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What Kind of Derivatives User Is Your Fund?

[Rule 18f-4](#) is somewhat unusual in that it gives management investment companies (including business development companies but excluding money market funds, "Funds") alternative means of complying with its exemption from Sections [18](#) and [61](#). A Fund may either:

- Limit the way and extent to which the Fund engages in derivatives transactions (a "Limited Derivatives User"), or
- Adopt a Derivatives Risk Management Program (a "DRM Program") that, among other requirements, limits the Fund's Value-at-Risk ("VaR") relative to an index, its non-derivatives portfolio or its net assets (a "VaR Fund").

[As the rule has been published in the most recent Code of Federal Regulations, we will stop linking to the version published in the adopting release.] A Fund may opt to be a VaR Fund even if it could qualify as a Limited Derivatives User. If a Fund's adviser already uses VaR models in its risk management program the VaR Fund approach may be a viable alternative. But we anticipate that advisers who do not currently employ VaR models, and do not have an independent reason to start, will try to operate their Funds as Limited Derivatives Users.

Flavors of VaR Funds

Our [initial post](#) on the final version of Rule 18f-4 identified four types of Funds classified by the new rule. Three of these Fund types represent different varieties of VaR Funds. Specifically:

- Closed-end Funds that have already leveraged themselves by issuing preferred stock in compliance with Section 18 or 61 ("Closed-End w/ Preferred Funds");
- Open-end funds that, as of October 28, 2020, had outstanding shares issued in a public offering and disclosed in their prospectus that they seek to provide investment returns that exceed 200% of the performance or the inverse of the performance of a market index over a predetermined period ("Grandfathered Leveraged/Inverse Funds"); and
- All other VaR Funds.

A Grandfathered Leveraged/Inverse Fund must limit its VaR relative to the index and the percentage disclosed in its prospectus. All other VaR Funds may choose to limit their VaR relative to either the VaR of an appropriate index or the VaR of their portfolio excluding their derivatives transactions (a "Relative VaR Test"). If neither of those relative measures properly reflects the VaR Fund's investments, investment objectives, and strategy, these other VaR Funds may limit their VaR as a percentage of their net assets (an "Absolute VaR Test").

Putting the 18f-4 Puzzle Together

The following table summarizes when a Fund must adopt a DRM Program, the VaR tests available to each type of VaR Fund and the test's percentage limit on the Fund's VaR.

		VaR Test Limit		
Type of Fund	DRM Program	Relative		Absolute
		Index	Portfolio	
Limited Derivatives User	Not Required	None if Derivatives Exposure ≤ 10% of Net Assets		
Grandfathered Leveraged/Inverse	Required	As disclosed in prospectus	N/A	N/A
Closed -End w/ Preferred	Required	250%	250%	25%
Other VaR Fund	Required	200%	200%	20%

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Combining

types of Funds, VaR tests and VaR limits shows there are seven "flavors" of VaR Funds, in addition to the "vanilla" Limited Derivatives User.

Mostly Vanilla Funds

The SEC staff estimated that, as of September 2020, [nearly 80% of Funds](#) could qualify as Limited Derivatives Users. This may be an upper limit if some Fund complexes opt to treat all their Funds as VaR Funds rather than running a separate compliance program for their Limited Derivatives Users. Still, we anticipate that most Funds will try to qualify as Limited Derivatives Users for reasons we'll explain in our next post.

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