

April 22, 2020

**VIA EMAIL**

Ms. Vanessa Countryman  
Secretary  
Securities and Exchange Commission 100 F Street NE  
Washington, DC 20549-1090

Re: *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, File No: S7-24-15*

Dear Ms. Countryman:

Foreside Financial Group, LLC<sup>1</sup> ("Foreside") submits this letter in response to the U.S. Securities and Exchange Commission ("Commission") proposed new Rule 18f-4 under the Investment Company Act of 1940, Rule 15l-2 under the Securities Exchange Act of 1934, and Rule 211(h)-1 under the Investment Advisers Act of 1940 (collectively, the "Proposed Rules"). We appreciate the opportunity to comment on the Proposed Rules, and while we applaud the Commission for its continued dedication to investor protection, we would recommend a change to the requirements related to a Derivatives Risk Manager in Rule 18f-4. Further, we believe that proposed Rules 15l-2 and 211(h)-1 (together, the "Sales Practice Rules") do not meet the Commission's goal of investor protection, but rather set forth overly prescriptive and unnecessary restrictions on investments in Leveraged/Inverse Investment Vehicles.

**Proposed Rule 18f-4 – Derivatives Risk Manager**

We agree that the appointment by a fund's board of directors/trustees ("Board") of a Derivatives Risk Manager to administer the fund's Derivatives Risk Management Program

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<sup>1</sup> Foreside Financial Group, LLC is the parent company of Foreside Fund Services, LLC and 19 other FINRA registered broker-dealers through which Foreside serves as the principal underwriter for registered investment companies, including mutual funds and exchange traded funds. Foreside's other subsidiaries include Foreside Consulting Services, LLC, and Foreside Fund Officer Services, LLC, through which Foreside provides customized regulatory compliance consulting to investment advisers and broker-dealers, and fund officer services to mutual funds and exchange traded funds.

will be beneficial to the fund and Board. We recommend, however, that the Commission permit third parties, unaffiliated with the fund's investment adviser, to serve as the Derivatives Risk Manager if the Board, after appropriate due diligence and review, determines that such third party brings the relevant experience regarding the management of derivatives risk.

Foreside currently provides outsourced fund chief compliance officers and principal financial officers to registered investment companies, and we believe that one of the primary advantages to outsourcing in this context is the broad experience outsourced officers may attain from working with multiple clients and service providers throughout the industry.<sup>2</sup> This experience enables them to understand industry best practices. An outsourced Derivatives Risk Manager could bring the same enhanced perspective and understanding of industry best practices, along with an unbiased, independent eye which would provide additional value to the maintenance of the funds' Derivative Risk Management Program.

## **Sales Practice Rules**

We strongly disagree with the Commission's approach to regulating the sales of Leveraged/Inverse Investment Vehicles ("LI Vehicles") for three primary reasons. First, the Sales Practice Rules are based on the inaccurate premise that LI Vehicles present the same risks and complexities as options. Second, the issues the Commission is attempting to address with these Sales Practice Rules are already addressed by existing requirements. And, finally, the Sales Practice Rules are a significant divergence from the Commission's disclosure-based approach to regulation and could set a dangerous precedent for future regulation and/or public understanding of the Commission's role in the markets.

### **1. LI Vehicles Do Not Present the Same Risks as Options**

While LI Vehicles may be complex and represent a certain level of volatility, especially if held for longer periods, the essential risks of LI Vehicles are no less understandable to the average investor than many other complex investment products. Products such as exchange-traded warrants, master limited partnerships, structured notes, and exchange-traded notes, among others, can be very complex and difficult for an average investor to understand, and yet, investors are permitted to invest in, and intermediaries are permitted to offer, these products, provided that appropriate disclosures are made to potential investors.

The Commission, however, has seemingly decided that LI Vehicles are more complex than these types of products and instead compares them to options. This comparison is misguided. Options and option trading strategies are inherently riskier and more complex than LI Vehicles. Option trading not only includes the possibility of losing

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<sup>2</sup> Foreside does not currently, and does not have any immediate plans to, offer Derivatives Risk Managers as an outsourced service, however, we strongly believe in the value of skilled and experienced outsourced, independent service providers to funds in support of their compliance and risk management programs.

100% of an initial investment, but in certain situations investors may in fact owe large amounts beyond their initial investment. At no time does an investor in an LI Vehicle face the prospect of losing more than 100% of his or her investment. Moreover, to effectively engage in an options trading strategy, investors must understand, among other concepts: strike prices; puts and calls; spreads, and straddles; directional risk exposure; and volatility risk. Understanding these concepts in many cases requires sophisticated mathematical monitoring or mathematical analysis which is well beyond the capability of the average investor. In contrast, investors in LI Vehicles do not need to engage in sophisticated mathematical monitoring or analysis.

The Commission's determination that investors interested in LI Vehicles should be subject to the same rigorous requirements applicable to those looking to engage in options trading is based on an incorrect premise that LI Vehicles and options present the same level of risks and complexity.

## **2. The Commission Should Rely on Existing Requirements**

The Sales Practice Rules will apply to registered investment advisers and registered broker-dealers that may offer LI Vehicles to their customers. There is no need for these additional requirements, however, given the existing fiduciary standard to which all registered investment advisers are subject and the Commission's own Regulation Best Interest ("Reg BI"), which will go into effect in June of this year. These two standards are designed to ensure that those entrusted with assisting investors to make important decisions regarding their investments put their clients' interests ahead of their own.

The Commission has estimated that the costs of complying with the Sales Practice Rules in the first year will be over \$2.4 billion<sup>3</sup>. It seems hard to justify that substantial cost coming on the heels of Reg BI. The Commission should assess the effectiveness of Reg BI on the markets and, in particular, on investments into LI Vehicles before adopting another expensive regulation, which could lead many firms to simply not offer these products, thereby reducing investor choices in the market.

## **3. A Divergence from Disclosure-Based Regulation**

As the Commission states on its website, "The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."<sup>4</sup> The U.S. securities regulations are designed around a basic concept, disclosure, and provide protections for investors harmed by misleading statements or the omission of material facts. With these Sales Practice Rules, the Commission has gone well beyond the idea of

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<sup>3</sup> "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," Release no. 34-87607, November 24, 2019.

<sup>4</sup> "What We Do." <https://www.sec.gov/Article/whatwedo.html>

ensuring adequate disclosure and has selected LI Vehicles for different treatment. Will the Commission now get into the business of assessing the merits of different types of products and investments? Do these regulations signal to investors that the Commission will now opine on all types of investment products? If the Commission doesn't require additional protections for certain products, are investors to infer that they are, in fact, safe investments? The answers to these questions get to the very heart of the Commission's mission and could lead to further misunderstanding by investors about the Commission's role as arbiter of safety in the markets.

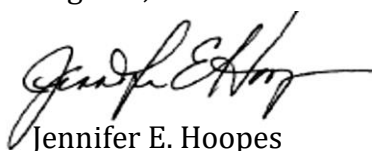
If the Commission is concerned that some investors do not fully understand these products, then perhaps the disclosure regime for these products can be strengthened. That would fit within the Commission's overall disclosure-based approach to regulating the markets.

#### **4. Conclusion**

The Commission's mission is to: "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."<sup>5</sup> It has met this mission effectively through a disclosure-based approach to regulation and has avoided overly prescriptive methods of regulating, except in limited situations, such as options (which as discussed above are substantially more complex than LI Vehicles). We believe the Commission should rely on its own existing requirements to address the risks of LI Vehicles and avoid promulgating a regulation that diverts it from disclosure as its guiding principle for regulation.

Foreside appreciates having this opportunity to comment on the Proposed Rules. Should you have any questions regarding our comments, please contact the undersigned.

Regards,



Jennifer E. Hoopes  
Senior Managing Director and General Counsel

cc: The Honorable Jay Clayton  
The Honorable Hester Pierce  
The Honorable Elad Roisman  
The Honorable Allison Lee  
Brett Redfearn, Director, Division of Trading and Markets

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<sup>5</sup> "What We Do." <https://www.sec.gov/Article/whatwedo.html>