



The release adopting [Rule 18f-4](#) (the "Adopting Release") devotes an entire [section](#) to discussing how "a fund that invests in other registered investment companies ('underlying funds')" should comply with the value-at-risk ("VaR") requirements of the rule. This post considers three circumstances in which a fund investing in underlying funds:

1. Does not invest in any derivatives transactions (a "Non-User Fund-of-Funds");
2. Allows its derivatives exposure to exceed 10% of its net assets (a "VaR Fund-of-Funds") ; and
3. Limits its derivatives exposure to 10% of its net assets (a "Limited Derivatives User Fund-of-Funds").

We use the term "Fund-of-Funds" for convenience, meaning to include funds that hold both direct investments and underlying funds in compliance with [Rule 12d1-4](#) or other exemptions.

## Non-User Fund-of-Funds

The Adopting Release confirmed that

an acquiring fund that does not use derivatives transactions would not be required to comply with the final rule or to look through to an underlying registered investment company or BDC's use of derivatives transactions for purposes of determining the acquiring fund's derivatives exposure."

This is because each underlying fund must comply with Rule 18f-4 and will be thereby limited in its use of derivatives transactions. This should permit a Non-User Fund-of-Funds to hold a mix of Limited Derivatives Users and VaR Funds. However,

[i]f a fund enters into derivatives transactions indirectly through controlled foreign corporations, these derivatives transactions are treated as direct investments of the fund ...."

The Adopting Release does not discuss whether other controlled underlying funds should be treated in this manner.

## VaR Fund-of-Funds

According to the Adopting Release:

[w]hen an acquiring fund does engage in derivatives transactions beyond the 10% limited derivatives user threshold and also holds shares of underlying funds, the acquiring fund will be required under the rule to calculate its own VaR."

This implies that a VaR Fund-of-Funds must comply with an applicable [VaR Test Limit](#). Given the "challenges associated with obtaining daily transparency into the holdings of the underlying funds," a VaR Fund-of-Funds may "use the historic returns of the underlying funds" in calculating its VaR. However, a VaR Fund-of-Funds cannot "use its own historic return for calculating VaR," in lieu of the returns of its direct investments and the underlying funds.

## Limited Derivatives User Fund-of-Funds

The Adopting Release does not directly discuss the circumstance in which a Fund-of-Funds seeks to comply with the Limited Derivatives User requirements. The quoted guidance provides, however, that:

- a Non-User Fund-of-Funds is not required to look through to derivatives transactions used by underlying funds "for purposes of determining the acquiring fund's derivatives exposure," because the underlying funds must already comply with Rule 18f-4, and
- an acquiring fund is required "to calculate its own VaR" when it "engage[s] in derivatives transactions *beyond the 10% limited derivatives user threshold.*"

This guidance suggests to us that a fund can engage in derivatives transactions within the 10% Limited Derivatives User threshold without looking through to the derivatives exposure of its underlying fund. In other

words, a Limited Derivatives User Fund-of-Funds should not include underlying funds (unless it controls the funds) in its derivatives exposure. In our next post, we will review the guidance for sub-advised funds.

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