March 28, 2016

<u>Via Electronic Submission</u>

rule-comments@sec.gov
Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-24-15
Comments on Proposal Related to Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

WisdomTree Asset Management, Inc. ("WisdomTree") appreciates the opportunity to submit comments to the Securities and Exchange Commission (the "SEC" or "Commission") on its recent proposed Rule 18f-4 (the "Proposed Rule") regarding the use of derivatives by registered investment companies and business development companies as set forth in the proposing release (the "Proposal").[1] WisdomTree is currently the 5th largest provider of exchange traded funds ("ETFs") in the United States. WisdomTree helped to pioneer the concept of fundamentally weighted ETFs through proprietary methodologies, while also becoming a leader in currency hedged ETFs, and introduced some of the first actively managed ETFs, including the industry's first managed futures ETF. These strategies, among others used by WisdomTree ETFs, incorporate the use of derivatives. As a leader in establishing innovative ETFs, WisdomTree believes it has a unique perspective on the potential issues that the Proposal may cause with respect to ETFs.

WisdomTree strongly believes, and its ETFs have demonstrated, that registered funds' use of derivatives can provide significant benefits to such funds and their shareholders and, when used properly with sound risk management practices accompanied by comprehensive, clear disclosure, do not pose excessive risks to fund shareholders. Portfolio managers may use derivatives, consistent with a fund's investment objective and strategies, in seeking, among other uses, to track the performance of an index, hedge portfolio exposures, gain or reduce exposure to certain markets, sectors and/or securities more quickly and/or with lower transaction costs than with other portfolio management tools, and reduce overall portfolio volatility. Regulatory requirements that curtail use of these instruments may have significant unintended and adverse consequences, as explained more fully below.

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[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Inv. Co. Act Rel. No. 31933 (2015), 80 Fed. Reg. 80884.

I. Executive Summary

We summarize our key points below:

(1) Section 18 of the Investment Company Act of 1940, as amended ("1940 Act"), by its terms and the accompanying legislative history, was designed to regulate the capital structure, not the portfolio activities, of registered funds. Notwithstanding the questionable application of Section 18 to derivatives use, the regulatory framework that has been in effect for over 30 years has focused on a fund's ability to meet counterparty obligations through adequate asset coverage (including the use of any liquid asset since 1996) and/or offsetting transactions. The industry has operated within this regime responsibly and without significant problems. Given the limitations on the Commission's authority as well as the absence of any indication of abuse or shareholder harm, there is no justification for imposing arbitrary portfolio exposure limits on the use of derivatives or reverting to allow only cash and cash equivalents for coverage.

(2) The Commission should take a principles-based approach to regulating the use of derivatives in recognition of the fact that there is a wide variety in the types of derivatives, the risks associated with them, and the manner in which they are used. The Commission should provide high level guidance on the factors that funds and boards should consider with the goal of curbing undue speculation and ensuring that funds can meet their obligations to counterparties. Similarly, the requirements of the derivatives risk management program represent an unprecedented intrusion into how funds and their advisers should manage and structure their operations, as well as how boards should oversee these efforts.

(3) If the Commission determines that portfolio exposure limits are essential, instruments that are used for hedging purposes should be excluded from such limits. Otherwise, the result will be *increased* risks to shareholders. Further, while it is not clear that value at risk (VaR) is an appropriate risk measurement method to be used, we believe that if the Commission determines that VaR must be used, any particular derivative instrument that lowers the VaR of a fund should be excluded from prescribed limits.

(4) Coverage assets should not be limited to cash and cash equivalents, as imposing these restrictions will interfere with a fund's ability to manage its portfolio. A better approach would be to allow any liquid asset to be used, consistent with the Commission's final liquidity management rules, and require appropriate adjustments to the value of such securities as are in place currently through collateral accounts and required by other regulators.

(5) The Proposed Rule would have many unintended consequences, including: (i) the forced deregistration or liquidation of certain investment strategies now available to retail shareholders with the protections of the 1940 Act; and (ii) with respect to ETFs, the potential to increase tracking error, decrease liquidity and increase costs in the arbitrage function and in the secondary market, and hurt tax efficiency.

(6) Forcing funds that use derivatives into cash or cash equivalent markets for coverage and/or out of derivatives and into other financial markets would put pressure

on the liquidity of fund portfolios, contrary to another stated policy concern of the Commission.

(7) The Commission's concerns about undue speculation can be addressed through transparency and increased disclosure, and the Commission should consider whether fewer restrictions are appropriate for funds that provide daily transparency of portfolio holdings.

II. Neither the Plain Language of Section 18, its Legislative History, nor Industry Developments, Justify the Imposition of Portfolio Limits and Strict Reversion in Asset Coverage Requirements

For more than 30 years, the SEC and its staff have applied Section 18 of the 1940 Act to the use of derivatives by registered funds through a seminal release, numerous no-action letters, comments to individual fund registration statements, speeches and other public statements. However, the application of Section 18 to a fund's trading practices and portfolio holdings is far from obvious, given the plain language of the statute and the legislative history accompanying Section 18.

Section 18 generally prohibits funds from *issuing* senior securities, subject to limited exceptions. "Senior security" is defined as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." In considering Section 18, Congress expressed concern that funds were routinely issuing debentures (a form of debt) and/or several classes of preferred stock, creating leveraged structures that undermined the interests of common stockholders.[2] Section 18 was, therefore, clearly intended to regulate a fund's capital structure and not fund investments or trading practices. Moreover, the definition of senior security clearly does not contemplate instruments that do not meet the definition of security, such as swaps on broad-based indexes or futures contracts.

In 1979, the Commission published Release 10666, expanding the definition of "senior security" and thus the reach of Section 18 to certain trading practices that create leverage.[3] Release 10666 represents the first instance where the Commission interpreted Section 18 broadly enough to encompass portfolio investment and trading practices, as opposed to the capital structure, of a fund. Release 10666 addressed the use of: (1) reverse repurchase agreements; (2) firm commitment agreements; and (3) standby agreements (collectively, the "Trading Practices"). Release 10666 noted that the Trading Practices were only examples, and if a fund "were to issue a security which affected its capital structure in a manner analogous to the [Trading Practices], and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture."[4]

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[2] *See* Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. at 790 (1940) ("Senate Hearings") (Statement of E. Merrick Dodd, Jr.). *See also* Senate Hearings at 1025 (memorandum titled, Provisions of the Proposed Bill Relating to Capital Structure (Sections 18, 19(b) and 21(c)).

[3] *Securities Trading Practices of Registered Investment Companies*, Inv. Co. Act Rel. No. 10666 (1979), 44 Fed. Reg. 25128, 25129 ("Release 10666").

[4] Id. at 25128.

Release 10666 stated that there would be no violation of Section 18 (*i.e.,* no senior security created) if a fund engaging in any of the Trading Practices maintains a segregated account of "liquid assets" to "cover" the obligation associated with a transaction.[5] The purpose of the segregated account was to limit the speculative character of an investment in the fund by reducing the fund's risk of loss and assuring the availability of adequate assets to meet the obligation associated with the transaction.[6]

Following the publication of Release 10666, the Division of Investment Management (the "Division") issued many no-action letters further extending the definition of senior security to a variety of derivatives contracts and other types of leveraged transactions (*e.g*., short sales of securities) that it believed were "analogous to" the Trading Practices. In the course of these no-action letters, the Division provided guidance on an instrument-by-instrument basis as to how a fund could avoid a violation of Section 18 by covering specific types of transactions through asset segregation, offsetting transactions, or a combination of the two.[7]

Thus, from an interpretive perspective, for over 30 years, the Commission and then the Division looked to the ability of a fund to meet its potential obligation to the derivatives counterparty, or the ability to "cover" this obligation, as the means of eliminating the issuance of a senior security. There was no imposition of any other restriction or portfolio limit on the use of derivatives. Furthermore, for nearly 20 years, the Division has permitted a fund to use any liquid asset, including equity securities, for coverage purposes.[8] In issuing the Merrill Lynch letter, the Staff concluded that segregating any type of liquid asset would serve adequately to limit a fund's ability to leverage, but also any potential increases in the speculative nature of its outstanding shares.

During this period, WisdomTree and other asset managers have effectively managed derivatives risk through volatile and distressed market conditions (including limiting undue speculation while providing sufficient asset coverage). Even throughout the financial crisis that began in 2007, we are unaware of any fund that has reported being unable to meet its obligations under a derivatives agreement to the detriment of fund shareholders, including as a result of the type of liquid asset being segregated.

Notwithstanding the absence of any indication that funds are using derivatives or covering their derivatives exposure in a reckless or irresponsible manner that in any way adversely impacts the interests of fund shareholders or creates undue speculation, the Proposal now takes a dramatically different and far more restrictive approach to interpreting Section 18. For the first time, the Commission, through the Proposal, takes the position that even if a

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[5] Liquid assets included cash, U.S. government securities and other high grade debt obligations.
[6] Release 10666 at 25132.
[7] *See, e.g.,* Dreyfus Strategic Investing, SEC No-Action Letter (June 22, 1987) (the "Dreyfus letter"). In the Dreyfus letter, the Division addressed the use of asset segregation and offsetting transactions to cover short sales and certain derivatives transactions, including the purchase and sale of futures contracts, the sale of options, and the purchase and sale of currency forwards. The Dreyfus letter stated that funds may cover these derivatives transactions by engaging in certain offsetting transactions, or by segregating the full notional amount of the fund's potential obligation under the derivatives contract.
[8] *See* Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "Merrill Lynch letter").

fund has adequate coverage assets to meet its obligations to counterparties, its use of derivatives will constitute the issuance of a senior security unless it also limits its exposure to derivatives to one of two portfolio limit thresholds. Further, the Commission is effectively overturning nearly 20 years of precedent by reverting to allow only cash and cash equivalents for coverage.

The Commission arguably lacked authority in 1979 to apply Section 18, a provision that Congress clearly intended to address a fund's capital structure, to a fund's portfolio activities. Now, through the Proposal, the Commission undertakes an even broader and more restrictive interpretation of Section 18. WisdomTree urges the Commission to reconsider these positions, as an expansive reinterpretation of the statute is not justified given the plain language of the statute nor any evidence of shareholder harm that has occurred under the interpretations in place for decades. Such dramatic changes may seem warranted if the Commission demonstrated a particular critical need for remedial regulatory action. The Proposal fails to describe such circumstances. Because these portfolio limits and more restrictive asset coverage requirements are not warranted and can lead to unintended consequences as described below, WisdomTree believes that the Commission should reconsider whether hard portfolio limits and stricter asset coverage requirements are appropriate or necessary.

III. The SEC's Proposed Prescriptive Approach to Derivatives Regulation is Not Necessary or Appropriate

A. The SEC Should Take a Principles-Based Approach to Derivatives Regulation

WisdomTree does not believe that any set of prescriptive and generally mechanical rules properly takes into account the diversity of derivatives and the different ways that derivatives can be used by funds. Others have shared similar views prior to the publication of the Proposed Rule and we anticipate similar comments on the Proposed Rule itself. Specifically, a Task Force of the American Bar Association recommended that the SEC take a "principles-based and flexible approach" permitting funds to adopt appropriate procedures for establishing minimum asset segregation requirements for each type of derivative, including the types of assets that may be segregated, and further recommended that the SEC provide general guidance on, for example, instruments that require greater amounts of asset coverage such as those exhibiting issuer or transaction-specific risk.[9] Similarly, we believe that the SEC should take a principles-based approach to the amount and types of derivatives that a fund may hold. A set of bright-line rules, such as those being proposed, cannot take into account the diversity of derivatives that range from standardized exchange-traded instruments to highly customized over-the-counter contracts between two parties, or the varying ways that derivatives may be used by portfolio managers, including whether the use of derivatives significantly reduces the risk to shareholders. Further, such bright-line rules do not take into account that different derivatives have very different risk and volatility profiles, such that even a fund with greater than 300% of notional derivatives exposure may have an overall

[9] ABA Section of Business Law, Committee on Federal Regulation of Securities Report of the Task Force on Investment Company Use of Derivatives and Leverage (July 6, 2010) (the "ABA Derivatives Report") at 17.

lower risk profile than a fund with substantially less derivatives exposure. Finally, the Proposal does not consider the different ramifications of its restrictions on passively managed as opposed to actively managed funds.

A principles-based approach would require the adoption of appropriate policies and procedures under Rule 38a-1, which would be subject to review and approval by a fund's board and oversight by the funds' Chief Compliance Officer, as well as subject to SEC staff inspection and examination. These policies and procedures could establish asset segregation standards tailored to: (1) the characteristics of particular derivatives, such as liquidity and volatility; (2) how such derivatives are used by the portfolio manager; and (3) whether the fund receives collateral from, or is required to provide collateral to, a counterparty. A principles-based approach would accommodate a broad range of investment strategies while requiring appropriate risk management measures and adequate fund resources to meet obligations to counterparties. If the Commission deemed appropriate, it could articulate principles around the amount of collateral required.

Moreover, the derivatives risk management program also should be less prescriptive and more principles-based. The Proposed Rule would require funds to adopt a formalized risk management program with a designated derivatives risk manager separate from the fund's portfolio managers. The Proposed Rule specifies the requirements of the risk program, including which policies and procedures should be included, what the board needs to do to oversee the program, and who within the organization should be responsible for the program, including specifying the person's qualifications. WisdomTree appreciates the need for funds to have robust compliance programs in place to ensure compliance with the federal securities laws, and compliance with any derivatives rule adopted by the Commission should be no exception. However, WisdomTree respectfully submits that the Proposed Rule takes a far too prescriptive approach to compliance and risk management, crossing the line into inappropriately mandating how funds and their advisers manage and structure their organizations, and micromanaging how the board's oversight role should function.

We believe that the vast majority of registered fund investment managers have a formalized risk oversight function and/or incorporate the consideration of various types of risks into how they conduct their daily operations, including portfolio management. Similarly, registered fund boards have developed a variety of ways in which to oversee a risk management process and registered funds are specifically required, per Form N-1A, to "disclose the extent of the board's role in the risk oversight of the [registered fund], such as how the board administers its oversight function and the effect that this has on the board's leadership structure."[10] This, too, is necessary and appropriate. The key point here is that fund complexes vary in size, structure, outsourcing, and staffing, depending on the types and number of products they manage, and boards employ a variety of ways to oversee these fund complexes.

The Division has made significant progress in improving the disclosure about the use of derivatives, which is critical for shareholders to understand how derivatives are used, the

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[10] *See* Form N-1A, Item 17(b)(1).

risks associated with their use, and how they contribute or detract from fund performance.[11] WisdomTree strongly supports these efforts and any additional efforts towards enhancing disclosure to shareholders in a measured manner. These efforts would address concerns about undue or unknown speculation surrounding the use of derivatives, and would add support to a more principles-based as opposed to prescriptive approach to regulating derivatives use by registered funds.

WisdomTree believes that the Commission should: (1) allow funds to adopt procedures reasonably designed to facilitate compliance with the Proposed Rule within the Rule 38a-1 process, which has proven effective for all the other requirements of the federal securities laws; and (2) provide high-level guidance regarding the various areas of risk and compliance (*e.g.*, disclosure, operational, leverage) to be considered, while allowing advisers and funds (and fund boards) the flexibility to develop programs and reporting suited to their respective businesses. The Proposed Rule requirements regarding a designated derivatives risk manager, his or her relationship with portfolio managers, the person's qualifications, and escalation procedures, is intrusive, costly, and unnecessary, and clearly not the only way to ensure that risks are properly monitored, addressed and reported. Depending on the structure of an organization, a specific derivatives risk manager may result in a derivatives risk assessment that is compartmentalized away from investment considerations, when a portfolio management team may be best suited to assess the risk (or risk mitigation) that derivatives contribute to a fund, with support from compliance, operations and other functions. The approach taken in the Proposed Rule represents unprecedented micromanagement by the Commission into the daily operations of a fund's and adviser's business, including functions for which there is no reference in the 1940 Act and may be beyond the Commission's statutory mandate, and accordingly should be reconsidered or abandoned.

B. The SEC Should Engage in Further Study Before Requiring Prescriptive Rules

Much of the Proposal focuses on the Proposed Rule's expected minimal impact on the industry based on the study conducted by the Commission's Department of Economic and Risk Analysis ("DERA"). Although the Commission asserts "a substantial majority of funds in the DERA sample did not use derivatives or used derivatives to a limited extent,"[12] it remains to be seen how many funds will be materially affected by the Proposed Rule. The DERA analysis purports to have surveyed a cross section of the registered fund industry to evaluate the extent of derivatives use, but those statistics and conclusions by definition are arbitrary and imprecise. The DERA Analysis surveyed only 10% of funds from each of several categories, leaving significant questions as to the full impact of the Proposal on the industry.

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[11] *See* Letter from Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010) . *See also Investment Company Reporting Modernization*, Inv. Co. Act Rel. No. 31610 (2015), 80 Fed. Reg. 33590, 33594.

[12] Proposal at 80958.

When calculating each fund's derivative exposures, no consideration was given as to the reasons why funds use derivatives, nor could DERA distinguish between derivatives that create potential future obligations and those that do not. Furthermore, DERA did not consider the costs associated with restricting the use of derivatives, including through reduced returns and reduced diversification of investment strategies if funds must restructure their portfolios.

DERA conducted no analysis as to the impact of the requirement that funds use only cash and cash equivalents to cover derivatives exposure, as opposed to all liquid assets as currently allowed. As explained in Sections IV. and V. below, there could be a significant impact and increase in costs triggered by this requirement, including specifically with respect to ETFs, none of which was considered by DERA.

WisdomTree respectfully submits that a more comprehensive review of the impact of the approach taken in the Proposed Rule is necessary before these restrictions are imposed.

IV. Substantive Limits and Restrictions

In the event the Commission determines not to pursue a principles-based approach to derivatives regulation, and to instead impose substantive limits and restrictions, there are at least two specific requirements that should be modified: the method by which portfolio exposure limits are calculated, including the impact of individual derivative instruments that *lower* risk in the fund's portfolio, and the limitation on coverage assets to cash and cash equivalents.

A. Portfolio Limits, if Imposed, Should Not Include Hedging Instruments

If the Commission determines that portfolio exposure limits must be incorporated into any final rule, WisdomTree urges the Commission to consider excluding from the exposure limits those derivatives that are used for hedging purposes. If one of the key Commission policy imperatives is to limit speculation to protect shareholders, it does not make sense to limit the use of instruments that are designed to *lower* the risk associated with a fund's portfolio securities. Therefore, to the extent that a fund can tie a particular derivative instrument as a hedge against risk associated with a specified portfolio holding or holdings, WisdomTree believes that these derivatives should be excluded from the calculation of any portfolio limits. Otherwise, a fund's ability to hedge risk would be curtailed in a manner that could, perversely, *add* risk and speculation to a portfolio, which is counter to the Commission's stated policy rationale for the limits. Examples of instruments that might fall into this category are: (1) currency forwards, which are typically used to hedge or eliminate currency risk; (2) Treasury futures or interest rate swaps, which are frequently used to lower the duration of a bond portfolio to make the portfolio less sensitive to a change in interest rates; (3) equity index swaps, which are frequently used to hedge equity risk; and (4) credit default swaps, which are frequently used to hedge credit risk associated with a particular bond.

B. The Impact of Individual Derivative Instruments Should be Considered in Assessing VaR Rather Than the Totality of Derivative Instruments

While it is not clear that VaR is an appropriate risk measurement method to be used, if the Commission determines that VaR must be used in assessing limits on derivatives exposure, any derivative instrument that lowers the VaR of a fund should be excluded from such limits. We do not believe that derivatives should be grouped together for this purpose; rather, if a derivative instrument *lowers* the VaR associated with a fund's portfolio securities, it should be excluded independent of other derivative instruments.

C. Coverage Assets Should Not be Restricted to Cash and Cash Equivalents

As explained above, we support the concept of asset coverage as an effective way to serve investor protection goals. We also agree that it is appropriate to require funds to designate an amount greater than the marked-to-market exposure of certain derivatives in the form of a risk-based amount, or cushion, to ensure that a fund may meet its obligations to counterparties in volatile or declining markets.

However, as noted earlier, we strongly disagree that the types of liquid assets should be limited to cash and cash equivalents as indicated in the Proposal. The Merrill Lynch letter permitted a fund to use any liquid asset for asset coverage purposes, which enabled funds using a wide variety of securities to use derivatives effectively without interfering with their core investment strategies. A reversion by the Commission to allow only cash and cash equivalents for coverage purposes may be in conflict with the stated investment objective and strategies of many equity, bond and alternative funds in the marketplace today and would effectively prevent such funds from being able to use derivatives when derivatives are the most effective way, and in some cases the only way, for such funds to implement their strategies and meet their objective. Not only would this be potentially disruptive to a wide array of existing funds and their shareholders as funds would need to restructure their portfolios to hold a greater portion of their assets in cash or cash equivalents, but it also may serve to reduce returns or modify portfolio characteristics to the detriment of such funds' investors. Forcing funds to hold more cash and cash equivalents could have an adverse impact on performance (*i.e.,* cash drag) in certain market conditions, particularly harmful in a very low interest rate or even negative interest rate environment where these holdings could trigger capital losses.

This detriment may be particularly acute for investors in ETFs and contrary to important marketplace goals and Commission objectives for ETFs, as we further discuss in Section V. below. As noted above, such potential impacts were not even explored in the Proposal or in the DERA analysis.

The Merrill Lynch letter enabled funds to use derivatives in a responsible manner without sacrificing their respective portfolio strategies by holding cash instead of securities. Yet, we recognize the Commission's concerns regarding the potential for changes in value of liquid assets. Accordingly, we ask the Commission to consider that the amount of coverage assets be determined by reference to a fund's policies and procedures, tailored to the type of derivative and taking into account market-based requirements of counterparties that require a

"cushion" on top of marked-to-market variation margin, and which apply various haircuts to different types of coverage assets, as endorsed by other regulators.[13] This approach would align with marketplace practices, while reasonably ensuring that single-day market movements do not leave a fund with insufficient assets to meet its derivative coverage obligations. The designation of which assets are deemed sufficiently liquid for asset coverage purposes could be determined in accordance with any final rule adopted with respect to fund liquidity as has been proposed by the SEC.

V. Rule 18f-4, as Proposed, Would Trigger Many Unintended Consequences, Particularly with Respect to ETFs

There are several other unintended consequences that may result from adopting the Proposed Rule. As a general matter, the Proposed Rule would produce greater homogenization among investment products and entirely negate certain derivatives-based or derivatives-heavy mutual fund and ETF strategies such as managed futures or long/short strategies, which offer investors diversification benefits, portfolio volatility reduction or portfolio protection in declining markets. More specifically, the Proposed Rule would: (1) force deregistration and/or liquidation of certain products that serve the interests of retail investors; (2) undermine the ability of certain index-funds, particularly ETFs, to track their respective indexes, and adversely impact the arbitrage function and secondary market activities associated with ETFs; (3) increase risks associated with increased holding of cash and cash equivalents; and (4) reduce the overall liquidity of fund portfolios for ETFs and other registered funds alike.

A. Forced Deregistration or Liquidation

The Proposal acknowledges that vehicles using certain strategies may need to cease operating or deregister as investment companies.[14] However, there are numerous benefits and protections for retail shareholders encompassed by the 1940 Act that are not available through other structures, such as greater transparency and liquidity. It seems an odd result from a public policy standpoint to adopt arbitrary requirements that would force investors to obtain access to diversifying investment strategies through less regulated and more expensive structures, such as exchange traded notes and hedge funds. Moreover, vehicles such as hedge funds are available only to certain types of investors (*e.g.*, high net worth investors and institutions) and therefore retail investors may be entirely precluded from accessing these strategies.

B. With respect to ETFs, Limitation of Coverage Assets to Cash and Cash Equivalents Has the Potential to Increase Tracking Error and Trading Costs, and Undermine Tax Efficiency

The Proposal may disproportionately impact ETFs. Presently, index-tracking ETFs that use any liquid asset to cover derivatives exposure may minimize tracking error by using

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[13] *See, e.g.*, Margin Requirements For Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

[14] Proposal at 80961.

liquid securities that are components of the index. Under the Proposed Rule, such ETFs will be required to use cash or cash equivalents to provide cover – which will produce "cash drag" index tracking error that potentially could be material. This may cause representations made by ETFs and/or their advisers in exemptive applications filed with the Commission with respect to ETF index tracking error to no longer be accurate. Further, since most ETFs can create and redeem through in-kind transfer of securities, they generally do not maintain a significant cash buffer. As explained below, the cash or cash equivalent holdings could significantly affect the costs of the investment strategy and the *trading of* the ETF product, which may disrupt the arbitrage mechanism, contrary to a clear policy goal of the Commission for ETFs to operate with an effective arbitrage mechanism.

Adding cash or, more likely, cash equivalents, to ETFs that contain derivatives would add a new dynamic of risk, volatility and valuation to all impacted ETFs. Market maker and other liquidity provider pricing models for ETF strategies that do not include cash or cash equivalents will now have to account for an additional asset class variable and additional volatility. For instance, an international equity ETF with a currency hedge would, under the Proposed Rule, now be affected by the trading nature and possible turmoil of the U.S. Treasury market.[15] During the "taper tantrum" of the summer of 2013, such volatility would have been priced into the secondary market bid/ask spreads and felt by investment strategies in ETFs that otherwise would be, and may be designed to be, immune to that market segment. From a market maker and liquidity provider pricing perspective, the spread of an ETF is based on the costs and risks associated with trading the underlying basket. When adding a new variable, such as U.S. Treasuries, to the basket, that is another pricing variable and source of volatility that will be accounted for, and spreads will likely widen. The pricing mechanism for such ETFs will also be more complicated by adding another asset class and certain market makers not fluent in fixed income trading may back away from providing liquidity or widen spreads as well. This could have serious ramifications on the efficient secondary market liquidity of ETFs.

C. Increased Costs and Counterparty Risk

Notwithstanding potential performance drag and ETF trading issues, holding an artificially high percentage of fund assets in cash for coverage will increase costs as well as counterparty risk for funds. Custodial banks are charging clients to hold cash because of the cost to the bank of having these assets on its balance sheet. This phenomenon has been well documented.[16] Moreover, because cash is not covered by the requirement in Rule 17f-2 under the 1940 Act to be held in a segregated client account, a fund's cash assets are subject to the credit risk of the bank.

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[15] While our focus is on U.S. Treasuries, we believe the same issues would arise with respect to holding other cash equivalents, such as agency securities, commercial paper and money market funds, which have also experienced turmoil during and/or after the financial crisis.

[16] *See, e.g.*, Juliet Chung and Sarah Krouse, *Big Banks to America's Firms: We Don't Want Your Cash,* Wall Street Journal (Oct.18, 2015).

D. Decreased Liquidity of Fund Portfolios

If funds, instead of holding cash for coverage as described in the preceding paragraph, opt to hold U.S. Treasuries or other cash equivalents for coverage, the increased demand could place stress on the market for these securities or other cash equivalents. Such a result may be particularly untimely as money market reform has led to an increased demand for cash and cash equivalents such as short-term U.S. government securities, which will only increase as prime money market funds convert to government money market funds during the coming year, with unknown effects of that transition on an already limited supply for U.S. government securities.[17] In addition, such a transition may also cause the other liquid assets being sold (*e.g.,* longer-term bonds, equities, etc.) to be left with a less liquid market while increasing volatility.

Moreover, for funds able to comply with the Proposed Rule by converting exposure obtained through derivatives to exposure in other financial markets, the result could be less leverage but greater liquidity risk, contrary to another of the Commission's stated concerns.[18] Using derivatives to gain exposure to certain asset classes, including U.S., international and emerging markets fixed income and equity securities, can be far more efficient and cost effective than buying and selling securities on the open market. To the extent these securities are difficult to locate or are in short supply, transaction costs for funds that need this exposure will increase if the use of derivatives is limited. For funds that need to reduce exposure, particularly for index-based funds such as ETFs, a decline in the markets can be accommodated more easily if derivatives are available; if funds are forced into the cash markets, then mass selling in these asset classes could trigger the very pressure on liquidity that the Commission has sought to address in the liquidity management proposal.[19]

Finally, restricting the ability of funds to use portfolio securities as coverage assets may force sales of these securities when such sale is not advantageous from a tax perspective, causing funds, and particularly ETFs, to lose their tax efficient benefits for fund shareholders.

VI. Enhanced Transparency and Disclosure Would Address Concerns About Undue Speculation

WisdomTree has placed transparency at the forefront of its fund business and overall operations. As an ETF-focused investment manager, all of our ETFs, whether index-based or actively managed, offer transparency of holdings and related information on a daily basis, which includes: (1) with respect to securities, each ETF's securities holdings, securities identifier (such as a ticker symbol), securities' weights in the portfolio, sector weights and country weights (as applicable); and (2) with respect to derivatives, a description of the derivative (*e.g.,* currency forward, option, etc.) held by the applicable ETF and amount held.

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[17] *See, e.g.*, Katy Burne, *Money Funds Clamor for Short-Term Treasurys*, Wall Street Journal (Oct. 19, 2015).
[18] *See generally Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, Inv. Co. Act Rel. No. 31835 (2015), 80 Fed. Reg. 62274.
[19] Id. at 62280-81.

By contrast, most traditional asset managers disclose such information on a significantly less frequent basis, such as quarterly or monthly (including certain ETF managers).

WisdomTree believes that there is no better way for an investor to understand the potential risks associated with a fund's investments than through daily portfolio transparency and appropriate disclosure. We embrace daily portfolio transparency because we believe transparency is an extremely valuable investment tool for investors, from a retail investor to the largest institution, as investors seek greater certainty, predictability and precision for asset allocation purposes and in their general investments. Further, such transparency may help mitigate against style drift or unintended market over-weights/concentrations (*i.e.,* an investor holds two different funds that both have a high allocation to U.S. corporate bonds), while providing investors with the information they desire in making informed decisions, including potential risks, without providing information overload with respect to other portfolio statistics or information that investors generally do not find relevant or may not understand. We understand that the Division staff, along with SEC Commissioners, similarly view transparency as a significant investor benefit.

For these reasons, WisdomTree believes that the Commission should consider more flexible regulatory treatment for funds that provide daily transparency of portfolio holdings, whether in final rulemaking surrounding derivatives or other current pending and any future rulemaking initiatives related to fund investments.

VII. Conclusion

WisdomTree respects that disparate practices associated with the use of derivatives across the industry warrant Commission guidance in this important area. However, given the variety of derivative instruments used by registered funds, and the various ways in which these instruments are used, WisdomTree believes that prescriptive restrictions as embodied in the Proposed Rule are not appropriate and would do a disservice to fund shareholders. If, nonetheless, portfolio limitations are to be imposed, any portfolio limitation should exclude derivatives that are used for hedging purposes and to reduce risk. All liquid assets, with an appropriate haircut, should be allowable for asset coverage. A disclosure oriented, principles-based approach would be far more effective in protecting shareholders while providing funds with the flexibility to use derivatives effectively.

Kind regards,

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