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Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Via email: rule-comments@sec.gov

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

Dear Mr. Fields:

State Street Corporation[1] ("State Street") appreciates the opportunity to comment on the proposal[2] ("Proposal") by the United States ("US") Securities and Exchange Commission ("Commission") to update its approach to the regulation of the use of derivatives by investment funds organized under the Investment Company Act of 1940, as amended ("1940 Act").[3]

State Street strongly supports the Commission as the primary regulator for the US asset management industry, and is supportive of the Commission's current initiatives to update its approach to regulation of registered funds, including its previous proposals related to reporting and liquidity management.

[1] Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $27.508 trillion in assets under custody and administration and $2.245 trillion in assets under management as of December 31, 2015, State Street operates in more than 100 geographic markets worldwide. State Street is organized as a US bank holding company, with operations conducted through several entities, including State Street Global Advisors (SSGA), its asset management division. This comment letter represents the views of State Street and SSGA collectively.
[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933, 80 Fed. 80884 (Dec. 28, 2015) available at: https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf
[3] Such funds include mutual funds, exchange-traded funds, closed-end funds, and business development companies and are referred to collectively as "registered funds."

Generally, we support many elements of the pending derivatives proposal but have some suggested modifications which we describe in this letter. While existing Commission rules and guidance related to registered funds' use of derivatives have worked well over the past three decades, the Commission's initiative to formalize, clarify and update its approach is timely due to a variety of factors, including the increase in total registered funds' assets under management in recent years, the ever-increasing variety of strategies and risk management techniques used by registered funds, and the significant post-crisis changes to the derivatives markets.

The Commission's Proposal includes three major provisions:

1) New portfolio limitations for derivatives, which we oppose, particularly if based on notional measures of derivative exposures;

2) Asset segregation requirements, similar to existing guidance but with several changes, which we support, with further refinements; and

3) Risk management program requirements, which we support.

Use of Derivatives by Registered Funds

We do not disagree with the Commission's focus on the use of derivatives by registered funds, and agree with the Commission's long-standing investor protection-based policy of limiting the use of derivatives by registered funds that may impact such funds' ability to meet their obligations. The daily investor liquidity provided by registered funds is critical to their success as a primary investment option for both retail and institutional investors, and there are other options available for investors seeking more speculative or less liquid investment strategies.

Nevertheless, registered funds use derivatives for a number of purposes that are completely compatible with the Commission's goal to protect the integrity of the registered fund regulatory regime, and which are, in fact, essential to the risk management and efficient operation of many registered funds.

The Commission notes several of these uses of derivatives by registered funds in the Proposal, including to hedge risks associated with the funds' securities investments, to equitize cash to gain exposure quickly and to obtain synthetic positions. These are all important tools for registered fund managers which enhance, rather than detract, from investor protection for registered fund shareholders. The ability to hedge risk allows registered funds to provide shareholders exposures to intended investment assets isolated from other risks, such as currency risk for an international fund. The ability to equitize cash quickly improves managers' ability to remain fully invested in a fund's stated investment strategy. And the ability to obtain synthetic positions gives investors greater ability to obtain exposures that might otherwise be unavailable or significantly more expensive to trade (as in some emerging markets.)

While the Commission appropriately focuses its discussion in the Proposal on situations where high leverage or low liquidity may impact a registered fund's ability to meet its obligations under the 1940 Act, it is equally important for the Commission to protect the ability of registered funds to engage in derivatives that provide risk mitigation or asset diversification benefits to investors in a manner consistent with the protections offered by the 1940 Act.

The Commission's Proposal

The Commission's Proposal includes three primary sets of conditions under which a registered fund will be permitted to enter into derivatives transactions:

First, the fund must comply with one of two alternative portfolio limitations: a limit on notional derivatives exposures to 150% of the fund's net assets, or a higher limit if the fund can demonstrate that its use of derivatives reduced market risk, using a prescribed value-at-risk ("VaR") based test.

Second, the fund must maintain sufficient "qualifying coverage assets" to meet its obligations under its derivatives transactions. While similar to existing registered funds' asset segregation practices, the rules under the Proposal would be more restrictive, expanding the defined derivatives-related obligations beyond mark-to-market to include an estimate of potential future losses, and limiting qualifying coverage assets to just cash and cash equivalents.

Third, the fund, with limited exceptions, must establish a formalized derivatives risk management program administered by a designated derivatives risk manager.

Our comments on these three major components of the Commission's Proposal, as well as further commentary on the treatment of securities lending under the Proposal, follow below.

Portfolio Limitation Requirements

As described below, we believe the historic focus of the Commission on asset segregation requirements as the primary tool to address concerns with inappropriate use of derivatives by registered funds has worked well, and that it remains the Commission's most effective approach going forward.

While we understand the Commission's goal in proposing portfolio limitation requirements is to address perceived undue speculation and asset insufficiency, in some cases, by registered funds, we respectfully disagree with the proposed limitations, particularly the option proposed by the Commission that relies solely on the notional value of a derivatives contract. Notional value is a crude and inaccurate measure of risk for a derivatives contract. Imposing a portfolio limitation based on notional value risks greatly overstating the risk a derivatives contract poses to a fund, and incorrectly presumes that higher notional value of derivatives contracts is an indicator of undue speculation, when, in fact, the derivative's exposure may be solely risk mitigating. While we understand the Commission's second proposal --- where a fund may exceed the notional value cap if a VaR analysis can show the overall use of derivatives reduces market risk --- is intended to permit funds greater flexibility, we are concerned that it is unworkable from a technical perspective, and inappropriately appears to only apply when all derivatives transactions are risk-reducing.

State Street recommends that the Commission forego its proposed portfolio limitation requirements in favor of an updated asset segregation requirement, as described below.

Asset Segregation Requirements

We believe that the Commission's asset segregation requirements, developed over the past three decades through a combination of guidance and no-action letters, has provided a solid foundation to address the risks of undue speculation and asset insufficiency identified by the Commission as the purpose of the Proposal. We support codifying this approach in new exemptive rule 18f-4, as proposed by the Commission.

The Proposal suggests several changes from the Commission's existing approach to asset segregation, most notably to expand the required coverage amount by adding a measure of potential future obligation to the existing mark-to-market obligation, and to limit qualifying coverage assets to cash and cash equivalents.

With respect to the Commission's first major change --- the addition of potential future obligations to the current mark-to-market obligations --- we agree that some measure of such future obligations is appropriate. Consideration of the potential future volatility and market value of derivatives instruments is consistent with the treatment of derivatives for a variety of other regulatory purposes, and will give a more complete assessment of a fund's asset sufficiency under future stressed conditions. While we support, in concept, this requirement, there are details of the new requirement, as proposed, related to the recognition of netting of offsetting transactions, the calibration of "stressed conditions" and the treatment of cleared transactions that require further revision and clarity to properly determine an appropriate potential future obligation requiring asset segregation coverage.[4]

We are more concerned with the Commission's second major change from existing asset segregation practices, where the Proposal unduly limits qualifying covering assets for derivatives transactions solely to cash and cash equivalents.

We urge the Commission to take a more flexible approach to the definition of qualifying covering assets. Registered funds invest in a broad variety of investment strategies. While for some strategies holding of sufficient cash and cash equivalents to meet qualifying covering asset needs may be acceptable, for many strategies, such as equity of high-yield bond funds, a cash/cash equivalent only approach to qualifying covering assets will create conflict with the fund's investment objectives, and reduce a fund's ability to be fully invested.

While we agree that cash and cash equivalents are highly liquid, and can be easily converted to cash without a loss of value, we do not agree that cash and cash equivalents are the only available options for accomplishing the Commission's goals. We suggest the Commission look to other recent regulatory initiatives, particularly the Basel/International Organization of Securities Commissions ("IOSCO") agreement on margin for uncleared swaps, as a model for

[4] See Investment Company Institute's comment letter.

expanding the scope of qualifying covering assets. While policymakers focused on these uncleared margin rules were similarly focused on ensuring that collateral was liquid and readily available to convert to cash, the Basel/IOSCO agreement permits a much broader range of eligible collateral for initial margin, but addresses volatility and liquidity concerns by establishing a standardized table of haircuts by asset type.

We also note here that, despite the Commission's references to historical data on over-the-counter ("OTC") transactions showing high levels of cash margin, recent rules implementing the Basel/IOSCO agreement on margin for uncleared swaps are intended to reduce levels of cash margin. The final rule by the US banking agencies and the US Commodity Futures Trading Commission, for example, allow cash to be posted as margin, but require prompt reinvestment of such cash into other eligible collateral, including the broad list of eligible collateral agreed to in the Basel/IOSCO agreement.

In summary, we support the Commission's proposed codification of an asset segregation requirement, but urge the Commission to more fully recognize the benefits of netting in the calculation of potential future obligations, and to expand the list of qualifying coverage assets following the model of the Basel/IOSCO agreement on eligible collateral for uncleared swaps.

Derivatives Risk Management Requirements

We support the proposed requirement for formalized risk management programs for registered funds that engage in more than limited use of derivatives. We agree with the Commission that such programs are an important complement to the proposed asset segregation and portfolio limit regulations, providing an important structure for evaluating and mitigating market, counterparty, leverage, liquidity and operational risk which may be imperfectly captured by the specific regulatory requirements of the Commission's proposed new Rule 18f-4.

Securities Lending Transactions

The Proposal follows existing Commission practice, and does not propose to classify securities lending transactions as financial commitment transactions, but does ask commenters whether the Commission should revise its approach to securities lending.

We support the Commission's proposal to leave securities lending outside of the definition of financial commitment transaction. As described in the Proposal, the Commission and its staff have considered issues related to registered funds' use of securities lending arrangements in separate guidance under which registered funds may not have on loan at any given time securities representing more than one-third of a fund's total assets.

Funds engage in securities lending for the purpose of earning short-term, cash-like returns for making portfolio securities available to borrowers, not to create investment leverage. Such loans are over-collateralized, with daily mark-to-market of collateral, and funds may also benefit from a borrower default indemnification provided by their agent lender. They share none of the risk characteristics which the Commission points to as the basis for its proposed new Rule 18f-4, and we are concerned that inappropriately including such transactions under the Proposal as either financial commitment transactions or transactions subject to the proposed portfolio limits could make this widely-used, low-risk source of income unattractive to large numbers of registered funds.

Conclusion

Thank you for the opportunity to comment on the important matters raised within the Proposal. As noted above, State Street supports the Commission's efforts to address the use of derivatives by registered funds, but has concerns with certain elements of the Commission's proposal, particularly the proposed portfolio limitations, which we believe are unnecessary and unduly restrictive. Please feel free to contact me at [redacted] should you wish to discuss State Street's submission in further detail.

Sincerely,

Stefan M. Gavell