SEC Derivatives Rule Comments

Lessons Learned and Suggested Modifications

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Submitted by Dechert LLP on behalf of certain client registered investment companies and business development companies and their investment advisor.

Introduction

Given the extraordinary and unprecedented market volatility that the fund industry experienced during the height of the pandemic-related market stress that occurred in March 2020, we have concerns with the binding constraints that the SEC VaR limit proposal could have on prudent portfolio and risk management decisions that are in the best interest of our funds and their shareholders. With that in mind, we would like to outline the lessons learned from March 2020 and our targeted recommendations for how to address such concerns.

Lessons Learned in March 2020

- During periods of heightened market volatility, depending on a fund's VaR model and parameters used, the fund's VaR percent calculated by its VaR model can change in unintuitive ways, even with no changes to the fund's holdings. To the extent these changes in a fund's VaR model outputs cause the fund to exceed its VaR limit, position by position reviews to reconcile the differences are required, in addition to potentially re-running VaR at the portfolio level.
- The general market practice is for positions held in a fund's portfolio to be booked at the fund administrator on a T+1 basis. This means that any fund that sources its position data from the fund administrator to run VaR calculations will have to wait until T+2 to see the actual impact of any positional changes on the fund's VaR. This timeline creates pressure under the proposed three business day compliance period for VaR exceedances.
- The sum of the components does not equal the whole. Since VaR compliance is assessed at the fund portfolio level, determining which fund positions to adjust to bring VaR down is not always intuitive or predictable.
- UCITS funds that exceeded the relative 200% VaR test in March 2020 were predominately fixed income funds.
- During periods of market stress, it is not always in the best interest of shareholders for a fund to make changes to its portfolio for risk reduction or other portfolio management purposes, due to asset liquidity constraints and the possibility of incurring excessive transaction costs.

Suggested Rule Modification #1

Modify the limit structure to account for fixed income funds

Recommendation to amend the relative VaR test either:

1) For funds primarily invested in fixed income securities, the VaR of the fund's portfolio does not exceed the lesser of 300% of the VaR of the designated reference index or 10% of the fund's net asset value (NAV); or
2) Alternatively, if the SEC does not want to delineate between types of funds, we would support another industry proposal for all funds, the VaR of the fund's portfolio does not exceed the greater of 200% of the VaR of the designated reference index or 10% of the fund's NAV.

- Fixed income funds generally take more active exposure versus their benchmarks than equity funds because of the breadth of instruments within many fixed income benchmarks, and the impracticality from a portfolio construction perspective of holding all of the securities (e.g., liquidity, transactions costs, tracking error, immateriality, etc.).
    1) This is common across fixed income funds regardless of whether they hold derivatives. Our analysis indicates that some fixed income funds that held only securities would have been in breach of the 150% relative VaR test.
    2) We believe it would be counterintuitive to curtail active risk for fixed income funds on the basis of holding derivatives, which in many cases are held as substitutes for securities, particularly when funds with similar direct securities holdings would not be subject to a VaR test.
    3) Creating customized benchmarks reflecting more active exposures to avoid this problem often is infeasible due to the administrative and cost burdens (which include index creation, maintenance and oversight).
    4) Our suggested rule modification also addresses staff concerns about fixed income funds taking "equity like" risk and also acknowledges that the absolute risk taking of some fixed income funds generally is less than that of equity funds (e.g., the VaR of the designated reference index of certain short durations funds could be in the 10-30bps range).

Suggested Rule Modification #2

Remove the sense of urgency post a limit breach

Recommendation to either:

1) Eliminate the concept of the 3 business day grace period for VaR test compliance issues and instead require that funds reduce risk in the best interest of investors and in line with an advisor's fiduciary responsibilities. This would eliminate the SEC reporting requirement on Form N-RN and the board reporting requirement immediately post a limit breach. Enhance Form N-PORT with some information from Form N-RN including date of VaR exceedance and fund and benchmark VaR (if applicable) on each exceedance date; or
2) Extend the grace period to bring a fund into compliance with limits to 10 business days.

- We acknowledge the SEC's need for transparency and information, especially in times of market stress. However the current proposal would not necessarily achieve that and therefore, does not outweigh the negative outcomes it may cause.
- Sensitivity to having to self-report to the SEC may incentivize some fund managers to engage in forced sales or fire sales to avoid VaR test compliance issues and having to report. Therefore, in many cases no information would be shared with the SEC. This may result in:
    a. An increase of systemic risk by increasing market volatility and realized losses within funds as managers flood the market at the same time during a period of market stress, thus undermining the Fed and other regulatory efforts to stabilize the markets;
    b. Wider bid-offers in pricing and higher transaction costs to be borne by the funds; and
    c. A reluctance by, or worse, a restriction on (due to the penalty period), fund managers in engaging in hedges or other derivatives transactions intended to mitigate risks which are in the best interest of fund shareholders – either because they are concerned with breaching the limit or being second-guessed if such actions do not result in a reduction of risks or VaR breaches.

Suggested Rule Modification #2 Continued

Remove the sense of urgency post a limit breach

- Immediately reporting VaR breaches would not give the SEC much information. Full understanding of funds' VaR breaches would require additional discussions with industry participants and trade associations to better understand the drivers of the breaches, whether the breaches were active or passive (which may be hard to identify as some funds may take actions to correct passive breaches), specific challenges in current market conditions, and other factors.
  a. The proposed Form N-RN reporting would only be a snapshot in time and would not paint a clear picture of the current landscape (which could be changing rapidly);
  b. While the immediate reporting may help the SEC then focus on specific fund complexes and managers and follow-up questions, as noted above this possibility could deter funds from reporting in the first place and incentivize them to do forced sales, etc. described above; and
  c. If the reporting becomes public (to investors, the press, research firms, etc.), it could lead to mass redemptions from funds, negative press or a competitive disadvantage.
- While the information sharing will be delayed if only through N-PORT, we would expect funds to engage in dialogue with the SEC about the current state of the markets. In addition, including the number of days of exceedances in N-PORT would give the SEC transparency into whether the breach was a unusual occurrence due to current conditions or a more serious issue for that fund. Given the unprecedented volatility in March, the SEC should recognize that it could take several days/weeks to rectify breaches. Having an immediate report does not give the SEC a window into how different managers may have dealt with similar scenarios and any outliers, trends, etc.
- The feedback loop post a risk reduction is not immediate because of the market practice of updating positions at the fund administrator on a T+1 basis as described above. In practice, if risk was reduced on a Monday, the updated VaR reflecting Monday's risk reduction would not be available until Wednesday. Risk metrics need to be available in a timely manner to be effective.
- Prior to any risk reduction, the VaR numbers for both the fund and benchmark need to be validated which involves reviewing market data, benchmarks weights, and positions. In some instances, VaR will need to be re-run which further elongates the timeframe.
- Governance items, including both internal and regulatory limit breaches, are typically reported to the fund board. It is the immediate SEC posting, not the Board reporting requirement, which creates the sense of urgency and may cause forced selling not in the best interest of the fund.

Suggested Rule Modification #3

Remove the harshest consequence of a VaR limit breach

Recommendation:
If the grace period concept remains in the final rule, remove the requirement that any derivative trades executed during the 3 days following the expiration of the grace period must be designed to reduce risk.

- The current proposal implies a pre-trade requirement which may prevent portfolio managers and risk managers from taking appropriate prudent actions.
- With market data shifting and other portfolio position changes, it is not always intuitive as to which transactions will reduce versus increase a fund's VaR on a prospective basis. Accordingly, the current proposal leaves fund managers potentially being subjected to second guessing.