Blogs
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Asset Management ADVocate

Dealing with the New Derivatives Rule—Definition of Derivatives Transactions and Classifications of Funds

Following onto our recent podcast discussing new Rule 18f-4 at a very high level, we thought it would help to post a series of blogs that go into more detail and point out some open questions. We begin with the most basic elements:

- What is Rule 18f-4?
- What alternatives are available for compliance?
- When must funds comply with Rule 18f-4?

What Rule 18f-4 Does

Rule 18f-4 primarily permits funds to engage in "derivatives transactions" that would otherwise be subject to the restrictions of Section 18 of the Investment Company Act of 1940 on their issuance of "senior securities." The relief under Rule 18f-4 is available to any "fund," which (with one exception discussed in our next post) means a registered open- or closed-end investment company (other than a money market fund) or a business development company. The rule's definition of a "**derivatives transaction**" includes a list of specific "derivatives instruments" (such as futures, forwards and swaps), borrowing assets for short sales, and a catchall for:

> any similar instrument under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise."

We will examine this definition in later posts. Additionally, Rule 18f-4 regulates the application of Section 18 to reverse repurchase agreements and unfunded commitment agreements. The final rule also provides that certain "non-standard settlement transactions" are not senior securities.

Compliance Alternatives

Short of never engaging in derivatives transactions, a fund will need to satisfy characteristics and requirements applicable to one of four types of funds.

Type of Fund	Characteristics	Requirements

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<tr><td>Limited Derivatives Fund</td><td>A fund that limits the notional amount of derivatives transactions and the value of securities sold short ("derivatives exposure") to not more than 10% of the fund's net assets. Derivatives exposure does not include 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 currency derivatives), or the fund's borrowings, provided that the notional amounts of such derivatives do not exceed the value of the hedged investments, or the principal amount of fixed-income investments or borrowings, by more than 10%.</td><td>Adopt policies and procedures reasonably designed to manage the fund's "derivatives risks", including:
leverage,
market,
counterparty,
liquidity,
operational, and
legal risks, and
any other risks the fund's investment adviser deems material.</td></tr>
<tr><td>Closed-End Preferred Stock Fund</td><td>A closed-end fund that is not a Limited Derivatives Fund and has outstanding shares of a class of senior preferred stock.</td><td>Adopt a derivatives risk management ("DRM") program that meets the requirements of Rule 18f?4(c)(1). Limit value-at-risk ("VaR") to either 250% of the VaR of a designated index or the fund's securities portfolio or, if the fund's derivatives risk manager determines this would not provide an appropriate reference portfolio, 25% of its net assets. Comply with Board oversight and reporting requirements of Rule 18f?4(c)(3).</td></tr>
<tr><td>Grandfathered Leveraged/Inverse Fund</td><td>A fund that, as of October 28, 2020, was in operation, had outstanding shares issued in one or more public offerings to investors, and disclosed in its prospectus that it seeks to provide investment returns that exceed 200% of the performance or the inverse of the performance of a market index over a predetermined period, and
does not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks to provide; and
discloses in its prospectus it is not subject to the limit on fund leverage risk in Rule 18f?4(c)(2).</td><td>Adopt a DRM program that meets the requirements of Rule 18f?4(c)(1). Limit its VaR to the specified percentage of the VaR (or inverse VaR) of its market index. Comply with Board oversight and reporting requirements of Rule 18f?4(c)(3).</td></tr>
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Other Type of Fund	A fund that is not a Limited Derivatives Fund, Closed-End Preferred Stock Fund or Grandfathered Leveraged/Inverse Fund	Adopt a DRM program that meets the requirements of Rule 18f?4(c)(1). Limit VaR to either 200% of the VaR of a designated index or the fund's securities portfolio or, if the fund's derivatives risk manager determines this would not provide an appropriate reference portfolio, 20% of its net assets. Comply with Board oversight and reporting requirements of Rule 18f ?4(c)(3).

Effective and Compliance Dates

Although it was adopted on October 28, 2020, the final release for Rule 18f-4 was not published in the Federal Register until December 21. The effective date of the rule is therefore February 19, 2021 (sixty days after publication). Funds have eighteen months (until August 19, 2022) to come into compliance. A fund may rely on Rule 18f-4 any time after its effective date, but the fund must comply with all requirements of the rule.

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