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March 24, 2020

VIA ELECTRONIC DELIVERY

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Investment Company Act Release No. IC-33704 (File No. S7-24-15) Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles

Dear Ms. Countryman,

We appreciate the opportunity to respond to the request by the U.S. Securities and Exchange Commission ("Commission" or SEC) for comments regarding the above-referenced proposal ("Proposal").[1] The Proposal contemplates a new approach to the regulation of funds' use of derivatives and other transactions that raise "senior securities" issues under Section 18 of the Investment Company Act of 1940 ("1940 Act") as set forth in re-proposed new Rule 18f-4 under the 1940 Act ("Proposed Rule") and certain other proposed rules and reporting requirements and form amendments.

We applaud the Commission's attention to the use of derivatives by registered investment companies, including open-end and closed-end funds and exchange-traded funds ("ETFs"), and business development companies ("BDCs") (each a "fund" and collectively, "funds"). Further, we generally support the Commission's efforts through rulemaking to provide additional certainty with respect to funds' use of derivatives and other transactions that may create leverage under Section 18 with certain modifications discussed herein.

1 Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (Jan. 24. 2020) ("Proposing Release"), *available at* https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

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However, we believe that certain elements of the Proposed Rule present serious concerns and other issues, as discussed herein.

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. In the United States, we represent a substantial number of U.S. mutual fund complexes, closed-end funds, ETFs, BDCs, fund boards, fund independent directors, fund advisers and fund service providers. In developing these comments, we have drawn on our extensive experience in the financial services industry generally. Although we have discussed certain matters addressed in the Proposing Release with some of our clients, the comments that follow reflect only the views of a group of attorneys in our financial services practice, and do not necessarily reflect the views of our clients, other members of our financial services group or the firm generally.

I. COMMENTS ON THE PROPOSED LIMIT ON FUND LEVERAGE RISK

A. Add Flexibility In Determining Whether to Comply with the Absolute or Relative VaR Tests

1. Permit the Derivatives Risk Manager to Choose the VaR Test for the Fund Taking into Account the Fund's Risk Profile and Strategy

The Proposed Rule would provide that a fund could comply with the absolute VaR test, under which the VaR of the fund's portfolio could not exceed 15% of the value of the fund's net assets, only if the fund's derivatives risk manager is unable to identify an unleveraged designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy.[2] In all other cases, the Proposed Rule would require a fund to comply with the relative VaR test, under which the VaR of the fund's portfolio could not exceed 150% of the VaR of the fund's designated reference index. The Proposed Rule and the Proposing Release provide generally that the selection of a designated reference index would have to be based on "the markets or asset classes in which the fund invests."[3] The derivatives risk manager, as discussed in more detail below, also would be required to explain in board reports the basis for the selection of the designated reference index or why the derivatives risk manager was unable to identify a designated reference index.[4]

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2 *See* Proposed Rule 18f-4(c)(2)(i).

3 *See* Proposed Rule 18f-4(a) (defining "designated reference index").

4 *See* Proposed Rule 18f-4(c)(5)(ii).

For the reasons discussed below, we do not believe the use of the relative VaR test necessarily would be more likely to be consistent with investor protection than the absolute VaR test. Moreover, any benefits identified by the Commission in the Proposing Release may be outweighed by the significant reductions of efficiency that could result from the proposed framework.

Accordingly, instead of requiring the derivatives risk manager to determine that it is "unable to identify a designated reference index that is appropriate for the fund," we recommend that the Commission modify the Proposed Rule to permit a fund's derivatives risk manager to choose whether to apply the absolute VaR test or relative VaR test for a fund, taking into account the fund's risk profile and investment strategy. In connection with this proposed change to the framework under the Proposed Rule, and to address concerns raised by the Commission in connection with the choice between the two tests, we propose that the Commission also provide guidance that (1) a fund may not change between tests solely due to a failure to comply with a selected VaR test; (2) a fund should disclose in its prospectus the specific risks it may face in connection with derivatives investments and how the fund manages such risks; and (3) the derivatives risk manager's annual report to the fund's board include summary information regarding the VaR test with which a fund has decided to comply.

If the Commission determines not to provide this requested flexibility, we recommend that the Commission provide assurances that the Commission staff on examination or disclosure review would not second-guess a derivatives risk manager's exercise of its reasonable business judgment in making the determination that a designated reference index is not available. Whether or not the Commission makes the changes requested in this section, we are also proposing that the Commission change the definition of designated reference index, as discussed below.

2. There Is No Compelling Policy Reason to Make the Relative VaR Test the Default

The Proposing Release states that the proposed requirements under the limit on fund leverage risk are designed to limit leverage risk "consistent with the investor protection purposes underlying Section 18 and to complement the proposed risk management program."[5] The Proposing Release further states that the Commission proposed the relative VaR test "as the default means of limiting leverage risk because it resembles the way that [S]ection 18 limits a fund's leverage risk."[6] The Proposing Release also states that a VaR test, "and especially one that compares a fund's VaR to an unleveraged index that reflects the markets or asset classes in which the fund invests," can be

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5 Proposing Release at 4454.

6 Proposing Release at 4471.

used to identify whether a fund is using derivatives for leverage or for other reasons.[7] These and other statements in the Proposing Release suggest that the Commission's view is that the relative VaR test is more closely tied to Section 18 than the absolute VaR test.[8]

While the Proposing Release draws this analogy between the relative VaR test and the Section 18 limits on bank borrowing, we believe that the discussion in the Proposing Release demonstrates only a tenuous connection between the 150% test and Section 18, and that the reasoning discussed therein is unconvincing. Section 18 is designed not just to limit leverage, but also the amounts that a fund could owe to a third party and thus potentially have to repay. However, VaR is not designed to address this risk, and thus a 150% limit on VaR may be more risk-limiting than Section 18. In this regard, a fund obtaining the full amount of bank borrowings permissible under Section 18 may have more or less than 150% of the VaR of the particular designated reference index selected for the fund, depending on the composition of the fund's pre- and post-borrowing portfolio of investments. For example, a fund that holds only certain of the securities in an index or holds the same securities of an index in different weightings than the index could have a much different VaR than that of the full index. Moreover, the proposed VaR tests would include and take into account the leverage effects from instruments other than derivatives and potential losses that could arise from non-leverage-related variables. Accordingly, the proposed VaR tests would restrict a fund's ability to utilize leverage more severely than the Section 18 limits on bank borrowings, because the fund's VaR calculation would account for losses created by many different variables other than leverage. As a result, we do not believe that the relative VaR test, as opposed to the absolute VaR test, more closely resembles the limits on leverage under Section 18.

The discussion of the Commission's economic analysis in the Proposing Release notes that allowing a choice between the VaR tests depending on the derivatives risk manager's preference "may result in less uniformity in the outer limit on funds' leverage risk across the industry."[9] It then states that certain funds could obtain significantly more leverage under an absolute VaR test, causing investors in such funds to be less protected from leverage-related risks than under the structure set forth in the Proposed Rule.[10] However, we do not believe that the Proposing Release

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7 *See* Proposing Release at 4469.

8 The Proposing Release analogizes that the proposed 150% relative VaR test limit resembles the hypothetical VaR of a fund that obtains the full amount of bank borrowings permissible under Section 18(f) and has total assets equal to 150% of the fund's net assets. The Proposing Release states that such a fund's VaR would be approximately 150% of the VaR of the fund's designated reference index.

9 Proposing Release at 4530.

10 *See* Proposing Release at 4530.

makes a convincing case or provides a quantitative, data-driven cost-benefit analysis showing that the 150% limit would have prevented harms to investors that outweigh the benefits of derivatives use under the absolute VaR test. Moreover, the Proposing Release does not discuss any specific benefits to funds and investors that would be gained from establishing the relative VaR test as the default limit for funds that could be viewed as outweighing the potential inefficiencies discussed herein.

The Commission states in the Proposing Release that reliance on the absolute VaR test "may be inconsistent with investors' expectations where a designated reference index is available."[11] The Commission highlighted as an example of such an instance that a fund that invests in short-term fixed income securities using the absolute VaR test could "substantially leverage its portfolio" beyond the VaR of a hypothetical designated reference index of short-term fixed income securities.[12] Moreover, we do not believe that investors will form expectations regarding a specialized risk management technique such as VaR based on the index used as a benchmark for fund performance. To the extent the Commission can establish that this is a legitimate concern, we believe that a fund can instead address investor expectations by including appropriate registration statement disclosures indicating the nature of the level of risks that an investor should expect that the fund's investments and derivatives use may create. Accordingly, we do not believe that the result of the use of the relative VaR test necessarily would be more likely to be consistent with investor expectations. Further, our proposal that the Proposed Rule require that a fund not change between tests solely due to a failure to comply with a selected VaR test also would ensure that the use of a particular VaR approach remains consistent with investor expectations, as made through disclosures.

We believe that each of the absolute VaR test and the relative VaR test equally can serve as an appropriate metric to help assess and limit the extent to which a fund's derivatives transactions create leverage and therefore both can serve to address the undue speculation and asset sufficiency concerns underlying Section 18, consistent with investor protection. We also note that, in addition to the new requirements we are proposing, the limit on fund leverage risk would be complemented by the derivatives risk management program that would manage a fund's derivatives risk generally, including other types of risk that may be posed by a fund's use of derivatives that may not be addressed by either VaR test.

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11 Proposing Release at 4471.

12 *See* Proposing Release at 4471.

3. There Is an Inherent Difficulty In the Proposed Derivatives Risk Manager Determination

As noted above, the Proposed Rule and the Proposing Release provide generally that the selection of a designated reference index would have to be based on "the markets or asset classes in which the fund invests"[13] and should take into account the fund's "investments, investment objectives, and strategy."[14] However, there is no standard for or substantive instruction on what type of index may be an appropriate designated reference index for a particular fund. Further, the Proposed Rule and the Proposing Release do not provide guidance on how a derivatives risk manager should make a determination that it is unable to identify a designated reference index.[15] Until there is more guidance or experience with Commission administration of the Proposed Rule, we believe that the Commission and its examination staff should give considerable deference to the judgments of derivatives risk managers in such situations.

Without such deference, or further, reasonable guidance, it would be too difficult for a derivatives risk manager to identify definitively whether or not an appropriate designated reference index exists for certain funds. Accordingly, under the Commission's proposed framework for the limit on fund leverage risk, it is likely that the absolute VaR test would only be used in very limited circumstances.

This uncertainty may raise particular issues for fund managers currently managing parallel Undertaking for Collective Investing in Transferable Securities ("UCITS") funds and U.S. funds, where a UCITS fund currently uses the absolute VaR approach, but a U.S. fund may have to use the relative VaR approach under the proposed framework. This could reduce efficiency for the U.S. fund and be detrimental to fund returns and investors.

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13 Proposing Release at 4471.

14 *See* Proposing Release at 4559.

15 The Proposing Release discusses only "multi-strategy funds" that "implement a variety of investment strategies, making it difficult to identify a single index (even a blended index)," as the sole example under which it would be appropriate for a derivatives risk manager to conclude that it is unable to identify an appropriate designated reference index.

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B. Proposed Changes and Requests for Additional Guidance with Respect to Elements of the Limit on Fund Leverage Risk

1. Increase the Relative and Absolute VaR Test Limits to 200% and 20%

For the reasons discussed below, we propose that the Proposed Rule be modified to increase the relative VaR test limit to 200% of the VaR of a fund's designated reference index and increase the absolute VaR test limit to 20% of a fund's net assets, rather than the respective 150% and 15% limits currently proposed.

As discussed above, we believe the Commission's analogy to the Section 18 borrowing limits for open-end funds is not strong enough to provide a basis to set the relative VaR test as the default. We similarly believe that the Commission's rationale for the proposed 150% relative VaR test limit based on this analogy it is not strong enough to justify the negative impact that this limit would have on certain funds.

The tie to Section 18 for the 15% limit under the absolute VaR limit identified by the Commission in the Proposing Release is similarly tenuous. It is also predicated heavily on funds investing in large cap equity securities (*i.e.*, allowing the fund to have roughly 1.5 times the historic mean VaR of the S&P 500 index).[16] In this regard, while many funds may use the S&P 500 index as a performance benchmark, that index may not reflect the assets or strategy of a particular fund. In addition, there are funds that use derivatives and invest in asset classes, such as emerging markets stocks or technology stocks, which are more volatile than large cap equity stocks and typically have higher VaRs. The use of the S&P 500 index as the basis for the absolute VaR test would unduly constrain funds with strategies involving securities that are inherently more volatile than the S&P 500 index. We also note that using the historical mean VaR of the S&P 500 index as the basis for the proposed limit under the absolute VaR test does not consider that index's wide range of variability.

Further, as noted above, the Proposed Rule's VaR test-based leverage limits would restrict a fund's ability to utilize leverage more severely than the Section 18 limits on bank borrowings because the fund's VaR calculation would account for losses created by many different variables other than leverage. A fund's VaR may exceed the VaR of its designated reference index for a multitude of

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16 The Proposing Release describes that the Commission set the absolute VaR test at 15% of a fund's net assets with the intent of providing approximately comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the Standard & Poor's ("S&P") 500 as their designated reference index during periods when the S&P 500's VaR is approximately equal to the historical mean of 10.4% (as identified by the staff of the Commission's Division of Economic and Risk Analysis ("DERA")).

reasons (*e.g.*, varying active management strategies). If a fund's VaR already exceeds the VaR of its designated reference index before accounting for leverage, such inherent variations would significantly reduce the amount of leverage that the fund could incur through derivatives, and such a fund would suffer from a significant competitive disadvantage that is not attributable to derivatives or even leverage. Thus, the VaR test would actually be a limit on how much risk overall—regardless of derivatives trading—a fund could take, which also would be a *de facto* limit on how much return a fund could deliver.

In addition, we note that any applicable VaR test limit may be impractical for a fund to apply and comply with at any given time due to increases in market volatility that may occur. We understand that certain fund groups and others in the industry will submit comment letters and numerous data set that will support the proposed 200% and 20% limits and demonstrate that such limits will be more practical to comply with and apply in different market conditions. We urge the Commission to seriously consider the feedback and data regarding the challenges of complying with the VaR test limits, as proposed by the Commission, provided in such comment letters.

The Commission also suggests in the Proposing Release that many investors, including investors in funds that are not broad-based large capitalization equities funds, may understand the risk inherent in broad-based large capitalization equities indexes as the level of risk inherent in the markets generally.[17] We are concerned that this line of reasoning is deeply flawed in that the risks presented by such funds may be quite different than those presented by funds that are not broad-based large capitalization equity funds; the Commission is essentially suggesting that investors may rely on highly inapt comparisons. As discussed above, we believe that a fund can address the investor expectation issue raised by the Commission by including appropriate registration statement disclosures indicating the nature of the level of risks that an investor should expect that the fund's investments and derivatives use may create.

The increased VaR test limits we are proposing have already been successfully implemented and tested through a variety of market conditions for UCITS funds under the Committee of European Securities Regulators (CESR – now ESMA) Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS ("UCITS Guidelines"). We do not believe the Commission has justified the proposed significant differences from the thresholds under the UCITS Guidelines. There is no indication that the UCITS Guidelines have led to inappropriate derivatives use. Thus, U.S. fund investors should be able to access the same risk/return exposures as their European counterparts. In addition, fund managers that sponsor registered investment companies in the U.S. and UCITS funds using parallel strategies would face significant issues with managing such strategies under similar regulatory structures that impose different percentage

[17] *See* Proposing Release at 4475.

limits. As noted above, such managers may need to change the U.S. fund's use of derivatives and maintain a different portfolio compared to the corresponding UCITS fund in order to comply with the more limiting VaR tests under the Proposed Rule. This could reduce efficiency for a U.S. fund compared to the corresponding UCITS fund and be detrimental to fund returns and investors. Portfolio management, risk management, and compliance functions would be forced to adopt even more complex systems, and funds would be subject to greater technology and operational costs in order to manage compliance under both regulatory regimes. These costs likely would ultimately be borne by shareholders.

Based on the above, we believe that funds and their shareholders could suffer from disadvantages as a result of having to comply with more restrictive VaR tests. Accordingly, the selection of the 150% and 15% limits appears to be arbitrary.

We note that any percentage limits on a fund's leverage risk would be complemented by the fund's derivatives risk management program (including required stress testing and backtesting), which would be overseen by the fund's board. In this regard, these additional requirements and related board oversight would be analogous to the requirements that the Commission adopted for setting a "highly liquid investment minimum" under Rule 22e-4 under the 1940 Act, under which the liquidity risk manager, which is in the best position to assess a fund's liquidity risk, sets a fund's highly liquid investment minimum under the oversight of the fund board and as a part of a broader liquidity risk management program.

Providing additional flexibility to funds would enable more funds to continue to pursue their current investment strategies, and the Commission could simultaneously impose a limit on a fund's leverage risk that is consistent with global standards.

2. A Fund's Designated Reference Index Should Reflect the Fund's Risk Profile and Investment Strategies

As noted above, the Proposed Rule would require a fund to comply with the relative VaR test unless the derivatives risk manager is "unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy."[18] In determining appropriateness, the derivatives risk manager must choose an unlevered designated reference index that "reflects the markets or assets classes in which the fund invests."[19]

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18 *See* Proposed Rule 18f-4(c)(2)(i).

19 In addition, an affiliated person of the fund, its investment adviser or principal underwriter must not administer the index, and the fund or its adviser must not have requested the index, unless the index

We propose that the Commission instead require a fund's designated reference index to reflect the risk profile and investment strategy of the fund. The element of the Proposed Rule's definition of the term "designated reference index" tied to the markets or asset classes in which the fund invests does not take into account how funds in practice seek to meet their investment objectives. This disconnect would create practical concerns for funds and their derivatives risk managers, particularly for funds that have investment strategies that could change under different market conditions or that seek target volatilities. Under the proposed definition, it is possible that an index could reflect the markets or asset classes in which the fund invests, but be significantly different in composition and risk characteristics than the fund. As noted above, a fund that holds only certain of the securities in an index or holds the same securities of an index in different weightings than the index could have a much different VaR than that of the full index, regardless of whether the fund holds derivatives, which we believe would mean that the index in fact is not an appropriate designated reference index.

We believe that a standard based on the fund's risk profile and investment strategy would better reflect the volatility and risks of a fund's investments and assets and would provide a more appropriate baseline against which to measure the risk arising out of a fund's derivatives use, given that the index would reflect the actual investments of the fund, as opposed to just the asset classes or markets in which the fund invests. We also believe that this standard would better align the relative VaR test with investor expectations for a particular fund. We note that this approach would be workable for a fund following an index strategy or a fund with more latitude with respect to assets and investment techniques.

This element of the definition also contributes to the difficulty inherent in a derivatives risk manager's determination of whether or not an appropriate designated reference index exists for certain funds, as discussed above. We note that the proposed requirement that funds use a relative VaR test as the default leverage limit indicates the Commission's strong preference for the relative VaR test, and derivatives risk managers may feel pressure to choose an index, however inappropriate, absent additional guidance and our proposed change in standard. Retaining the standard in the Proposed Rule could force a derivatives risk manager into using a designated

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is widely recognized and used; and the index must be an "appropriate broad-based index" or "additional index" as defined in Instruction 5 to Item 27 of Form N-1A.

The Proposing Release highlights three provisions that would prevent derivatives risk managers from selecting inappropriate indexes: (1) the derivatives risk manager must select the index and periodically review it; (2) the index would be disclosed relative to the fund's performance in the fund's annual report; and (3) the board of directors would receive a written report providing the derivatives risk manager's basis for selecting the index. *See* Proposing Release at 4744.

reference index with volatilities and risks that are inconsistent with a fund's investment strategy, simply because it was able to identify an index meeting the "markets and asset classes" standard.

The modified standard that we are proposing has already been successfully implemented and tested through a variety of market conditions for UCITS funds.

3. Additional Guidance on the Evaluation of Designated Reference Indexes Is Needed

As discussed above, derivatives risk managers will have difficulty with making index determinations, particularly for funds that have investment strategies that could change under different market conditions or that seek target volatilities. Without more guidance, derivatives risk managers could be subject to second guessing by Commission examination staff, and funds could become subject to potential liability.

We request that the Commission clarify instances in which derivatives risk managers could reasonably conclude that there is no designated reference index for a fund, if the final rule requires this determination. The guidance should specifically state that a derivatives risk manager is unable to identify a designated reference index when it determines, in its reasonable business judgment, that there is no index that reflects in all material aspects the fund's investment strategies and risk profile (*i.e.*, how the fund is run and the volatility or risks of the fund). We note that the proposed requirement that funds use a relative VaR test as the default leverage limit indicates the Commission's strong preference for the relative VaR test, and as noted above, derivatives risk managers may feel pressure to choose an index, however inappropriate, absent additional guidance.

We request that the Commission also clarify that there is no presumption that a fund must use its performance benchmark as its designated reference index. A fund's performance benchmark, which is typically a broad-based index[20] for open-end funds, is intended to assist investors with understanding a fund's performance, not the fund's investment strategy or risk. As with indexes that simply reflect the markets and asset classes in which the fund invests, a selected performance benchmark does not necessarily reflect the volatility or risk characteristics of its corresponding fund. The Commission provides an example in which a fund's chosen performance benchmark (the S&P 500 index) could not be used as its designated reference index, because the benchmark did not reflect the markets or asset classes in which the fund invests - commodity futures contracts.[21]

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20 *See* Items 4 and 27(b)(7)(ii) of Form N-1A.

21 *See* Proposing Release at 4471.

We agree with the Commission's example but request that guidance address other and more nuanced situations.

Similarly, the Commission should also identify certain additional broad categories of funds that it would not expect to have designated reference indexes and clarify that there may be other types of funds not listed that would typically not use the relative VaR test. The funds that would need this guidance would not be able to identify indexes that reflect all the asset classes or markets that the fund invests in, or the revised definition reflecting the fund's investment strategy and risk profile as we have proposed, under different market conditions. For example, a multi-asset class absolute return fund may choose a performance benchmark that is a broad-market equity index, but the breadth of the fund's investment mandate would result in the fund not being expected to select one particular index, even a blended one, to reflect the markets and asset classes in which the fund invests while also appropriately taking account of the fund's investment strategies. These categories could include funds that employ different investment strategies in different market environments and funds that invest in unique asset classes that do not typically have indexes, including market-neutral funds, multi-alternative funds/non-correlated strategy funds, long-short funds, managed futures funds, and funds that invest in unique asset classes that may not have a broad-based index (*e.g.*, insurance-linked securities).

4. The Commission Should Allow More Flexibility for the Required Confidence Level and Time Horizon for VaR Calculation Models

The Proposed Rule would require that any VaR model used by a fund for purposes of determining the fund's compliance with the applicable VaR test would have to, among other requirements, use a 99% confidence level and a time horizon of 20 trading days.[22] The UCITS Guidelines approach would allow funds to deviate from the default VaR confidence interval and holding period calculation standards (*i.e.*, confidence interval of 99% and holding period of one month (20 business days)), provided that the confidence interval is not below 95% and the holding period does not exceed one month (20 business days).[23] It is our understanding that the Commission will receive comments and data from industry participants supporting scaling of confidence levels and greater flexibility with respect to time horizons used in VaR calculation models, consistent with the UCITS Guidelines. We urge the Commission to take into consideration this information, which will indicate that the Proposed Rule's relevant requirements are overly limiting and will prevent

22 *See* Proposed Rule 18f-4(a) (defining VaR).

23 UCITS funds using absolute VaR are required to scale down the 20% test to account for the different calculation standards but no adjustment is necessary to the 200% VaR limit where non-standard parameters are used. These points would need to be contemplated in the Proposed Rule if the Commission allows non-standard parameters.

industry participants and investors from fully realizing the efficiencies and benefits of being able to drawn on and leverage existing fund systems and processes.

C. Alternative Requirements for Certain Types of Funds

1. Closed-End Funds Should be Subject to Higher VaR Test Limits

The Proposing Release states that the Commission considered permitting closed-end funds to have higher leverage limits than open-end funds, but that it determined not to do so.[24] The Proposing Release states that the Commission does not believe that a registered closed-end fund's ability to issue preferred stock suggests that registered closed-end funds should be permitted to obtain additional indebtedness leverage through derivatives transactions.[25] We disagree with this view.

We strongly believe that closed-end funds should be permitted either to (i) comply with VaR limits of 200% or greater under the relative VaR test and 20% or greater under the absolute VaR test, or (ii) increase the applicable VaR test limit in an amount corresponding to the fund's intended amount of structural leverage disclosed by the fund. With respect to the request in item (ii), for example, a closed-end fund that discloses it is 50% leveraged should be permitted to use a designated reference index that is similarly 50% leveraged.

We also recommend that, in the event the Commission determines to increase the VaR limits for open-end funds to 200% under the relative VaR test and 20% under the absolute VaR test, the VaR limits noted in request item (i) be further increased for closed end funds to at least 250% under the relative VaR test and 25% under the absolute VaR test, to account for the increased amounts of leverage closed-end funds are permitted to obtain.

Section 18 imposes asset coverage requirements of different levels for different types of closed-end fund structural leverage (*i.e.*, 200% for preferred stock and 300% for debt), and allows closed-end funds to obtain greater overall levels of leverage than open-end funds.[26] Given the ability to issue preferred stock subject to the 200% asset coverage test, closed-end funds are permitted to incur two times more leverage than open-end funds.

Under the proposed VaR test limits, a fund's VaR is measured at the portfolio level. There is no practical way for funds to isolate the portfolio leverage arising from indebtedness from the portfolio leverage arising from preferred stock. Thus, under both proposed VaR tests, a fund's VaR would

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24 *See* Proposing Release at 4474.

25 *See* Proposing Release at 4474.

26 BDCs are subject to different percentage asset coverage requirements.

reflect the risk attributable to investments purchased with the proceeds of any indebtedness or preferred stock issued by a closed-end fund, in addition to its investments in derivatives and other relevant transactions. The approach of the Proposed Rule to impose the same leverage limits on all funds fails to take into account Congress' intent that is reflected in the provisions of Section 18 that closed-end funds be permitted to take on greater amounts of leverage than open-end funds.

Moreover, Section 18 has long been interpreted as recognizing a meaningful distinction between the structural leverage that could be obtained by closed-end funds through the issuance of preferred stock or debt and portfolio leverage that could be obtained through investments in derivatives. Closed-end funds are permitted to simultaneously obtain structural leverage in the form of borrowing or issuing preferred stock or debt, which increase a fund's total assets, and portfolio leverage in the form of investments in derivatives, reverse repurchase agreements and tender option bonds (among other things). We believe that structural leverage does not create the same type of leverage risk that the Proposed Rule is designed to address. We believe that closed-end funds' ability to obtain structural leverage and greater overall levels of leverage generally supports certain differing treatment for closed-end funds under the Proposed Rule.

Such closed-end funds typically disclose the level of structural leverage that they utilize. In addition, closed-end funds are not expected to be able to meet daily redemption requests and generally are not subject to the same types or levels of liquidity risk as open-end funds. Moreover, because they do not have daily liquidity obligations, closed-end funds are currently able to invest in smaller, less liquid, companies as part of their alternative strategies than certain open-end funds. As a result, closed-end funds have been seen to enhance capital formation, one of the longstanding enunciated Commission goals, and serve an important purpose in the U.S. capital markets.

2. Index Funds Tracking Affiliated Indexes Should Be Permitted to Use the Affiliated Index as a Designated Reference Index

The Proposed Rule would restrict an affiliated person of a fund, its investment adviser, or principal underwriter from administering the designated reference index and would restrict the fund or its investment adviser from requesting the creation of the index, unless the index is widely recognized and used.[27] In the Proposing Release, the Commission stated that these restrictions reduce the likelihood that an index provider would design an index with the intent of allowing a fund to incur additional leverage-related risk.[28]

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27 *See* Proposed Rule 18f-4(a) (defining "designated reference index").

28 *See* Proposing Release at 4472.

We believe that the Commission should permit a derivatives risk manager to a passively-managed index fund that tracks an affiliated index (a "self-indexed fund") to select the index as its designated reference index. As discussed below, any concern that the Commission has that an affiliated index provider might design an index to permit additional leverage-related risk is addressed already or can be mitigated. In addition, restricting a self-indexed fund from using an affiliated index that best reflects the investment objective and strategy of the fund and the assets and markets in which the fund invests would appear to be incompatible with the Commission's goal of having funds use designated reference indexes that match investor expectations' of volatility and risk.

It is not entirely clear how the Commission's concern underlying this requirement would apply to a self-indexed fund. It is possible that the concern is with the affiliated index provider adding securities to the index that increase the VaR of the index. For increased leverage, a fund could then invest in derivatives or other instruments that may not necessarily be in the index, so that it has up to 150% of the higher VaR of the index. However, this appears to be a remote concern with respect to index funds and one in which the potential benefit to the affiliated index provider is not immediately apparent.

Any concern that an index provider could design an index with the intent of allowing the fund to obtain additional leverage-related risk should be offset by the fact that the fund's board would need to approve the fund's stated investment objective and strategy to track the index in the first place. To the extent the fund's index tracking strategy involves the use of derivatives, the board would consider that information in approving the fund's objectives and strategies to track the specified index. The concern would also be addressed by the information on the designated reference index that is proposed to be required to be reported to the fund's board and the board's general role of oversight, including over these types of affiliated relationships, under the Proposed Rule.[29]

The proposed requirement that a self-indexed fund use an index other than the index that it is required to track as its designated reference index could force the fund to alter its investments and thus incur index tracking errors. An index fund typically invests in or gets exposure to the component assets of the relevant index in order to replicate the performance of the index.

29 We also note that the Commission stated in adopting Rule 6c-11, Exchange-Traded Funds, that "existing securities laws adequately address any special concerns presented" by self-indexed ETFs, "including the potential ability of an affiliated index provider to manipulate an underlying index to the benefit or detriment of a self-indexed ETF." Exchange-Traded Funds, 84 Fed. Reg. 57162, 57168-9 (Oct. 24, 2019) (citing protections under Rule 38a-1 under the 1940 Act, Rule 17j-1(c)(1) under the 1940 Act, Section 204A of the Investment Advisers Act of 1940 ("Investment Advisers Act"), and Section 15(g) of the Exchange Act).

Artificially increasing the VaR of the relevant index therefore would yield little benefit to an index fund to gain additional leverage through other investments.

In addition, if an index fund is unable to use the index it tracks as its designated reference index, it may be required to choose another index with a VaR that is different than the fund's VaR. In these circumstances, the fund would need to monitor closely and confine its VaR to the VaR of the designated reference index to stay within the proposed relative VaR test limit. This would have the effect of causing the fund essentially to track two indexes – the affiliated index for tracking error and the designated reference index for the relative VaR test. If the VaRs of the two indexes differ, the fund may need to abstain from making certain investments to stay within the VaR confines of the designated reference index, rather than minimizing its tracking error to the affiliated index. This could result in index tracking errors.

For an index fund, investors would expect the fund to yield substantially similar performance, volatility and risk most closely to the underlying index that the fund tracks. Given the variations in risk and volatility that funds could have from general benchmarks, we believe that index funds should always be permitted to select their underlying index (even if the index is affiliated) – the most representative benchmark of the fund's strategy – as their designated reference index, and that this would better align with investor expectations.

D. Proposed Changes Regarding VaR Breaches and Remediation Requirements

1. The Period During which a Fund Could Be Out of Compliance with its VaR Test Should Be Extended

Under the Proposed Rule, a fund would be required to determine its compliance with the applicable VaR test at least once each business day.[30] If a fund determines that it is not in compliance with its VaR test, it must return to compliance within three business days.[31] If, after the three business days, the fund remains non-compliant, then requirements regarding board reporting, derivatives risk management program analysis and updating, and restrictions on entering into certain derivatives transactions would apply.[32] The Proposing Release states that the three-business-day period before

[30] Proposed Rule 18f-4(c)(2)(ii).

[31] *See* Proposed Rule 18f-4(c)(2)(ii).

[32] *See* Proposed Rule 18f-4(c)(2)(iii).

a fund is required to take specific remedial actions is similar to the remediation approach for asset coverage compliance with respect to bank borrowings under Section 18.[33]

We believe the Commission should extend the three-business-day period to five business days or, at the very least, seven calendar days. A period of more than three business days of non-compliance with the applicable VaR test is necessary to provide sufficient indication of a fund's inability to comply with its VaR test or that a fund bears too much leverage risk from its derivatives holdings. The period set forth in the Proposed Rule would be an insufficient amount of time for many funds to adjust their portfolios in a reasoned and thoughtful manner to come back into compliance with a VaR test. The potential harm a fund could suffer from being required to come back into compliance so quickly could be greatly exacerbated if a fund receives large redemption requests during the same period.

We believe that the comparison in the Proposing Release to the remediation approach for asset coverage compliance with respect to bank borrowings under Section 18 is not appropriate, as credit facilities generally contemplate and permit an immediate reduction in the outstanding amount of borrowings. In contrast, a fund may not practically be able to terminate or unwind its derivatives transactions within this time frame. We note that under Rule 22e-4 under the Investment Company Act, a fund merely needs to reasonably expect to be able to sell or dispose of an investment in seven calendar days or less in order for the investment not to be considered an "illiquid investment."[34] Funds often negotiate early termination rights in their over-the-counter derivatives agreements with that timeframe as a guideline, or may have to agree to a negotiated price for termination at the time of termination if they do not have agreed early termination rights, which can be a time-consuming process. Accordingly, increasing the number of days would be more consistent with market practice for derivatives trading and existing regulatory standards, while still providing strong investor protection.

Extending the three-day period would help prevent a fund from having to exit certain derivatives trades at potential "fire sale" prices in order to avoid being beyond the applicable VaR limit for three business days and having to take the remedial steps set forth in the Proposed Rule. Requiring a fund to exit a trade or trades in a shorter period of time than expected in order to avoid the required remedial steps would be disruptive to the fund's trading and strategy and could result in an actual, realized substantial loss to fund investors whereas the risk for fund investors of the breach of a VaR limit would have only have been theoretical.

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33 *See* Proposing Release at 4479.

34 *See* Rule 22e-4(a)(8).

2. The Restriction on Entering Into New Derivatives Transactions Should Be Eliminated

As discussed above, under the Proposed Rule, if a fund determines that it is not in compliance with its VaR test, the fund would have to come back into compliance with the VaR test within three business days. If the fund is not in compliance with its VaR test within three business days, among other requirements, the fund could not enter into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been back in compliance with its VaR test for three consecutive business days.[35] To support this provision, the Proposing Release merely cites without empirical evidence a concern that funds could come back into compliance and immediately increase their market risk, which "could potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test." For the reasons set forth below, we believe that this restriction should be removed from the Proposed Rule.

Restricting the ability of a fund to enter into certain derivatives transactions for this period of time could be very disruptive to a fund's investment strategy if the fund obtains significant amounts of its investment exposure through the use of derivatives transactions. This may have a particularly negative impact on such a fund in periods of increasing market volatility. If a fund was prevented from reacting to volatility, changing asset liquidity or market dislocations by not being able to enter into derivatives transactions during the relevant period, the restriction in the Proposed Rule could adversely impact a fund's performance and harm the fund's shareholders.

In addition, prohibiting a fund from rolling positions or hedging certain positions (such as currency exposure, which hedging may not reduce a fund's VaR) during the three-business day period, and accordingly decreasing fund's investment exposure obtained through investments in derivatives or increasing a fund's exposure to risk, in a volatile market could lead to capital loss and exacerbate liquidity risk. Certain abnormal market conditions or events may also require funds to respond rapidly and make different investments on a time-sensitive basis, and derivatives may provide the most efficient means for making prudent investments in such circumstances. For example, liquidity events sparked by different market or fund-related events could create significant issues for a fund's portfolio construction and necessitate a fund making investments that could temporarily increase the fund's VaR. A fund will be in the best position to determine what actions to take to address VaR test breaches and manage derivatives risk at that time in light of the fund's portfolio holdings and current market conditions.

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35 *See* Proposed Rule 18f-4(c)(2)(iii)(C).

In addition, the Proposed Rule requirements for funds to report to their boards on the results of backtesting,[36] and to report to the Commission on Form N-RN regarding such VaR test breaches,[37] should adequately address the concern raised by the Commission in the Proposing Release that funds may constantly exceed the leverage limit.

In addition, it is practically difficult and complex for funds definitively to determine whether a particular derivatives transaction will reduce a fund's VaR prior to or at the time the fund enters into that transaction. A fund may enter into a derivatives transaction for the purpose of reducing the fund's VaR, but could later determine that such transaction actually had the effect of increasing the fund's VaR, possibly due to changes in market conditions or other general, industry-wide trends.

In addition, we note that under the Proposed Rule, a fund would not be prohibited from entering into non-derivatives transactions during the three-business day period, which may have the effect of increasing a fund's VaR. We do not see a meaningful distinction between derivatives and non-derivatives transactions that increase a fund's VaR under these circumstances.

This requirement also presents practical challenges for funds that manage parallel UCITS and U.S. funds and could require the portfolio management of the two funds to diverge for periods of time.

3. Funds Should at Least Be Permitted to Enter Into Certain Types of New Derivatives Transactions After VaR Test Breaches

If the Commission determines not to remove the restriction on entering into derivatives transactions during the remediation period following a VaR test breach, we believe that the Proposed Rule should be modified to permit funds to enter into derivatives transactions during the remediation period for purposes of (1) responding to abnormal organizational or market conditions or events, (2) rolling over current holdings, (3) meeting liquidity and redemption needs, and (4) mitigating risks within the fund's portfolio more generally. These legitimate bases for entering into derivatives transactions other than for leverage purposes reflect significant concerns for certain funds, and funds should not be restricted from entering into derivatives transactions for these purposes for any period of time. We propose that in such circumstances the derivatives risk manager report on such occurrence at the next regularly scheduled board meeting.

In addition, there are certain circumstances under which a fund could breach its VaR test without entering into a new transaction (*i.e.*, a passive breach). A fund experiencing a passive breach of its

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[36] *See* Proposed Rule 18f-4(c)(5)(iii).

[37] *See* Proposed Rule 18f-4(c)(7).

VaR test should not be subject to the same remediation requirements as applicable to other VaR test breaches that occur in connection with a fund's active portfolio management or investment decisions. A passive breach of a VaR test may occur as a result of a change in market conditions or other general, industry-wide trends. A fund's passive breach of its VaR test would not necessarily be indicative of the fund bearing too much leverage arising out of its derivatives holdings. Accordingly, we believe that the restriction on entering new derivatives transactions should not apply after a fund experiences a passive breach of its VaR test.

II. DERIVATIVES RISK MANAGEMENT PROGRAM

Under the Proposed Rule, a fund (other than a limited derivatives user) would be permitted to enter into derivatives transactions, notwithstanding the requirements of Sections 18(a)(1), 18(c), 18(f)(1) and 61 of the 1940 Act, subject to the conditions set forth in the Proposed Rule.[38] A fund (other than a limited derivatives user) that engages in derivatives transactions would be required to adopt and implement a written derivatives risk management program, which would have to include policies and procedures reasonably designed to manage the fund's derivatives risks[39] and to reasonably segregate the functions associated with the program from the portfolio management of the fund (the "Program").[40] A fund's Program would be required to include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing, (4) backtesting, (5) internal reporting and escalation and (6) periodic review of the Program by the derivatives risk manager and the fund's board.[41]

We agree in principle that funds that invest in derivatives (other than limited derivatives users) should adopt a Program that includes policies and procedures to assess and manage the risks associated with those investments, and we recognize the Commission's view that such a Program is "critical" to appropriate derivatives risk management and "foundational" to the Proposed Rule.[42]

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38 *See* Proposed Rule 18f-4(b) and (c).

39 These risks include leverage risk, market risk, counterparty risk, liquidity risk, operational risk, and legal risk, as applicable, and any other derivatives risks that a fund's derivatives risk manager deems material. *See* Proposed Rule 18f-4(a) (defining "derivatives risk").

40 *See* Proposed Rule 18f-4(c)(1).

41 *See* Proposed Rule 18f-4(c)(1). The derivatives risk manager would have to review the Program at least annually to evaluate the Program's effectiveness and to reflect changes in risk over time. The periodic review must include a review of the VaR calculation model (including the backtesting requirement) and any designated reference index to evaluate whether it remains appropriate. *See* Proposed Rule 18f-4(c)(1)(vi).

42 *See* Proposing Release at 4453.

Nonetheless, we recommend modifications to specific elements of the Program, which we believe stay true to the Commission's regulatory objectives while easing associated burdens on funds. We discuss below our specific comments on the proposed Program, including recommendations regarding: (1) the proposed Guidelines (defined below), (2) stress testing requirements and (3) backtesting requirements.

Absent these recommended changes, a fund might determine that the potential costs and compliance burdens associated with the Program outweigh the benefits the fund could achieve through derivatives use. A fund that makes this determination likely would need to change and reduce the ways it uses derivatives to implement its investment objectives and strategies, manage risk and meet the conditions of the limited derivatives user exception, as discussed below, which could reduce the efficiency of the fund's investment activities and be detrimental to fund returns and investors. Without modification, the costs and additional burdens imposed by the Proposed Rule have the potential to create a *de facto* barrier to the use of derivatives transactions in more than a *de minimis* amount for these funds.

A. Clarify the Derivatives Risk Guidelines Requirement

Under the Proposed Rule, a fund's Program would be required to provide for the establishment, maintenance, and enforcement of investment, risk management or related guidelines that provide for quantitative or otherwise measurable criteria, metrics, or thresholds ("criteria") of the fund's derivatives risks ("Guidelines").[43] A fund's Guidelines would be required to specify levels of the given criterion, metric, or threshold that a fund does not normally expect to exceed, and measures to be taken if they are exceeded.[44]

1. Additional Guidance to Avoid Second-Guessing Is Needed

We appreciate the flexibility to implement the Guidelines-related requirements based on a fund's investment portfolio, the scope and objectives of the fund's use of derivatives and the fund's disclosures. However, we believe that the Guidelines-related requirements need additional clarity to be an effective component of a fund's Program. For example, the Guidelines-related requirements lack detail on how the criteria should be defined, and do not provide specific examples of which types of criteria should be used for a fund's Guidelines (*e.g.*, metrics such as VaR, notional amounts or duration). In addition, the Guidelines-related requirements do not specify under what circumstances the derivatives risk manager would be permitted to change the Guidelines, criteria or pre-established responses. We are concerned that these ambiguities may create questions

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43 Proposed Rule 18f-4(c)(1)(ii).

44 Proposed Rule 18f-4(c)(1)(ii).

regarding whether, for example, a derivatives risk manager's implementation of such changes were appropriate and whether they must be reported to the fund's board prior to a derivatives risk manager's regularly scheduled annual report.

We believe the latent ambiguities associated with the Guidelines-related requirements increase the risk that Commission examination staff will make negative comments regarding the determinations of a fund and its derivatives risk manager with regard to, for example, the initial establishment of Guidelines, measures and pre-established responses, changes thereto, and the adequacy of responses that are taken in response to exceedances of the fund's Guidelines and related measures. Such negative comments could lead to adverse consequences, such as required disclosures in due diligence processes. We do not believe the Commission intends for the Proposed Rule to result in such an outcome and do not believe that it would be appropriate for Commission examination staff to issue such negative comments (or require a fund or its derivatives risk manager to change the fund's Guidelines, criteria or pre-established responses via the examination process).

Accordingly, we recommend that the Commission acknowledge that determinations made by a derivatives risk manager exercising its reasonable judgment should not be subject to *post hoc* scrutiny by Commission examination staff.

2. The Commission Should Not Require Public Disclosure of a Fund's Guidelines

Request for comment number 31 in the Proposing Release asks whether the Commission "should require that a fund publicly disclose the guidelines it uses and the quantitative levels selected."[45] We do not believe that a fund should be required to publicly disclose its Guidelines (or portions thereof).

We believe that requiring funds to publically disclose Guidelines may necessitate disclosure of proprietary information (particularly with respect to quantitative models) that would harm the competitive interests of funds. Rather than providing meaningful or useful information to investors, we believe such a requirement could instead incentivize funds to structure Guidelines in a way that would minimize disclosure of proprietary information, but that would not be useful for purposes of risk monitoring and management (*e.g.*, setting restrictions that are too loose, or excluding certain information altogether). Moreover, to address idiosyncratic risks and investment strategies unique to a given fund, funds likely will be required to employ complex and divergent methodologies to establish their Guidelines. Accordingly, any information being publically disclosed would be inherently subjective and hypothetical and would be difficult for investors to use as a tool for

[45] Proposing Release at 4462.

comparing different funds. Accordingly, we do not believe that funds should be required to publicly disclose their Guidelines or portions thereof.

B. Refine the Stress Testing Requirement

Under the Proposed Rule, a fund's Program would be required to provide for stress testing of the fund's portfolio to evaluate potential losses to the fund's portfolio 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.[46] The Proposing Release notes that market risk factors commonly considered for this purpose include liquidity, volatility, yield curve shifts, sector movements or changes in the underlying instrument's price, and should include payments to counterparties.[47]

We generally support the Commission's proposed stress testing requirement and agree that stress testing complements the VaR-based limit on fund leverage (with modifications, as discussed above). We also believe that stress testing should provide funds with valuable information regarding potential losses in periods of stress that a VaR model alone would not necessarily identify. However, as discussed below, we believe that the scope and frequency of stress testing under the requirement should be reduced.

Further to our recommendation above, we urge the Commission to acknowledge that a fund's derivatives risk manager may need to make determinations in its reasonable judgment with respect to these and all other aspects of the Program, and that such determinations would not be subject to second-guessing by Commission examination staff, particularly if a derivatives risk manager fails to consider any specified correlations.

The Proposed Rule would permit a fund to determine the frequency with which stress tests are conducted, provided that the fund must conduct stress testing at least weekly.[48] In determining testing frequency, a fund would be required take into account the fund's strategy and investments and current market conditions.[49] The Proposing Release notes that the weekly testing minimum is intended to balance the benefits of frequent stress testing against the burdens of conducting stress testing, but that the selected frequency should "best position" the derivatives risk manager "to

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46 *See* Proposed Rule 18f-4(c)(1)(iii).

47 *See* Proposing Release at 4462.

48 *See* Proposed Rule 18f-4(c)(1)(iii).

49 *See* Proposed Rule 18f-4(c)(1)(iii).

appropriately administer, and the board to appropriately oversee, a fund's derivatives risk management, taking into account the frequency of change in the fund's investments and market conditions."[50]

We recommend that the Commission decrease the minimum frequency of the Proposed Rule's stress testing requirement to be a monthly testing requirement. We believe that weekly stress testing may be too frequent, burdensome and costly for funds to implement, especially when there is a period of low market stress. We do not believe that weekly testing is generally necessary for a fund to benefit from an overlay of stress testing to the VaR-based limits on fund leverage risk. Instead, we believe that a monthly minimum stress testing frequency requirement would allow a fund to assess multiple sets of testing results throughout a year and observe trends and changes over time without sacrificing its ability to assess, in a timely manner, its risk of potential loss.

Such a requirement would not preclude a fund's derivatives risk manager from initially determining that more frequent stress testing is appropriate, and the derivatives risk manager would always remain subject to its general obligation to review periodically the fund's Program to evaluate its effectiveness and to reflect changes in risk over time. During the course of such a review, the derivatives risk manager may appropriately determine that more frequent stress testing is necessary in light of market conditions or for other reasons.

C. Reduce the Frequency of Backtesting of the VaR Calculation Model

Under the Proposed Rule, a fund's Program would be required to provide for backtesting of the results of its VaR calculation model used in connection with the relative VaR test or the absolute VaR test (as applicable) by, on each business day, comparing the fund's gain or loss with the corresponding VaR calculation for that day, estimated over a one-trading day time horizon, and identifying as an exception any instance in which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss.[51] The Proposing Release states that this proposed requirement "is designed to require a fund to monitor the effectiveness of its VaR model . . . and help identify when funds should consider model adjustments."[52] The Proposing Release suggests that such adjustments would likely be needed if a fund experienced back testing exceptions more or less frequently than expected using the required confidence level.[53]

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50 *See* Proposing Release at 4462-63.

51 *See* Proposed Rule 18f-4(c)(1)(iv).

52 *See* Proposing Release at 4463.

53 *See* Proposing Release at 4463.

We recommend that the Commission reduce, from daily to monthly, the frequency with which a fund must conduct the backtesting of its VaR calculation model, but include a requirement that funds consider the one-day value change for each trading day in the period as compared to the corresponding VaR calculation.[54]

The Proposing Release states that the Proposed Rule requires daily backtesting so that a fund's VaR calculation model could more readily and effectively be adjusted, allowing the fund to more effectively manage its derivatives risk and notes that the changing market risk factors and fund investments could necessitate frequent changes to a VaR model.[55]

However, we do not believe that daily backtesting is necessary for VaR backtesting to be an effective and beneficial tool to monitor the proper functioning of a fund's VaR model. While we understand that more than one day's backtesting results may be a helpful indicator in assessing whether an exceedance warrants a change to a fund's VaR model, we do not believe the additional burdens and costs associated with daily VaR backtesting would provide substantive benefit over monthly backtesting with a daily review requirement.

Rather, we believe that our proposed monthly backtesting requirement that considers the relative change for each business day during the period would allow a fund to monitor the accuracy and performance of its VaR calculation model, and, if necessary, make appropriate adjustments over time, without incurring the significant costs associated with daily testing. Further, if market risk factors or fund investments change, funds could determine to run more frequent backtesting on an as-needed basis. We believe that daily testing with a one-day horizon (using one year of historical data) would not provide enough data points for purposes of model validation, and we believe that VaR backtesting could provide more meaningful results if smoothed by a longer period of data points.

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54 We note this approach would align with the UCITS Guidelines. The UCITS Guidelines require monthly backtesting for UCITS to monitor the accuracy and performance of a UCITS fund's VaR model, with retroactive comparison of the VaR measure generated by the VaR model compared to the UCITS fund's actual VaR for each business day. *See* UCITS Guidelines Section 3.6.4 (Back Testing).

55 *See* Proposing Release at 4464.

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III. DERIVATIVES RISK MANAGER

A. Permit a Fund's Investment Adviser and Non-Officers of the Investment Adviser to Serve In the Role of Derivatives Risk Manager and Lessen Related Board Obligations

The Proposed Rule would require that a fund's board of directors, including a majority of directors who are not interested persons of the fund, approve the designation of a derivatives risk manager, taking into account the derivatives risk manager's relevant experience regarding the management of derivatives risk.[56] The derivatives risk manager would be required to be an officer or officers of the fund's investment adviser and would be responsible for the administration of the fund's Program and related policies and procedures.[57] The Proposed Rule further provides that the derivatives risk manager may not be the fund's portfolio manager, if a single officer serves in the position, and that the derivatives risk manager may not have a majority composed of portfolio managers, if multiple officers serve as derivatives risk manager.[58]

The Proposing Release compares the Proposed Rule's derivatives risk manager position and the corresponding function under Rule 22e-4 under the 1940 Act.[59] Rule 22e-4 provides that the "person(s) designated to administer the [liquidity risk management] program" (the "liquidity risk manager") would mean the fund's "investment adviser, officer, or officers (which may not be solely portfolio managers of the [fund]) responsible for administering the program and its policies and procedures. . . ."[60] Request for comment 17 in the Proposing Release requests comment on whether the Commission should align the final rule with Rule 22e-4,[61] which would allow a fund's investment adviser, as opposed to a specific individual or individuals, to serve as a fund's derivatives risk manager.

We believe that the Commission should permit a fund's investment adviser (as an entity) to serve as derivatives risk manager and, further, the Commission should permit the investment adviser to

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56 *See* Proposed Rule 18f-4(c)(5)(i).

57 *See* Proposed Rule 18f-4(a) (defining "derivatives risk manager"). As with the Proposing Release, the term "investment adviser" generally refers to any person, including a sub-adviser, that is an ''investment adviser'' of an investment company as that term is defined in Section 2(a)(20) of the 1940 Act. *See* Proposing Release at 4458.

58 *See* Proposed Rule 18f-4(a)(1) (defining "derivatives risk manager").

59 *See* Proposing Release at 4459.

60 *See* Rule 22e-4(a)(14).

61 *See* Proposing Release at 4459.

staff the investment adviser's Program administration function with non-officer employees. We also believe that the Commission should permit a fund's board to designate non-officer staff of the investment adviser to serve as a fund's derivatives risk manager.

There is no discussion in the Proposing Release of why a fund's investment adviser and/or non-officers of the investment adviser could not serve as a fund's derivatives risk manager. We note that, in our experience, it has become common practice for a fund's investment adviser to be designated as the fund's liquidity risk manager, and many funds have benefited from this flexibility.[62]

Requiring a fund's board to approve a specific person or persons to serve as a fund's derivatives risk manager places a unique burden on the board to determine whether a given person is qualified to serve in that role. This would require a fund's board to take on more management-like responsibilities, which contravenes the recognized role of a fund's board to represent the interest of fund shareholder through independent oversight.[63] It is a longstanding belief a fund's board should not be required to "micro-manage" operational matters that "should be handled primarily or exclusively by the investment adviser."[64]

In addition, we believe that such a Program's policies and procedures could be designed in such a way that the appointment of the investment adviser as derivatives risk manager would not reduce the effectiveness of the Proposed Rule's requirement that there be a reasonable segregation of the

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62 *See* "Investment Company Liquidity Risk Management Programs Frequently Asked Questions" (Modified Apr. 10, 2019), *available at* https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq ("Liquidity Risk Management FAQs"). The Liquidity Risk Management FAQs note that "[n]either [Rule 22e-4] nor the [Rule 22e-4 Adopting Release (defined below)] prescribes whether or how a program administrator could delegate responsibilities—either for administering the entire [liquidity risk management] program or for handling discrete responsibilities under the fund's [liquidity risk management] program. Therefore, the staff believes that, subject to appropriate oversight, a program administrator has flexibility regarding delegation, provided that each responsibility is delegated to, and assumed and handled by, an appropriate entity." Liquidity Risk Management FAQs at Answer 1.

63 Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. IA-2107, 68 Fed. Reg. 7038 (Feb. 11, 2003) at 7042; *cf.* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. IA-2204, 68 Fed. Reg. 74714 (Dec. 24, 2003) at 74721 (discussing the adoption of a definition for the term "material compliance matter," relating to "those compliance matters about which the fund's board *reasonably needs to know in order to oversee* fund compliance") (emphasis added).

64 SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) at 266.

Program and portfolio management functions. In our experience, funds have achieved a reasonable segregation of these roles in their liquidity risk management programs where the board has designated the adviser as the liquidity risk management program administrator.

We further believe that requiring the derivatives risk manager to be an officer of the investment adviser (as opposed to a non-officer member of the investment adviser's staff) could result in persons who would otherwise qualified to serve in this role being unable to be selected and similarly could result in less qualified officers serving in the role merely because they are the closest among an investment adviser's officers to having the requisite knowledge. This concern could be of particular impact for investment advisers that are large and multi-faceted organizations.

We also suggest that the Commission remove the requirement that a fund's board take into account the derivatives risk manager's "relevant experience" when approving the derivatives risk manager. There is no obligation that a fund's board take into consideration a fund's liquidity risk manager's experience under Rule 22e-4, and there is no discussion in the Proposing Release of a rationale for requiring it to do so under the Proposed Rule.

Moreover, the Commission does not explain what "relevant experience" means or the qualifications a derivatives risk manager must have. For example, it is not clear whether the Commission require a derivatives risk manager to have "relevant experience" with respect to derivatives, risk management, or both, or whether experience a derivatives risk manager could satisfy this requirement by having "relevant experience" in related fields (*e.g.*, finance, compliance, trading). Requiring a board to take into account a derivatives risk manager's relevant experience, therefore, places additional burdens on a fund's board and could expose the board to potential liability and second-guessing by Commission examination staff.

In addition, the Commission should acknowledge that a fund's board will be granted deference in the exercise of its reasonable business judgment when approving a derivatives risk manager.[65]

IV. ROLE OF THE BOARD

The Proposing Release notes that the requirements of Rule 38a-1 under the 1940 Act regarding board approval of fund policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund and its service providers "would encompass [a board's responsibilities for overseeing] a fund's compliance obligations" with respect to the Proposed

[65] *See* Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82142 (Nov. 18, 2016) at 82212 ("Rule 22e-4 Adopting Release").

Rule.[66] The Proposing Release further states that the Commission believes that a fund's board should: (1) "understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program;"[67] (2) "ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation;"[68] and (3) view oversight as an iterative process and therefore should "inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including risks that may change over time."[69]

The Proposed Rule would require a fund's board to approve the derivatives risk manager, and the derivatives risk manager would be required to have a direct reporting line to the fund's board and to directly inform the fund's board, as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified through exceedances of guidelines or by stress testing.[70] In addition, the derivatives risk manager would be required to provide a written report to the board on or before implementation of the Program and thereafter at least annually providing a representation that the Program is "reasonably designed to manage the fund's derivatives risks" and to incorporate the required Program elements.[71] The report would have to include the derivatives risk manager's basis for the representation and information reasonably necessary for the board to evaluate the adequacy of the fund's Program and (after implementation) the effectiveness of Program implementation.[72] The report also would have to include the basis for the selection of the designated reference index or explain why the derivatives risk manager was unable to identify an appropriate index.[73] The derivatives risk manager would be required to provide to the board, at a frequency determined by the board, a written report regarding the derivatives risk manager's analysis of any exceedances of the fund's Guidelines, and the results of certain stress testing and backtesting, required under the Program, that occurred since the last report to the board.[74] The report would have to include information reasonably necessary for the board to evaluate the fund's response to any exceedances and the results of the stress testing and would have

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66 *See* Proposing Release at 4459.

67 *See* Proposing Release at 4466.

68 *See* Proposing Release at 4466.

69 *See* Proposing Release at 4466.

70 *See* Proposed Rule 18f-4(c)(1)(v)(B).

71 *See* Proposed Rule 18f-4(c)(5)(ii).

72 *See* Proposed Rule 18f-4(c)(5)(iii).

73 *See* Proposed Rule 18f-4(c)(5)(ii).

74 *See* Proposed Rule 18f-4(c)(5)(iii).

to explain how and when the derivatives risk manager reasonably expects that the fund will come back into compliance.[75]

We support the Commission's proposal to formalize the board oversight role under the Proposed Rule. However, we believe that the Commission should clarify the board's obligations with respect to approval of the Program (and policies and procedures thereunder), and, more generally, the expected level of involvement that a fund's board must have in the day-to-day operations of a fund's Program. Rather than giving a fund's derivatives risk manager the sole discretion to communicate to a fund's board material risks of a fund's derivatives investments, we recommend that the Commission permit funds' boards to work with derivatives risk managers to establish policies and procedures outlining under what circumstances such risks should be communicated. For the reasons discussed below, we further recommend that the Commission permit derivatives risk managers to provide summaries to a fund's board of directors regarding the following items: risk guideline exceedances, the derivatives risk manager's basis for choosing the fund's designated reference index, and stress testing and backtesting results.

We are concerned that, taken together, the statements in the Proposing Release (noted above) regarding a board's obligations suggest that board members may need to take on a more active and time-consuming role with respect to a fund's Program than is required under state law and standard practice and norms, under the board oversight role described in Release 10666, and under the corresponding board oversight role under Rule 22e-4.[76] We also believe that even the incremental imposition of new requirements can lead to a gradual shift in perception as to the appropriate balance of oversight and management which boards should be expected to engage.[77] We believe that the board obligations contemplated under the Proposed Rule would go far beyond a board's obligations under Rule 38a-1, which requires only that a fund board's approval of a fund's or service provider's policies and procedures be based on a finding that such policies and procedures are reasonably designed to prevent the violations of the specified laws and rules. For example,

75 *See* Proposed Rule 18f-4(c)(5)(iii).

76 *See* Rule 22e-4 Adopting Release at 82212. The Rule 22e-4 Adopting Release further notes that Rule 22e-4 "retains a role for the board in overseeing the fund's liquidity risk management program, but in response to commenters, eliminates certain of the more specific and detailed approval requirements. 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." *Id.*

77 *See* Dalia Blass, Director, Division of Investment Management, SEC, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017) (noting that boards' "responsibilities have accumulated with the decades" and that such accumulation "did not happen all at once but rather incrementally over the years").

calling the process an "iterative" one suggests a level of board involvement that exceeds its standard role of providing oversight.

The Commission's statements in the Proposing Release, together with the detailed level of information required to be provided to a fund's board under the reporting requirements, could be viewed as assigning fund boards with responsibility to be actively engaged in the derivatives risk management function—a role that is more appropriately handled by the investment adviser or derivatives risk manager. The Commission's statements also suggest that board members would need to have a level of substantive knowledge with respect to the derivatives used by the funds they oversee beyond what would be required in their traditional oversight role. In addition, while there is no explicit requirement in the Proposed Rule for a board to approve a fund's Program, it is not clear what the board's obligations would be with respect to approval of the Program and policies and procedures thereunder. Moreover, the Proposing Release provides no rationale as to why the board's oversight role should be similar, but be substantively different and more involved, than the board's oversight role under Rule 22e-4.

Thus, in adopting a final rule, the Commission should replace these statements with guidance affirming that the role of a fund's board is one of general oversight and that the Commission expects that board members will exercise their reasonable business judgment in overseeing a fund's Program, similar to the statements of guidance provided in the Rule 22e-4 Adopting Release.[78] Board members should be able to rely on the derivatives risk manager, and any third parties the derivatives risk manager engages, to assist it in carrying out its function, and should not necessarily have an iterative role with respect to the Program.

We also urge the Commission to eliminate certain of the more detailed and specific obligations imposed on fund boards under the Proposed Rule's reporting framework. For example, rather than requiring detailed reports on exceedances of Guidelines, the derivatives risk manager's basis for choosing the fund's designated reference index and the results of certain stress testing and backtesting requirements, we request that the Commission permit a fund's derivatives risk manager to provide executive summaries of relevant findings, similar to the framework set forth under Rule 22e-4.[79] Funds' boards are being increasingly inundated with information, and requiring boards to

[78] *See* Rule 22e-4 Adopting Release at 82212.

[79] *See* Rule 22e-4 Adopting Release at 82212-13 noting "directors may satisfy their obligations with respect to this initial approval by reviewing summaries of the liquidity risk management program prepared by the fund's investment adviser, officer, or officers administering the program, legal counsel, or other persons familiar with the liquidity risk management program. The summaries should familiarize directors with the salient features of the program and provide them with an

evaluate extensive reports on a fund's Program will lead to the unnecessary involvement of a fund's board in detailed and technical determinations of the type that have historically been left to the discretion of a fund's portfolio management. Funds' boards already provide oversight of funds' use of derivatives as part of their general oversight duties, and boards recognize that any number of factors related to a fund's use of derivatives may, in some circumstances, merit additional board consideration. We believe that executive summaries would allow a fund's board to receive only relevant information and would allow them to better evaluate actual concerns raised by a fund's use of derivatives. A fund's board would remain empowered to ask questions about any report (or portion thereof) that it believes warrants additional consideration.

V. LIMITED DERIVATIVES USER EXCEPTION

A. Overview of Proposed Changes to the Limited Derivatives User Exception

Under the Proposed Rule, a fund would not be required to adopt a Program, comply with the limit on fund leverage risk, appoint a derivatives risk manager, comply with the board reporting requirements, or consider such derivatives transactions for purposes of computing asset coverage, if the fund: (1) adopts and implements policies and procedures "reasonably designed to manage the fund's derivatives risks;" and (2) either (i) limits its derivatives exposure to 10 percent of its net assets (the "exposure-based exception"), *or* (ii) uses derivatives transactions solely to hedge certain currency risks and the notional amounts of such derivatives do not exceed the value of the hedged instruments by more than a negligible amount (the "hedging exception").[80]

We commend the Commission for including the limited derivatives user exception in the Proposed Rule and strongly support the exception. We propose certain suggested changes for the Commission's consideration, including (1) extending the hedging exception to apply to derivatives transactions that reduce the risk exposure of a portfolio security or group of securities, when the derivatives transaction is directly related to such security or securities; (2) excluding currency hedges (and other hedges as we proposed in (1) above) for purposes of the exposure-based exception and allowing concurrent reliance on both the hedging and exposure-based exceptions; (3) permitting funds an option not to treat firm and standby commitment agreements and similar instruments as derivatives transactions subject to compliance with an modified asset segregation regime; (4) providing a definition of "negligible amount" for purposes of the hedging exception;

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understanding of how the liquidity risk management program addresses the required assessment of the fund's liquidity risk.").

80 *See* Proposed Rule 18f-4(c)(3)(i)-(ii).

and (5) providing specific timing requirements with respect to remediation of breaches of the limited derivatives user exception.

B. Extend the Hedging Exception to Apply to other Derivatives Transactions that Reduce Risk and are Directly Related to a Fund's Assets

Under the Proposed Rule, a fund may be eligible to rely on the limited derivatives user exception if the fund limits its use of derivatives to currency derivatives for hedging purposes. More specifically, a fund would only be eligible to rely on this exception if its derivatives exposure is limited solely to currency derivatives used to hedge the currency risks of "specific foreign-currency-denominated equity or fixed-income investments held by the fund" and provided that the notional amount of the currency derivatives does not exceed the value of the fund's foreign-currency-denominated investments "by more than a negligible amount."[81] The Proposing Release explains that a fund's use of currency derivatives for hedging the fund's foreign currency risk does not raise the concerns underlying Section 18 of the 1940 Act.[82] Further, the Commission notes that while it is generally difficult to distinguish "most hedging transactions from leveraged or speculative transactions," it believes currency hedging is more easily definable as it only involves one risk factor (*i.e.*, currency risk) and the currency derivatives "must be tied to specific hedged investments" (*i.e.*, foreign-currency-denominated investments).[83]

We recommend that the Commission broaden the scope of the hedging exception to include additional derivatives transactions that funds use for hedging or offsetting purposes, including derivatives transactions that reduce the risk exposure of an asset or assets held in the fund's portfolio, when the derivatives transaction is directly related to such asset or assets.

These transactions should include, for example: (1) written call options on securities in a fund's portfolio; (2) written options for which the fund's obligation is fully covered by offsetting purchased options; (3) interest rate swaps or similar derivatives entered into for the purpose of hedging risks associated with future leverage-related interest payment obligations of a fund, including in connection with the expected expiration of a credit line or maturity or other replacement of current debt or preferred stock issuances; (4) purchased single-name credit default swaps ("CDS") that provide credit protection on the issuer of a security held by the fund with a notional exposure that does not exceed the principal amount of the security; and (5) transactions

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81 *See* Proposed Rule 18f-4(c)(3)(ii).

82 *See* Proposing Release at 4488.

83 *See* Proposing Release at 4488.

under which a fund "rolls" derivatives positions from one expiring contract to another that involve the same security and amount with a similar maturity date.

In addition, we also recommend that the hedging exception allow for the netting of derivatives holdings with identical underlying assets with different counterparties in order to allow funds to reduce hedging exposure created by derivatives transactions that are no longer needed but cannot be terminated.

We believe that expanding the hedging exception for these additional derivatives transactions entered into for direct hedging or offsetting purposes can be distinguished from a transaction that increases leverage from an objective perspective. Just as currency hedging is easily definable because it only involves one risk and requires that the currency derivative is tied to a specific hedged investment, the additional derivatives transactions we set forth above each involve specific risks it is intended to reduce and is used in a way that is tied to a specific asset or assets in the fund's portfolio. Further, as with currency derivatives, funds do not use such transactions to increase leverage and these transactions do not raise the concerns underlying Section 18 of the 1940 Act. We also note that a fund's practices with respect to each of these transactions could be formalized under the fund's policies and procedures required for funds that are limited derivatives users to ensure that the fund does not enter into such transactions for purposes other than hedging or offsetting. Moreover, funds that limit their derivatives use to such transactions would still be required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks, thus providing investors with additional protection without imposing unnecessary burdens on funds that limit their use of derivatives to certain hedging and offsetting transactions.

C. Allow Concurrent Reliance on Both the Hedging and Exposure-Based Exceptions

Under the Proposed Rule, the limited derivatives user exception would only be available to a fund that either limits its derivatives exposure to 10% of its net assets *or* uses derivatives transactions solely to hedge certain currency risks. The Proposing Release explains that the Commission considered allowing a fund to rely on the exposure-based exception if the notional amount of the fund's derivatives transactions, excluding currency hedges, was below 10% of its net assets.[84] The Proposing Release states that the Commission determined instead to adopt two separate bases for qualifying for the limited derivatives user exception "to preclude a fund that is operating as a limited derivatives user from engaging in a broad range of derivatives transactions" that the Commission believes should be addressed through the Program and limit on fund leverage risk requirements.[85]

84 *See* Proposing Release at 4488.

85 *See* Proposing Release at 4488.

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Accordingly, a fund that invests in both currency derivatives and other types of derivatives would only be eligible to rely on the exposure-based exception, and only for so as long as the total notional amount of its derivatives exposure is below 10% of its net assets.

Under the Proposed Rule, a fund that aims to reduce risk through hedging 10% or more of its foreign currency exposure would be barred from engaging in other derivative transactions, regardless of whether those transactions are limited or do not materially change the risk profile of the fund, without complying with the Program and the requirements regarding limits on fund leverage risk. In addition, a fund that generally uses derivatives (other than currency derivatives for hedging purposes) in a limited manner and also seeks to engage in risk-reducing hedging or offsetting derivatives transactions would be forced to alter its investment and strategies to avoid the requirement to implement a full Program and comply with the limit on fund leverage risk. Otherwise, these funds and their shareholders would incur the costs and bear the compliance burdens of implementing a Program and complying with the other conditions of the Proposed Rule. We believe that this would lead to inefficiencies and would likely be detrimental to a fund's returns, while potentially creating additional risks for the fund if the fund were to determine not to engage in such risk reducing transactions in order to avoid application of these requirements. Moreover, as proposed, these limitations may disadvantage funds that engage in currency hedging (and other hedging and offsetting transactions) compared to funds that do not engage in such activities.

We believe that the currency and other hedging and offsetting transactions outlined above should be excluded from the relevant calculation under the exposure-based exception. This would allow a fund to concurrently rely on both the hedging exception and the exposure-based exception.

This exclusion would align with, and be supported by, the statement in the Proposing Release that "currency hedges are not intended to leverage [a] fund's portfolio"[86] and thus "do not raise the policy concerns underlying Section 18" of the 1940 Act that the Proposed Rule is intended to address.[87] We believe that a fund engaging in both hedging and offsetting positions, consistent with the hedging exception, and a limited amount of derivatives transactions, consistent with the exposure-based exception, would not raise additional risks that could not be managed under the principles-based policies and procedures required to be adopted for funds relying on the limited derivatives users exception. As discussed above, each of the currency and other hedging transactions we propose to include in the hedging exception involves specific risks it is intended to reduce, is used in a way that is tied to a specific asset or assets in the fund's portfolio, and is not used to increase leverage.

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86 *See* Proposing Release at 4488.

87 *See* Proposing Release at 4488.

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Thus, we believe that these transactions should not be considered when determining whether a fund should be required to have a Program or adhere to leverage limits. Accordingly, we request that the Commission combine the exposure-based exception and the broadened version of the hedging exception as we request above.

If the Commission determines not to exclude derivatives transactions used for hedging or offsetting purposes as we suggest, we recommend that the Commission exclude currency hedging derivatives from the exposure-based exception.

D. Allow Funds an Option to Exclude Firm and Standby Commitment Agreements for Purposes of the Limited Derivatives User Exception

Under the Proposed Rule, a fund would generally have to treat firm and standby commitment agreements, and any transactions that are similar to these agreements, as derivatives transactions. As such, those funds seeking to qualify for the limited derivatives user exception would need either: (1) to stop trading firm and standby commitment transactions and similar agreements if qualifying for the exception as a fund that uses derivatives transactions to hedge certain currency risks or (2) to aggregate the notional value of the firm and standby commitment transactions and similar agreements with the rest of the fund's derivatives exposure such that the fund remains under the 10% net assets test.

We do not think that there is sufficient justification for this treatment of firm and standby commitment transactions comparable transactions and, given that under the current regulatory framework, firm and standby commitment transactions are subject to the asset segregation conditions of Release 10666. The Commission has not identified any reason that the current asset segregation framework does not adequately address the undue speculation and asset sufficiency concerns underlying Section 18 with respect to these transactions. We believe that the issues addressed by Section 18 are not raised if a fund is complying with the asset segregation conditions of Release 10666, and therefore firm and standby commitment transactions should not count as derivatives in these circumstances.

The Proposed Rule's treatment of firm and standby commitment agreements and similar transactions would represent a significant change from the current asset segregation framework for these transactions under Release 10666. In addition, we are not aware of any issue in which funds encountered issues in their use of these transactions that would suggest that the current asset segregation framework does not adequately protect funds and their investors.

We believe that the current asset segregation framework under Release 10666 is sufficient with respect to firm and standby commitment agreements and similar transactions because these transactions are covered with liquid assets equivalent to the full amount of the fund's exposure under the transaction. We note that the Commission itself recently has acknowledged that these types of transactions do not raise concerns related to compliance with Section 18 if fully covered, in introducing the predecessor rule proposal to the Proposed Rule. In the 2015 Rule Proposal, the Commission stated that a "fund's payment obligation may be largely known and fixed at the time the fund enters into many financial commitment transactions, such as reverse repurchase agreements or firm commitment agreements." The Commission also posited that "requiring a fund to maintain qualifying coverage assets sufficient to cover its full obligations under a financial commitment transaction may effectively address many of the risks that otherwise would be managed through a risk management program." These statements are still valid and justify the continued application of the Release 10666 asset segregation framework as applied to firm and standby commitment agreements and similar transactions.

Funds use these transactions—which as noted above, create fixed and known payment obligations at the time a fund enters into these transactions—for a variety of different reasons beneficial to funds aside from providing leverage. However, we understand that funds that invest in a limited amount of derivatives transactions in addition to certain firm and standby commitment agreements may find the cost of implementing a Program and complying with the limits on fund leverage risk to be prohibitive. Accordingly, such a fund may determine that it is necessary to limit its use of such transactions in order to comply with the limited derivatives user exception. Such a fund may prefer to rely on the Release 10666 asset segregation framework and continue to utilize these transactions.

Therefore, we believe that there is no policy reason that the Commission should create a disincentive for funds to utilize these transactions by requiring funds to comply with new and different requirements with respect to these transactions. Accordingly, as an alternative approach to that included in the Proposed Rule, we recommend that the Commission provide an option for funds to segregate assets to cover these types of transactions, as is allowed under the current framework under Release 10666, rather than treating them as derivatives transactions.

To address the Commission's perceived asset sufficiency concerns, we recommend that the Commission modify the current framework to allow only for the limited use of the asset segregation regime for firm and standby commitment agreements, and any transactions that are similar to these agreements, which would allow a fund to cover its obligations under these transactions with an amount of assets classified as "highly liquid investments" or "moderately liquid investments," as defined under Rule 22e-4 under the 1940 Act, equal to the fund's obligations to make a payment or delivery under the transactions. These categories of investments are inherently the types of investments that a fund could liquidate quickly to meet its payment obligations under the relevant transactions, and thus should be sufficient to address any Commission concerns regarding asset segregation.

E. Clarify what Amount of Derivatives Exposure Is a "Negligible Amount"

Under the Proposed Rule, the notional amounts of derivatives entered into in reliance on the hedging exception may not exceed the value of the hedged instruments (or the par value thereof, in the case of fixed-income investments) by more than a "negligible amount."[88] The Proposing Release does not explain what is considered a "negligible amount" for purposes of the hedging exception. We expect that this lack of clarity could result in confusion and disparate practices by various funds relying on the exception. Accordingly, we request that the Commission provide a clear definition and/or guidance of "negligible amount" for purposes of the hedging exception. In the alternative, we request that the Commission provide reasonable assurances that it will not second-guess a fund's reasonable interpretation and application of what it believes to be a "negligible amount."

F. Provide Guidance on Funds' Obligations for Remediation of Non-Compliance with the Limited Derivatives User Exception

The Proposed Rule and the Proposing Release do not provide specific guidance as to when a fund relying on the limited derivatives user exception must remediate non-compliance with the exposure-based exception. The Proposing Release simply states that a fund must "promptly" reduce its derivatives exposure to the 10% or comply with the Program and limit on fund leverage risk requirements.[89] Similarly, the Commission did not address breaches of the hedging exception at all.

We believe that this lack of clear guidance as to when a fund's obligation to remediate such breaches will arise may cause confusion within the industry as to whether and when a fund would be deemed by the Commission to be non-compliant with the limited derivatives user exception. Further, we note that the lack of clarity may lead to funds having divergent policies and procedures to address exceedances of the exposure-based exception. In addition, we are concerned that the Commission examination staff may raise questions during the exam process as to whether a fund's remediation activities were timely without the fund having adequate notice of the staff's views.

In light of this potential uncertainty, we recommend that the Commission include a specific cure period for breaches of the limited derivatives user exception or guidance thereon.

Separately, the Proposed Rule and Proposing Release do not address how soon a fund would need to come into compliance with the other elements of the Proposed Rule if it were to determine that it were no longer able to comply with the limited derivatives user exception. We recommend that

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88 *See* Proposed Rule 18f-4(c)(3)(ii).

89 *See* Proposing Release at 4486.

the Commission provide a specific cure period in which a fund that has failed to remain in compliance with the limited derivatives user exception would have to adopt and implement a Program, comply with the limit on fund leverage risk, and comply with the board oversight and reporting requirements that would apply to funds that do not qualify as limited derivatives users under the Proposed Rule or guidance thereon. This compliance period should take into account and provide sufficient time for the process that would be necessary for a fund to adopt a Program and come into compliance with the other elements of the Proposed Rule.

Alternatively, we recommend that the Commission provide reasonable assurances that it will not second-guess reasonable actions and interpretations taken by funds in the absence of more definitive regulatory guidance.

VI. REVERSE REPURCHASE AGREEMENTS AND SIMILAR FINANCING TRANSACTIONS

A. Allow Funds an Option to Determine how to Treat Reverse Repurchase Agreements and Similar Financing Transactions

Under the Proposed Rule, a fund would have to treat reverse repurchase agreements and similar financing transactions as bank borrowings or other indebtedness, subject to the full asset coverage requirements of Section 18.[90] As proposed, funds would be required to combine the aggregate amount of indebtedness associated with reverse repurchase agreements and other similar financing transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.[91] Under the current regulatory framework, a fund complying with the asset segregation conditions of Release 10666 is not required to count the obligation created under a reverse repurchase agreement toward its Section 18 asset coverage ratio for indebtedness. Thus, the Proposed Rule represents a dramatic shift away from this well-established and longstanding framework.

The Proposing Release states that "reverse repurchase agreements and other similar financing transactions that have the effect of allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets should be treated for [S]ection 18 purposes like a bank borrowing or other borrowing, as they achieve effectively identical results."[92] We note that while some funds use reverse repurchase agreements to finance other investments and obtain leverage, other funds generally use reverse repurchase agreements transactions on a short-term

[90] *See* Proposed Rule 18f-4(d).

[91] *See* Proposed Rule 18f-4(d).

[92] *See* Proposing Release at 4504.

basis to enhance their liquidity. Further, reverse repurchase agreement transactions often can be a more efficient and less costly means to obtain short-term liquidity than using a traditional secured borrowing under a credit facility. Moreover, if these changes are adopted in the final rulemaking, it is our understanding that a number of funds will need to adjust their operations, which could decrease fund use of reverse repurchase agreements and which in turn could reduce capital formation, as the Commission noted in the Proposing Release.

We believe that the current asset segregation model under Release 10666 is sufficient, since reverse repurchase agreements and similar financing transactions are covered with liquid assets equivalent to the full amount of the fund's exposure under the transaction. The Commission has not identified any reason that the current asset segregation framework does not adequately address the undue speculation and asset sufficiency concerns underlying Section 18. In addition, we are not aware of any issue in which funds have encountered issues in their use of reverse repurchase agreements and similar financing transactions that would suggest that the current asset segregation framework does not adequately protect funds and their investors.

The Commission's policy judgment to change the treatment of reverse repurchase agreement transactions and similar financing transactions is not founded on a clear cost-benefit analysis that demonstrates the benefits outweigh the costs created by this change. In its cost-benefit analysis, the Commission noted the number of funds it anticipates will need to adjust their operations in response to this change and concluded that the change could decrease fund use of reverse repurchase agreements which in turn could reduce capital formation.[93] However, the Commission did not provide any data or analysis addressing the degree to which funds use reverse repurchase agreements and similar financing transactions to obtain leverage. The Commission also did not address the lost efficiency from limiting funds' ability to obtain short-term liquidity or leverage through using these transactions. Therefore, in light of the benefits of the use of these transactions and the potential costs to changing the approach under Section 18 with respect to these transactions, we believe that there is no policy reason that the Commission should create a disincentive for funds to utilize reverse repurchase agreement transactions and similar financing transactions by adopting new and different requirements with respect to these transactions. Accordingly, as an alternative approach to that included in the Proposed Rule, we believe that Commission should retain the provide funds the option to segregate assets to cover these types of transactions as is allowed under the current framework under Release 10666 rather than treating such transactions as subject to the asset coverage requirements of Section 18.

To address the Commission's perceived asset sufficiency concerns, similar to our proposal with respect to standby and firm commitment agreements and other similar transactions, we recommend

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93 *See* Proposing Release at 4522.

that the Commission modify the current framework to allow only for a limited asset segregation regime for reverse repurchase agreements and similar financing transactions, which would allow a fund to cover its obligations under these transactions with an amount of assets classified as "highly liquid investments" or "moderately liquid investments," as defined under Rule 22e-4 under the 1940 Act, equal to the fund's obligations to return assets under the transactions. As noted above, these categories of investments are inherently the types of investments that a fund could liquidate quickly to meet its payment obligations under the relevant transactions, and thus should be sufficient to address any Commission concerns regarding asset segregation.

B. Permit Funds to Engage in Securities Lending Activities Consistent with Current Guidance

Under the Proposal, a fund would be allowed to engage in securities lending arrangements without subjecting those transactions to Section 18's asset coverage regime, so long as it does not "sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio," and the fund invests "cash collateral solely in cash or cash equivalents."[94] The Proposing Release notes that "currently, funds that engage in securities lending typically reinvest cash collateral in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, and funds generally do not sell or otherwise use non-cash collateral to leverage the fund's portfolio."[95] The Proposing Release further notes that "a fund that engages in securities lending under these circumstances is limited in its ability to use securities lending transactions to increase leverage in its portfolio."[96]

We recommend that the Commission continue to treat securities lending arrangements and the collateral thereunder consistent with current Commission and staff positions, including exemptive orders and no-action relief. Funds currently reinvest cash collateral received for loaned securities in certain highly liquid, short-term instruments that may not qualify as cash or cash equivalents. The Proposing Release contemplates treating funds that reinvest cash collateral in these other highly liquid, short-term instruments, as similar to reverse repurchase agreements or similar financing transactions.[97]

As with cash and cash equivalents, we believe that highly liquid, short-term investments similarly should serve, and have been serving, to address concerns associated with securities lending

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94 *See* Proposing Release at 4504.

95 *See* Proposing Release at 4504.

96 *See* Proposing Release at 4504.

97 *See* Proposing Release at 4504.

collateral, and effectively limit funds' ability to use securities lending arrangements as a source of leverage. Further, we believe that it is not necessary for a fund to eliminate all potential investment risk to avoid its collateral investment activity being viewed as having a leveraging effect. We note that funds have invested in these instruments for decades with no issue. Therefore, we believe that no change is warranted or needed in this area, and that the manner in which a fund engages in short-term cash management-type investing is an investment decision subject to the business judgment of the fund's investment adviser and board (along with proper disclosure to investors).

VII. MONEY MARKET FUNDS SHOULD BE PERMITTED TO INVEST IN FIRM AND STANDBY COMMITMENT AGREEMENTS AND SIMILAR INSTRUMENTS THAT ARE PERMITTED BY RULE 2a-7

We support the Commission's proposal to exclude money market funds from the scope of the Proposed Rule. However, if money market funds are no longer permitted to rely on Release 10666, which the Commission is proposing to rescind, money market funds would not be permitted to invest in securities and other instruments that could be characterized as "senior securities" under Section 18. The Commission acknowledges this outcome,[98] stating that "money market funds currently do not typically engage in derivatives transactions or the other transactions permitted by [the Proposed Rule]," and that "these transactions would generally be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, and especially if used to leverage the fund's portfolio."[99]

Although money market funds generally do not invest in securities and other instruments characterized as derivatives instruments (*e.g.,* swaps), money market funds routinely invest in securities and other instruments that are within the scope of Release 10666, including "firm commitment agreements." These securities and other instruments are included within the definition of "derivatives transaction" under the Proposed Rule.[100] These securities and other instruments could include, for example, delayed-delivery and when-issued securities (and other similar instruments that have a forward settlement feature beyond regular-way settlement). Money market funds do not invest in these securities and other instruments for speculative purposes. Indeed, because the value of these investments fluctuate minimally, they do not represent the type of

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98 *See* Proposing Release at 4527 ("Money market funds are excluded from the scope of [the Proposed Rule]. As we are proposing to rescind Release 10666, however, money market funds would not be able to enter into transactions covered by [the Proposed Rule], including derivatives transactions and reverse repurchase agreements.").

99 *See* Proposing Release at 4455.

100 *See* Proposing Release at 4456 (explaining that a "firm commitment agreement has the same economic characteristics as a forward contract.").

investment typically associated with speculative investing. Money market funds typically invest in these securities and other instruments in order to secure better pricing and supply. We therefore believe these investments do not materially implicate the undue speculation concerns underlying Section 18, and any asset sufficiency concerns that may be associated with these investments are addressed through compliance with the risk-limiting conditions under Rule 2a-7. Moreover, we believe these investments are not inconsistent with a money market fund's objective of maintaining a stable net asset value per share or minimizing principal volatility.

If money market funds are not permitted to invest in securities and other instruments that could be characterized as "senior securities" under Section 18, money market funds could potentially be prohibited from investing in, for example, when-issued U.S. Treasury securities. The Proposing Release suggests that "when-issued" securities are "derivatives transactions," without distinguishing between when-issued U.S. Treasury securities and other when-issued securities (and without regard to their actual trading characteristics).[101] These securities, the terms of which are known on the trade date (*e.g.,* price, yield, maturity), are important sources of investment for government money market funds. These securities have relatively short settlement periods (even when purchased on a when-issued basis) and create a fixed and known obligation for money market funds on the trade date. There are significant benefits to purchasing U.S. Treasury securities on a when-issued basis, including the potential to secure better pricing and supply, and there is no justification for prohibiting money market funds from investing in these securities.

We also believe that delayed-delivery and when-issued securities (and other similar instruments that have a forward settlement feature beyond regular-way settlement) are permitted by Rule 2a-7 (subject to the rule's risk-limiting conditions). In fact, the Commission has explicitly amended Rule 2a-7 to accommodate delayed-delivery and when-issued securities,[102] demonstrating the

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101 *See* Proposing Release at 4455 ("Do money market funds currently engage in any transactions that might qualify as derivatives transactions under the rule or any of the other transactions permitted by the rule? For example, do money market funds engage in reverse repurchase agreements, "to be announced" dollar rolls, or "when issued" transactions?").

102 *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005, 56 Fed. Reg. 8113 (Feb. 27, 1991) at 8120. The Commission stated that:

> With respect to securities other than Government securities, as suggested by several commenters, the rule extends the maximum permitted maturity of individual securities to thirteen months. *This change has been made in order to accommodate funds purchasing annual tender bonds, and securities on a when-issued or delayed delivery basis. These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them.* Since the purchaser must "book" the security on the day it agrees to purchase it, the maturity period begins on that day. The revised rule allows funds

Commission's historical view that these investments are not inappropriate for money market funds, notwithstanding their objective of maintaining a stable net asset value per share or minimizing principal volatility.

Rule 2a-7 provides a strong regulatory framework to address any asset sufficiency concerns that may be associated with these investments, and requires money market funds to comply with stringent risk-limiting conditions. These risk-limiting conditions, which include liquidity, stress testing and maturity requirements, [103] have been revised and refined several times over decades and provide sufficient protections for money market fund shareholders, in light of the types of securities in which money market funds invest. Accordingly, we recommend that money market funds be permitted to continue to invest in firm and standby commitment agreements and similar instruments that are permitted by Rule 2a-7.

VIII. OTHER REGULATORY ISSUES

The Commission and its staff have, over time, considered the application of the broader 1940 Act regulatory framework (beyond Section 18) to funds that use derivatives. These include 1940 Act requirements regarding diversification, investments in securities issued by securities-related issuers, concentration, and fund names, among other requirements, and whether the regulatory framework "continues to fulfill the purposes and policies underlying the [1940] Act and is consistent with investor protection."[104]

Funds commonly consider a range of issues and face interpretive challenges in determining how to assess compliance with these requirements with respect to derivatives transactions and other transactions that are the subject of the Proposed Rule. These issues include identifying the appropriate value to assign to a derivatives transaction (that is, the current market or fair value, the notional value, or some other value) and the appropriate issuer or investment exposure to consider

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> to invest in securities with a remaining maturity of no more than thirteen months (397 days). (emphasis added) (internal citations omitted)

103 *See, e.g.,* Rule 2a-7(d)(i)-(iii) (limiting illiquid securities to 5% of total assets, limiting "daily liquid assets" to 10% of total assets and limiting "weekly liquid assets" to 30% of total assets); Rule 2a-7(g)(8) (requiring money market funds to stress test the ability to maintain sufficient liquidity (at least 10% of total assets in weekly liquid assets) and minimize principal volatility or maintain a stable price per share, as applicable, based on certain hypothetical events in combination with increasing shareholder redemptions).

104 *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, Investment Company Act Release No. IC-29776, 76 Fed. Reg. 55237 (Sept. 7, 2011) at 55238 ("Derivatives Concept Release").

(that is, the counterparty, the reference asset, or both) for purposes of a specific requirement, among other matters.

The Commission and its staff have never issued public guidance on many of these issues and interpretive challenges. While the 2011 Derivatives Concept Release requested in-depth feedback from the public to help determine whether regulatory initiatives or guidance were necessary under certain of these requirements, neither the 2015 Rule Proposal nor this proposal provides for such a rulemaking or guidance. Nonetheless, in our experience, funds and their advisers have reached a number of good faith interpretations of these provisions intended to adapt these provisions to the risks presented by derivatives. However, without further guidance from the Commission and its staff, issues and interpretive challenges will continue to arise under these requirements, for example, under the prohibition on purchase or acquisition of securities issued by securities-related issuers under Section 12(d)(3) of the 1940 Act and Rule 12d3-1 thereunder, which was, in part, designed to limit a fund's exposure to the entrepreneurial risks of securities-related issuers,[105] and the "names rule" set forth in Rule 35d-1 under the 1940 Act.[106] These provisions are intended to align a fund's risk profile with investor expectations, in most cases as shaped by a fund's disclosures and representations to investors.

We believe that certain issues previously considered relevant to these aspects of the 1940 Act framework may be appropriately addressed by the derivatives risk management framework that the Proposed Rule would require for funds that use derivatives. Under the Proposed Rule, a fund's Program would be required to address market, counterparty and liquidity risks, among others, to align the fund's risk profile with the fund's disclosed investment objectives, policies and

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105 *See* Derivatives Concept Release at 55252; *see also* "The Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities," ABA Section of Business Law (July 6, 2010) ("2010 ABA Derivatives Report") (observing that the need to limit counterparty risk should be limited to the extent that a counterparty's obligations to the fund are secured by collateral provided by the counterparty). The Commission and its staff acknowledged this view in the Derivatives Concept Release but have never explicitly endorsed this view.

106 In our experience, the Commission's staff has in recent years issued comments to many funds that the appropriate method of valuing certain derivatives for purposes of assessing compliance with the names rule is market value. However, many funds continue to believe that the use of the notional value of a derivative transaction can be more appropriate, *e.g.*, if a derivative creates economic exposure equivalent to a cash investment in the underlying issuer equal to the notional value of the derivatives transaction. We applaud the Commission for suggesting that Rule 35d-1 and the framework created under these comments "may not be well-suited to derivatives instruments that provide significant exposure to a 'type of investment' …" *See* Request for Comment on Fund Names, Investment Company Act Release No. IC-33809 (Mar. 2, 2020).

restrictions.[107] The Program would be required to provide for the establishment, maintenance and enforcement of investment, risk management and/or other guidelines that provide for quantifiable or otherwise measurable risk metrics or thresholds. The Proposing Release makes clear that these guidelines are intended to address market, counterparty and liquidity risks, among others. These are the same risks, and the same risk management tools, that are embodied in the 1940 Act's provisions regarding diversification, investments in securities issued by securities-related issuers, concentration, and fund names.

The Program requirements are of course not intended to replace these other provisions of the 1940 Act. Nonetheless, we believe that when the Program requirements are implemented, interpretive differences relating to these other provisions will diminish in significance. Accordingly, the we believe that it would be helpful if the Commission provided guidance in issuing a final rule or other guidance to the effect that funds would satisfy the derivatives-related policy purposes of these sections of the 1940 Act by implementing a derivatives risk management program meeting the requirements of the Proposed Rule, and that such funds could adopt and rely on reasoned views in assessing fund investments in derivatives transactions and compliance with these other provisions of the 1940 Act regulatory framework.

IX. THE PROPOSED NEW SALES RULES FOR LEVERAGED/INVERSE FUNDS

In tandem with proposing Proposed Rule 18f-4, the Commission also proposed new Rule 15l-2 under the Exchange Act and new Rule 211(h)-1 under the Advisers Act (together, the "sales practices rules"). In the Proposing Release, the Commission explained that "most" leveraged/inverse funds would be unable to satisfy Proposed Rule 18f-4, so the Commission is "proposing a set of alternative requirements" to protect investors and to allow sales of interests in such vehicles to continue. Under the proposed sales practices rules, before a broker-dealer or investment adviser (referred to collectively as a "firm")[108] could, respectively, accept an order from or place an order for a retail investor (defined below) involving shares of a leveraged/inverse investment vehicle,[109] the firm would have to "approve the retail investor's account for buying and

107 Proposing Release at 4457.

108 The Proposing Release states that the term "firm" "collectively refers to Commission-registered broker-dealers and investment advisers" as well as "associated persons of such broker-dealers" and "supervised persons of such investment advisers."

109 Under the proposed sales practices rules, a "leveraged/inverse investment vehicle" is defined as "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time." Accordingly, the definition of "leveraged/inverse investment vehicle" for purposes of the

selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement," adopt and implement certain policies and procedures and make and maintain certain records.

The Proposing Release states that these vehicles are "short-term trading tools" with strategies "predicated on leverage" that are rebalanced daily, such that "performance over longer holding periods" can significantly diverge from the underlying reference index. In particular, the proposed sales practices rules are "designed to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating the risks these products present."

The sales practices rules would be separate from and different than the best interest standard adopted by the Commission in Regulation Best Interest ("Regulation BI") and its companion interpretive release, the investment adviser standard of conduct ("Standard of Conduct"), and would be the first such rules to target a particular type of registered investment company.

A. The Proposed Sales Practices Rules Would Be a Move Toward a Merit-Based Regulatory Regime

In the proposing release, the Commission requested comment on whether the leveraged/inverse investment vehicle definition is appropriate or if additional complex financial products similar to those discussed in FINRA Regulatory Notice 12-03 should be subject to the same standards. We believe that no registered investment vehicle should be subject to the sales practices rules or similar rules, since these Rules would move the Commission significantly toward a merit-based regulatory regime that would disrupt competition and investor choice.

At its core, one of the greatest strengths of the federal securities laws is that they do not form a regime of merit regulation: the Commission does not use its immense powers to favor or disfavor certain investments. Rather, the regime imposes certain neutral, rule-based protections, fosters investor education and choice through a full-disclosure system, and then allows investors to make informed investment decisions. Adopting the proposed sales practices rules would be a departure from this regime, has a tinge of paternalism and could be replicated in the future to regulate any product.

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proposed sales practices rules would cover a wider range of investment vehicles than those eligible for the alternative requirements available to "leveraged/inverse funds" under the Proposed Rule, in that the definition in the proposed sales practices rules also includes exchange-listed commodity- or currency-based trusts or funds. Note this definition excludes trusts or funds that hold only commodities and currencies.

The FINRA regime for options accounts is an exception that proves the rule, because (unlike leveraged/inverse funds, which are investment companies, and virtually all other securities), they present an unlimited risk of loss. Before importing a regime emulating the FINRA regulation of options accounts and imposing a form of merit regulation, it seems to us to be more prudent to allow the Regulation BI and Standard of Conduct regime to take full effect and then analyze the degree to which leveraged/inverse vehicles still present risks to investors in a manner that warrants imposing a heavier-handed regulatory regime.

B. Regulation BI and the Standard of Conduct Renders the Proposed Sales Practices Rules Unnecessary

Investment advisers already have an obligation to act in their client's best interest under the Standard of Conduct (and broker-dealers will be subject to a best interest obligation beginning June 30, 2020). An investment adviser has a duty to act in the best interest of its client, including with respect to a retail client (that is not deemed sophisticated by the adviser) receiving advice regarding a leveraged/inverse investment vehicle. For example, under the Standard of Conduct, as part of an investment adviser's duty of care an adviser has a duty to act in the client's best interest, which includes an obligation to give advice that is appropriate to the client's objectives. Forming a reasonable belief of a client's best interest requires that (among other considerations) an adviser have a reasonable understanding of a retail client's objectives, which generally includes making a reasonable inquiry into, and then understanding, the client's investment profile (e.g., the investor's financial situation, sophistication, experience and goals). Critically, the Commission stated in the Standard of Conduct interpretive release that an investment adviser already is required to apply heightened scrutiny to certain products for retail clients, including complex investments or products such as inverse and leverage exchange-traded products. As such, the proposed sales practices rules are duplicative of an adviser's obligation to act in its client's best interest.

Similarly, Regulation BI imposes on broker-dealers a duty to act in the customer's best interest when making a securities recommendation. As of Regulation BI's compliance date, its "Care Obligation" will require broker-dealers to exercise reasonable diligence, care and skill to understand the risks, rewards, and costs associated with its recommendation. Regulation BI also requires broker-dealers to have a reasonable basis to believe that a securities recommendation is in the best interest, at the time it is made, of a retail customer based on the retail customer's investment profile, as defined in Rule 15l-1, and the potential risks, rewards, and costs associated with the recommendation.[110] The adopting release for Regulation BI explains that the Care Obligation

110 *See* Rule 15*l*-1(a)(2)(ii).

requires broker-dealers recommending inverse or leveraged investment vehicles to understand the terms, features and risks before recommending such products to a retail customers.

As these obligations demonstrate, just last year, the Commission completed a multi-year rulemaking in which the Commission carefully and exhaustively considered the exact policy issues relating to the protection of retail investors in connection with investments in leveraged/inverse investment vehicles. In that rulemaking, the Commission reached a reasoned conclusion that comprehensive, robust, principles-based best interest obligations that apply to all investment vehicles represents the best balance of the policy objectives at issue here—investor protection, investor choice, capital formation and competition. This rulemaking drew praise and support from a wide-range of stakeholders precisely because it is comprehensive and largely gets the balance right. We believe that this regulatory regime is well-designed to address the protection of investors in leveraged/inverse investment vehicles.

However, less than a year later, and before this regime has had time to be implemented and tested, the Commission is proposing a significant move away from Regulation BI and the Standard of Conduct. This proposed change would obviate the principles-based best interest judgment of thousands of firms that have an obligation to, and are in a better position to, understand their customers' and clients' investment profiles. Instead of the personalized, considered judgment reflected in Regulation BI and the Standard of Conduct, the proposed sales Practices Rules would require a less flexible, rules-based process. The Commission would do so without providing a meaningful empirical analysis comparing the potential benefits and costs of the sales practices rules with the benefits that will be realized when the regime created by Regulation BI and the Standard of Conduct is fully realized. A likely result will be to disrupt the balance of investor protection, choice, capital formation and competition so carefully struck by the Commission in Regulation BI and the Standard of Conduct.[111]

C. The Proposed Sales Practices Rules Should Not Apply to Self-Directed and Unsolicited Transactions

For the reasons discussed above, we believe that the Commission should not apply heightened scrutiny such as what would be required under the sales practices rules to investors making their own, unsolicited, investment decisions and directing their brokers to execute such transactions. In promulgating Regulation BI and the Standard of Conduct, the Commission carefully considered the scope of those obligations in light of the policy objectives described above, and, consistent with

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111 We note that the proposed sales practices rules are in particular more prescriptive than the principles-based rules that typically govern advisers, which the Commission has recognized is key to regulating this diverse population of registrants. Standard of Conduct at 33670 at n.11.

its authority under Section 15(*l*), determined not to include self-directed and unsolicited transactions. The proposed sales practices rules would disrupt the balance of regulatory objectives by placing obstacles in the way of investor choice, where an investor, acting on her or his own and for her or his own account, chose a leveraged/inverse investment vehicle. There also is significant risk that the heightened scrutiny and decision-making associated with opening a new account (or approving an existing account) for these vehicles could subject broker-dealers to second-guessing and liability for investor losses related to products that investors self-determine to purchase.

In addition, the Commission cites as authority for promulgating the sales practices rules Section 15(*l*)(2) of the Exchange Act and Section 211(h) of the Advisers Act, which give the Commission the power to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." We observe that Congress added these provisions to the securities law as part of the Dodd-Frank Act amendments designed to give the Commission the authority to regulate the standard of conduct applicable to broker-dealers and investment advisers providing personalized investment advice to retail customers. It seems to us that this authority does not include the power to impose rules on self-directed customers, who by definition are not receiving such advice.

X. COMMENTS ON REPORTING AND PUBLIC DISCLOSURE REQUIREMENTS

A. Fund Reports to the Commission on Derivatives Exposure and VaR Backtesting Exceptions Should Not Be Publicly Available

Under the Proposal, funds (other than BDCs) that rely on the Proposed Rule would be required to report certain derivatives-related information on Form N-PORT.[112] This information would include a fund's derivatives exposure as a percentage of the fund's net asset value at the end of the period[113] and certain VaR-related information including the number of VaR backtesting exceptions the fund identified during the relevant reporting period.[114] Funds must file Form N-PORT no later than 60

112 Information on Form N-CEN also becomes public upon filing. Funds must file Form N-CEN no later than 75 days after the end of the fund's fiscal year. *See* Form N-CEN.

113 *See* Items B.9 and B.10 of Form N–PORT. A fund could adjust the derivatives exposure reported for interest-rate derivatives to a 10-year bond equivalent and delta adjust the notional amounts for options. *See* General Instruction E to Form N–PORT.

114 The VaR information would include a fund's highest daily VaR during the reporting period and its corresponding date, and the median daily VaR for the monthly reporting period. *See* Proposing Release at 4525; Proposed Items B.10.a through d of Form N-PORT. Additionally, for a fund that uses the relative VaR test, the Commission would require the fund to report information about the designated reference index (name and index identifier) and the highest VaR ratio (fund VaR divided

days after the end of the reporting period (*i.e.*, each calendar month), and the information reported on Form N-PORT would be made public for the third month of each fund's fiscal quarter upon filing.[115]

We support adding these new reporting requirements. However, we do not believe that such information should be publicly disclosed because such disclosure could reveal proprietary information to a fund competitors and would be confusing and unnecessary for investor protection. We believe that public reporting of derivatives exposure amounts and VaR backtesting exception information is not necessary or appropriate and could cause confusion among investors who may not understand the importance of or have the context necessary in order to understand the data.

In this regard, point-in-time information on a fund's derivatives exposure may not present meaningful information, depending on the use of derivatives transactions by a fund, and does not give a meaningful metric by which an investor can measure a fund's leverage achieved through derivatives or derivatives risk. Moreover, derivatives exposure would include the notional amounts of transactions not traditionally considered as derivatives by investors. Moreover, Form N-PORT includes other, more useful, information on a fund's portfolio holdings on a holding-by-holding basis.

In addition, information on the number of a fund's VaR backtesting exceptions during a period could confuse investors into believing a fund presents more compliance and leverage risk than the fund does if such investors do not realize that a reported VaR backtesting exception does not mean that the fund's actual VaR exceeded its leverage limit, but rather reflects the backtesting results of the fund's VaR model. Similarly, VaR backtesting exceptions that would be required to be reported may represent isolated incidents that are not reflective of a fund's overall risk profile, and funds could have VaR backtesting exceedances during periods when their VaR does not breach the applicable proposed VaR-based limit on fund leverage risk.

Finally, such information would be reported and publicly disclosed on a 60-day time lag based on the Form N-PORT reporting schedule. Such a delay in time in which the information would be

by the designated reference index VaR) during the reporting period and its corresponding date, and the median VaR Ratio during the reporting period. *See* Proposed Items B.10.a through d of Form N-PORT. Information reported for the third month of a fund's fiscal quarter on Form N-PORT would be made publicly available 60 days after the end of the fiscal quarter.

115 *See* General Instruction F of Form N-PORT; Rule 30b1-9 under the 1940 Act. The Commission also proposes to amend Form N-CEN to require funds to disclose information regarding the exemptions or exceptions a fund relied on from the various requirements of Proposed Rule 18f-4. *See* Proposed Item C.7 of Form N-CEN.

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disclosed, while critical to protecting the fund, may reduce or eliminate any potential value to be derived by investors from receiving such information.

XI. COMPLIANCE AND TRANSITION PERIODS

The Commission has proposed a one-year transition period from the date that the adopting release is published in the Federal Register in which to implement the Proposal. After that date, funds must be in compliance with the Proposed Rule in order to invest in derivatives transactions, reverse repurchase agreements and similar financing transactions, and unfunded commitment agreements, and in compliance all other applicable aspects of the Proposal, as applicable. Also on that date, the Commission will rescind Commission and Commission staff guidance and no-action letters that funds currently rely on to invest in such investments, and will require registered broker-dealers and investment advisers to comply with the requirements under the proposed sales practice rules.

We believe that, in order to grant funds sufficient time to adjust to and implement the new requirements, the Commission should extend the transition and compliance period for all aspects of the Proposal from one year to twenty-four months.

In support of this request, we note that the requirements under the Proposal will impact nearly every component of an applicable fund's business, including, but not limited to, portfolio management, compliance, legal, and operations. Funds will need sufficient time to implement the new Program and VaR-based limit on fund leverage risk requirements, which likely will be the most burdensome changes to the current framework under Section 18. Many funds do not currently have VaR models in place and would have to decide whether to engage a third-party vendor or to conduct the VaR tests in-house. Moreover, funds that already have VaR models in place will need to adjust such models to adhere to the new requirements under the Proposed Rule. Similarly, numerous funds will need to build Programs from the ground up. Even those funds that already have such derivatives risk management programs in place will need to update their programs meet the Program requirements. Furthermore, limited derivatives users will need to implement general policies with regards to their limited use of derivatives.

In addition, many fund groups will rely on vendors in an effort to come into compliance with the new requirements under the Proposed Rule, and the Commission should be mindful of the fact that vendors will have to update their systems as well. We remind the Commission of issues surrounding vendor preparedness for the liquidity risk management program and investment company reporting modernization rules. In both cases, compliance deadlines were extended due to vendors' lack of preparedness.[116]

Finally, smaller fund complexes may need to significantly increase the financial and human capital resources to meet the detailed requirements under the Proposed Rule. Larger fund complexes that have more funds that will implicate the Program requirement also will need to increase their dedicated financial and human capital resources. Fund complexes of all sizes may need to draft licensing agreements and engage in due diligence regarding the capabilities of potential vendors.

Accordingly, we believe that a twenty-four month transition period is more appropriate in light of the complexity of and the updates that will need to be made under the Proposed Rule.

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We appreciate the opportunity to comment on the Proposing Release. Please feel free to contact Philip T. Hinkle at ([redacted] Audrey Wagner at [redacted] Mark D. Perlow at [redacted], Brenden P. Carroll at [redacted], K. Susan Grafton at [redacted], Ashley N. Rodriguez at [redacted], or Nadeea R. Zakaria at [redacted] with any questions about this submission.

Very truly yours,

/s/ Dechert LLP

Dechert LLP

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116 The liquidity risk management framework was adopted in October 2016 with an initial compliance date of December 2018 for larger fund complexes. The Commission later extended the requirements related to liquidity "bucketing" to June 2019, which proved critical additional time for fund complexes and third parties to implement the new requirements and for the Commission staff to provide related guidance that facilitated implementation.