INVESTMENT ADVISER ASSOCIATION

March 28, 2016

Via Electronic Mail (rule-comments@sec.gov)

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Rel. IC-31933; File No. S-7-24-15

Dear Mr. Fields:

The Investment Adviser Association ("IAA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to adopt a new rule to govern the use of derivatives by registered funds.[2] We support many of the Commission's goals in this important rulemaking, which marks the third proposal in a series of rulemakings designed to enhance the SEC's risk monitoring and regulatory safeguards for funds and the asset management industry.

We are opposed, however, to the Commission's proposed overall portfolio limitations based on a fund's gross notional exposure to derivatives. In our view, conditioning the use of derivatives on compliance with either the 150 percent or 300 percent tests is unnecessary to protect investors and appropriately limit leverage in fund portfolios, and will reduce investor access to certain types of funds and portfolio strategies—including some that serve to mitigate investment risk. For reasons explained below, we urge the Commission to reconsider that aspect of the Proposal.

In addition to our opposition to the proposed portfolio limits, we have a number of other recommendations that would be consistent with the Commission's goals while making compliance less burdensome for advisers that manage funds. In particular, we suggest that:

- *The definition of "qualifying coverage assets" should include liquid assets other than cash and cash equivalents.* The Commission should reconsider limiting

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA's membership consists of nearly 600 firms that collectively manage $16 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. More than 40 percent of IAA members manage at least one registered investment company or business development company ("BDC"). For more information, please visit www.investmentadviser.org.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Rel. IC-31933 (Dec. 11, 2015) ("Proposal"), available at http://www.sec.gov/rules/proposed/2015/ic-31933.pdf. The rule applies to mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and companies that have elected to be treated as a BDC, collectively referred to in the Proposal and this letter as "funds."

qualifying coverage assets to cash and cash equivalents, recognizing that other holdings can be sufficiently liquid to ensure that assets are available for a fund to meet its obligations under a derivatives transaction, even in stressed conditions. In this regard, the Commission might consider applying "haircuts" to qualifying coverage assets other than cash and cash equivalents, similar to those that have been developed with respect to various forms of collateral.

- *The Commission should more appropriately tailor the requirement for a full-blown derivatives risk management program.* While we support the basic concept in the Proposal, the implementation of a derivatives risk management program and the appointment of a derivatives risk manager will be a substantial compliance undertaking, particularly for smaller fund advisers. The Commission should consider ways to ensure that this burden falls only on those funds with greatest risk to investors from the use of derivatives.

- *The oversight function of a derivatives risk manager should be able to be fulfilled by either an individual or a committee.* Firms should not have to designate one individual to be a derivatives risk manager, where the desired oversight function could be more successfully implemented in a different way, such as through a committee.

- *The Commission should clarify the definition of "derivatives."* We strongly support the proposed definition of "derivatives transaction," but recommend that it be clarified slightly to exclude variation margin under the CFTC rules for margin for uncleared swaps.

- *The implementation period should be reasonable.* The Proposal is necessarily complex, and has the potential to significantly change the nature of compliance with Section 18 under the Investment Company Act. Funds and their advisers will need significant time to understand the final rule, develop the necessary policies and procedures, hire and train personnel, and make appropriate portfolio management systems changes.

We discuss all of these recommendations below.

I. The Commission Should Reconsider the Proposed Portfolio Limitations

The Commission, for the first time, proposes to condition compliance with Section 18 of the Investment Company Act on the cumulative portfolio exposure of all of a fund's derivatives transactions, financial commitments and indebtedness.[3] This represents a significant change in the Commission's approach to regulating funds' use of derivatives, and would supersede decades of guidance—so much so that the Commission states that it would cause some currently operating funds to cease operating as registered investment companies:

> Funds that use derivatives extensively . . . may be unable to scale down their aggregate exposures or otherwise de-lever their funds in a way that allows the fund to maintain its investment objectives or provide a product that has sufficient investor demand. . . . [These funds] may choose to deregister under the Act and liquidate, and/or the fund's sponsor may choose to offer the fund's strategy as a private fund or (public or private) commodity pool.[4]

The Commission states that because "the fund industry has grown significantly since 2010 and certain funds [alternative strategy funds and leveraged ETFs] that make greater use of derivatives have received a disproportionately large share of fund inflows," that it is important for the Commission to take this "new approach" to regulating derivatives transactions under Section 18.[5]

We respectfully disagree with this approach. While we understand the Commission's goal to limit leverage in fund portfolios and its efforts to take a principles-based approach that does not depend on a security-by-security analysis under Section 18, we believe that the overall portfolio limits are unwarranted for a number of reasons. First and foremost, the other elements of the Proposal are sufficient to constrain leverage and protect investors. Second, gross notional

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[3] The rule would prohibit a fund from using derivatives unless its "aggregate exposure" is either: (1) no more than 150 percent of the net asset value of the portfolio, or (2) the fund's full portfolio VaR (with securities and derivatives) is less than the fund's securities VaR (with securities) and the aggregate exposure of the fund is no more than 300 percent of the net asset value of the portfolio. The Commission has defined "exposure" to mean the sum of (immediately after the fund enters into any senior securities transaction): (i) the aggregate "notional amounts" of the fund's derivatives transactions, after the fund nets any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms; (ii) the aggregate financial commitment obligations of the fund; and (iii) the aggregate indebtedness (and with respect to a closed-end fund or BDC, involuntary liquidation preference) with respect to any senior securities transactions entered into by the fund pursuant to Section 18 or 61 (without regard to the exemption in that section).

[4] Proposal at 288.

[5] The SEC noted in the Proposal that some funds make extensive use of derivatives to obtain notional investment exposures far in excess of the funds' net asset values (with some exposures up to ten times a fund's net assets). The Proposal noted this exposure appears to be inconsistent with the purposes and concerns underlying the Investment Company Act and that such funds do "not appear to be subject to a practical limit on leverage" as the SEC contemplated in its seminal release addressing Section 18, Securities Trading Practices of Registered Investment Companies, SEC Rel. IC-10666 (Apr. 18, 1979) ("Release 10666").

exposure from derivatives transactions is an inapt way to measure leverage and risk. And third, the limits would constrain advisers' ability to employ certain types of risk-mitigation strategies that are beneficial to investors. Much more generally, however, we fundamentally disagree with an approach that limits investor access only to those strategies that the Commission currently believes are "acceptable" for retail investors and forces advisers to close funds that were created based on a good faith understanding of the Commission's and staff's positions on Section 18. We discuss each of these points below.

a. Portfolio Limits are Unnecessary to Constrain Leverage and Protect Investors

Given other important components of the Proposal, the proposed portfolio limitations are not necessary to appropriately constrain leverage or protect fund investors. In particular, the Proposal contains significant new asset segregation requirements that include earmarking an amount beyond that necessary to exit the derivatives transaction. This additional "risk-based coverage amount" would provide a cushion that both addresses potential future losses and naturally constrains a fund's ability to take on leverage.

There are safeguards in the Proposal to ensure that the risk-based coverage amount is meaningful. In particular, the risk-based coverage amount for potential future losses on a derivatives transaction would be based on policies and procedures tailored to address a fund's specific derivatives transactions and the underlying reference asset and the fund's investment strategies and risks. As a result, a fund would be obligated to maintain an amount of cash or other assets[6] that is greater than the fund would likely be required to pay or deliver under the derivatives transaction, even in stressed conditions.[7] Given that segregated assets could only be earmarked for a single transaction, the existence of the cushion naturally constrains the ability to take on leverage.

In addition to these new segregation rules, the Proposal would require advisers to implement a derivatives risk management program, appoint a derivatives risk manager, and subject the fund's derivatives use to greater fund board oversight. These measures are also significant, and provide a natural constraint on any fund's practical ability to take on excessive amounts of leverage.

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[6] As discussed below, we largely support the asset segregation parts of the Proposal. We do, however, recommend expanding the types of assets that would be acceptable "qualifying coverage assets."

[7] *See* Proposal at 168-170. The Proposal notes that a fund's policies and procedures to determine potential amounts payable in stressed conditions could include using financial models and "stress testing" to estimate the effects of various adverse events on the portfolio. Alternatively, the Proposal notes that a fund's policies and procedures could provide that, for some derivatives transactions, the adviser would use a "stressed VaR model" to estimate the potential loss the fund could incur, at a given confidence level, under stressed conditions. Stressed VaR refers to a VaR model that is calibrated to a period of market stress.

b. Gross Notional Exposure Does Not Accurately Measure Leverage in a Fund Portfolio

The portfolio limits are based, at least in part, on the aggregate gross notional exposure of a fund's derivatives. As we have noted in other contexts, the gross notional exposure of derivatives in a portfolio or managed by an adviser is not an accurate representation of leverage[8] or systemic risk.[9] Gross notional value, at best, is a measure of volume (*i.e.*, how many contracts are put in place). It does not take into account the purpose for which the derivative is used or measure its actual economic exposure by including factors that may result in lower economic exposure, such as netting or the posting of collateral. As a result, it does not measure risk.[10]

We note, and the Commission clearly recognizes, that other regulators have taken a different approach in measuring exposure. For example, retail funds in Europe (UCITS) may engage in derivatives transactions subject to compliance with either the "commitment" approach or the absolute or relative "VaR approach."[11] The commitment approach is based on a UCITS fund's *net* exposure from derivatives, which may not exceed 100 percent of the fund's net asset value.[12] The Proposal differs significantly in that regard, as the European approach permits

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[8] *See* Letter from Robert C. Grohowski, IAA General Counsel, to SEC re: Proposed Amendments to Form ADV and Investment Advisers Act Rules, SEC Rel. IA-4091 (Aug. 11, 2015), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/150811cmnt.pdf.

[9] *See* Letter from Karen L. Barr, IAA President & CEO, IAA and Tim Cameron, Head of Asset Management at SIFMA AMG, to Financial Stability Oversight Council re: Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/150325cmnt.pdf; *see also*, Letter from Karen L. Barr, President & CEO, IAA, to the Financial Stability Board/International Organization of Securities Commissions re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (May 29, 2015), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/150529cmnt.pdf.

[10] *See, e.g.*, Office of Financial Research, 2015 Financial Stability Report (Dec. 15, 2015) at p. 38, available at https://financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf (noting, in discussion about hedge fund data on Form PF, that one shortcoming of a fund's gross notional exposure (GNE) is that it does not differentiate between different types of derivatives, making it difficult to identify a fund's portfolio risks by position type or notional size).

[11] *See* Proposal at 342 (discussing the Committee of European Securities Regulators ("CESR", which is now known as the European Securities and Markets Authority, or "ESMA") 2010 Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS ("CESR Global Exposure Guidelines"), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf.

[12] Proposal at 343.

UCITS funds to reduce their calculated derivatives exposure for netting and hedging transactions.[13]

If the Commission moves forward with portfolio limitations despite our objections, it should consider a similar approach to more accurately reflect the risk associated with each derivative investment. For example, the Commission should consider whether to distinguish among types of derivatives so that those that are less risky contribute less to the overall portfolio limit. For example, certain more liquid derivatives, such as those that are easily converted to cash in times of stressed conditions to meet redemptions, fall into the one-day or three-day liquidity bucket in the Commission's liquidity management proposed rules,[14] and/or are centrally cleared or traded on an exchange (which generally requires the terms of these securities to be highly standardized)[15] should count far less toward the proposed limit. Similarly, the Commission could consider "risk weighting" the measurement of fund exposure to underlying derivatives transactions by, for example, providing a haircut to the value of derivatives when calculating the aggregate notional value. It might also consider other adjustments along these lines, such as eliminating "financial commitments" from the 150 percent notional test or permitting funds to offset the market value of short positions with equivalent long positions.

c. The Proposed Limits Could Constrain Certain Risk-Mitigating Strategies

The 150 percent test is an arbitrary exposure-based limit that does not distinguish between derivatives that add risk and those that mitigate it. As proposed, it will cause funds to

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[13] Proposal at 344. Netting derivatives transactions is permitted regardless of the derivatives' due dates, as long as the trades are "concluded with the sole aim of eliminating risks linked to the positions." Proposal at 344 (citing CESR Global Guidelines at 13). Under the CESR Global Guidelines, UCITS funds are permitted to reduce their exposures for hedging arrangements, which are defined as "transactions that do not necessarily refer to the same underlying asset but are entered into for the 'sole aim of offsetting risks' linked to other positions." *Id.* (citing CESR Global Guidelines at 18).

[14] *See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release,* SEC Rel. IC-31835 ("Proposed Liquidity Rules"), available at https://www.sec.gov/rules/proposed/2015/33-9922.pdf ("three-day liquid asset" means any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale. In determining whether a position or portion of a position in an asset is a three-day liquid asset, a fund must take into account the required factors as applicable.) We do not address the proposed definition of "three-day liquid asset" in this letter.

We note, however, that there is an inherent tension between this Proposal and the Proposed Liquidity Rules that the Commission must carefully consider. Fixed income derivatives often may be more liquid than the underlying cash markets, putting portfolio managers in a difficult position. The Proposed Liquidity Rules generally would encourage funds to invest in more liquid instruments, but this Proposal may restrict their ability to use derivatives. The Commission should consider the two rule proposals together in evaluating their impact on the operation and construction of fund portfolios.

[15] *Id* at 90.

manage well below that limit to reduce regulatory risk, and significantly constrain the potentially beneficial use of derivatives in funds.

We appreciate that the Commission crafted an alternative "risk based portfolio limit" that would allow a fund to obtain exposures up to 300 percent if the fund complies with the VaR test described in the Proposal, which is designed to provide an indication of whether a fund's derivatives transactions, in aggregate, have the effect of reducing the fund's exposure to market risk.[16] While we support the concept of drawing a distinction between derivatives used to gain additional exposure and those used for hedging or risk mitigation purposes, we question the need for an exception with another—albeit higher—express cap. Any portfolio limit is going to suffer from the same failings as the 150 percent limit (except in scale), and in extremely volatile markets, may in fact constrain certain risk-mitigation strategies that would otherwise benefit investors. For example, some funds (often those underlying insurance products) employ derivatives overlays for risk mitigation and hedging purposes rather than for speculation or arbitrage. We understand that in most cases, advisers could execute these types of strategies while remaining below the 300 percent limit, but may exceed that limit in volatile markets—at precisely the moment where the strategies could most benefit investors.[17]

d. The Proposed Approach Could Limit Investor Access to Certain Strategies

On a much more general level, the portfolio limits are inappropriate for the very reason the Commission highlights in its Proposal—that they may force certain types of strategies out of the retail marketplace. We understand from an expansive industry study that 471 funds out of 6,661 funds sampled (or 7.1 percent), with $613 billion in assets, would exceed the 150 percent exposure limit, and, of those funds, 173 funds (or 2.6 percent) with $338 billion in assets would exceed the 300 percent exposure limit.[18] Based on the industry study, at least 369 funds, with $458 billion in assets under management, either will have to de-register or substantially change their investment strategies to continue their businesses as registered funds.[19] The significant impact of the Proposal—which is much larger than that identified by the Commission's review—reduces investors' access to a broad range of beneficial strategies, introduces significant

[16] Proposal at 115-116.

[17] These risk mitigation and hedging strategies generally would not be able to comply with the 150 percent exposure-based portfolio limit, particularly in volatile markets, and so the advisers generally would need to comply with the 300 percent risk-mitigation test.

[18] *See* Letter from David W. Blass, General Counsel, Investment Company Institute ("ICI"), to SEC on Proposal (Mar. 28, 2016). The ICI data in its study is based on information received from 6,661 funds with $13.6 trillion in assets under management as of year-end 2015. The ICI study also showed the Proposal would have a disproportionate impact on taxable bond funds. The Commision's study, on the other hand, sampled 1,188 (or 10 percent) open-end funds, closed-end funds, ETFs, and BDCs for its analysis, based on limited SEC data on derivatives in those funds.

[19] *Id.* The ICI study noted that the 369 funds and $458 billion estimates are based on ICI's survey responses indicating that a fund exceeded 300 percent notional exposure, or had notional exposure between 150 percent and 300 percent and failed the VaR test or indicated the fund would fail the VaR test.

uncertainty into advisers' business planning, and ultimately puts the Commission in the untenable position of having to express a particular view as to what is an "acceptable" amount of risk in fund portfolios.

Investors may have chosen these funds to diversify their portfolios, to pursue returns uncorrelated with the broader securities markets, or to protect their retirement or other savings and investments from downside risk in volatile markets. It is not appropriate for the Commission to retroactively determine that a particular investment should no longer be available. Investors have legitimate investment needs addressed by these funds that, with appropriate disclosure of the associated risks, should not be taken away because the Commission's views on the appropriate amount of risk in a fund portfolio have changed, particularly when articulated as an arbitrary limit on derivative transaction volume.

The fact that these strategies could be used in private funds if the rule is adopted as proposed is not a saving grace. Advisers to the existing funds most impacted by this Proposal expended considerable time, effort, and expense to develop those funds based on the adviser's good faith understanding of decades-old Commission and staff positions on Section 18. If the rule is adopted as proposed, advisers in the future understandably may be far less willing to be innovative, further reducing the range of beneficial options available to investors in the marketplace.

For all of these reasons, we strongly believe that the Commission should forego the use of express portfolio limits, focusing instead on ensuring that every fund has the appropriate asset coverage for any obligations arising from derivatives transactions. Subject to the comments below, we believe the other main elements of the Commission's Proposal appropriately address that concern.

II. <u>Qualifying Coverage Assets</u>

The Commission proposes to require funds to maintain an amount of "qualifying coverage assets" for each derivatives transaction that it enters into, designed to enable the fund to meet its obligations arising from that transaction. The amount includes both a mark-to-market coverage amount and a risk-based coverage amount that "represents a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions."[20]

[20] Proposal at 154. We believe that the use of a risk-based coverage amount addresses the Commission's primary concern that "funds' use of the mark-to-market segregation approach with respect to various types of derivatives, plus the segregation of any liquid asset, enables funds to obtain leverage to a greater extent than was contemplated in Release 10666." Proposal at 37. As we stated above, obligating a fund to maintain an amount greater than what the fund would likely be required to pay or deliver under the derivatives transaction, even in stressed conditions, creates an appropriate natural constraint on leverage.

We strongly support this approach, with one caveat: we recommend that the Commission expand the types of eligible qualifying coverage assets. We also request one clarification on the types of collateral that would reduce the amount required to be segregated.

a. The Commission Should Expand the Types of Permissible Qualifying Coverage Assets

Under the Proposal, a fund would generally be required to segregate cash and cash equivalents as qualifying coverage assets.[21] The Commission explains that it did not propose to include other types of assets, even subject to a haircut, due to concerns about the possibility that such assets could decline in value at the same time the fund's potential obligations under the derivatives transaction increase. The Commission also explains that its proposed approach is appropriate, in its view, in light of the fact that some amount less than full notional value would be required to be set aside.

We respectfully disagree, and ask the Commission to reconsider this aspect of the Proposal. In similar contexts, other types of assets are permitted to be posted as collateral subject to appropriate haircuts. For example, for purposes of the CFTC's rules for margin requirements for uncleared swaps, the CFTC permitted certain eligible collateral for margin that the CFTC determined "should remain liquid and readily marketable during times of financial stress."[22] Specifically, eligible margin under the CFTC rules includes cash; debt securities issued or guaranteed by the United States (or by another U.S. governmental agency, the BIS, the IMF, the ECB, or multilateral development banks); certain Government Sponsored Entities' debt securities; certain foreign government debt securities; certain corporate and municipal debt securities certain listed equities;[23] shares in certain investment funds; and gold.[24] The CFTC rules permit assets that are eligible as initial margin to also be eligible as variation margin for

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[21] The Proposal notes that "U.S. generally accepted accounting principles define 'cash equivalents' as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates." Proposal at 179. The Proposal cites the following as examples of items commonly considered to be cash equivalents: certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.

[22] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, CFTC RIN 3038-AC97, 81 Fed. Reg. 636, 667 (Dec. 18, 2015) ("CFTC Margin Rules"), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister121615.pdf (defining material swaps exposure ("MSE") as an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds $8 billion. The MSE threshold is intended to identify entities that engage in significant derivatives activity in order to determine whether their swaps activity should be subject to initial margin requirements under the final rule.) *See also*, discussion in CFTC release for margin for uncleared swaps, available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf.

[23] Under the CFTC margin rules, certain equities are eligible collateral, with the requirement for a minimum 15 percent haircut on equities in the S&P 500 Index and a minimum 25 percent haircut for those in the S&P 1500 Composite Index but not in the S&P 500 Index.

[24] CFTC Margin Rules at 666.

swap transactions between a covered swap entity and a financial end user, subject to applicable haircuts for each type of eligible collateral.[25]

In addition, the BIS suggested eligible collateral assets include, among other things, high-quality government and central bank securities, high-quality corporate bonds, high-quality covered bonds, equities included in major stock indices, and gold. The BIS noted that to the extent the initial margin or variation margin collateral is exposed to excessive credit risk, market risk, and currency risk, "appropriately risk-sensitive haircuts should be applied."[26]

We recommend a similar approach here. A system of haircuts can allay concerns that the value of the segregated assets may decline and protect the fund from the possibility that it will not have assets available to satisfy obligations as they come due, in the same way that it protects counterparties from their risk of loss.

b. The Treatment of OCC Escrow Margin

We appreciate that the amount required to be segregated is reduced by the value of any assets that represent variation margin or collateral.[27] In this regard, we note that collateral is undefined, but we request the Commission confirm that any arrangement for margin or collateral, such as escrow posted as part of the Options Clearing Corporation's escrow margin program, would be similarly treated.

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[25] CFTC Margin Rules at 668. A covered swap entity must calculate the required amount of initial margin daily, on the basis of either a risk-based model or a table-based method, as described in the rules. *Id.* at 684. The value of the eligible collateral collected or posted to satisfy margin requirements is determined according to a standardized haircut schedule in the CFTC rules. In particular, initial margin haircut value is the sum of the following discounts: (A) an eight percent discount for initial margin collateral denominated in a currency that is not the currency of settlement for the uncleared swap, except for eligible types of collateral denominated in a single termination currency designated as payable to the non-posting counterparty as part of the eligible master netting agreement; and (B) the discounts set forth in the table in the rule. The value of variation margin collateral is computed as the product of the cash or market value of the eligible collateral asset times one minus the applicable haircut expressed in percentage terms. The total value of all variation margin collateral is calculated as the sum of those values of each eligible collateral asset.

[26] BIS at 17.

[27] Proposed rule 18f-4(c)(6)(ii).

III. The Commission Should More Appropriately Tailor the Requirement for a Full-Blown Derivatives Risk Management Program

The Commission proposes to require any fund with derivatives transactions exceeding 50 percent of the value of the fund's net assets or any complex derivatives to implement a derivatives risk management program. The program would be administered by a designated derivatives risk manager.

While we generally support this part of the Proposal, we note that the implementation of a derivatives risk management program and the appointment of a derivatives risk manager will be a substantial compliance undertaking, particularly for smaller fund advisers. The compliance program rules under the Investment Company Act and the Investment Advisers Act already require funds and advisers to implement policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act, respectively. In addition, a number of recent regulatory initiatives either do or likely will require the development of additional policies and procedures, several of which include the appointment of an individual or committee to oversee compliance.

Given the cumulative costs of compliance, only those funds with truly significant derivatives exposure should be required to bear the expense of a full-blown derivatives risk management program. We appreciate that the Commission has taken exactly that type of approach—proposing a *de minimis* threshold that is intended to relieve many advisers from this bligation. But we encourage the Commission to consider increasing that threshold, to even better identify those funds that warrant this burden.[28]

We also recommend that the Commission provide greater flexibility with respect to the one-time or infrequent use of complex derivatives. By proposing that an adviser implement a full-blown derivatives risk management program before entering into even one complex derivative, the Commission has effectively created a prohibition—a barrier so significant that it would be reasonable to assume that no adviser would go to such lengths to accommodate the infrequent use of those types of investments. We understand the Commission's concerns with complex derivatives, but also envision scenarios where the occasional use of a complex derivative might benefit the fund and its shareholders. We recommend that the rule provide additional flexibility, limited to those funds that have a policy that generally prohibits investment in complex derivatives but allows for infrequent use subject to appropriate internal controls and review.

[28] For example, the Commission could consider the approach taken by CFTC Rule 4.5, which exempts funds from regulation if the aggregate net notional value of the fund's commodity futures, commodity options contracts, or swaps positions does not exceed 100 percent of the liquidation value (net asset value) of the pool's portfolio after taking into account unrealized profits and losses.

IV. The Commission Should Permit Committees to Oversee the Derivatives Risk Management Program

We recommend that the Commission permit funds to appoint a committee to oversee the risk management program. We recognize that the Commission considered and rejected this approach, explaining that "having a specific person designated as responsible for administering the program rather than a committee or group should help to more clearly delineate lines of responsibility and oversight over these risks for those funds that choose to engage in them."[29]

We urge the Commission to reconsider. As it recognizes, smaller funds and advisers to smaller funds have a limited number of employees or officers who are not portfolio managers of the fund. These funds and firms should have the flexibility to tailor their programs and supervision of their funds' derivatives use and compliance with the Investment Company Act to their particular operation, as is appropriate for their fund's risk tolerances and Board-approved investment strategies. A prescriptive requirement could create a significant barrier to engaging in derivatives transactions for smaller advisers.

A better approach would be to allow an adviser to designate a committee to perform the same functions. This would be consistent with many advisers' general risk management, as advisers often involve committees or groups of employees in the vetting and analysis of portfolio risk and other types of risk.[30] And as the Commission recognizes, it would also be consistent with the recent proposal on liquidity risk management programs.

Many advisers have expressed a related concern over the potential liability of the derivatives risk manager and the interplay between that person and the fund's and adviser's chief compliance officers. For some organizations, the use of a committee might alleviate some of these concerns and help clarify what is, and should be, a firm responsibility that is shared among multiple employees with various functions.

Ultimately, funds, fund advisers, and fund boards should be permitted the flexibility to tailor their risk management programs to their particular use of derivatives, including implementing appropriate controls over any perceived undue influence in the determination to enter into derivatives transactions on behalf of a fund. The adviser's fiduciary duty would require no less.

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[29] Proposal at n.438 and accompanying text.

[30] In a committee setting, it also may be more appropriate to engage the portfolio managers or other investment professionals, while controlling for the conflicts that the Commission intended to address by proposing to require to strictly separate the derivatives risk manager from any portfolio management function. To the extent the Commission allows for committees in the final rule, it should clarify the extent to which portfolio managers could be included or participate.

V. The Commission Should Clarify the Definition of "Derivatives"

The Proposal defines "derivatives transaction" to mean "any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ('derivatives instrument') under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise."[31] We strongly support this definition, as it appropriately captures the types of derivatives that raise Section 18 concerns while excluding other instruments that may be considered derivatives under some uses of the term that do not involve any potential future obligation to pay (*e.g.*, purchased options).

We request, however, that the Commission clarify that the term "derivative" does not include any obligations with respect to variation margin that may be owed to a fund's counterparty under new banking and CFTC rules for margin for uncleared swaps and security-based swaps. Under the Title VII Dodd-Frank uncleared swap margin rules recently issued by U.S. banking regulators and the CFTC, bilateral variation margin will be required to be exchanged for swaps and, in some cases, security-based swaps, including options that fall within those definitions, entered into between a swap dealer and a fund. For example, currency or foreign exchange options, and other types of options, will be subject to this requirement.

In the event that the value of the transaction decreased, a fund purchasing such a call option would not, under the Title VII margin rules, need to post variation margin to its dealer counterparty because the fund fully paid for the transaction at trade date and would not have any additional payment obligation to pay for the option. The fund's dealer counterparty, however, would need to calculate the mark-to-market value of the option on a daily basis and would need to post variation margin to the fund to the extent that the option was in the money for the fund. Due to market movements and the requirement under the margin rules for variation margin to be calculated and exchanged daily for the duration of the transaction, over the course of the transaction, the fund could be required to return some or all of the variation margin posted to it by its dealer counterparty (or for a segregated account, release the fund's security interest in the collateral held in the account). The fund would not need to hold additional cash reserves in its portfolio to meet this obligation. Accordingly, we urge the Commission to clarify that under such an arrangement, the transaction would be excluded from the definition of derivatives transaction under the proposed rules.

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[31] Proposal at 414.

VI. <u>The Commission Should Provide a Reasonable Implementation Period</u>

Advisers to funds that engage in derivatives transactions will need considerable time to implement the new rule, which is complex and would significantly change the nature of compliance with Section 18 under the Investment Company Act. Funds and their advisers must have significant time to, for example, understand the final rule, develop and update the necessary fund and adviser policies and procedures, hire and train personnel, update any affected fund investment restrictions and investment strategies, and make appropriate portfolio management systems changes. Further, affected funds whose businesses may no longer be viable under the rule would need appropriate time to consider alternatives to a registered investment company structure and the possibility of transitioning to another type of investment vehicle, as well as appropriate time to address legitimate shareholder concerns. Given the extraordinary impact the rule will have on funds and advisers, we urge the Commission to adopt a compliance date of at least 18 months from the date of adoption.

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We appreciate the opportunity to provide comments on the Proposal and would be pleased to meet with the Commission and its staff regarding our comments and to provide any additional information. Please contact me or Monique S. Botkin, IAA Associate General Counsel, at [redacted] with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

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

David Grim, Director, Division of Investment Management
Diane Blizzard, Associate Director, Division of Investment Management