September 29, 2020

VIA ELECTRONIC DELIVERY

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)

Dear Ms. Countryman:

On April 21, 2020, AQR Capital Management, LLC ("AQR"),[1] submitted a comment letter[2] to the Securities and Exchange Commission ("SEC" or "Commission") on re-proposed Rule 18f-4 (the "Proposal")[3] under the Investment Company Act of 1940. In that letter we express broad support for the overall framework of the Proposal, while recommending modifications to the proposed VaR test including: (1) raising the Absolute VaR threshold to at least 20%, (2) providing an alternate Relative VaR threshold, (3) allowing funds to extrapolate the VaR calculations from a 95% to a 99% confidence level to create a more stable and accurate metric, and (4) revising the VaR breach remediation time periods. Our analysis suggested that each of these changes was needed for the proposed VaR test to operate as an appropriate outer bound limit, and that adopting only part of these combined recommendations would likely be insufficient to make the Proposal work as intended.

We submitted the AQR Comment Letter in the midst of historic market volatility related to the Covid-19 crisis. Now that a number of months have passed since the most volatile market period, we are submitting these supplemental comments in an effort to provide the Commission with further insights into

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[1] "We," "us," "our" and "ourselves" as used in this letter refer to AQR.

[2] *See* AQR Comment Letter on SEC Use of Derivatives by Registered Investment Companies and Business Development Companies Proposal (Apr. 21, 2020), *available at* https://www.sec.gov/comments/s7-24-15/s72415-7100727-215810.pdf ("AQR Comment Letter").

[3] *See* 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, 85 Fed. Reg. 4446 (Jan. 24, 2020).

the potential impact of the Proposal. We believe that the Commission's final rule will benefit from analysis of new data that was not available to the Commission at the time of the Proposal.

1. Recent events provide further support for modifications to the Proposal

The volatile market events of March 2020 provide an excellent case study for analyzing the operation of funds that utilize derivatives and the impact that the Proposal would have on these funds. Based on our current understanding of fund performance during these events – and as discussed in more detail below – we believe that mutual funds utilizing derivatives generally operated as expected during March volatility and did not experience large-scale problems or broadly exhibit the kinds of severely negative performance that might be expected of unduly speculative funds that should be limited by the Proposal.

Despite real-world performance results suggesting that funds generally did not present outsized risks to investors during an acute market downturn, data obtained through an extensive industry survey by the Investment Company Institute ("ICI") suggests that during this same period the Proposal's VaR test – if in effect – would have severely restricted the operations of a significant percentage of funds in its attempt to address concerns about potential undue speculation. For example, the ICI survey found that during the March 2020 events 15.7% of respondents would have exceeded their relevant VaR limit under the Proposal, despite the fact that analysis based on the Proposal indicated that its VaR test would likely capture only around 0.04% of funds.[4]

The fact that the proposed VaR test would have restricted a much broader set of funds than predicted by the Proposal, while at the same time these funds generally did not exhibit the characteristics we would expect from unduly speculative activities, suggests that the VaR test as proposed is not appropriately calibrated to serve as the intended outer bound limit. As a result, we believe that the March events strongly support the need for modifications to the VaR test as recommended in the AQR Comment Letter. These changes would not weaken the effectiveness of the Proposal in overseeing the use of derivatives by funds, but rather would re-center on the Proposal's core strength which is requiring a programmatic approach to risk management, including stress testing.

2. Impacted funds are simply not that risky

The fact that the proposed VaR test would have a much more expansive impact than suggested by the Proposal does not in and of itself demonstrate that the proposed test is flawed. Despite constraining a substantially larger proportion of the market than initially contemplated, the current calibration of the VaR test could be justified if the impacted funds truly represent undue speculation and pose outsized risks to investors. The fundamental question is thus whether the proposed VaR test is limiting funds that present the types of risks the Commission should be constraining under its statutory mandate, or whether it is instead capturing funds that do not present these types of risks and is therefore inconsistent with the Commission's mandate to address undue speculation?

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[4] *See* ICI Comment Letter on SEC Use of Derivatives by Registered Investment Companies and Business Development Companies Proposal at 5 (Apr. 20, 2020), *available at* https://www.sec.gov/comments/s7-24-15/s72415-7098125-215777.pdf ("ICI Comment Letter").

Based on analysis of data from the extraordinary Covid-19 crisis period[5] we find that the proposed VaR limits would restrict a broad range of funds that are not unduly speculative and do not present outsized risks to investors.

In analyzing Covid-19 crisis period events for purposes of this letter we have focused on one diverse category of mutual funds (based on Morningstar classifications) that are generally low/moderate risk and would be severely impacted by the proposed VaR test – alternatives strategies – but we recognize that other categories of relatively low/moderate risk funds would also be meaningfully constrained by the Proposal's VaR test (*e.g.*, taxable bond funds).

Prior to the onset of the Covid-19 crisis period ICI collected data for its survey regarding fund VaR results during a historical stressed period. As highlighted in the ICI Comment Letter, over one quarter (26.4%) of ICI survey respondents who would be subject to the Absolute VaR test would have exceeded the proposed threshold during a historical stressed period.[6] Of these respondents, the highest incidence of exceedances came from funds classified as alternatives strategies.

Now that we have moved past the most volatile time frame of the Covid-19 market shock, we can use returns-based analysis to analyze the performance of this class of funds during historic levels of volatility to better understand whether they posed outsized risks to investors, as might be expected from a category of funds that according to ICI survey results would be broadly restricted by the proposed outer bound VaR limit.

What we find, as shown in Figure 1 below, is that funds employing alternatives strategies generally performed in line with or better than the stock market during the Covid-19 crisis period's historic volatility (with the stock market represented by returns of the S&P 500 (-34%) and Russell 2000 (-41%) during this period). Yet despite performance that was generally consistent with the stock market as a whole during a period of historic market volatility – and thus does not provide evidence of outsized risks to investors – a large percentage of these funds would be restricted by the Proposal's Absolute VaR limit, and many restricted funds would be substantially affected.

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[5] For purposes of the analysis in this comment letter the period used to represent the Covid-19 crisis was determined using the peak to trough performance results for the S&P 500 and thus our analysis is based on returns data from 2/20/20 through 3/23/20.

[6] *See* ICI Comment Letter at 5 and 32.

Figure 1: Returns of alternatives funds during Covid-19 crisis[7]

Returns at the Onset of the Covid-19 Crisis (Feb 20 - Mar 23)			
		Percentiles	
Morningstar Category	**99th**	**90th**	**50th**
US Fund Bear Market	5%	30%	55%
US Fund Trading--Miscellaneous	-9	-6	6
US Fund Multicurrency	-14	-11	0
US Fund Market Neutral	-18	-12	-7
US Fund Volatility	-20	-15	0
US Fund Long-Short Credit	-23	-18	-11
US Fund Managed Futures	-24	-16	0
US Fund Nontraditional Bond	-26	-18	-10
US Fund Multialternative	-32	-22	-13
US Fund Long-Short Equity	-37	-30	-21
US Fund Options-based	**-49**	-33	-23
Leveraged/Inverse Funds - Generally Not Covered By The Proposed VaR Limits			
US Fund Trading--Inverse Equity	46	53	86
US Fund Trading--Inverse Commodities	22	29	61
US Fund Trading--Inverse Debt	-22	-20	-12
US Fund Trading--Leveraged Debt	-25	-11	20
US Fund Trading--Leveraged Equity	**-77**	-68	-52

The data in Figure 1 reveals that at the 90th percentile of returns these categories of alternatives funds generally performed meaningfully better than the S&P 500 (-34%) or Russell 2000 (-41%), and that even at the 99th percentile of returns nearly all categories of alternatives funds performed better than or in line with these common benchmarks.

Only two alternatives strategies – options-based and leveraged equity – performed meaningfully worse than common market indices. Notably, these categories are either generally understood to not be captured effectively by VaR (*i.e.*, options-based)[8] or treated independently by the Commission for purposes of this Proposal (*i.e.*, leveraged equity).[9]

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[7] Fund categories and returns data from Morningstar.

[8] VaR does not appropriately capture the risks of options-based fund strategies because these strategies do not have a normal distribution of returns and the inherent nonlinearity of their returns causes VaR results to meaningfully understate the potential downside risk in these strategies unless an extreme market event is in the VaR calculation lookback period. As a result, we expect that these funds would likely not exceed the proposed VaR thresholds in advance of a severe drawdown, when the test needs to be helpful. The more effective way to manage risks in options-based strategies is stress testing, which we support as a key component of the Commission's multi-faceted approach to derivatives risk management in the Proposal.

[9] We note that the Commission treated "leveraged and inverse" funds uniquely under the Proposal and excepted these funds from the VaR

While this returns-based analysis cannot tell us whether any individual funds might be appropriately captured by a well-calibrated outer bound VaR limit, it does show that the broad category of alternatives funds did not present outsized risks to investors during this period of historically volatile markets. As a result, a rule designed to serve as an outer bound limit on unduly speculative behavior should not severely restrict a broad swath of this market segment – as the Proposal's VaR test would do.

Our analysis in this comment letter focuses on funds with alternatives strategies. However, similar evidence of the Proposal's overly broad reach likely exists for a variety of other fund categories given our understanding of industry performance during the Covid-19 crisis period and findings in the ICI survey that an extremely high percentage (15.7%) of respondents across all fund categories would likely be restricted by the proposed VaR limit.[10] Ultimately, we believe that data from real-world market events confirms the need for changes to the proposed VaR test to prevent it from unnecessarily restricting a variety of funds and fund strategies that are not unduly speculative, thereby ensuring that it operates consistent with the Commission's statutory mandate.

3. The proposed VaR limit will negatively impact investors

The overly broad impact of the proposed VaR test on a variety of funds that are not unduly speculative – as shown above – will result in a number of negative impacts on fund investors. While we believe these impacts are unintended, they are nonetheless foreseeable consequences of the Proposal that would not provide a justifiable regulatory benefit.

Potential consequences include forcing managers to design funds that perpetually run at artificially low levels of risk in order to stay below the VaR threshold in all market environments, making popular and diversifying strategies non-viable for most investors given the lack of meaningful potential return. Alternatively, funds that continue to be managed as they are today employing moderate levels of volatility will likely be forced to run with unnecessarily low risk for multi-year periods after heightened market volatility has returned to normal levels, which will severely impair investor return.

Funds may also be forced to quickly take down positions in future market environments in order to comply with the VaR limits. This could lead to large pro-cyclical selloffs into potentially volatile market conditions resulting in sub-optimal pricing for fund investors. In addition to increased selloff risks, we also expect that some managers will be forced to adjust their portfolios to comply with the rule in ways that would not produce the best overall outcome for investors. This result would occur when managers need to selectively reduce positions in an effort to maximize their VaR-reducing impact on the portfolio rather than maintaining their primary focus on investment performance, risk management, and good portfolio design.

On the whole, we believe that an overly restrictive VaR test will likely impede prudent risk management by forcing funds to make VaR the primary risk management tool instead of relying on a

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limits based on certain alternative conditions. We expect that funds designated as leveraged and inverse under Morningstar categories would generally fall within the separate framework for leveraged and inverse funds provided by the Proposal.

[10] *See* ICI Comment Letter at 5.

multi-faceted risk management approach, which the Commission determined through the Proposal to be the most effective way to manage derivatives risk in funds.

4. Conclusion

As noted in the AQR Comment Letter, we broadly support the Proposal and believe that the Commission's decision to rely on a multi-faceted approach to risk management – including stress testing – reflects a sophisticated approach to overseeing derivatives risk in funds. However, certain important changes are needed to make the proposed VaR test an effective outer bound limit within the rule's overall framework. These modifications include increasing the Absolute VaR limit to at least 20%, providing an alternate Relative VaR threshold, allowing funds to extrapolate the VaR calculations from a 95% to a 99% confidence level to create a more stable and accurate metric, and providing a more reasonable remediation period.

We believe that the changes we recommended in the AQR Comment Letter would benefit the Proposal without reducing its effectiveness in limiting potential derivatives risk in funds. We also believe that an examination of fund performance during recent market volatility, combined with the overly broad scope of the proposed VaR limits, justify our recommended modifications to the Proposal's VaR test.

We hope the Commission and its staff find these supplemental comments helpful and we would be pleased to discuss any aspect of this letter with the Commission or its staff. Please feel free to contact us with any questions at [redacted]

Sincerely,

/s/ Michael Mendelson	/s/ Michael Patchen	/s/ Richard Grant
Michael Mendelson Principal Portfolio Manager	Michael Patchen Principal Chief Risk Officer	Richard Grant Managing Director Head of Regulatory and Government Affairs