IDC Independent Directors Council
Promoting Excellence in Fund Governance

MEMORANDUM

[32890]	
November 3, 2020	
TO:	ICI Members Investment Company Directors
SUBJECTS:	Alternative Investments Compliance Derivatives Disclosure Exchange-Traded Funds (ETFs) Financial Stability Fund Governance Recordkeeping Risk Oversight
RE:	SEC's New Rule on Funds' Use of Derivatives: Summary of Fund Board Responsibilities

Last week, the Securities and Exchange Commission adopted new rules and amendments that provide an updated approach to the regulation of derivatives and similar instruments used by mutual funds, exchange-traded funds, closed-end funds, and business development companies (collectively, “funds”).[1] The rulemaking:

- Creates a new rule (Rule 18f-4) governing funds’ use of derivatives and similar instruments;
- Imposes related fund reporting requirements;
- Amends the ETF Rule (Rule 6-11) to allow leveraged and inverse ETFs to satisfy the ETF Rule’s conditions without the need for exemptive relief; and
- Rescinds certain SEC and staff guidance, exemptive relief, and no-action letters that no longer are necessary.

ICI Memorandum No. 32886 summarizes the new rule and related amendments.[2] This memorandum provides a summary of the fund board's responsibilities under new Rule 18f-4.

Rule 18f-4

Under the new rule, funds using derivatives must comply with certain conditions, including 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 ("VaR"). Funds that use derivatives in a limited manner ("limited derivatives users") will not be subject to these requirements but must adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks. Funds also will be subject to recordkeeping and reporting requirements.

As discussed below, the rule requires: (1) a fund's board to approve the designation of the fund's derivatives risk manager ("DRM"); and (2) the DRM to provide regular written reports to the board regarding the program's implementation and effectiveness, and analyzing exceedances of the fund's guidelines and the results of the fund's stress testing.

Derivatives Risk Management Program

The new rule requires a fund using derivatives (other than a limited derivatives user) to adopt a written derivatives risk management program, with policies and procedures reasonably designed to manage the fund's derivatives risks. The program must include the following elements:

- Risk identification and assessment;
- Risk guidelines;
- Stress testing;
- Backtesting;
- Internal reporting and escalation; and
- Periodic review.

The board is not required to approve the derivatives risk management program but is expected to oversee the program. As the Commission stated in the Adopting Release:

We believe the role of the board under the rule is one of general oversight, and consistent with that obligation, we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors.[3]

The Commission also noted that the board is responsible for overseeing a fund's compliance with Rule 18f-3 consistent with its responsibilities under Rule 38a-1, the fund compliance rule.[4]

Derivatives Risk Manager

The derivatives risk management program must be administered by a DRM, and the board must approve the designation of the DRM. The DRM must be an officer or officers of the fund's adviser, may

not be a portfolio manager (or, if multiple officers serve as DRM, may not have a majority composed of portfolio managers of the fund), and must have relevant experience regarding the management of derivatives risk. The Commission stated that, after considering comments made by IDC and others, it removed the specific requirement in the proposal that the fund's board "tak[e] into account the DRM's relevant experience regarding the management of derivatives risk" when approving the designation of the DRM.[5] Noting that the definition of "derivatives risk manager" requires the person fulfilling the role to have "relevant experience regarding the management of derivatives risk," the Commission stated its belief that a fund board's consideration of a candidate to serve as a DRM "necessarily would take into account the candidate's experience, among all other relevant factors, and that a specific requirement in the final rule requiring the board to take the candidate's experience into account is unnecessary."[6]

The rule does not permit the adviser to serve as the DRM, as was recommended by IDC and other commenters. The Commission acknowledged those comments but expressed its view that "requiring one or more officers of the adviser to serve in this role, rather than the adviser as an entity or a committee created by the adviser and composed of individuals selected by the adviser from time to time, would promote accountability to the board by creating a direct reporting line between the board and the individual(s) responsible for administering the program."[7]

Limit on Fund Leverage Risk

The rule generally will require funds engaging in derivatives transactions to comply with a VaR-based outer limit on fund leverage risk. The limit will be based on a relative VaR test that generally restricts a fund's VaR from exceeding 200 percent of the VaR of an unlevered "designated reference portfolio" that the DRM chooses, tested at least once each business day. In lieu of the relative VaR test, a fund can use an absolute VaR test when a DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio. In these situations, the fund must comply with an absolute VaR test restricting the VaR of its portfolio to no more than 20 percent of the value of the fund's net assets.

If a fund determines that it is not in compliance with the VaR test, it must return to compliance promptly, in a manner that is in the best interests of the fund and its shareholders. If it does not do so within five business days, then: (1) the DRM must provide a written report to the fund's board explaining how and by when the DRM reasonably expects that the fund will comply; (2) the DRM must analyze the circumstances causing the compliance issue and update any program elements appropriate to address those circumstances; and (3) the DRM must provide a written report within 30 calendar days of the exceedance to the fund's board explaining how the fund came back into compliance, the results of the DRM's analysis of the circumstances that caused the fund to be out of compliance for more than five business days, and any updates to the program elements; and (4) the fund must file a report to the Commission on Form N-RN.

Board Oversight and Reporting

As noted above, the new rule requires a fund board to approve the designation of the DRM, who will have a direct reporting line to the board and be responsible for administering the program. The DRM must provide regular written reports to the board on the program's implementation and effectiveness, analyzing exceedances of the fund's guidelines and the results of the fund's stress testing. These reports must occur at least annually, and the DRM must provide regular written reports periodically as the board determines.

The DRM must provide to the board, on or before the implementation of the program and at least annually thereafter, a written report representing that the program is reasonably designed to manage the fund's derivatives risks and incorporate the required elements of the program. The report must contain the basis for the representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program and, for reports following the program's initial implementation, the effectiveness of its implementation. The report also must include the DRM's basis for selecting the designated reference portfolio or an explanation as to why the DRM was unable to identify one and the basis for any change in the designated reference portfolio. In addition, in response to comments (including from IDC), the rule permits the DRM to provide a summary analysis of the exceedances that occurred during the period, along with stress testing and backtesting, rather than requiring the reporting of "any" exceedances of the guidelines.

The rule also requires a fund's derivatives risk management program to identify the circumstances under which persons responsible for portfolio management will be informed regarding the operation of the program, including guidelines exceedances and the results of the fund's stress testing. The rule specifies that a fund's DRM must also directly inform the fund's board, as appropriate, of material risks arising from the fund's derivatives use, including risks that exceedances of the guidelines and results of the fund's stress tests indicate.

Adopting Release Statements on the Board's Oversight Role

The Adopting Release includes statements expressing the Commission's view regarding the board's oversight role.[8] The Commission stated that it agrees with commenters that the board's role is distinct from that of the DRM and is not one that requires the board to be involved in the day-to-day management of the fund. The Commission stated that the reports and the requirements are designed to facilitate the board's oversight of the fund's derivatives risk management and compliance with the new rule. The Commission cautioned that board oversight should not be a passive activity and that the board should understand the program and the derivatives risks it is designed to manage. The board also should ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation.

The Commission stated that it continues to believe that boards should view oversight as an iterative process, and explained that the use of the term "iterative" is not intended to imply that the board is responsible for day-to-day management of fund derivatives risk but to clarify that the board's oversight

role requires regular engagement with the derivatives risk management program rather than a one-time assessment. It further stated that directors should take an “active” role that involves inquiry into material risks from the derivatives transactions and follow up on addressing those risks. [9]

The Commission clarified that whether a board requests follow-up information will depend on the facts and circumstances and quoted IDC’s comment letter, which stated, “[d]epending on the circumstances, regular follow-up may or may not be necessary, as the reports provided to the board may already contain sufficient information, or the matter may have been resolved.” [10]

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Notes

[1] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34078 (Oct. 28, 2020), *available at* https://www.sec.gov/rules/final/2020/ic-34084.pdf (“Adopting Release”).

[2] ICI Memorandum No. 32886 is *available at* https://www.ici.org/memo32886.

[3] Adopting Release, *supra* n. 1, at 85.

[4] *Id.* at 86.

[5] *Id.* at 89.

[6] *Id.*

[7] *Id.* at 57.

[8] *See generally id.* at 85-91.

[9] *See id.* at 85.

[10] *Id.* at 86.

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