INVESTMENT COMPANY INSTITUTE®

Paul Schott Stevens, PRESIDENT AND CEO

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

[redacted] FAX [redacted]

October 8, 2019

Ms. Dalia Blass, Director
Division of Investment Management
US Securities and Exchange Commission
100 F Street NW
Washington, DC 20549

Dear Ms. Blass:

The Investment Company Institute[1] is pleased that the Securities and Exchange Commission has on its regulatory flexibility agenda a proposed rule for the use of derivatives by registered investment companies and business development companies ("funds"). We strongly support the Commission's efforts to develop this rule. We also appreciate that it is an exceptionally challenging undertaking.

Funds use derivatives in a variety of ways; some may create leverage within a fund's portfolio, while others reduce or offset existing portfolio leverage. Globally, regulators have acknowledged the difficulties of measuring portfolio leverage in investment funds, recognizing that measures of fund leverage appropriate for one type of fund or strategy may be uninformative, less appropriate, or inappropriate, if applied to another fund or strategy. Despite this challenge, we appreciate that a goal of the Commission in this area has been to ensure funds are not "unduly speculative" as a result of their use of derivatives. To that end, we have been working with our members to further consider how various risk management approaches to the use of derivatives by funds could provide a boundary or limit consistent with the policy objectives of the Commission and Section 18 of the Investment Company Act of 1940 ("ICA").

Over the summer, we surveyed members about: (a) a de minimis threshold for application of a new rule; and (b) their views on certain risk management tests—ex ante stress loss and UCITS VaR—to limit the use of derivatives and prevent undue speculation.[2]

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[1] The Investment Company Institute ("ICI") is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$23.4 trillion in the United States, serving more than 100 million US shareholders, and US$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] An ex ante stress loss test would require a fund to manage its portfolio so that it does not expect to lose more than a specified percentage of its net asset value on any given day under stressed conditions. A value-at-risk or VaR test measures a fund's maximum potential loss over a specific period at a given confidence level (probability). Although VaR can be calculated using several different approaches and under a wide range of parameters, there are two main VaR tests that

The survey results supported a de minimis threshold for application of a new rule based on whether the use of derivatives is a principal investment strategy. On the approaches for limiting undue speculation, the results revealed a diversity of views, evidencing that, similar to the challenges of measuring portfolio leverage in funds, there is no "one size fits all" answer.

Generally, there was fairly even support for ex ante stress loss and UCITS VaR as effective methods for limiting undue speculation, with 41 percent favoring ex ante stress loss, 35 percent favoring UCITS VaR and 24 percent indicating both. In addition, 39 percent of respondents said that both approaches are relevant for the range of funds they manage. Another 39 percent reported that UCITS VaR alone was relevant, while 22 percent indicated that the ex ante stress test alone was most relevant for their funds.

While most fund complexes use both tests, the survey indicates that requiring one test over the other could impose significant burdens, depending on the type of fund managed and whether the fund currently employs the test or not. Given the difficulty of developing a single approach and the survey responses supporting both ex ante stress loss and UCITS VaR as effective in limiting undue speculation and relevant for funds managed under the ICA, we urge the Commission to craft a rule allowing funds the option of using either method—ex ante stress loss or UCITS VaR—for limiting the use of derivatives by registered investment companies consistent with the Commission's goals and Section 18 of the ICA.[3] Such an approach would better mitigate the burdens and costs associated with implementation of a new rule as funds could utilize and build upon existing resources and systems.

UCITS under EU and Member State laws utilize and could be used to limit a fund's use of derivatives, either: (i) an absolute VaR test; or (ii) a relative VaR test. The absolute VaR test limits the maximum VaR that a fund can have relative to its net assets. For UCITS, the absolute VaR is limited to 20% of a fund's net assets. A relative VaR test limits the maximum VaR that a fund can have relative to some percentage of the VaR of an unlevered reference portfolio ("benchmark"). For UCITS, the relative VaR is limited to two times the VaR of the benchmark. When using the term "UCITS VaR," we are referring to both the UCITS absolute VaR and the UCITS relative VaR.

[3] The Commission has considered or allowed this form of approach in other contexts. For example, the Commission's initial derivatives rule proposal would have enabled a fund to choose between one of two portfolio limits, each with different conditions—a 150 percent notional limit or a 300 percent notional limit. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), *available at* https://www.sec.gov/rules/proposed/2015/ic-31933.pdf. In addition, Form N-PORT permits funds to respond to various items using their own internal methodologies and the conventions of their service providers, provided the information is consistent with information they report internally and to current and prospective investors. The methodologies and conventions chosen must be consistently applied and the responses must be consistent with any instructions or other guidance related to the form. *See* General Instruction G of Form N-PORT, *available at* https://www.sec.gov/files/formn-port.pdf.

Survey Coverage

In July, ICI distributed a questionnaire to gather information on current derivatives risk management practices and how those practices might inform a rule on derivatives use by funds under the ICA. The survey focused on: (a) a de minimis threshold for requiring a fund to comply with a new rule on the use of derivatives, and (b) ex ante stress loss and UCITS VaR as approaches for limiting derivatives use.

We sent the survey to a broad base of ICI's member firms whose assets under management spanned the spectrum from small to very large. In total, 24 fund complexes with $13.8 trillion in long-term mutual fund and ETF assets accounting for 67 percent of industry assets as of June 2019 responded to the survey.[4] Not every responding complex answered each survey question. Some ICI member complexes using derivatives also did not respond to the survey.

De Minimis Threshold

Based on discussions with members, it was suggested that an appropriate de minimis threshold for application of a new derivatives rule could be whether a fund listed derivatives in its prospectus as a principal investment strategy. For the survey, ICI asked member firms questions about using this "principal investment strategy" approach.

Ninety-two percent of respondents indicated that their firms have funds that list derivatives as a principal investment strategy in their prospectus. In terms of burden, more than 80 percent of respondents indicated that it would be "not at all" to "only slightly" burdensome to implement principal investment strategy as a de minimis threshold for application of a rule.

Outer Bounds Test

Funds use derivatives in a variety of ways and utilize different derivatives risk management approaches. For many years, there have been discussions about ways to limit the use of derivatives by funds and prevent undue speculation consistent with the ICA. For purposes of the survey, we asked members questions relating to two options: (1) ex ante stress loss based on enumerated scenarios similar to those prescribed in Form PF;[5] and (2) VaR prescribed for UCITS under applicable EU and Member State laws.

Overall, the survey results reflect a diversity of views and demonstrate that there is no "one-size-fits-all" approach to an outer bounds test. Indeed, 73 percent of respondents use *both* some form of VaR

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[4] The survey was distributed to smaller fund complex members, yet relatively few responses were received from these smaller fund members. Based on anecdotal conversations with staff at these member complexes, the smaller fund firms described no to minimal use of derivatives.

[5] *See, e.g.*, Item 42 of Form PF (setting forth specified stresses to various asset categories), *available at* https://www.sec.gov/files/formpf.pdf.

and stress testing as derivative risk management tools.[6] Moreover, the decision to use VaR or stress testing can depend on the type of strategy the individual fund is using. As a result, complexes with different types of funds may employ both derivative risk management tools and place different weights on them.

When asked which of the two options (ex ante stress loss or UCITS VaR) would be *most* effective at limiting undue speculation in registered funds, the results were fairly even with 41 percent citing ex ante stress loss and 35 percent UCITS VaR. The remaining 24 percent of respondents indicated both methods were effective, and some explained that they could not generally choose between options because it depended on the type of fund.

When asked which of the two options (ex-ante stress loss or UCITS VaR) would be *most* relevant for the range of funds they manage, responses were again spread out with 39 percent indicating UCITS VaR and 22 percent noting ex ante stress loss. Here, too, a substantial share of respondents (39 percent) reported that *both* methods were relevant.

In terms of implementation burden, 45 percent of respondents indicated that it would be only slightly burdensome to implement a UCITS VaR test that used the same parameters as prescribed for UCITS. An additional 34 percent reported that it would be moderately burdensome. These results are not surprising since UCITS VaR is an established test in use for UCITS. Respondents overwhelmingly reported, however, that the burden would increase, in some cases very substantially, if a VaR test has different parameters or is more prescriptive than UCITS VaR.[7]

For the ex ante stress loss test as described in the survey, 27 percent of respondents indicated that implementation would be only slightly burdensome and 50 percent reported that it would be moderately burdensome. Nevertheless, depending on the type of fund managed and whether the fund currently employs the test for risk management purposes, some respondents viewed a stress loss test as being more burdensome to implement, while others viewed a VaR test as being more burdensome to implement. Several respondents indicated that the burden would particularly depend on the precise details of the rule.

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[6] Two complexes reported that none of their funds had derivatives listed as a principal investment strategy and did not complete the questions on the outer bounds test. As a result, they were dropped from the total of responding complexes on these questions.

[7] For example, one respondent noted that a level of prescription that goes beyond basic VaR parameters (i.e., horizon and confidence levels) would be more burdensome for two main reasons: (1) for funds with an existing UCITS business, different settings lead to greater operational complexity in the risk framework, with additional costs associated with establishing and maintaining different models; and (2) Other VaR parameters (e.g., lookback period, decay factor) can be specific to risk models and may prove difficult to standardize across different systems.

We hope this information is helpful to your efforts to propose a rule on the use of derivatives by funds. If you have any questions or require further information, please feel free to contact me at [redacted] or [redacted], Sean Collins, Chief Economist, at [redacted] or [redacted], or Susan Olson, General Counsel, at [redacted] or [redacted].

Sincerely,

Paul Schott Stevens
President and CEO
Investment Company Institute

cc: The Honorable Jay Clayton
Chairman, Securities and Exchange Commission

Brian Johnson
Assistant Director, Division of Investment Management