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August 11, 2020

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
File No. S7–24–15

Ladies and Gentlemen:

I am writing to comment on the definition and treatment of what would be defined as "unfunded commitment agreements" in Rule 18f-4 as proposed in the *Use of Derivatives by Registered Investment Companies and Business Development Companies; etc.*, investment Company Act Release No. 33704 (the "Re-Proposing Release").[1] I have focused on the treatment of unfunded commitment agreements because I lack the experience to make informed comments on the proposed Value at Risk ("VaR") limitations or general risk management requirements. These are my personal comments and do not reflect in any manner the views of my firm or its clients and other attorneys.

In these comments, I have sought to keep in mind the observations made in my comment letter of November 8, 2011, regarding the initial concept release on the use of derivatives by investment companies, namely that:

> appropriate guidance must walk a difficult line between substantive consistency—treating investments with the same economic terms in the same manner under the 1940 Act—and the "foolish" consistency that, for those who quote Emerson correctly, "is the hobgoblin of little minds." Sometimes, … it is not practical to treat similar investments in the same manner. This means that appropriate guidance on derivatives can never be simple or perfectly consistent.[2]

[1] 85 Fed. Reg. 4446 (2020).
[2] https://www.sec.gov/comments/s7-33-11/s73311-45.pdf.

My blog-post on leveraged/inverse funds and margin accounts[3] illustrates what I regard as substantive regulatory consistency. In contrast, unfunded commitment agreements illustrate why it is not always practical to treat like investments in a like manner, and any attempt to do so would be "foolish consistency."

These comments reflect my independent attempt to work out an appropriate means of separating unfunded commitment agreements from what proposed Rule 18f-4 would define as "derivatives transactions" and comparison of my results with the comments of the Investment Company Institute (the "ICI")[4] and SIFMA[5] on the treatment of unfunded commitment agreements. There are two distinct issues for the Commission to consider. First, how to continue to treat "to-be-announced" trades ("TBAs") for mortgage-backed securities ("MBS") as derivatives transactions while treating other "when-issued" or "delayed-delivery" trades as commitments agreements. Second, how to distinguish the types of loan and investment commitments identified in the Re-Proposing Release as commitment agreements from private forward and option agreements that should be treated as derivatives transactions.

1. Terminology

My comments will use the terms "commitment agreement" or "commitment" rather than "unfunded" commitment agreement. Dropping "unfunded" will make my sentences that much shorter. Additionally, I believe that, once funded, a commitment is no longer a commitment. I realize that commitment agreements may refer to both the "funded" and "unfunded" portions of a commitment, but the "funded" portion is simply what is to be subtracted from the original commitment amount, which is to say the portion no longer included in that commitment amount.

2. "Delayed-Delivery" and Forward Contracts

I join with the ICI and SIFMA in urging the Commission not to inadvertently limit the ability of investment companies to enter into certain "when-issued" or "delayed-delivery" contracts.[6] I am not persuaded, however, that either comment letter provides a wholly adequate basis for

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[3] Re-Proposed Rule 18f-4—Leveraged/Inverse Funds vs. Margin Accounts (Dec. 5, 2019), https://www.assetmanagementadvocate.com/2019/12/reproposed-rule-18f-4-leveraged-inverse-funds-vs-margin-accounts.

[4] Comment Letter of Paul Schott Stevens, President and CEO, Investment Company Institute (Apr. 20, 2020), https://www.sec.gov/comments/s7-24-15/s72415-7098125-215777.pdf (the "ICI Comments").

[5] Comment Letter of Timothy W. Cameron, Esq., Asset Management Group - Head, SIFMA, Asset Management Group and Jason Silverstein, Esq., Managing Director and Associate General Counsel, SIFMA, Asset Management Group (Apr. 21,2020), https://www.sec.gov/comments/s7-24-15/s72415-7100733-215794.pdf (the "SIFMA Comments").

[6] ICI Comments at 9; SIFMA Comments at 18.

distinguishing these contracts from TBAs and similar forward settlement agreements that the Commission intends to continue to treat as derivatives transactions.[7]

The ICI Comments in particular repeatedly refer to the fact that "when-issued" trades "create a fixed and known obligation on the trade date."[8] But this is true of any forward contract. On its trade date a TBA, for example, fixes the issuer (in terms of the government sponsored entity guarantying the MBS), maturity of the underlying mortgages, coupon, par amount, purchase price and settlement date.[9] Indeed, it is not always the case that the security delivered in a when-issued trade is fixed. SIFMA's *Practice Guidelines for When Issued Trading in GSE Auctioned Securities* allow for delivery of substitute securities when auctioned securities are not available.[10]

Any forward contract, as I understand the term, must fix the asset to be purchased, the quantity to be delivered, the purchase price[11] and the settlement date. What is unknown is the future cost of terminating or offsetting the forward contract in lieu of performance. Many transactions that the Commission should classify as commitment agreements are not susceptible to termination or offset, so this cost cannot be determined. But, in terms of both investment leverage and asset sufficiency, all forms of forward contracts, including when-issued and delayed-delivery, have similar risks.

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7 Re-Proposing Release at 4456-57. ("While this proposal does not specifically list firm or standby commitment agreements in the definition of 'derivatives transaction,' we interpret the definitional phrase 'or any similar instrument' to include these agreements. A firm commitment agreement has the same economic characteristics as a forward contract. Similarly, a standby commitment agreement has the same economic characteristics as an option contract, and the Commission has previously stated that such an agreement is economically equivalent to the issuance of a put option. To the extent that a fund engages in transactions similar to firm or standby commitment agreements, they may fall within the 'any similar instrument' definitional language, depending on the facts and circumstances." [Footnotes omitted])

8 ICI Comments at 10.

9 James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, FRBNY Economic Policy Review (May 2013), at 5, https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf.

10 https://www.sifma.org/wp-content/uploads/2017/08/GSEs_Practice-Guidelines-for-When-Issued-Trading-in-GSE-Auctioned-Securities.pdf. *See* Section 4, "Obligations Arising From A Mandatory Substitution Event."

11 This implies that an agreement to purchase securities at a to be determined current market value (or yield, in the case of debt securities) would not be properly considered a forward contract. *See* ICI Comments at 9. ("The Commission also acknowledged that transactions whose yields are determined on the date of delivery with reference to prevailing market interest rates do not have the potential for leverage and are not subject to Section 18, because they do not present an opportunity for a fund to realize gains and losses between the purchase date and settlement date.")

Not all forward contracts have the same degree of risk, however, which is why the Commission should avoid foolish consistency. SIFMA's proposed criteria for exempting when-issued and delayed delivery contracts seems a reasonable attempt to define when the risks of a forward contract should not be so significant as to raise concerns under Section 18. First, requiring physical settlement of the forward contract should assure that the transaction ultimately has the same impact on a fund's performance as an immediate purchase, albeit for a longer holding period. Second, requiring settlement within 35 days of trade date substantially limits the "opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment."[12] This may also result in substantive consistency by aligning Rule 18f-4 with the margin limits of Regulation T. Finally, requiring the fund to earmark cash resources to settle the contract would address asset sufficiency concerns.

The Commission should understand that SIFMA's criteria will change the interpretative position originally taken in Release 10666.[13] A TBA with a settlement date within 35 days of its trade date, which Release 10666 treats as a firm commitment agreement, would be excluded from the definition of derivatives transactions provided the fund purchases the announced MBS on the settlement date rather than "rolling" the TBA. I suspect this substantive consistency may be an appropriate refinement to the Commission's interpretation of "senior security."

3. Other Commitment Agreements

The commenters who suggested excluding commitment agreements from derivatives transactions do not appear to have been motivated by concerns over when-issued and delayed delivery transactions. Instead, they were principally concerned with long-term agreements to provide funding to a company, either as loans or private equity. These agreements are structured as commitments, rather than immediate investments, to accommodate the needs of the company rather than those of the investors. A commitment allows the company to draw funds only when needed, which reduces its funding costs.

These commitment agreements do not afford an "opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment." Unlike over-the-counter forward contracts for currencies and securities, these commitments are too idiosyncratic to allow a fund to offset its commitment at a profit or loss. At best, a fund might grant a participation[14] in its loan commitment to another lender. Although a lender might pay (or be paid) to participate in

[12] Re-Proposing Release at 4505.

[13] *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (1979)

[14] I would also recommend that the Commission make clear that an agreement to participate in a loan commitment would have the same character (whether unfunded commitment agreement or derivatives transaction) as the underlying loan commitment.

outstanding loans if the rates are above (or below) market, uncertainty as to whether and when loans will be drawn and repaid should make a premium for a participation in the commitment itself unlikely.

Unfortunately, the proposed definition of "unfunded commitment agreement" does not capture these messy factors. Essentially, the definition requires only:

- A commitment to make a loan to or invest equity in,
- The company,
- In the future,
- That is not a derivatives transaction.

If "transactions similar to firm or standby commitment agreements, … may fall within the 'any similar instrument' definitional language [of derivatives transactions], depending on the facts and circumstances," then the last condition risks turning "unfunded commitment agreements" into a null set. Unless the adopting release provides an exegesis of the "facts and circumstances" when what is concededly a firm or standby commitment is not a derivatives transaction, it may be difficult to determine when a commitment agreement satisfies this final condition.

I do not think there is a simple means of addressing these concerns. For example, although proposed Rule 18f-4 would not treat a structured note as a derivatives transaction if the fund does not have a future payment obligation,[15] the Commission may intend to treat a commitment to make a structured loan as a derivatives transaction rather than as a commitment agreement. The Commission has previously excluded the following commercial loans from the definitions of "swap" or "security-based swap:"

> Fixed or variable interest rate commercial loans or mortgages with embedded interest rate locks, caps, or floors, provided that such embedded interest rate locks, caps, or floors are included for the sole purpose of providing a lock, cap, or floor on the interest rate on such loan or mortgage and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed.[16]

These criteria could also be helpful in separating commitment agreements to make commercial loans from commitments to make structured loans, but they are far from simple.

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[15] Re-Proposing Release at 4456 n.87.

[16] *Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208, 48247 (2012). The interpretation also excludes similar embedded interest rate options.

Another example would be a commitment by a fund to purchase a company's publicly traded stock for a fixed price at the company's option. This would be equivalent to the fund writing an option for the stock, except that the issuer of the stock would hold the option. Price data for the underlying stock should allow the fund to fair value the commitment using Black-Scholes or a similar valuation model, and the resulting changes in the commitment's fair value could "increase the speculative character" of the fund's shares. I cannot see why the nature of the counterparty, the issuer of the shares, should prevent the Commission from treating this as a derivatives transaction.

These examples tempt me to suggest susceptibility to market valuation as a touchstone for when a commitment agreement should be treated as a derivatives transaction, but this approach is probably too simple. It might seem appropriate to treat any commitment agreement of greater than 35 days for which market quotations are readily available (as proposed to be defined in propose Rule 2a-5[17]) as a derivatives transaction. I am not convinced, however, that a commitment that can be fair valued only infrequently (such as a commitment to invest private equity or make a loan at a spread over an appropriate reference interest rate) should lose its status as a commitment agreement. A commitment for which a pricing vendor offers a daily evaluated price might seem similar to a commitment with readily available market quotations, but what if the fluctuations in the evaluated price are infrequent and consistently small?

Much as I try to avoid raising unresolved comments, I do not have a suggestion for a clear demarcation between commitment agreements and derivatives transactions. I only recommend the Commission clearly articulate the "facts and circumstances" favoring each characterization in either the adopting release for Rule 18f-4 or, preferably, in the rule itself.

4. Retaining an Asset Coverage Option

Stating the obvious, my 2011 comment letter observed that:

> An asset coverage requirement is a blunt instrument for regulating the potential volatility of an investment company's returns. The extent to which the requirement limits the addition of volatility depends on the nature of the fund's investment strategy and portfolio, the use of the borrowing proceeds and the cost of the borrowing.[18]

[17] *Good Faith Determinations of Fair Value*, Investment Company Act Release No. 33845, 85 Fed. Reg. 28734 (2020).

[18] *Accord*, Re-Proposing Release at 4483.

Blunt though it may be, when strictly interpreted, asset coverage is effective at limiting the leverage ratio of a fund's portfolio. If a fund must match liquid assets to the notional amount of its commitments, then the ratio of total investments to net assets should not exceed 200%.

Basing asset coverage on notional amounts is critical to achieving this two-to-one limit. If a fund must only cover initial and variation margin, then the market can set a limit well above 200%. If coverage is based on "expected" payments, then the investment adviser can set whatever limit it considers appropriate.

By requiring full asset coverage, the Commission retains control of the leverage ratio. Although a 200% ratio is higher than the 150% ratio implicit in the 300% asset coverage requirement of Section 18(f), it would be consistent with the Commission's interpretation of Release 10666 in Merrill Lynch Asset Management, L.P., SEC No-Action Letter (pub. avail. July 2, 1996).[19] In practice, fluctuations in assets due to daily flows make it unlikely that an open-end fund would operate close to this limit.

Therefore, I agree in principle with the ICI's recommendation that "funds not be required to treat 10666 Instruments … as derivatives transactions so long as the instruments are fully covered by liquid assets …, marked-to-market on a daily basis."[20] I am not sure how the ICI envisions this alternative, however. The proposed VaR test would measure VaR at a portfolio level, presumably including the 10666 Instruments, so this would not be a meaningful alternative for a fund otherwise subject to VaR limitations. If the assets used to cover the 10666 Instruments are volatile (no matter how liquid), I do not understand why 10666 Instruments should be excluded from VaR calculations.

The alternative would be useful if the calculation of whatever percentage limit the Commission ultimately chooses for a "limited derivatives user" excludes commitment agreements subject to full asset coverage. Indeed, I would propose to go further than the ICI on this point by excluding even derivatives transactions if the fund earmarks assets equal to its full notional obligations. This would basically allow funds to continue to operate under a stricter interpretation of the current Release 10666 requirements. A fund could buy a forward contract for a security if it earmarked liquid assets equal to the purchase price; it could sell a forward contract against a security held in its portfolio. It could even sell a forward contract for a security not held in its portfolio and each day

[19] https://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf. If the Commission were to decide that a 200% ratio is too high, it can lower the ratio by requiring more than 100% asset coverage for the full notional amount. The Commission should carefully consider, however, the impact of any higher coverage requirement on business development companies.

[20] ICI Comments at 12.

earmark liquid assets equal to the closing price of the security, which illustrates the potential 200% leverage of this approach.

This should allow funds to engage in unelaborate hedges without having to comply with onerous VaR testing, while keeping leverage ratios to historical (*circa* 1990's) levels. It could also eliminate the need to separate commitment agreements from derivatives transactions, as all transactions would be subject to the same requirements (either asset coverage or VaR limited).

5. Money Market Funds

I join with the ICI and SIFMA in recommending that the Commission address the impact of repealing Release 10666 on money market funds regulated under Rule 2a-7. The rule's strict limitations on minimal credit risk, maturity, WAM and WAL should prevent a money market fund from using derivatives transactions to increase the speculative character of its shares. Indeed, such speculation would be contrary to the investment objectives of money market funds that attempt to maintain a stable share price or at least minimize the volatility of their share price.

While Rule 2a-7 would not require asset coverage for derivatives transactions or commitment agreements, the fact that not more than 5% of a money market fund's assets can be illiquid securities, 10% must be daily liquid assets and 30% weekly liquid assets should make such a requirement superfluous. In any event, the Commission should not require a money market fund to do more than maintain cash resources sufficient to meet its obligations promptly and should deem acquisitions in compliance with Rule 2a-7 to also comply with Rule 18f-4.

Thank you for considering these comments. If you have questions, please do not hesitate to contact me.

Respectfully submitted,

/s/ Stephen A. Keen