FRANKLIN TEMPLETON INVESTMENTS

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March 28, 2016

Brent J. Fields
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

Dear Mr. Fields:

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 February 29, 2016, Franklin Templeton managed approximately $714 billion in assets, of which over $406 billion constituted investment companies registered with the SEC under the Investment Company Act of 1940.

Franklin Templeton appreciates the opportunity to comment on the SEC's proposal to adopt new Rule 18f-4 under the Investment Company Act, which would govern fund investments in derivatives. We participated in the development of, and broadly endorse, the comment letters on this proposal filed by the Investment Company Institute and the Asset Management Group of the Securities Industry and Financial Markets Association (though not necessarily each of the specific recommendations set forth in those letters).

General Comments on Proposal

Franklin Templeton supports several elements of the SEC's proposal. In particular, we believe the adoption of a uniform standard for the amount of assets that must be segregated by funds would be a significant improvement over the current framework, in which segregation equivalent to market value is required for certain transactions while other types of transactions require segregation of an amount equal to the full notional value (and, in the case of certain other transactions, there is no formal guidance whatsoever). In addition, we believe that the SEC's proposed approach – segregation of assets equivalent to market value plus an additional amount that reasonably approximates additional potential exposure under stressed conditions – is the most prudent way to address concerns that a fund may find itself unable to meet its obligations.[1]

[1] Consistent with the views of the ICI and SIFMA, we would support some broadening of the types of assets that could be utilized for asset segregation. Any such assets (i.e., beyond cash and cash equivalents) should be subject to "haircuts" (which would mean that a greater amount of such assets would be required to be segregated). We also support the SEC's proposal to permit funds to reduce the amount of segregated assets by the value of any margin or collateral, irrespective of the types of assets that are used for margin or collateral.

We also support the proposal to require funds that engage in more than a limited amount of derivatives transactions to have a formal derivatives risk management program. The existence of such a program should help facilitate compliance as well as oversight by fund boards.

We believe that the combination of the new asset segregation requirements and the risk management program would provide a robust framework for ensuring that fund investments in derivatives are consistent with the limitations set forth in the Investment Company Act, in particular those pertaining to senior securities under Section 18. However, the SEC's proposal goes further and would include an additional set of restrictions on investments in derivatives, based upon the notional value of those investments. The proposed notional limits are, in our view, unnecessary and not grounded in the governing statute. They also could have perverse consequences that would preclude funds from managing their portfolios in the best interests of their shareholders.

We discuss these points below.

Notional Limits are Unnecessary and Problematic

The Investment Company Act does not prohibit, or limit, fund investments in complex securities, including derivatives. It does, in Section 18, restrict a fund's ability to issue senior securities. While, on their face, portfolio investments in derivatives are quite different from the issuance of senior securities, since 1979 the SEC has taken the position that investments that potentially create future financial obligations raise issues under Section 18. The SEC further stated, however, that these issues could be addressed through asset segregation, and has subsequently expanded that approach to various types of derivatives and other transactions. It thus has been settled law for many years that fund investments in derivatives are permissible provided that the fund appropriately segregates assets.[2]

The SEC's notional limit proposal would reverse this long-standing position, and would do so on dubious grounds. To the extent that funds segregate assets in an amount sufficient to cover their potential exposure, which they would continue to be required to do under the proposal and which the SEC acknowledges can be less than the full notional amount, we do not understand on what basis those funds could be deemed to have issued "senior securities" in violation of Section 18. The limits on notional exposure in the proposal thus have little support in the Investment Company Act.[3]

The SEC seeks to justify notional limits by pointing out that funds are not required to segregate the full notional amount of derivative transactions, as was (supposedly) originally contemplated in 1979.[4] But this ignores the fact that, despite the trend towards segregation of assets equivalent to mark-to-market values, there have been virtually no instances of issues arising under Section 18 (and even the few cases the SEC cites in the proposing release did not involve funds being unable to satisfy redemptions). It also ignores the other aspects of the SEC's proposal – especially the requirement to segregate an additional amount based on stressed scenarios. To the extent that this enhanced asset segregation requirement

[2] Derivatives here refers to those derivatives that involve actual or potential future financial obligations.
[3] The proposing release habitually cites Section 1(b)(7) of the Investment Company Act, which sets forth the finding that the public interest and the interest of investors is adversely affected by excessive *borrowing and issuance of senior securities* (emphasis added) that unduly increase the "speculative character" of fund shares. But the Investment Company Act addresses this policy concern through Section 18; Section 1(b)(7) does not provide a separate *carte blanche* for the SEC to limit any activities it deems to be "speculative."
[4] See Investment Company Release No. 31933 (the "Release") at 34-48.

ensures that funds have adequate assets to meet their obligations – which is its clear intent – there seems to be little if any legal justification for imposing the proposed notional limits.[5]

Our concerns are not simply theoretical. The proposed limits would have a direct impact on existing registered funds, to the detriment of investors.

While the DERA study apparently concluded that only a small percentage of funds (mainly alternative strategy funds and certain leveraged ETFs) would be unable to meet the proposed notional limits, the ICI and others have found that a much greater number and types of funds would be impacted. This is consistent with our own assessment. Franklin Templeton does not offer leveraged ETFs or other types of speculative funds; all of our registered funds (including our alternative strategies funds) have consistently been able to cover their derivative transactions in accordance with existing guidance and would, we believe, continue to be able to do so under the SEC's proposed revisions to the asset segregation regime.[6] Yet several of these funds would find it difficult or impossible to assure compliance with the proposed 150% notional limit, absent significant changes to their investment strategies. And we wish to stress that most of the transactions that would raise issues for us under the proposal are "plain vanilla" investments such as currency forwards and interest rate futures and swaps. Restricting these types of investments in order to comply with an arbitrary numerical limit would only penalize our investors.

Of course, the SEC's proposal does offer funds the ability to rely on a higher notional limit (300%) if they are able to satisfy a relative VaR test. But the proposed condition (which would require real-time pre-trade testing) is all-but-unworkable and could be a trap for many funds. VaR can change due to market conditions, and even derivatives designed to hedge a specific portfolio risk can sometimes result in an increase in VaR. A fund that found itself out of compliance could then be unable to engage in any further derivatives transactions, including those designed to hedge risk or roll over existing positions. Ironically, these types of transactions might be especially important in times of market stress (which is precisely when VaR calculations might suddenly change). The SEC's proposal thus runs the risk of introducing destabilizing factors for funds and their investors.[7]

We question further the rationale for such a strict condition, which in effect demands that funds continuously guarantee that their investments in derivatives have a *zero* net increase in risk as measured by VaR. It beggars belief that anything north of this level would cause a fund to be "unduly speculative."

The SEC's proposed relative VaR test also would be highly problematic from an operational perspective. VaR calculations are relatively complex – much more so than, say, computing ownership percentages for purposes of diversification or industry concentration compliance. In our case, the risk model we use runs 100,000 random scenarios as part of a Monte Carlo simulation. This process is run overnight (U.S. time) and involves performing validation checks to ensure the quality of the output; by the time it is

[5] As the SEC has recognized, "[i]f an investment company . . .properly segregates assets, the segregated account will *function as a practical limit on the amount of leverage* which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock." Investment Company Release 10666, 44 Fed. Reg. at 25132 (1979) (emphasis added).

[6] Nevertheless, we still believe, as noted above, that the SEC should broaden the universe of eligible assets.

[7] We further do not understand the reason why funds should be forced to rely on only one of the two proposed limits and especially why it is necessary or appropriate to require *fund boards* to approve the limit.

complete, trading in Asia will have ended for the day, and trading in Europe will have already been underway for several hours. [8] It is thus not feasible to repeat this process prior to every trade.

For the above reasons, we urge the SEC to drop aggregate notional limits from its proposal. However, to the extent the SEC feels some limits are necessary, we offer below some suggestions that should help mitigate the most serious concerns.

Alternative Approaches to Notional Limits

We believe that the SEC could revise the notional limits proposal to make it more workable while still meeting its policy objectives. Set forth below are three possible approaches (which are not necessarily exclusive of one another). The three approaches are (1) applying haircuts to the notional measures, (2) a variation on the VaR tests used for UCITS that we believe addresses the SEC's concerns with that approach and (3) a revised relative VaR test that focuses on derivatives above a certain threshold.

Adjustments to Notional Amounts. The SEC admits that limits based on notional amounts are a "blunt instrument".[9] We agree, although this greatly understates the matter. There is a world of difference between the potential exposure a fund has when it, say, writes credit default protection through a swap on a below-investment grade issuer versus entering into a three-month U.S dollar-euro forward contract for the same notional amount. It simply makes no sense to treat the two identically.

Accordingly, we would urge the SEC to base any investment limits on *adjusted* notional amounts. We recognize the need for there to be some objective standards for such adjustments and therefore believe that the SEC should look to existing regulatory regimes (e.g., the swap margin rules adopted under the Dodd Frank Act by the Commodity Futures Trading Commission and the U.S. banking regulators, or the Bank of International Settlements Initial Margin Schedule) in fashioning such standards.

Enhanced UCITS Test. Similar to the SEC's proposal, UCITS domiciled in the EU are subject to a VaR-based regime with respect to their derivatives investments. Generally speaking, UCITS that invest in derivatives are permitted to utilize a VaR-based approach under which they must satisfy one of two tests: either the VaR of the portfolio (including derivatives) must be no more than 200% of an unleveraged reference portfolio or index, or the absolute VaR of the full portfolio must be less than 20%.[10] These limits act as practical, risk-based constraints on investments in derivatives, and would be much easier to monitor than the SEC's proposed limits. Franklin Templeton, as a significant sponsor and manager of UCITS (with over $108 billion in assets under management), has a great deal of experience in complying with these limits, and we believe that there is significant merit in having common, or at least similar, global standards, particularly where, as here, the offshore regime has worked well.

The SEC's release discusses the UCITS approach, but notes certain reservations, including that the use of an absolute VaR test might not prevent funds from obtaining substantial amounts of leveraged exposures and that use of a reference or benchmark portfolio for purposes of the relative VaR test raises certain issues.[11] We believe these concerns can be fully addressed by (1) retaining the 300% investment

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[8] For this reason, we strongly recommend that funds be permitted to conduct any VaR test, including the variations discussed below, on a once-a-day basis and have that test only govern *subsequent* derivative transactions.
[9] Release at 70.
[10] UCITS may also rely on the "commitment" approach, as described in the Release.
[11] Release at 346-347.

limit[12] and (2) requiring the relative VaR test to reference a fund's actual portfolio (excluding derivatives), rather than a benchmark or index.

We believe that, if the SEC is determined to adopt investment limits, this enhanced UCITS test would still achieve the SEC's objectives, but in a more flexible and workable manner. In particular, a 200% relative/20% absolute VaR standard would recognize that funds use derivatives for purposes other than hedging and that even hedging can sometimes be VaR increasing. Funds thus should not be penalized if, under certain market conditions, their derivative investments (modestly) increase VaR. (Funds that go beyond the VaR limits would, per the SEC's proposal, be subject to a lower notional limit.) And, retaining some form of the 300% limit would ensure that there would continue to be an "outer bound" on derivatives investments.

Alternative Relative VaR Test. The ICI has suggested another alternative to the SEC's proposed relative VaR test – rather than comparing the VaR of the fund's full portfolio to the VaR of the portfolio absent all derivatives, the ICI would permit funds to compare the full portfolio VaR to the VaR of a portfolio including derivatives, but only up to the lower notional limit.[13] This approach is fully consistent with the logic of the SEC's proposal – since all funds would be permitted to invest in derivatives with an aggregate notional value of up to 150% of the fund's total net assets (irrespective of the fund's VaR), it makes sense to use this as the reference portfolio, and only require derivative investments beyond this level to be risk-reducing in the aggregate.[14]

Additional Comments on Proposed Notional Limits

In addition to the above comments, if the SEC adopts notional limits, we recommend that they incorporate the following revisions.

Ten-Year Equivalent for Interest Rate Derivatives. The SEC requested comment on whether it should permit funds to normalize the calculation of notional exposure for interest rate derivatives by using ten-year bond equivalents.[15] We believe it should. Use of ten-year equivalents is consistent with market practice and properly recognizes the differences in potential exposure of a short-term (e.g., three-month) contract versus a longer-term one.[16]

Exclusion of Direct Hedges. We believe the SEC should exempt derivative transactions that are direct hedges from any investment limits. The SEC rejected this approach out of concerns that it might be difficult to define what constitutes a direct hedge. But there are clearly *some* types of transactions that should unambiguously qualify, such as currency hedging transactions where a fund owns a security

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[12] Ideally this limit should be based on the adjusted notional amount set forth above. At the very least, the notional amount should be modified in the case of certain interest rate derivatives and direct hedges, as discussed below. It also should be noted that, even in the absence of the 300% limit, the asset segregation requirements would serve as a practical limit on a fund's aggregate exposures to derivatives.

[13] 150% under the SEC's proposal; the ICI recommends that this be raised to 200%.

[14] For the reasons noted above, we believe that funds should be permitted, under either the enhanced UCITS alternative or the ICI proposal, to compute VaR only once a day. It is our preliminary sense that, while we could successfully implement the ICI proposal, it would be somewhat more complicated and costly than the enhanced UCITS alternative.

[15] Release at 89.

[16] We note that a special rule permitting the use of ten-year bond equivalents may not be necessary if the SEC adopts broader adjustments to notional values as recommended above.

denominated in the same underlying currency. There is no reason why such transactions should be limited by the proposed rule.

Clarify Treatment of Certain Derivatives with Nominal Future Obligations. The proposed rule correctly only applies to derivatives transactions in which funds will or may be required to make future payments. In certain cases, however, such future obligations are fairly certain and less than the notional amount of the derivative. A good example is where a fund purchases protection on a bond through a credit default swap. Under such a contract, although the periodic "premium payments" involve future obligations, the fund would *receive*, rather than pay, net amounts based on the principal amount of the underlying credit in the event of a default. Thus, the fund's potential exposure would be significantly less than notional value. The final rule should clarify that these types of transactions would either be excluded from the rule or, in the alternative, that the notional amount for purposes of any investment limit would be equal to the aggregate future payment obligations under the swap.

Financial Commitment Transactions. Consistent with the views of the ICI, we recommend that financial commitment transactions be excluded from the calculation of notional exposure limits. As the proposal requires segregating the full amount of a fund's obligations under these transactions, there is even less justification to reverse the SEC's long-standing position that Section 18 concerns are sufficiently addressed through asset coverage. Excluding financial commitment transactions also would be consistent with the approach taken in the proposal for determining when a risk management program is required.[17]

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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,

Craig S. Tyle

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

David W. Grim, Director
Diane C. Blizzard, Associate Director
Division of Investment Management

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[17] We also recommend that the SEC permit funds to net financial commitment transactions (such as offsetting TBA buy and sell transactions) for purposes of determining the amount of qualifying coverage assets to be segregated.