Blogs

This post will bring to a close, for now, our survey of the requirements of new Rule 18f-4, which investment companies must comply with by August 19, 2022. This post considers whether a Chief Compliance or Risk Officer should seek to treat some or all of their funds as Limited Derivatives Users and how that choice, in turn, relates to the decision about whether to treat reverse repurchase agreements as derivatives transactions. But first, we review the compliance procedures required by Rule 18f-4 for (nearly) every fund. We also provide links to compliance checklists provided in earlier posts.

Compliance Procedures Nearly Every Fund Should Have

18f-4(f) Procedures for Non-Standard Settlements Every management investment company, including business development companies ("BDCs") and money market funds, should have procedures for delayed-settlement securities that are not "senior securities" for purposes of Section 18. Our checklist for these procedures can be found here. 18f-4(e) Procedures for Unfunded Commitment Agreements Every management investment company, including BDCs **but not money market funds** ("Funds"), should have procedures for documenting a reasonable belief that the Fund will have sufficient cash and cash equivalents to meet its obligations when it enters into an unfunded commitment agreement. We recommended including these in the Fund's Liquidity Risk Management Program (if it has one) and provided a checklist here.

Which Funds Should Seek to Qualify as Limited Derivatives Users?

We suspect that Fund complexes will find the decision of whether to comply with the Limited Derivatives User requirements an "all or none" proposition. If every Fund in a complex uses futures, forwards, and swaps only to equitize cash positions and hedge currency or interest-rate risks, then they are likely to qualify as Limited Derivatives Users. Assuming the SEC Staff eventually clarifies how to calculate the gross notional amounts of derivatives transactions, the calculation of a Fund's derivatives exposure could be programmed into a compliance system. (See our Derivatives Exposure Equation to see all the variables involved.) Compliance will be simplified if the Fund does not use options (no need for daily delta adjustments), uses swaps only to hedge interest-rate risk (no need to adjust to 10-year bond equivalents) and uses currency derivatives only to hedge currency risk (no need to convert notional amounts to U.S. dollar equivalents). On the other hand, if even one Fund in a complex cannot qualify as a Limited Derivatives User, it may be more efficient to treat all Funds in the complex as VaR Funds. This will be true if the upfront costs of establishing a Derivatives Risk Management Program ("DRM Program") and a Limited Derivatives User compliance system are relatively high, while the marginal cost of adding a Fund to the DRM Program is relatively low. Except as discussed in the next paragraph, a relative or absolute VaR limit should be less restrictive on the use of derivatives transactions than the 10% net asset limit for a Limited Derivatives User, so there should not be a downside to adding a Fund to the DRM Program. Maintaining compliance programs for both VaR Funds and Limited Derivatives Users, on the other hand, may be significantly more expensive and complicated. A Fund with a strategy to concentrate in securities not included in its benchmark index and that makes little use of derivatives transactions might be the exception to this analysis. The VaR Test Limit applies to all of a Fund's investments, regardless of whether they are derivatives transactions, while the Limited Derivatives User requirements limit only derivatives transactions. This means that the VaR Test Limit might be more restrictive for this type of Fund. Funds are not required to use an index as their referenced portfolio, however, and have the option to use their securities portfolio (*ex* derivatives transactions) as their reference portfolio. If derivatives transactions are not a significant part of the Fund's strategy, the VaR of the Fund's securities portfolio should track its overall VaR closely and comply with the VaR Test Limit.

Should Funds Treat Reverse Repurchase Agreements as Derivatives Transactions?

Funds have the option to either (a) include reverse repurchase agreements and similar financing transactions when calculating their asset coverage under Sections 18 or 61, or (b) treat these as derivatives transactions under Rule 18f?4. We recommend that a VaR Fund elect to treat these financial transactions as derivatives transactions, as a VaR model will already include the risks of these transactions. Electing to treat these transactions as derivatives transactions avoids the asset coverage limitations without affecting the Fund's compliance with its applicable VaR Test Limit. On the other hand, a Limited Derivatives User should not treat these transactions as derivatives transactions, as this will increase its derivatives exposure and make it more

difficult to remain within the 10% net asset limit. Our checklist explains the changes an open- or closed-end fund will need to make to include these transactions in its asset coverage calculations.

Concluding Conclusion

We hope readers have found our year-long excursion into Rule 18f-4 helpful. We will provide updates if there are further developments.

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