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AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

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## A DIVIDED SEC (FINALLY) ADOPTS SWEEPING RULE GOVERNING FUND USE OF DERIVATIVES

*The SEC's new rule requires mutual funds (with some exceptions) that use more than a limited amount of derivatives to adopt a comprehensive derivatives management program, designate a board-approved derivatives risk manager, and not exceed a designated maximum outer limit on leverage based on value at risk. The author discusses the background and provisions of the new rule in detail. He notes that the Commission did not adopt its proposed and controversial sales practice rules for leveraged/inverse funds.*

By Jay G. Baris \*

The U.S. Securities and Exchange Commission, on October 28, 2020, adopted a new rule under the Investment Company Act of 1940, as amended (the “1940 Act”) and amended related forms, governing how investment companies use derivatives (the “New Rule” or “Rule 18f-4”). The New Rule caps a decades-long effort to clarify and streamline a patchwork of confusing and often conflicting guidance and interpretations by the SEC and its staff that struggled to keep up with rapidly evolving investment techniques and markets.<sup>1</sup>

In a nutshell, Rule 18f-4 requires mutual funds (other than money market funds), exchange-traded funds

(“ETFs”), and registered closed-end funds (including business development companies, or “BDCs”) that use derivatives in more than a limited amount to adopt a comprehensive derivatives risk management program, and designate a board-approved derivatives risk manager. The New Rule sets a maximum outer limit on leverage, based on value at risk, or VaR, pegged to a designated benchmark index (generally 200% for mutual funds and ETFs, and 250% for closed-end funds) or, alternatively, an absolute VaR limit (generally 20% of the net assets of a mutual fund or 25% of the net assets of a closed-end fund). Funds that use derivatives in a more limited manner are subject to slimmed-down requirements (“Derivatives Lite” regulation).

Notably, the SEC pulled back from proposed rules that would have introduced significant speed bumps for

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<sup>1</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies, 1940 Act Release No. IC-34084 (Oct. 28, 2020), 85 Fed. Reg. 83126 (Dec. 21, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-12-21/pdf/2020-24781.pdf> [hereinafter the Adopting Release].

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