Brent J. Fields, Secretary
Securities and Exchange Commission
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AFG comments on

Use of Derivatives by Registered Investment Companies and Business Development Companies

General comments

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity given to comment on the SEC consultation on the Use of Derivatives by Registered Investment Companies and Business Development Companies.

Our association represents French asset managers whose European funds are stricly regulated in terms of leverage calculation by the existing European directives (UCITS, AIFM, EMIR, SFTR). AFG believes that it is very useful for US asset managers too to follow a comprehensive approach regarding the regulation of their funds' use of derivatives.

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. More than 600 management companies are based in France. AFG members manage over 3,000 billion euros, making the Paris fund industry a leader in Europe for the financial management of collective investments (with 1,500 billion euros managed from France, i.e. 19% of all EU assets managed in the form of investment funds). In the field of collective investment, our industry includes – beside UCITS – the whole range of AIFs, such as: employee savings schemes, regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment funds. AFG is an active member of the European Fund and Asset Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

Utility from making use of derivatives in asset management

It should be reminded that derivatives bring a significant economic benefit as firms in real economy may need to hedge the risks they are not ready to take, allowing them to focus on core strategies, long term investment projects, etc.

Derivatives are also very useful, if not vital, tools in asset management permitting to optimise the investment solutions adapted to investors' needs in terms of protection, innovation and costs. We firmly believe that derivatives use should not be curbed, but need a comprehensive and appropriate risk management framework.

We would like to refer to the conslusions of a 2013 academic study pertaining to the all-important use of derivatives in the context of asset management : "*The Unintended Consequences of Banning Derivatives in Asset Management*[2]" by Alessandro Beber of Cass Business School and Christophe Pérignon of HEC Paris.

The authors illustrate by concrete examples the usefulness of derivatives. The study says that:

"derivatives allow individuals and firms to achieve payoffs that they would not be able to achieve or could only achieve at much greater cost. More specifically, derivatives can be used to hedge risks and to obtain exposure to an asset class. In both cases, these activities could not be implemented efficiently without the use of derivatives. Furthermore, we show that derivatives are also used to extract information about future market volatility and other key economic variables."

The angle of the result of a ban on the use of derivatives is also explored. The authors affirm that

"Without derivatives:

- Risks would be harder to manage, as derivatives allow fund managers to lower their risk exposures
- Fund performance would be lower, as derivatives reduce transaction costs and allow access to new asset classes
- The investable choice set for final investors would be dramatically reduced
- The cost would be particularly high for smaller asset managers, who cannot benefit from economies of scale when implementing alternative risk management strategies."

The authors also conclude that :

"all the common fears about derivatives use are misplaced for the asset management industry, as the asset manager derivative user is competent and derivative usage is carefully controlled and disclosed. »

[2] https://studies2.hec.fr/jahia/webdav/site/hec/shared/sites/perignon/acces_anonyme/bp.pdf

Portfolio limitation on the amount of leverage that can be used

Regarding the methods used to set limits in the use of derivatives, we would like to stress some important principles for us.

We believe that such a calculation (called leverage or global risk or use of derivatives' limit…) should relate to risk, not to a simple sum of notionals, as the objective is to minimise the risks to investors.

The idea is to ***protect investors against unexpected amplification of market movements***. But this does not mean that the permitted strategies should necessarily be simple enough to be captured by a simple method, or that per se the quantitative use of derivatives should be limited in absolute terms (i.e. without taking into account the related risk).

Thus, the objective is to benefit from a calculation method robust enough so as not to curb added value or innovation and that takes into account the relation to the risk (ie the capacity of amplification of the underlying risk). It is important that the method chosen adequately accounts for the netting and hedging of value of derivatives used that truly act as hedges, i.e. actually act to reduce the risks (it should be mentioned also that the netting and hedging arrangements should involve also security positions, ie the market value of security positions can be used to offset gross commitment). For instance, the use of currency derivatives are most of the time meant to be hedges so as to effectively temper the effects of currency fluctuation on the fund's returns. A too simple method may give as risky a strategy using heavily currency hedging, while the actual result is a fund that reduces currency and volatility risks. And in conjunction with rules regulating the counterparty risk (such as collateral measures and/or central compensation as well as counterparty risk limits[3]), there is no additional risk brought to the fund.

It is also important to note that the use of derivatives may also be a less costly and more liquid means of obtaining an exposure to a financial asset without changing the risk profile of the fund. It is thus useful to benefit - in the case of a linear method calculation and under conditions – from compensation rules between the derivative and the amount of cash held in portfolio (this is equivalent to holding a cash position in the given financial asset) and that the netting and hedging arrangements involve also security positions.

Taking UCITS fund methods of calculation as an example, we would like to put forward some important principles used in the calculation of the global risk limit such as:

- ***2 principal alternative methods*** permitting to adapt to the particular type of strategies operated within a fund (one adapted for more simple and straightforward strategies – the "commitment method" - and another one for more complicated strategies or instruments used and particularly where the commitment method would not help to apprehend correctly the underlying risk – the "Value at Risk method").

- Regarding the ***"commitment method"*** (which constitutes a linear approximation), detailed provisions of netting, duration-netting, hedging (with the market value of security positions that can be used to offset gross commitment) and cash netting (when cash + derivative is equivalent

[3] These rules are part of the European regulatory framework either through the EMIR Regulation or product regulation such as the UCITS Directive.

to holding a cash position in the given financial asset) permit to adjust the method to give a more precise view of the real capacity of amplification of risks present in the fund.

- Regarding the "***Value at Risk method***"[4], provisions of stress testing and back testing complement the use of the method. The use of the VaR method allows for integrating all types of instruments in the calculation and thus permits financial innovation. The VaR method allows for balancing different types of instruments' risks (which is not the case for exposure-based methods, such as the commitment method). Indeed, the commitment method simply adds up equity risk and fixed income risk. Since the VaR method was introduced (2006), no incident or default linked to the leverage has been reported on a UCITS using the VaR method. Leverage calculations should properly reflect the risks encountered by the investor. Developments implemented by the European Securities Markets Authority (ESMA) regarding possible netting among financial instruments based on their sensitivity to different market variables under the commitment method definitely remain a huge accomplishment. Nevertheless, the commitment method remains "empirical" in the sense it cannot be exhaustive and favours certain strategies over the others. Even if correlations are time-varying, global exposure calculated through methods that take into account risks that effectively compensate are more precise provided that the VaR models used are properly calibrated through an extensive back testing.

- The respect of the regulatory metric for measuring the global risk is not replacing the ***operational risk management framework*** to be implemented by the manager so as to adequately apprehend and control the risks within the fund.

Given our concrete track-record of using derivatives in funds in France (since 1986) and subsequently detailed European rules and guidelines on the subject, we would be very interested to further exchange with you on the use of derivatives and the leverage calculation within funds. We remain at your disposal to bring up our members' experience in the field of derivative use and leverage calculation for funds.

If you need any further information, please don't hesitate to contact myself [redacted]).

Sincerely Yours,

Adina Gurau Audibert

Head of Investment Management Techniques

[4] Where the SEC proposal uses Value at Risk as a test, the European rule uses the metric as an alternative method.