FRANKLIN TEMPLETON

April 23, 2020

Submitted electronically: https://www.sec.gov/rules/proposed.shtml

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

RE : File Number 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:

I am writing on behalf of Franklin Resources, Inc., a global investment manager that operates under the name Franklin Templeton Investments ("Franklin Templeton"). As of March 31, 2020, Franklin Templeton managed approximately $580 billion in assets, of which over $329 billion constituted investment companies registered with the SEC under the Investment Company Act of 1940 (the "1940 Act").

Franklin Templeton appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's ("SEC") reproposal to adopt new Rule 18f-4 under the 1940 Act,[1] which would govern fund investments in derivatives and sales practices with respect to certain leveraged/inverse investment vehicles. We participated in the development of, and broadly endorse, the comment letter on this proposal filed by the Investment Company Institute (though not necessarily each of the specific recommendations set forth in that letter).

We view the SEC's reproposal as a substantial step forward from the current framework predicated on asset segregation and a significant improvement on the aspects of the SEC's 2015 proposal that would have imposed limitations on investments in derivatives based on their notional value. As described further below, we support a number of elements of the reproposal. At the same time, we have recommendations for enhancements, which are designed to improve the efficiency and effectiveness of the reproposal in a manner consistent with the protection of fund investors.

Comments on the VaR Tests

<u>VaR Based Tests—Limits</u>. As an analytic metric with time-tested and broad utilization across the financial services sector, Value-at-Risk, or "VaR," is a measurement that represents a more efficient approach to regulating a fund's derivatives activities than asset segregation or exposure-based notional

[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 (Nov. 25, 2019) [85 FR 4446 (Jan. 24, 2020)] ("Release").

limits.[2] We therefore support the SEC's decision to rely upon it in the context of the reproposal. However, as discussed further below, we urge the SEC to adjust the upper boundaries of the relative VaR test and the absolute VaR test to 200% of the VaR of the designated reference index and 20% of a fund's net assets, respectively.

In proposing a 150% limit in the case of the relative VaR test, the SEC cites the limits on leverage stemming from an open-end fund's obligation to maintain 300% asset coverage for a bank borrowing.[3] In our view, however, the analogy falls short because of the distinct risk attributes that the two activities underscore. When undertaken at excessive levels, borrowing places a fund at risk of asset insufficiency and being unable to discharge its debt obligations. VaR is different – it is a metric that reflects the risk of monetary loss at a moment in time, rather than a fund's possible insolvency.[4] Thus, while a higher relative VaR attributable to derivatives, on the one hand, and financial leverage from borrowing, on the other, can each be associated with magnifying the degree of potential gains and losses in a fund's portfolio, there is no direct correspondence between VaR and borrowing. Moreover, the VaR of a fund can be higher than the VaR of its designated reference index or benchmark due to differences in the characteristics of the underlying securities in its portfolio, even without the use of any derivatives and in the absence of any borrowing. Accordingly, we see no reason that the limits on a fund's borrowing activities imposed by Section 18(f)(1) of the 1940 Act should dictate a specific VaR limit or preclude a reasonable upward adjustment to the scale of a fund's permitted relative VaR levels.

Another reason to adjust the level for each VaR test in the manner that we recommend is that doing so would align the levels with the corresponding standards applicable to Undertakings for Collective Investment in Transferable Securities ("UCITS") under the E.U. regulatory regime.[5] There are substantial efficiencies from establishing a common global standard, which would, in turn, benefit shareholders of U.S. registered funds. Conversely, if the VaR tests diverge, managers of U.S. registered funds may be compelled to modify their investment programs, perhaps substantially, by not being able to replicate trades in U.S. registered funds to the full extent allowed for E.U. registered funds, thereby reducing the efficiency of portfolio management to the detriment of shareholders. In making these recommendations, we stress that harmonization of the VaR tests with E.U. standards would not impair the policy objective of ensuring that fund portfolios do not take on an unduly speculative character. On this point, the SEC should take notice of the fact that the higher limits of VaR-based tests applicable to UCITS have a demonstrated record of allowing utilization of derivatives in retail funds in a manner consistent with safeguarding the interests of fund investors.

Definition of Designated Reference Index. The rule would require a fund to use relative VaR by default 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."[6] The SEC proposes to define "designated reference index" as an unleveraged index that, among other things,

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[2] With respect to the latter, we articulated some of the detriments that the imposition of bluntly measured notional limits would produce for fund shareholders in our comment letter to the 2015 proposal. See comment letter of Franklin Resources, Inc. (Mar. 28, 2016) at pgs. 2-4 (https://www.sec.gov/comments/s7-24-15/s72415-109.pdf) ("2016 Franklin Letter").
[3] *See* Release at pg. 110.
[4] As the Release acknowledges, "VaR is not itself a leverage measure." (pg. 92).
[5] *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788 (July 28, 2010), at pgs. 24 and 26, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf ("CESR Global Guidelines").
[6] Proposed Rule 18f-4(c)(2)(i)

"reflects the markets or assets classes in which the fund invests."[7] A fund's investment strategy is central to assessing its volatility profile and should not, as proposed, merely factor into the determination of an index's appropriateness to serve in this role. Without the framework for how investments are made within the context of a fund's investment strategy, markets and asset classes are unable to consistently produce meaningful alignment between the VaR of an index and that of a fund's portfolio. A more complete and practical picture of a fund's investment program and its associated leverage risks would be captured by instead defining this term as an index that reflects a fund's *investment strategy*. Consistent with this recommendation, the E.U. regulatory regime specifically permits use of relative VaR benchmarks reflective of the investment strategy, including blended benchmarks.

<u>Availability of Absolute VaR Test</u>. Also in alignment with the E.U. regulatory scheme,[8] we believe that giving funds the discretion to select *either* the relative or absolute VaR test would result in a more efficient framework. An elective approach to the VaR test may be helpful in addressing situations where it may be unclear when a derivatives risk manager would be deemed "unable" to identify an appropriate designated reference index.[9] We would recommend that, if the SEC were to adopt this discretionary approach, funds should be required to document the basis for their determination to follow an absolute VaR test. For funds that so elect, the absolute VaR limit would operate in conjunction with the separate requirements of the formalized derivatives risk management program, including quantitative risk guidelines and stress testing, to ensure that derivatives risks are effectively managed.

<u>Choice of VaR Model and Parameters for VaR Test</u>. The SEC's proposal would establish reasonable parameters for VaR models, including with respect to time horizon and historical market data. We support the SEC's proposal to give a fund's derivatives risk manager the responsibility and flexibility to select a fund's VaR model. While providing for this flexibility, we would recommend that funds be required to institute reasonable controls around their ability to make material modifications to a VaR model. Such controls should be designed to address potential concerns around selectively adjusting metrics and assumptions of the VaR model in order to "game" testing outcomes, and could include, for example, documentation of the supporting rationale and/or providing notification to a fund's board or its chief compliance officer. We also support the SEC's proposal that a fund using the relative VaR test not be required to apply its VaR model consistently in calculating the respective VaRs of its portfolio and of its designated reference index. The SEC's approach recognizes the substantial expected costs to funds that would result from a requirement for consistent calculation.[10]

<u>Implementation –Remediation</u>. We believe a five business day, or one week, period for remediating compliance with a fund's VaR test would strike a more appropriate balance between managing the leverage risks the VaR limit is designed to address and providing a reasonable opportunity for the resolution of temporary conditions that may have led to non-compliance than the proposed three business day period. In our experience, funds that experience sudden spikes in VaR levels during periods of market dislocation and impaired liquidity can face considerable challenges to ratcheting down risk in short order. A three business day period could exacerbate impacts to funds by compelling remediation of VaR levels on a timeframe too compressed to allow for an orderly transition.

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[7] *See* proposed Rule 18f-4(a).
[8] *See* CESR Global Guidelines at pg. 23.
[9] An example of this would be when it might be possible to construct a custom blended index from multiple underlying indices, but such an index would be overly complex.
[10] As the SEC noted, a fund may need to incur licensing fees to access detailed information about index constituents necessary perform a consistent calculation. *See* Release at pg. 279.

In addition, we would recommend that the rule accommodate appropriate exceptions to the specified remediation period -- in particular, situations when the primary market for derivative positions may be closed. Such periods should be excluded from the remediation period.

We also believe that the proposed three business day period for refraining from non-VaR reducing derivatives transactions after a reportable non-compliance event could, in many circumstances, unreasonably impair a fund's ability to effectively reassess and recalibrate its derivatives exposures. During the proposed three business day standstill following a breach, a fund could be required to inopportunely unwind investments at a loss because it would be precluded from "rolling" exposures originally implemented as a hedging strategy if, for example, the derivative exposure in question would not unambiguously be expected to reduce VaR at the time of renewal. Accordingly, we believe that the SEC should dispense with the proposed requirement to refrain from certain derivatives activities for three business days.[11]

Comments on the Limited Derivatives Users Exception

We support the establishment of an exception from the proposed risk management program and VaR-based limit for limited derivatives users, and agree that a fund that relies on the exception should be required to adopt policies and procedures that are reasonably designed to manage its derivatives risks. However, we believe the exposure-based test is unnecessarily narrow in its proposed construction. We also recommend below clarifications on how funds should apply the exposure-based test with respect to specific derivative instruments or investment techniques under a final rule.

<u>Limited Derivatives Users—Alternative Exposure-Based Tests; Additional Hedging Exclusions</u>. The two exposure-based tests for a limited derivatives user should be combined rather than, as under the proposal, be formulated as alternatives. In other words, a fund should qualify as a limited derivatives user if its derivatives exposure does not exceed 10% of net assets, *excluding currency hedges* (as well as the other categories of risk-reducing derivatives exposures that we recommend below). In the Release, the SEC itself states that "using currency derivatives solely to hedge currency risk does not raise the policy concerns underlying section 18."[12] We agree -- because the purpose of currency hedging is to mitigate potential losses without creating leverage, this is not the sort of activity that gives rise to the risks that need to be governed by the enhanced requirements of a VaR-based limit or derivatives risk management program. In short, a fund with significant currency hedging exposures that would otherwise qualify as a limited user (based on its other derivatives usage) does not have an inherently higher risk profile than an excepted limited user that does not employ currency hedging.

We also urge the SEC to expand the hedging exception to include the other types of derivatives activity described below. Like currency hedging, these strategies are inherently designed to reduce investment risk.

> <u>Covered Call Options</u>. A covered call option written by a fund should be excluded from the 10% exposure-based test. When a fund writes a covered call option, its potential future obligation to deliver the reference asset will be entirely offset by the covering shares already owned. The rule should be clarified such that ownership of the reference security effectively means the future obligation has been satisfied.

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[11] We support those aspects of the proposal that would require board reporting and program analysis and updates as part of the remediation.

[12] Release at pg. 164.

Derivatives with Nominal Future Obligations. The notional exposure under certain derivatives with nominal future obligations for a fund should be excluded for purposes of calculating the 10% exposure-based test. Instead, only the nominal amounts of a fund's future obligations should be included in the calculation. As noted in our 2016 comment letter on the original proposal, in certain derivatives transactions, such as a fund's purchase of credit protection on a bond through a Credit Default Swap, a fund that has periodic future payments would receive, rather than pay, net amounts in the event of a bond default, and the fund's potential exposure would be significantly less than the notional value.[13]

Box Trades. A fund's exposure as part of a "box trade"[14] should be excluded for purposes of calculating the 10% exposure-based test. A fund may engage in a box trade that, in isolation, creates a future payment obligation, but when paired with a corresponding existing derivatives position, operates to close out the position. In light of the risk reducing impact of box trades, the associated derivatives positions should not be counted toward the 10% exposure-based exception.

The limited derivatives users exception should operate as a simple but efficient way to identify funds for which derivatives usage gives rise to limited risks that can be adequately governed by appropriate policies and procedures, with due consideration given to the potential benefits and burdens of the additional regulatory requirements imposed. We believe that a 10% exposure-based test still effectively fulfills that purpose if currency hedges, covered call options, derivatives with nominal future obligations and box trades are excluded in a combined test.

Additional Comments on Reproposal

In addition to the above comments, we offer the following recommendation relating to an element of the proposed derivatives risk management program.

Stress Testing. We agree that stress testing would provide an important complement to the proposed VaR-based limits to assist in managing tail risks that fall outside the confidence level of a VaR model. In our view, however, the minimum normal frequency for performing stress testing should be monthly rather than weekly. (Of course, the fund's derivative risk manager should be able to conduct stress tests on a more frequent basis, if he or she determines it would be appropriate to do so.) The proposed minimum weekly frequency is unduly burdensome in light of the multiple other elements comprising the proposed regulatory framework, including a fund's daily determination of compliance with the VaR test. We would note that monthly stress testing, using daily lookback data, is standard business practice in the UCITS regulatory regime and has worked well over the nine plus years it has been applied. In addition, Rule 2a-7 requires periodic testing for money market funds at intervals determined to be appropriate and reasonable in light of current market conditions.[15] In our experience, a monthly stress test of money market funds normally has been an appropriate frequency and should provide a more appropriate interval to address various tail risks that are not optimally managed through adherence to a VaR-based limit alone.

[13] *See* 2016 Franklin Letter at pg. 6.
[14] The definition of a box trade can be derived from the rules for netting contained in the report "Recommendations for a Framework Assessing Leverage in Investment Funds" issued by IOSCO in December 2019. The report defines netting as "a combination of trades on derivative instruments and/or security positions referring to the same underlying assets, irrespective of the maturity date of the derivative instruments, and where those trades are concluded with the sole aim of eliminating the risks linked to positions taken through the other derivative instruments or security positions." Report at pg. 21.
[15] *See* Rule 2a-7(g)(8)(i) under the 1940 Act.

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We appreciate the SEC's consideration of our comments and would be pleased to respond to any questions from the SEC or the staff.

Very truly yours,

/s/ Craig S. Tyle

Craig S. Tyle

cc: The Honorable Jay Clayton
The Honorable Allison Herren Lee
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia O. Blass, Director, Division of Investment Management