to coordinate implementation of Derivatives Risk Manager oversight and Program implementation. Fund managers should review the Rule carefully in light of their current portfolio management practices to assess how best to structure compliance with the new requirements. We expect that, after affording the fund industry a period of time to become familiar with and comply with the provisions of the Rule, the SEC examination staff will closely examine funds' compliance with these provisions.

In addition, given the change in administration, the on-going review by the SEC staff into regulation of Leveraged/Inverse Funds and other complex products and the comments made by SEC Commissioners Lee and Crenshaw in their dissents to the Rule, it is possible that the SEC may adopt additional requirements or propose modifications to the Rule.[112] In that regard, it is noteworthy that the two dissenting SEC Commissioners raised the following concerns in their statements regarding the Rule and the Reporting Rules: (i) the VaR levels included in the Rule are so high that they do not impose "meaningful extrinsic limits,"[113] (ii) the flexibility granted by the Rule in calculating limits is too broad and allows funds to "tinker with or manipulate those outer bounds;"[114] (iii) the Reporting Rules failed to include proposed disclosures to the public that would have better informed investors regarding the use of derivatives by funds in which they invest;[115] (iv) the Rule does not include sufficient incentives for funds that have exceeded limits to come back into compliance with the

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112 *See* Statement of Commissioner Lee ("[T]his rule did not live up to the promise of the proposal. In fact, it underwent a substantial overhaul—increasing risk, reducing transparency around that risk, and dropping basic sales practice rules for extremely complex products—all to the detriment of retail investors."); Statement of Commissioner Crenshaw ("The use of derivatives, the focus of today's rule, can present an inordinate amount of risk to funds and the investors who hold them, particularly in the face of market volatility. Yet during this global pandemic, as we have seen increased trading in some of these products, we have failed to address the significant risk that derivatives can pose to funds and investors.").

113 Statement of Commissioner Lee.

114 *Id.*

115 *Id.* ("[I]f we are going to allow funds to take on greater leverage risk, we should at a minimum ensure fulsome disclosures that would allow investors and the public to understand and evaluate that risk. Instead, the final rule eliminates much of the disclosure that was proposed, purportedly to reduce the likelihood for unsophisticated investors to misinterpret the information.").

limits (*i.e.*, the Rule "lacks a reliable backstop");[116] and (v) the elimination of the sales practices requirements from the rulemaking package reflects a failure to "address the risks retail investors face when buying leveraged and inverse funds."[117] In light of the possibility that the SEC may seek to address these and other concerns and further revise Rule 18f-4 and the Reporting Rules, fund managers should continue to closely track developments in the area in connection with their development of new types of funds and their adoption of policies and procedures to comply with Rule 18f-4.

ANNEX A

Summary of Responsibilities of the Derivatives Risk Manager

(i) Administering and maintaining the Program and the policies and procedures that are reasonably designed to manage the fund's derivatives risks;

(ii) Identifying the risks associated with the fund's derivatives transactions or its use of derivatives transactions;

(iii) Approving the selection of a designated reference portfolio for the Relative VaR Test;

(iv) Recommending compliance with the Absolute VaR Test when the Derivatives Risk Manager is unable to identify an appropriate designated reference portfolio;

(v) Informing portfolio management personnel in a timely manner, and also directly informing the Fund Board as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified by the fund's exceedance of a criterion, metric, or threshold provided for in the fund's risk guidelines or by stress testing;

(vi) Reviewing the Program at least annually to evaluate its effectiveness and to reflect changes in risk over time, including a review of the VaR calculation model used by the fund (including back-testing) and any designated reference portfolio to evaluate whether it remains appropriate;

(vii) Providing to the Fund Board on or before the implementation of the Program, and at least annually thereafter, a written report (a) providing a representation that the Program is reasonably designed to manage the fund's derivatives risks, (b) incorporating the Program elements provided in the Rule discussing the Derivatives Risk Manager's basis for approving any designated reference portfolio or any change in the designated reference portfolio during the period covered by the report or explaining the basis for the Derivatives Risk Manager's

[116] Statement of Commissioner Crenshaw.

[117] *Id.*

determination that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test; and

(viii) Periodically, at a frequency determined by the Fund Board, submit to the Fund Board a written report regarding the Derivatives Risk Manager's analysis of VaR test exceedances, and the results of the stress testing and back-testing conducted, since the previous report to the Fund Board, each such report to include such information as may be reasonably necessary for the Fund Board to evaluate the fund's response to exceedances and the results of the fund's stress testing.

When a fund is not in compliance with its applicable VaR-based limit for five business days, the Derivatives Risk Manager must:

(i) Explain how and by when (*i.e.*, number of business days) the Derivatives Risk Manager reasonably expects that the fund will come back into compliance;

(ii) Provide a Non-Compliance Report to the Fund Board, which analyzes the circumstances that caused the fund to be out of compliance for more than five business days and updates any Program elements to address those circumstances, as appropriate;

(iii) Provide a Fund Analysis and Program Update within 30 calendar days of the exceedance to the Fund Board explaining how the fund came back into compliance and the results of the Derivatives Risk Manager's analysis and updates; and

(iv) If the fund remains out of compliance with the applicable VaR test at that time, the Derivatives Risk Manager must update the previously provided Non-Compliance Report and update the Fund Board on the fund's progress in coming back into compliance at regularly scheduled intervals at a frequency determined by the Fund Board.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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