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On October 28, 2020, the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") adopted, by a 3-2 vote, a new rule governing the use of derivatives by mutual funds, closed-end funds, ETFs and business development companies.[1] As adopted, the new derivatives rule reflects changes to the rule as initially proposed by the Commission, and represents a comprehensive overhaul of the current regulatory framework governing the use of derivatives by registered investment companies.

This bulletin is part of a series of articles in which Vedder Price attorneys will share perspectives on the practical and business implications of the new derivatives rule (the "Rule"), including considerations for mutual fund independent directors. In this first part of our series, we provide our initial observations as well as a summary of the major features of the Rule. We anticipate that our series of articles will culminate with a webinar highlighting our key takeaways regarding the Rule and its implications.

▶ Our Take: Initial Observations of the New Derivatives Rule

The Rule represents a comprehensive overhaul of the framework for the regulation of derivatives by registered funds and will replace a patchwork of current guidance that has evolved over the last 40 years through various SEC staff positions, no-action letters, and the disclosure process. The Rule will level the playing field so that all similarly situated registrants are subject to the same requirements and seeks to modernize the regulatory framework to keep pace with market developments. Importantly, upon the Rule's effectiveness, the Commission will rescind all current guidance and funds will then be permitted to enter into derivatives and financial commitment transactions only as permitted by the Rule or Section 18 of the Investment Company Act of 1940 (the "1940 Act"), absent additional relief from the SEC or its staff. However, the current regulatory landscape will remain in place for at least the next year and a half; the Rule will be effective 60 days after its publication in the Federal Register and funds will have an 18-month transition period—commencing on the effective date—to come into compliance with the Rule before the Commission rescinds its current guidance.

Because the Rule is a comprehensive overhaul of the current framework, we believe that industry efforts to implement its components effectively will require thoughtful and careful consideration. In particular, areas of focus include:

- **Process.** Significant technological and process enhancements may be necessary to capture the data necessary to implement, monitor, test and report on the new VaR-based requirements (discussed below) and other risk metrics required by the Rule. Closely associated with that are internal reporting and escalation procedures, which will depend on automated and systemic reporting, that could mitigate or address derivatives risks as they arise.
- **People.** While the level of board oversight and the extent of reporting requirements represent a significant relaxation from those included under previous guidance, board members will need to understand various aspects of the newly required Derivatives Risk Management Program ("DRMP", as discussed below), including the adequacy of the program and the

effectiveness of its implementation. Some fund groups may need to seek external expertise to meet the requirements of the required derivatives risk manager ("DRM", as discussed below).

- **Products.** For funds that rely heavily on the use of derivatives, fund groups will need to evaluate whether each strategy remains viable in its current form or whether strategies and investment guidelines will need to be modified to comply with the new VaR-based parameters.
- **Documentation.** For funds that issue debt or preferred securities or have borrowing facilities, the current asset coverage limits under Section 18 may be embedded in the fabric of credit facilities and other documentation governing such leverage. Funds will need to undertake a comprehensive review of such documents to ensure that they continue to comply with both leverage documentation, which may be based on the old regulatory regime, and the new limits based on the Rule.

The Adopting Release is available at:

https://www.sec.gov/rules/final/2020/ic-34078.pdf

► Overview of the Rule

The Rule, adopted as new Rule 18f-4 under the 1940 Act, will permit a fund to enter into derivatives transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under Section 18 of the 1940 Act, subject to the following conditions:

- **Derivatives Risk Management Program.** Funds—other than those that are limited derivatives users—must adopt and implement a written DRMP with, among other things, risk guidelines reflecting how the fund's use of derivatives may affect its investment portfolio and overall risk profile. A fund's derivatives risk manager will be required to periodically review the DRMP, at least annually, to evaluate the program's effectiveness and to reflect changes in risk over time.
- **Limit on Fund Leverage Risk.** A fund engaging in derivatives transactions must comply with an outer limit on leverage based on a comparison of the fund's value at risk ("VaR") to the VaR of a "designated reference portfolio" for that fund—referred to as the "relative VaR test." In a change from the SEC's proposed rule,[2] a designated reference portfolio may be either an index that meets certain requirements, or, for an actively managed fund, the fund's own securities portfolio (excluding derivatives transactions). If—in considering the fund's investments, investment objectives and strategy—the fund's DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund would be required to comply with an "absolute VaR test" instead.
- **Board Oversight and Reporting.** A fund's board of directors must approve and oversee the fund's DRM, who will be responsible for administering the fund's DRMP. However, unlike the liquidity risk management program required by Rule 22e-4 under the 1940 Act, the board does not need to approve the DRMP itself. The fund's DRM—who generally must be an officer of the adviser but not a portfolio manager (if a single individual serves as DRM)—is required to report to the fund's board on the implementation and effectiveness of the DRMP and the results of the fund's stress testing.

Other elements of the Rule and related amendments adopted by the SEC include:

- **Exception for Limited Derivatives Users.** Limited derivatives users will be excepted from the DRMP requirement, the VaR-based limit on fund leverage risk, and the related board oversight and reporting requirements, provided that the fund adopts and implements written policies and procedures reasonably designed to manage the fund's derivatives risk. This exception is available to a fund that limits its derivatives exposure (excluding certain currency and interest rate hedging transactions) to 10% of its net assets. If such a fund exceeds the 10% threshold and does not reduce its exposure within five business days, the fund's adviser must provide a written report to the fund's board informing it whether the adviser intends to reduce the exposure promptly, but within no more than 30 days, or put in a place a DRMP and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable.

- **Flexibility for Treatment of Reverse Repurchase Agreements and Similar Financing Transactions.** The Rule will permit funds to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments by either meeting the asset coverage requirements under Section 18 of the 1940 Act or by electing to treat these transactions as derivatives transactions under the Rule.

- **Ability for Funds to Invest in Securities on a Non-Standard Settlement Cycle.** The Rule includes a new provision that will permit funds, including money market funds (otherwise excluded from the Rule), to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, subject to conditions.

- **Reporting Amendments.** In conjunction with the Rule's adoption, the SEC adopted amendments to Form N-PORT, Form N-LIQUID (which will be renamed Form N-RN) and Form N-CEN to require funds to provide information regarding compliance with the Rule, including: (1) certain identifying information about the fund (e.g., identifying the provisions of the Rule that the fund is relying on to engage in derivatives transactions and other transactions addressed by the Rule); (2) as applicable, information about a fund's VaR and designated reference portfolio, and VaR backtesting results; (3) VaR test breaches, to be reported to the SEC in a non-public current report; and (4) for a fund operating as a limited derivatives user, information about the fund's derivatives exposure and the number of business days that its derivatives exposure exceeded 10% of its net assets.

- **Amendments to Rule 6c-11 under the 1940 Act for Leveraged/Inverse ETFs.** The SEC also adopted amendments to Rule 6c-11 under the 1940 Act to permit new leveraged/inverse ETFs to come to market if they comply with all applicable provisions of the Rule, effectively limiting the market exposure of such new leveraged/inverse ETFs to 200% of the return of the relevant index. After considering comments, the SEC determined not to adopt the proposed sales practices rules for leveraged/inverse products or the proposed exception from the VaR-based limits that was predicated on those rules. Nevertheless, existing leveraged/inverse ETFs with market exposure exceeding 200% of the return of the relevant index will be permitted to operate subject to certain conditions.

► Key Components of the Rule

Scope. The Rule will apply to a "fund," defined as a registered open-end or closed-end investment company or a business development company ("BDC"), including any separate series thereof. Therefore, the Rule will apply to mutual funds, ETFs, registered closed-end funds and BDCs. However, money market funds (with a limited exception) and unit investment trusts will not be permitted to rely on the Rule.

Covered Transactions. The Rule defines a "derivatives transaction" to mean:

1. any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise;
2. any short sale or borrowing; and
3. reverse repurchase agreements or similar financing transactions, for those funds that choose to treat

these transactions as derivatives transactions under the Rule.

Limited Derivatives Users. The Rule will except limited derivatives users from the derivatives risk management program requirement, the VaR-based limit on fund leverage risk, and the related board oversight and reporting requirements. The limited derivatives user exception is available to a fund that limits its derivatives exposure to 10% of its net assets. A fund may exclude from the 10% threshold derivatives transactions that are used to hedge certain currency and/or interest rate risks and positions closed out with the same counterparty.[3] A limited derivatives user will be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks.

The Rule defines "derivatives exposure" to mean the sum of:

1. the gross notional amounts [4] of a fund's derivatives transactions such as futures, swaps and options; and
2. in the case of short sale borrowings, the value of any asset sold short. [5]

Derivative instruments that do not involve future payment obligations—and therefore are not a "derivatives transaction" under the Rule—are not included in a fund's derivatives exposure. [6]

Derivatives Risk Management Program

Program Requirement Generally. The Rule will require funds that are users of derivatives—other than limited derivatives users—to have a formalized risk management program with certain specific elements. A fund will have to adopt and implement a written DRMP, which will include policies and procedures reasonably designed to manage the fund's derivatives risk. The elements of the program include:

- *Risk Identification and Assessment.* The DRMP will have to provide for the identification and assessment of a fund's derivatives risks, [7] which will take into account the fund's derivatives transactions and other investments.
- *Risk Guidelines with Discrete Metrics.* A fund must establish, maintain and enforce investment, risk management or related guidelines with discrete metrics or other measurable criteria or thresholds that a fund does not normally expect to exceed and the measures to be taken if they are exceeded.[8] The Rule does not impose specific risk limits. Instead, the quantitative thresholds should be those that are "most pertinent to [the fund's] investment portfolio, and that the fund reasonably determines are consistent with its risk disclosure." [9]
- *At Least Weekly Stress Testing.* A fund will be required to undertake at least weekly stress testing to evaluate potential losses in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties.[10] While the Rule requires weekly stress tests, the scope of such testing may vary. [11]
- *Weekly Backtesting.* A fund will also be required to backtest the results of its VaR calculation model used in connection with the relative VaR or absolute VaR test, as applicable. Specifically, each week the fund will need to compare its daily gain and loss to the estimated VaR for each business day during the week. The backtesting will require a 99% confidence level over a one-day time horizon.
- *Internal Reporting and Escalation.* The DRMP must identify the circumstances under which the DRM will inform portfolio managers "in a timely manner" regarding the operation of the program, including guideline exceedances and stress testing results. The DRM must also directly inform the fund's board, "as appropriate" (i.e., in the DRM's discretion), of material risks arising from the fund's derivatives use.[12] Escalation requirements should be tailored to a fund's size, sophistication and needs. [13]

- *Periodic Review of the Program.* A fund's DRM will be required to review the DRMP, including each of the required program elements, at least annually to evaluate its effectiveness and to reflect changes in the fund's derivatives risks over time. The Rule does not prescribe review procedures or incorporate specific developments that a DRM must consider as part of its review. [14]

Derivatives Risk Manager and Program Administration

- *Derivatives Risk Manager.* The Rule requires a fund's board of directors to approve the designation of the fund's DRM, who must be one or more natural persons. However, the fund's adviser may play a central role in identifying and evaluating an officer or officers of the adviser (and/or of a sub-adviser) to serve as the DRM, responsible for the day-to-day administration of the fund's DRMP. A fund's portfolio manager may not serve as its DRM. However, if a fund has multiple officers designated as the DRM, then portfolio managers may serve in this capacity so long as a majority of the officers are not portfolio managers (e.g., if a committee acts as the DRM). [15] In other words, a group or committee could serve as a fund's DRM, member(s) of whom could be portfolio managers. Although a third-party service provider may not itself serve as the fund's DRM, the Rule does not preclude a DRM from delegating specific derivatives risk management activities that are not specifically assigned to the DRM, subject to appropriate oversight. [16]

- *DRM Qualifications.* Serving as DRM will require relevant experience regarding derivatives risk management.

- *Segregation of DRMP from Portfolio Management.* In order "to promote objective and independent identification, assessment, and management of the risks associated with derivatives use," a fund will be required to "reasonably segregate" the functions of the DRMP from portfolio management. However, strict protocols regarding communication between specific fund personnel—such as a "firewall"—are not required.

Board Oversight and Reporting

- *Board Approval of Derivatives Risk Manager.* As noted, a DRM responsible for administering the DRMP must be approved by the fund's board, including a majority of directors who are not interested persons of the fund.

- *Initial and Annual Reports on DRMP Implementation and Effectiveness.* The DRM will be required to provide to the fund's board, on or before the implementation of the DRMP and at least annually thereafter, a written report including a representation that the DRMP is reasonably designed to manage the fund's derivatives risk and to incorporate the required elements of the program as well as the basis for the representation.

- *Required Elements of the Initial and Annual Written Reports.* The Rule will require that the reports include:
  - the basis for the DRM's representation [17] and information reasonably necessary to evaluate the adequacy of the fund's DRMP and—for reports following the initial implementation of the program—the effectiveness of its implementation; and
  - the basis for the DRM's approval of a designated reference portfolio, the basis for any change in the designated reference portfolio, or, if applicable, an explanation of why the DRM was unable to identify a designated reference portfolio appropriate for the fund such that the fund relied on the absolute VaR test instead. [18]

- *Regular Board Reporting and Required Elements.* The Rule also requires a DRM to provide to the fund's board, at a frequency determined by the board, a written report analyzing instances when the fund's risk guidelines are exceeded and including the results of the fund's stress testing and backtesting. The report must also include such information as may be reasonably necessary for the board to evaluate the fund's responses to such instances that occurred during the reporting period and the stress testing and backtesting results.[19]

► Limit on Fund Leverage Risk

THE VaR-BASED TEST

- *The Relative VaR Test.* The Rule will generally require funds engaging in derivatives transactions in reliance on the Rule to comply with a relative VaR test that compares the fund's VaR to the VaR of a "designated reference portfolio." A fund will satisfy the relative VaR test if the VaR of its entire portfolio does not exceed 200% of the VaR of its designated reference portfolio. For a closed-end fund with outstanding preferred stock, the relative VaR must not exceed 250%of the VaR of its designated reference portfolio.

- *Designated Reference Portfolio.* A fund generally can use either an index that meets certain requirements—defined under the Rule as a "designated index"—or the fund's own securities portfolio (excluding derivatives transactions), as its designated reference portfolio. A designated index must be unleveraged and reflect the markets or asset classes in which the fund invests. The designated index may not be administered by an organization that is an affiliated person of the fund, its investment adviser or principal underwriter, or created at the request of the fund or its adviser, unless the index is widely recognized and used.[20] A fund may use a blended index as its designated index, provided that each constituent index meets the Rule's requirements.[21]

- *Designated Reference Portfolio for Index-Tracking Funds.* In a change from the proposal, the Rule provides that, if the fund's investment objective is to track the performance (including a leverage multiple or inverse multiple) of an unleveraged index, the fund must use that index as its designated reference portfolio, even if the index otherwise would be an impermissible prohibited index under the Rule (e.g., an index administered by an affiliate).[22]

- *The Absolute VaR Test.* If the DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, the fund must instead comply with an absolute VaR test, under which the VaR of its portfolio will not be permitted to exceed 20% of the value of the fund's net assets. For a closed-end fund with outstanding preferred stock, the absolute VaR must not exceed 25% of the value of such fund's net assets.

- *Exception for Leveraged/Inverse Funds.* Generally, a fund that is a leveraged/inverse investment vehicle will be required to comply with the VaR-based limit on fund leverage risk. However, existing leveraged/inverse funds in operation as of October 28, 2020 that exceed the 200% VaR-based limit may continue operating in excess of the threshold as long as they comply with all other provisions of the Rule and meet certain additional requirements, such as the obligation to disclose in its prospectus that it is not subject to the Rule's limit on fund leverage risk.

- *Exception for Limited Derivatives Users.* As noted, the Rule also provides an exception for a fund that uses derivatives only to a limited extent or to hedge currency and interest rate risks.

- *VaR Model Requirements.* The Rule requires that a fund's VaR model use a 99% confidence level and a time horizon of 20 trading days. The VaR model must be based on at least three years of historical data. In addition, the model must incorporate all significant identifiable market risk factors associated with the fund's investments.[23] The Rule will also require that VaR calculations comply with the VaR definition and its specified model requirements. Unlike the European Union regulatory regime that applies to Undertakings for the Collective Investment in Transferable Securities (UCITS) funds, the Rule will not require third-party validation of a fund's chosen VaR model.[24] Notwithstanding these parameters, a fund's DRM is free to choose among the VaR model types referenced in the Rule — historical simulation, Monte Carlo simulation or parametric models. [25]

- *VaR Testing Frequency.* The Rule requires a fund to determine its compliance with the applicable VaR test at least once each business day at the time that is most efficient, based on the fund's facts and circumstances.
- *VaR Test Remediation.* If a fund determines that it is not in compliance with the applicable VaR test, then the Rule will require the fund to come back into compliance promptly and within no more than five business days after such determination.
- *Failure to Remediate within Five Business Days.* If the fund is not in compliance within five business days, then:
  - the DRM must provide a written report to the fund's board and explain how and by when (i.e., the number of business days) the DRM reasonably expects that the fund will come back into compliance;
  - the DRM must analyze the circumstances that caused the fund to be out of compliance for more than five business days and update any DRMP elements as appropriate to address those circumstances; and
  - the DRM must provide a written report to the fund's board within 30 days of the VaR-limit exceedance 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 and any updates made to the DRMP.

Additional Accommodations under the Rule

- **Amendments to Rule 6c-11 under the 1940 Act for Leveraged/Inverse ETFs**
  Currently, leveraged/inverse ETFs are prohibited from relying on Rule 6c-11 under the 1940 Act that generally permits ETFs to operate without obtaining an SEC exemptive order, subject to certain conditions. The SEC is amending Rule 6c-11 to include leveraged/inverse ETFs within the scope of that rule, provided that they comply with the applicable provisions of the new derivatives Rule. This will enable new leveraged/inverse ETFs to come to market without obtaining exemptive relief from the SEC. The SEC is also rescinding the exemptive orders previously issued to leveraged/inverse ETFs on the compliance date for the Rule, in eighteen months. [26]
- **Flexibility in Treatment of Reverse Repurchase Agreements or Similar Financing Transactions**
  Under the Rule, a fund is permitted to engage in reverse repurchase agreements and similar financing transactions, including unfunded commitments, so long as (1) they meet the asset coverage requirements under Section 18 of the 1940 Act or (2) they treat them as derivatives transactions under the Rule. A fund's election will apply to all of its reverse repurchase agreements or similar financing transactions so that all such transactions are subject to consistent treatment under the Rule. [27]
- **Delayed-Settlement Securities Provision**
  The Rule includes a provision that will permit funds, including money market funds, to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, subject to certain conditions. The provision rests on the conditions that (1) the fund must intend to settle the transaction physically and (2) the transaction must settle within 35 days of its trade date. [28] Importantly, the SEC will not subject qualifying transactions to an asset segregation requirement.

If you have any questions regarding the topics discussed in this article, please contact **W. Thomas Conner** at +1 (202) 312 3331, **Juan M. Arciniegas** at +1 (312) 609 7655, **Nathaniel Segal** at +1 (312) 609 7747, **Tyrique J. Wilson** at +1 (312) 609 7689 or any Vedder Price attorney with whom you have worked.

ENDNOTES

1. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (2020) (the "Adopting Release").

2. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-33704 (Nov. 25, 2019).

3. The Rule does not permit a fund to exclude offsetting positions across multiple counterparties for purposes of calculating derivatives exposure relative to the 10%threshold. However, a fund seeking to exit a derivatives position that enters into a directly offsetting position with the same counterparty, resulting in no credit or market exposure, may exclude such closed-out positions from its "derivatives exposure." Adopting Release at 171–72.

4. The definition of "derivatives exposure" includes two adjustments designed to address limitations associated with measures of market exposure that use derivatives' notional amounts without adjustment. Specifically, the Rule permits a fund to (1) convert the notional amount of interest rate derivatives to 10-year bond equivalents; and (2) delta adjust the notional amount of options contracts. Adopting Release at 169–170.

5. Because the Rule permits a fund to treat reverse repurchase agreements or similar financing transactions as derivatives transactions under certain circumstances, a fund treating these transactions as derivatives transactions also must include in its derivatives exposure the proceeds that the fund received but has not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with each such transaction. Adopting Release at 169.

6. As noted in the Adopting Release: "A derivative that does not impose any future payment obligation on a fund generally resembles a securities investment that is not a senior security, in that it may lose value but it will not require the fund to make any payments in the future. Whether a transaction involves the issuance of a senior security will depend on the nature of the transaction. The label that a fund or its counterparty assigns to the transaction is not determinative." Adopting Release at 40.

7. The Rule defines the derivatives risks that must be identified and managed to include leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other risks the DRM deems material. Adopting Release at 65. For limited derivatives users, the definition of derivatives risks includes any other risks that the fund's investment adviser (as opposed to the fund's DRM) deems material, because a limited derivatives user would be exempt from the requirement to adopt a DRMP and, therefore, also be exempt from the requirement to have a DRM. Adopting Release at n.171.

8. The measures to be taken "should provide the fund's [DRM] with a clear basis from which to determine whether to involve other persons, such as the fund's portfolio management or board of directors, in addressing derivatives risks appropriately." Adopting Release at 69.

9. *Id.* Funds may use a variety of approaches in developing guidelines that comply with the Rule. Adopting Release at 70.

10. The specific factors to consider in a particular stress test may vary from fund to fund and will require judgment by fund risk professionals in designing stress tests. Adopting Release at 72.

11. As an example, the Adopting Release notes that funds might conduct more detailed scenario analyses less frequently while conducting more focused weekly stress tests. Adopting Release at 74.

12. Like other elements of the Rule, the SEC emphasizes that the internal reporting and escalation program requirements are "principles-based," with flexibility for funds to implement these requirements based on their particular investment strategies and the manner in which derivatives risks are managed by funds. Adopting Release at 80.

13. Adopting Release at 82.

14. Adopting Release at 83.

15. Adopting Release at 59. While a DRM could obtain assistance from third parties in administering the DRMP, the Rule will not permit a third party to serve as DRM. Adopting Release at 58. The Adopting Release explains that the Rule does not preclude a DRM from delegating specific derivatives risk management activities that are not specifically assigned to the DRM, subject to appropriate oversight. Adopting Release at 63.

16. The Rule provides flexibility for funds to involve sub-advisers and to seek input from third-party service providers in administering the DRMP. For instance, the DRM may—in fulfilling his or her responsibilities under the Rule—reasonably rely on information provided by sub-advisers or otherwise delegate certain activities to a sub-adviser, so long as the fund's policies and procedures generally address the oversight of any delegated activities, including the scope of and conditions on activities delegated to a sub-adviser (or any other sub-delegates). Adopting Release at 63–64. The Adopting Release cautions, however, that delegation of certain elements of the DRMP to a sub-adviser that manages a sleeve of a fund's portfolio would not be consistent with the fund's obligations under the Rule. Adopting Release at 64. As an example, the Adopting Release indicates that stress testing must be evaluated at the portfolio level. *Id.*

17. The DRM's representation may be based on "reasonable belief after due inquiry." Adopting Release at 91. The Adopting Release suggests that a DRM could form its reasonable belief based on an assessment of the DRMP and taking into account input from fund personnel, including the fund's portfolio management, or from third parties. *Id.*

18. The Adopting Release clarifies that the Rule will not limit a DRM from receiving input from the fund's portfolio managers or others regarding the fund's designated reference portfolio. Adopting Release at 91.

19. A simple listing of exceedances and stress testing and backtesting results without context, in contrast to an analysis of these matters, would not satisfy the requirement that the reports include such information as may be reasonably necessary for the board to evaluate the fund's response to exceedances and stress testing results. Adopting Release at 97.

20. In a change from the SEC's proposed rule, the designated index is not required to be an "appropriate broad-based securities market index" or an "additional index" as defined in Item 27 of Form N-1A or Item 24 of Form N-2. Adopting Release at 114.

21. Adopting Release at 118.

22. Adopting Release at 119–120.

23. The Rule includes the following non-exhaustive list of market risk factors that a fund must account for in its VaR model, if applicable: (1) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (2) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (3) the sensitivity of the market value of the fund's investments to changes in volatility. Adopting Release at 432.

24. Adopting Release at n.973.

25. Adopting Release at 146–47.

26. Adopting Release at 217.

27. Adopting Release at 245.

28. The physical settlement may occur electronically through DTC or electronic platforms. Adopting Release at 45.

ABOUT THE INVESTMENT SERVICES GROUP

The Investment Services group at Vedder Price has experience in all matters related to the design, organization and distribution of investment products. We can assist with investment company and investment adviser securities regulation and compliance matters, derivatives and financial product matters, and ERISA and tax matters.

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