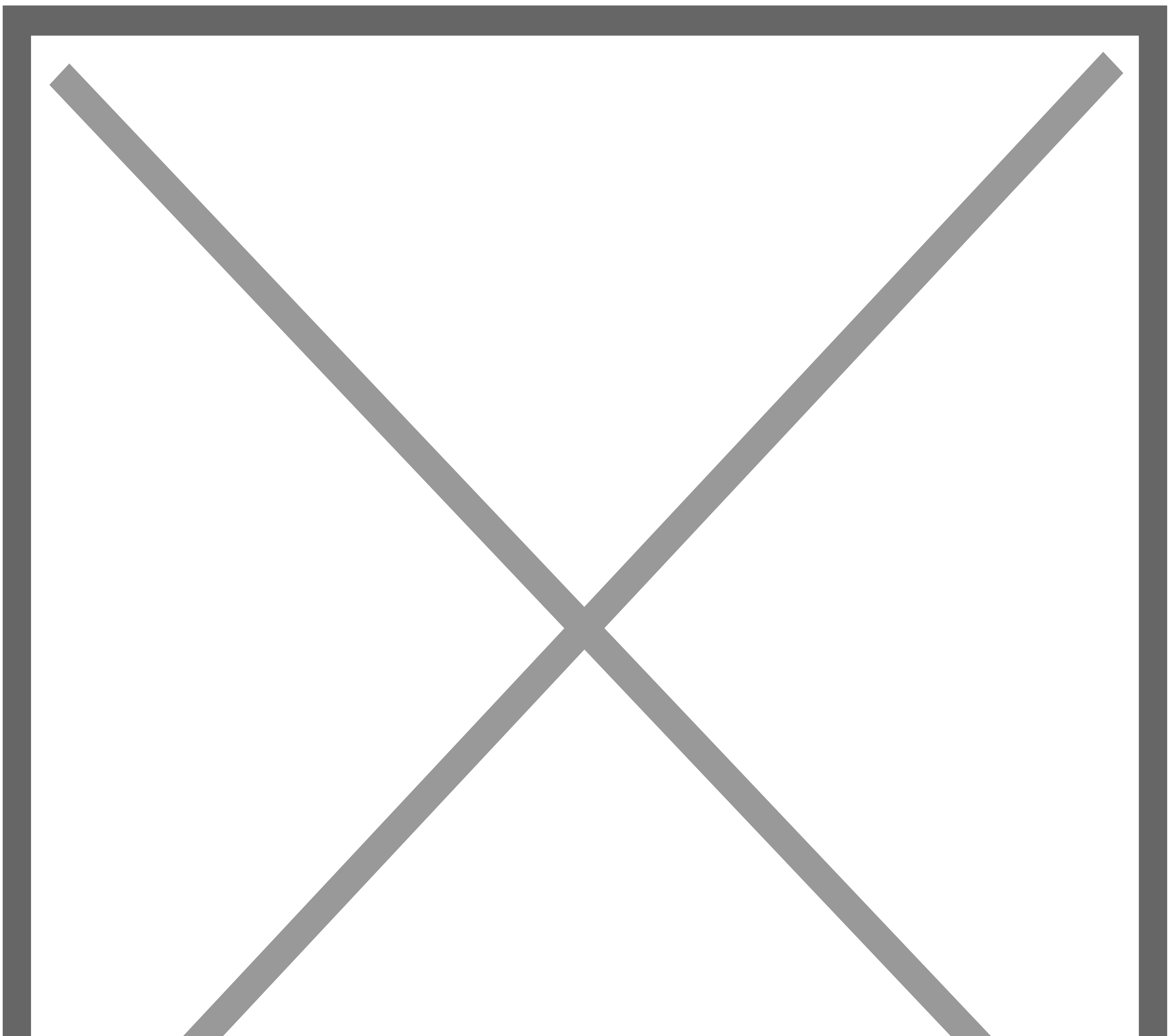
[Blogs](#)
February 13, 2020
Re-Proposed Rule 18f-4—Fund Taxonomy

The publication of the SEC's re-proposed rules for regulating the use of derivatives by investment companies in the [Federal Register](#) provides an opportunity to continue our consideration of this proposal. The publication fixes the deadline for comments at March 24, 2020. The proposed classifications of how funds may use derivatives, the taxonomy of these funds if you will, provides a useful starting place for organizing our consideration of re-proposed Rule 18f-4.

Managing Risk Based on Use

Re-proposed Rule 18f-4 would vary the level of risk management required for a fund to engage in derivative transactions based on (a) the fund's objective in using derivatives or (b) the extent to which the fund uses derivatives. Generally, a fund that limits its use of derivatives, either to specific currency hedging or in terms of their notional amount, would be subject to less stringent requirements than a fund that does not limit the notional amount or seeks to leverage its investment returns. The following table specifies how the requirements would vary for each type of fund, and how Rule 18f-4 would define each type.



Reverse Repo and Unfunded Commitments

All types of funds would have to:

- Include reverse repurchase agreements (in which the fund sells securities and agrees to repurchase them at a later date) and similar financing transactions in determining their compliance with the asset coverage requirements of Section 18 of the Investment Company Act of 1940; and
- Reasonably believe they will have sufficient cash and cash equivalents to meet their obligations with respect to all unfunded commitment agreements.

"Funds" exclude unit investment trusts and money market funds. We will consider the exclusion of money market funds in subsequent posts.

Initial Observations

Re-proposed Rule 18f-4 would only prohibit leverage of more than 300% of the investment returns of an unleveraged index, unless the returns could be derived without a VaR of more than 150% of the index. The treatment of Leveraged/Inverse Funds is similar to industry funds (e.g., utility or real estate funds). The SEC has long taken the position that industry funds must commit to concentrating in their industry; they generally cannot retain discretion not to concentrate. Similarly, Leveraged/Inverse Funds must commit to seeking leveraged index returns, presumably without retaining discretion to de-lever except in specific circumstances disclosed in their prospectuses. Rule 18f-4 would impose substantial costs on Other Funds that do not qualify as Limited Derivative Funds, as the mandated DRM program must include an independent derivatives risk manager and VaR modeling software. A Limited Derivatives Fund could only exceed 10% notional exposure by limiting its derivatives transactions to currency hedging. This may reflect an assumption that combinations of currency and other types of derivatives requires more sophisticated risk management. On the other hand, a global equity fund that hedges currency risk and sterilizes its cash balances with S&P 500 futures would not seem to require a full-blown DRM program. With this broad framework in mind, we can begin to consider specific aspects of re-proposed Rule 18f-4.

Explore more in

Investment Management