Press Release

SEC Adopts Modernized Regulatory Framework for Derivatives Use by Registered Funds and Business Development Companies

FOR IMMEDIATE RELEASE
2020-269

Washington D.C., Oct. 28, 2020 — The Securities and Exchange Commission today voted to enhance the regulatory framework for derivatives use by registered investment companies, including mutual funds (other than money market funds), exchange-traded funds (ETFs) and closed-end funds, as well as business development companies. The new rule and rule amendments will provide a modernized, comprehensive approach to the regulation of these funds' derivatives use that addresses investor protection concerns and reflects developments over the past decades. The Commission is committed to designing regulatory programs that reflect the ever-broadening product innovation and investor choice available in today's asset management industry, while also taking into account the risks associated with funds' increasingly complex portfolio composition and operations.

"Derivatives have come to play an important role for many funds in portfolio strategy and risk management, but the regulatory approach for derivatives use has been inconsistent and outdated," said SEC Chairman Jay Clayton. "Today's action provides for a comprehensive framework for funds' derivatives use that provides both meaningful protections for investors and regulatory certainty for funds and their advisers. Importantly, the new comprehensive limits on risk will prohibit derivatives use that is inconsistent with the leverage limits imposed by the Investment Company Act, but will allow virtually all funds to continue to serve their investors using the most efficient instruments. I thank the staff for their impressive work."

The Investment Company Act limits the ability of registered funds and business development companies to engage in transactions that involve potential future payment obligations, including obligations under derivatives such as forwards, futures, swaps and written options. The new rule permits funds to enter into these transactions if they comply with certain conditions designed to protect investors. These conditions include adopting a derivatives risk management program and complying with a limit on the amount of leverage-related risk that the fund may obtain based on value-at-risk, or "VaR."

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

Finally, the new rule requirements also apply to leveraged or inverse ETFs. The Commission has directed the staff to review the effectiveness of existing regulatory requirements in protecting investors, particularly those with self-directed accounts, who invest in complex investment products (including leveraged or inverse products). As part of this review, the staff will consider whether the Commission's promulgation of any additional requirements for these products may be appropriate. Today, Chairman Clayton and Directors Dalia

Blass, William Hinman and Brett Redfearn published a joint statement that discusses concerns associated with leveraged or inverse funds and other complex products.[i]

The new rule will be published on the Commission's website and in the Federal Register. The rule and related rule and form amendments will become effective 60 days after publication in the Federal Register. The Commission has provided for an eighteen month transition period for funds to comply with the rule and related reporting requirements.

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FACT SHEET
Use of Derivatives by Registered Investment Companies and Business Development Companies
October 28, 2020

Highlights

The Commission voted to adopt new rules, and rule and form amendments, designed to provide an updated, comprehensive approach to the regulation of funds' use of derivatives and certain other transactions. New rule 18f-4, an exemptive rule under the Investment Company Act of 1940 (the "Act"), permits mutual funds (other than money market funds), exchange-traded funds ("ETFs"), registered closed-end funds, and business development companies (collectively, "funds") to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under section 18 of the Act. In connection with these new rules, the Commission amended rule 6c-11 under the Act to allow leveraged or inverse ETFs to operate without obtaining an exemptive order. Finally, the Commission adopted new reporting requirements and amendments to certain disclosure forms.

Rule 18f-4 under the Investment Company Act

Rule 18f-4 provides certain exemptions from the Act subject to conditions. The conditions and other elements of the rule include the following:

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

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

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

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

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

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

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

Amendments to Rule 6c-11

Amendments to Investment Company Act rule 6c-11 permit leveraged or inverse ETFs to rely on rule 6c-11 if they comply with all applicable provisions of rule 18f-4. The Commission is rescinding the exemptive orders previously issued to the sponsors of leveraged or inverse ETFs in connection with these amendments.

Reporting Requirements

Funds will be required to report confidentially to the Commission on a current basis on Form N-RN if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than five business days. Funds currently required to file reports on Forms N-PORT and N-CEN will be required to provide certain information regarding a fund's derivatives use. This will include information regarding the fund's VaR, as applicable, and information about the fund's derivatives exposure (for funds that rely on the limited derivatives user exception in rule 18f-4).

Relevant Staff Guidance

The Commission is rescinding the 1979 General Statement of Policy (Release 10666) that provided Commission guidance on how funds may engage in certain trading practices in light of section 18's restrictions. In addition, staff in the Division of Investment Management has reviewed its no-action letters and other guidance addressing funds' use of derivatives and other transactions covered by rule 18f-4. Some of these staff letters and staff guidance will be withdrawn.

What's Next?

The new rule, and related rule and form amendments, will be published on the Commission's website and in the Federal Register. All will be effective 60 days after publication in the Federal Register.

The Commission is providing a transition period to give funds time to comply with the provisions of rule 18f-4 and the related reporting requirements. The Commission has adopted a compliance date that is eighteen months after the effective date. The rescission of Release 10666 also will be effective eighteen months after the effective date. The withdrawal by the staff of staff letters and staff guidance addressing funds' use of derivatives and other transactions covered by rule 18f-4 will be effective upon the rescission of Release 10666.

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[i] See Chairman Jay Clayton; Dalia Blass, Director, Division of Investment Management; William Hinman, Director, Division of Corporation Finance; Brett Redfearn, Director, Division of Trading and Markets, "Joint Statement Regarding Complex Financial Products and Retail Investors" (Oct. 28, 2020), available here.

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Related Materials

- Final Rule