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Managing Director
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March 28, 2016

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S-7-24-15)

Dear Mr. Fields:

J.P. Morgan Asset Management ("JPMAM") is pleased to respond to the Securities and Exchange Commission's (the "SEC" or the "Commission") request for comment on its proposal on the use of derivatives by registered investment companies and business development companies (the "proposal").[1] JPMAM offers 157 mutual funds, closed-end funds, and ETFs in the US (excluding money market funds), with a total of approximately $257 billion in assets under management at the end of February 2016.

JPMAM supports the SEC's goals of addressing the investor protection purposes and concerns underlying Section 18 under the Investment Company Act of 1940, and providing an updated and more comprehensive approach to the regulation of the use of derivatives by registered investment companies and business development companies (collectively "funds"). The existing regulatory framework was last addressed by the Commission in Investment Company Act Release 10666,[2] and has evolved in the subsequent years through a number of no-action letters and staff guidance. We believe that the absence of formal regulations on funds' use of derivatives under Section 18 has led to a wide range of market practices.

Meanwhile, there has been substantial growth in the variety, volume and availability of derivative instruments, and the derivatives markets and market structure have matured, especially in the years following passage of the Dodd-Frank Act. These developments have brought great benefits to

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015), 80 Fed. Reg. 80883 (Dec. 28, 2015) ("Proposing Release").

[2] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979) ("Release 10666").

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funds and their investors. Derivatives allow funds to efficiently hedge risk, manage liquidity, reduce transaction costs, gain exposure to markets and asset classes when direct investment is expensive or not possible, and reduce or eliminate other exposures through offsetting transactions. Thus, the Commission's efforts to clarify how funds may use these tools are timely and welcome.

The Proposing Release indicates that, in formulating Section 18, Congress was concerned with both the amount of investment exposure taken on by funds sold to the general public ("excessive borrowing … which increased unduly the speculative character of their junior securities"), and the ability of a fund to meet its financial obligations ("funds operating without adequate assets and reserves").[3] These concerns explain the SEC's dual approach to derivatives regulation: the portfolio exposure limitations act as a cap on the amount of derivatives exposure a fund can have, while the asset segregation requirements address funds' ability to meet their financial obligations. As the Proposing Release notes, under Release 10666 a single approach was sufficient, because the segregated account requirement (which required segregation of notional value) acted as a practical limit on leverage. As the SEC staff guidance evolved to allow increased reliance on the segregation of mark-to-market values, the potential for increased leverage grew, leading the SEC to consider, with this proposal, the establishment of an "outside limit."[4]

We support the SEC's two-pronged approach to addressing the concerns underlying Section 18. In the modern derivatives markets, particularly in light of the widespread adoption of initial and variation margin requirements, funds can readily ascertain their daily and potential future exposure to a derivative instrument ("risk-based coverage amount," or "cushion"), making segregation at full notional value unnecessary. That said, we recognize that where less asset segregation is required, absent any other parameters a fund could potentially take on a much higher level of exposure. We therefore understand the SEC's desire to impose an outside limit on funds' derivatives exposure.

Although we support the Commission's general approach to regulating funds' use of derivatives under Section 18, we wish to provide our comments on certain critical elements of the proposal, which we believe could have a meaningful impact on our ability to provide high-quality investment funds to our clients. We also concur with many of the comments provided by the Investment Company Institute and SIFMA's Asset Management Group, particularly with respect to the treatment of certain instruments and transactions under the notional exposure and asset segregation tests and the operational aspects of the risk management program.

As a preliminary matter, while we recognize the need for an outside limit on the amount of derivatives exposure a fund may take, we believe the proposed approach does not provide funds adequate flexibility to engage in common portfolio management techniques that benefit everyday investors. Specifically, we are concerned that the portfolio exposure limit test does not allow for a sufficient level of derivatives transactions with lower risk per unit of notional value ("unit risk"), and may limit funds' ability to use derivatives to offset exposures and otherwise optimize their portfolios – for example, fixed income funds that wish to adjust duration without buying and selling physical bonds. One possible solution would be to increase the exposure limits; however, doing so would

[3] Proposing Release at 14.

[4] Proposing Release at Sec. III.B.2.

also increase funds' ability to take higher-risk positions. Although we would not object to higher limits that would provide funds with more flexibility to achieve their investment outcomes, we think a better solution would be to apply risk-based adjustments under the notional exposure limit tests.

With respect to asset segregation, we support the proposed approach to require segregation based on mark-to-market and cushion amounts, reduced by the value of assets posted to meet variation and initial margin, and calculated on a net basis to the extent a transaction is covered by a netting agreement. Indeed, we believe that in most circumstances, such initial and variation margin will adequately cover a fund's potential future exposure. With respect to the type of assets that may be segregated against a derivative position beyond initial margin and variation, however, we recommend that the SEC allow certain instruments in addition to cash and cash equivalents. We understand the concern that in times of stress, non-cash assets may decline in value at the same time that a fund would face increasing obligations from its derivatives transactions, which would increase the possibility that such assets could be insufficient to cover the fund's obligations.[5] To effectively ensure that funds will have sufficient liquid assets to meet future obligations, we recommend that the Commission permit a broader group of coverage assets with an appropriate risk adjustment ("haircut"). This would provide funds with greater flexibility to achieve their investment objectives while addressing the Commission's concern.

Our comments are discussed in more detail below.

Portfolio limitations for derivative transactions

JPMAM supports the SEC's intent to impose an outside limit on funds' derivatives exposure. However, we believe the proposed 150% "exposure-based portfolio limit" does not allow funds adequate flexibility to engage in common portfolio management techniques that benefit everyday investors. While the proposed 300% "risk-based portfolio limit" appears to have been intended to address these instances, we believe the 300% limit is of limited utility even for funds that are largely using derivatives to reduce risk. We therefore recommend that the SEC permit funds to use a standardized risk conversion table to adjust notional values to more accurately account for the level of risk underlying particular instruments. One good model is the standardized initial margin schedule from the BCBS/IOSCO Margin Policy Framework. This schedule sets forth the amount of initial margin that must be posted for an uncleared derivative transaction, measured as a proportion of the transaction's notional value based on the underlying asset class.[6]

The proposal would require a fund to comply with one of two alternatives designed to impose a limit on the amount of leverage that a fund may incur through derivatives and other senior securities. Under the proposed 150% "exposure-based portfolio limit," a fund's gross notional exposure to derivatives would be limited to 150% of its net assets under management. In recognition that in certain circumstances it may be appropriate for a fund to obtain exposure in excess of the exposure-based limit, the proposed 300% "risk-based portfolio limit" would permit a fund to obtain gross notional exposure up to 300% of its net assets under management if the fund

[5] *See* Proposing Release at 179-80.

[6] Margin Requirements for Non-Centrally Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (March 2015) ("BCBS/IOSCO Margin Policy Framework").

can demonstrate that the value-at-risk ("VaR") of the entire investment portfolio ("portfolio VaR") is less than the VaR of the portfolio without derivatives ("securities VaR"). This test is intended to demonstrate that the fund's aggregate use of derivatives reduces, rather than magnifies, potential risk from market movements. Although the proposal permits a fund to net directly offsetting transactions under either test, the fund would not be allowed to reduce derivatives exposure with hedging or other risk-mitigating (but not perfectly offsetting) transactions.[7]

We acknowledge the Commission's desire to limit leverage in funds that are available to everyday retail investors. When using mark-to-market asset segregation, a derivative at its inception or in a "gain" position may require minimal collateral or other asset segregation. Absent an independent limit on derivatives exposure, a fund might be able to obtain excessive leverage and potentially undertake substantial future payment obligations. In extreme circumstances, losses on a fund's derivative positions could force liquidation of investments to meet obligations.[8] Thus, placing an upper limit on such exposure makes sense. We are concerned, however, that the proposed approach to limiting leverage by capping a fund's gross notional derivatives exposure at 150% of its net assets under management would constrain fund managers' ability to use lower unit risk derivative instruments to undertake common portfolio management strategies that benefit investors.

The 300% exposure limit does not provide a meaningful alternative, because it requires that *all* derivative transactions, in the aggregate, must be risk-reducing. Specific derivative instruments are used to target individual market risk factors, such as interest rate, spread, volatility, and foreign exchange. While such derivatives are intended to address these different market factors, they may not necessarily reduce VaR in all market conditions, even when intended to reduce risk against specific market factors. VaR calculations rely on inter-asset correlations and prevailing market factors that may change daily. Due to the dynamic nature of the markets and the limitations of VaR, a fund could alternate between passing and failing the risk-based limit test without any changes to its portfolio construction. Therefore, it would be very difficult, if not impossible, to construct a portfolio that would consistently pass the risk-based VaR test.

Take, for example, a bond fund that holds a portfolio of securities denominated in foreign currencies, and intends to manage currency risk and duration risk. The fund may obtain 100% notional exposure in currency forwards to hedge against foreign exchange risk. It may also acquire 100% or more notional exposure in Treasury futures to achieve its desired interest rate exposure, which is usually more cost effective than transacting underlying securities to achieve the same outcome (*e.g.*, selling short-dated bonds and buying long-dated bonds, rather than buying Treasury futures). This strategy would exceed the 150% exposure-based limit.

Although this strategy involves the use of derivatives to manage risk, and such positions are unlikely to pose undue risk or financial obligations, in many circumstances the fund would be unable to rely on the 300% exposure limit. While the currency forwards would likely reduce portfolio VaR, the Treasury futures would increase portfolio VaR if used to manage interest rate risk by increasing duration. Consequently, aggregate portfolio VaR could be higher than the securities VaR, simply by

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[7] A fund would only be permitted to "net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms." Proposing Release at 80.

[8] *See* Proposing Release at 29.

adjusting a fund's exposure to the prevailing interest rate environment or managing to a benchmark. Absent the ability to rely on the 300% exposure limit to achieve these modifications with derivatives, portfolio managers may be left with the choice of either incurring substantial additional costs to transact in physical securities or forgoing the adjustments altogether.

To allow for increased flexibility for lower unit risk instruments while maintaining an overall limit on leverage, we recommend that the SEC adopt a standardized schedule of notional adjustments to reflect the distinct risk profiles of different classes of derivatives. Under this approach, derivatives that pose less unit risk would contribute to the portfolio limits commensurate with relative risk, while the full notional value of the "riskiest" transactions would be counted. This would allow funds to continue using derivatives to effectively manage their portfolios, while recognizing that certain derivatives pose greater market and investment risk. Further, these notional adjustments could be applied with minimal incremental effort. Once a fund identifies qualifying transactions and classifies transactions according to derivative type, an adjustment to notional values could be applied before aggregating total exposure amounts. This process would be both highly transparent and easily monitored.

Many policymakers, including the SEC,[9] have acknowledged that derivatives with different underlying assets present different risk profiles. Several have approved rules that establish schedules prescribing adjustments to notional value, based on the type of derivative instrument, for purposes of evaluating a party's risk exposure.[10] These rules demonstrate the recognition that different derivatives have a range of risk profiles, and serve as examples of regulators' willingness to codify notional adjustments to reflect relative risk.

We recommend that the SEC look to the standardized initial margin schedule from the BCBS/IOSCO Margin Policy Framework ("BCBS initial margin schedule"), which determines the initial margin requirements for uncleared swaps using a percentage of notional amounts according to underlying asset classes.[11] The BCBS initial margin schedule is intended to reflect the varying risk

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[9] "[D]ifferent derivatives transactions having the same notional amount but different underlying reference assets—for example, an interest rate swap and a credit default swap having the same notional amount—may expose a fund to very different potential investment risks and potential payment obligations." Proposing Release at 70. *See also* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Securities and Exchange Commission, Release No. 34-68071 (Oct. 17, 2012), 77 Fed. Reg. 70213 (Nov. 23, 2012). (SEC proposal including a risk-based approach ("haircuts") to determining margin amounts for security-based swaps).

[10] *See, e.g.,* BCBS/IOSCO Margin Policy Framework; Margin and Capital Requirements for Covered Swap Entities, Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; and the Federal Housing Finance Agency; 80 Fed. Reg. 74839 (Nov. 30, 2015) at Appendix A ("U.S. Prudential Regulators Margin Rule"); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, Commodity Futures Trading Commission ("CFTC Margin Rule") 81 Fed. Reg. 636 (Jan. 2, 2016) at Section 23.154(c); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," Commodity Futures Trading Commission and Securities and Exchange Commission, 77 Fed. Reg. 30596 (May 23, 2012) ("CFTC and SEC Major Swap and Security-Based Swap Participant Registration Rule"); Lending Limits, Office of the Comptroller of the Currency, Treasury, 78 Fed. Reg. 37930 (June 25, 2013) ("OCC Lending Limits").

[11] As part of the G20 commitments to provide greater oversight and transparency of the derivatives markets, policymakers across the globe undertook significant efforts to establish an international framework for the regulation of

profiles for derivatives with different asset classes, and to ensure that swap counterparties properly assess and mitigate potential risks inherent across swap transactions. Because the initial margin schedule measures risk inherent in derivatives transactions and takes into account risk across asset classes, we believe this framework serves as a useful model to quantify a fund's aggregate leverage under the Commission's portfolio limit tests.

The BCBS initial margin schedule contemplates variations in risk across underlying asset classes and durations by assigning a multiplier to the notional amount of a transaction. We recognize that actual numerical values put forth in the BCBS initial margin schedule would be too small for purposes of the Commission's portfolio limit tests; however, the values can be used as a baseline to determine appropriate notional adjustments. The BCBS initial margin schedule assigns the largest initial margin requirements, 15% of notional value, to the riskiest transaction types, including commodities and equities. We support counting the full notional value of these asset classes towards the Commission's portfolio limit tests. Therefore, we suggest that the Commission apply a scaling factor of 6 2/3 to the initial margin requirements, which would result in 100% of the notional value of commodities and equities counting towards portfolio limit tests. To preserve the relative weightings from the initial margin schedule, the 6 2/3 scaling factor would also be applied to the remaining asset classes and durations. Under this approach, an interest rate derivative with a duration of two years or less would receive four times the notional adjustment of an interest rate derivative with a duration of more than five years, recognizing the additional risk exposure of the longer-dated derivative.[12]

We also considered the impact of other regulator-approved risk schedules, including the CFTC and SEC Major Swap and Security-Based Swap Participant Registration Rule and the OCC Lending Limits. Although we found that the application of these adjustments would have a similar effect as the BCBS initial margin schedule, we recommend using the BCBS model. This schedule was jointly developed by prudential and securities regulators across the globe and, as domestic regulation is implemented, will serve the important purpose of determining the initial margin exchanged between funds and their counterparties.

Other recommended adjustments to the portfolio limitation test

We recommend that the SEC adopt a normalized duration adjustment for short-term (less than one year) derivatives, consistent with the treatment of short-term instruments in the SEC Division of Economic and Risk Analysis (DERA) White Paper, *Use of Derivatives by Registered Investment Companies*.[13] As discussed in the proposal and recognized by DERA, calculating notional amounts for short-term derivatives without adjusting for duration could overstate the magnitude of the fund's

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the derivatives markets. These efforts include the global standards for margin requirements on non-centrally cleared derivatives, published by BCBS and IOSCO in March 2015. *See* Appendix Table 1.

[12] Specifically, a multiplier of 7% would be applied to interest rate derivative with a duration of less than two years, while a multiplier of 27% would be applied to an interest rate derivative with a duration greater than 5 years.

[13] Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies*, SEC Division of Economic and Risk Analysis (2015) ("DERA White Paper").

investment exposure.[14] In addition, failure to adjust for duration could lead to instrument selection based on notional value rather than other critical factors such as suitability, cost, and liquidity.

For example, four $100 million notional 3-month Eurodollar future contracts would result in $400 million of notional exposure. A fund could achieve an economically similar investment exposure with a single 1-year $100 million notional OTC interest rate swap, *i.e.,* 25 percent of the notional exposure of the Eurodollar futures. If, under the proposed rule, a fund was concerned about its overall notional exposure, the fund may forgo the Eurodollar future (a highly liquid, cost-efficient, exchange-traded and cleared instrument) and choose an OTC swap. In the absence of a duration adjustment on short-term instruments, complying with the portfolio limits may undermine sound investment decision criteria.

We also recommend that the SEC expand the instances in which netting is permitted. For example, for purposes of calculating gross notional exposure, we recommend that the SEC allow funds to net offsetting options where all material terms are identical *except* strike price.[15] Where the other material terms such as the type of transaction (put or call), underlying asset, quantity, and expiration date are identical, the fund's maximum potential loss can be predetermined, and a fund should be required to count solely that exposure toward its notional exposure. For example, assuming all other terms are identical, if a fund has purchased a put option with a strike price of $90, and sold (written) a put option with a strike price of $100, its maximum potential loss is $10. The fund should include $10 for purposes of notional exposure.[16] Likewise, if the fund has purchased a put option at $100, and sold (written) a put option at $90, the fund *has no possible additional loss*, and should not be required to include either of these positions in its exposure calculation.[17] It is important to note that in both of these examples, the fund's maximum potential exposure is predetermined and cannot be amplified by market fluctuations.

Asset segregation requirements for derivative transactions – qualifying coverage assets

JPMAM supports the SEC's proposed approach to calculating asset segregation based on mark-to-market and cushion amounts, reduced by the value of assets posted to meet variation and initial margin, and calculated on a net basis to the extent a transaction is covered by a netting agreement. However, we recommend that the SEC expand the types of assets that may be used for segregation purposes to include certain instruments in addition to cash and cash equivalents, subject to a risk-based haircut. This approach should be based on the qualifying assets and standardized haircut schedule identified in the U.S. Prudential Regulators and CFTC Margin Rules ("U.S. Prudential

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[14] *See, e.g.*, Proposing Release at 88; DERA White Paper at 11.

[15] As proposed, funds would only be permitted to "net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms." Proposing Release at 80.

[16] Under the proposed rule, we believe the fund would be required to consider the entire $100, subject to a delta-adjustment; the purchased put option would not be considered for the exposure tests.

[17] Where there is no potential for future loss, *i.e.,* where the paired options are otherwise identical and the strike price favors the fund (strike price is lower on the written call than purchased call; strike price is higher on the written put than the purchased put), we also request that the Commission clarify that no asset segregation is necessary.

Regulators and CFTC standardized haircut schedule"), which sets forth a list of cash and non-cash assets, with associated haircuts, that may be used as collateral for uncleared swaps transactions.[18] Expanding the type of assets that may be segregated would improve outcomes for investors and provide more flexibility in portfolio management, while addressing the SEC's concerns about funds' ability to meet potential future obligations.

The proposal would require all funds that enter into derivatives transactions to segregate certain assets ("qualifying coverage assets") to meet their potential future obligations. Qualifying coverage assets would generally be limited to cash and cash equivalents. Funds would have to segregate qualifying coverage assets equal in value to the amount that would be payable by the fund if it were to exit the transaction at the time of calculation ("mark-to-market" coverage amount) plus a reasonable estimate of the potential amount required to exit the transaction under stressed conditions ("risk-based coverage amount," or "cushion"). A fund would receive credit towards its mark-to-market and cushion requirements from assets that the fund posts to cover variation margin and initial margin, respectively. In addition, if a fund has entered into a netting agreement that allows it to net payment obligations with respect to multiple derivatives transactions, coverage amounts could be calculated on a net basis.

JPMAM supports the Commission's general approach to the proposed asset segregation requirements. In the current derivatives markets, particularly in light of the widespread adoption of initial and variation margin requirements, it is evident that funds can readily ascertain their daily and risk-based exposure to a derivative instrument, making segregation at full notional value unnecessary. We also support the proposal to allow funds to receive credit for assets posted as variation and initial margin. As the proposal notes, the mark-to-market and cushion amounts are "conceptually similar" to variation and initial margin.[19] Indeed, we believe that in most circumstances, initial and variation margin will adequately cover a fund's potential future exposure. For transactions subject to a netting agreement, allowing a fund to segregate net amounts more accurately reflects the fund's actual economic exposure to each of its counterparties.

However, with respect to the type of assets that a fund would have to segregate beyond those posted as initial and variation margin, we believe that limiting the qualifying coverage assets to cash and cash equivalents is unnecessarily restrictive and could negatively impact investors. For example, fixed income funds and funds invested in foreign securities can be large users of interest rate and currency derivatives. While these funds may hold a substantial amount of assets that would be acceptable collateral, they may not have enough cash and cash equivalents to cover even a modest interest rate or currency derivatives position. Increasing cash holdings for purposes of asset segregation would negatively impact funds' ability to implement their investment strategies, as would the alternative of reducing their exposure to derivatives. In addition, in September 2015 the SEC put forth its Liquidity Risk Management Proposal, which may require funds to hold additional cash and cash equivalents.[20] While we support requiring funds to maintain an appropriate level of highly

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[18] *See* U.S. Prudential Regulators Margin Rule at Section 23.156(a); CFTC Margin Rule at Appendix B.

[19] Proposing Release at 180.

[20] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015), 80 Fed. Reg. 62273 (Oct. 15, 2015) ("Liquidity Risk Management Proposal"). Among other requirements designed to

liquid assets,[21] we are concerned that requiring funds to hold still more cash and cash equivalents for asset segregation purposes would further constrain funds from pursuing their investment strategies.

We recognize the Commission's concern that non-cash assets may be more likely than cash and cash equivalents to decline in value at the same time that the fund experiences losses on its derivatives, particularly if a fund chooses to segregate assets that are correlated to the derivatives positions. A fund may be forced to sell portfolio securities to meet its derivatives payment obligations if it did not segregate a sufficient amount of assets. In a stressed market, a fund may receive discounted prices and find it difficult to meet its current and potential future obligations.[22]

This concern could adequately be addressed by applying a risk-adjusted "haircut" to the value of non-cash assets in calculating the amount of a fund's qualifying coverage assets. Using a broader group of qualifying coverage assets, combined with appropriate risk adjustments, would allow funds to continue to hold assets consistent with their investment strategy and preserve flexibility in portfolio management, while minimizing cash drag.[23]

Specifically, the SEC should permit the group of coverage assets, with associated standardized haircuts, identified in the recently published U.S. Prudential Regulators and CFTC standardized haircut schedule, as well as open-end funds and ETFs.[24] The U.S. Prudential Regulators and CFTC standardized haircut schedule recognizes that a broader group of assets could serve as margin, if subject to an appropriate haircut to ensure that a sufficient amount of assets would be available to meet potential payment obligations. This broader group includes cash, eligible government and related debt (*e.g.*, central bank, multilateral development bank, and U.S. Government-sponsored enterprise securities), eligible corporate debt, equities included in major stock market indices, and interests in money market mutual funds and certain ETFs. Risk adjustments would range from 0.5% for eligible government securities with a residual maturity of less than one year, to 25% for equity securities included in the S&P 1500 Composite or a related index (equity securities in the S&P 500 or a related index would receive a 15% haircut). The U.S. Prudential Regulators and CFTC Margin Rules were drafted under the BCBS/IOSCO Margin Policy Framework, in which

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promote effective liquidity risk management for open-end funds, the Liquidity Risk Management Proposal could require funds to maintain additional cash due to a requirement to establish a "three-day liquid asset minimum." The Liquidity Risk Management Proposal would require that assets segregated against a derivative position assume the liquidity profile of the derivative, which may exclude such cash positions from inclusion in the three-day minimum.

[21] *See* Letter from George Gatch, CEO – Global Funds Management & Institutional, J.P. Morgan Asset Management, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated January 13, 2016, at pp. 8-9, available at https://www.sec.gov/comments/s7-16-15/s71615-67.pdf.

[22] *See* Proposing Release at 41-42.

[23] This is particularly important for funds with strategies that are highly correlated to a benchmark. If funds are required to segregate cash against their derivatives positions, they will likely need to enter into additional derivatives to mimic benchmark exposure with respect to their segregated cash. This circular problem can be alleviated by expanding qualifying assets to include other portfolio assets, subject to a haircut.

[24] *See* Appendix Table 2.

policymakers across the globe considered these non-cash assets to be "highly liquid," and "after accounting for an appropriate haircut, [ ] able to hold their value in a time of financial stress."[25]

In addition to the categories of assets identified in the U.S. Prudential Regulators and CFTC standardized haircut schedule, the Commission should allow funds to use shares of other open-end funds and ETFs as qualifying coverage assets, subject to the same proposed haircut that would apply to the asset class of the underlying fund. For underlying funds that hold more than a de minimis amount of multiple asset classes (*e.g.,* for multi-asset, non-traditional, or "unconstrained" funds), we recommend applying, to the entire fund, the largest haircut that would apply to any asset class held in more than a de minimis amount. For example, an unconstrained bond fund that included long-dated corporate debt would receive an 8% risk adjustment. Allowing mutual funds and ETFs to be used as qualifying coverage assets is important because some funds, *e.g.* funds of funds, may hold a significant percentage of mutual funds and ETFs as part of their investment strategy. These underlying funds are no less liquid than the assets they hold, and therefore warrant equivalent treatment.

Reporting requirements

The proposal would require funds that use more than a limited amount of derivatives transactions, or that use certain complex derivatives, to provide position-level risk metrics such as gamma and vega for options and warrants, including options on a derivative, such as a swaption.[26] This information would be reported on Form N-PORT, which is proposed to be filed with the SEC monthly and made available to the public on a quarterly basis.[27] The proposal would also require funds that engage in derivatives transactions to identify which portfolio limitation the fund relied upon during the reporting period. This information would be disclosed on proposed Form N-CEN.[28]

JPMAM supports the proposed requirements to report additional position-level risk metrics on N-PORT to the Commission. We believe that the SEC should have the data it needs to better understand the potential risks associates with funds' use of derivatives, which in turn will help fulfill its mission to ensure orderly markets and investor protection. However, we question the value of providing such information to investors. These position-level risk metrics are complex and their calculation depends on a number of subjective assumptions. Further, they are easily subject to misinterpretation, and would at best be of limited utility and worse, potentially confusing to investors. While we agree that the SEC should have this information for regulatory oversight purposes, we recommend that the Commission not require that such disclosure be made public.

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[25] BCBS/IOSCO Margin Policy Framework at 5.

[26] *See* Proposing Release at 255.

[27] *See, e.g.,* Investment Company Reporting Modernization, Investment Company Act Release No. 31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015).

[28] *See* Proposing Release at 256.

JPMAM appreciates the opportunity to comment on the Commission's proposed rule. We would be pleased to provide any further information or respond to any questions that the Commission or the staff may have.

Very truly yours,

/s/ George C. W. Gatch

George C.W. Gatch

CC: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
David W. Grim, Director, Division of Investment Management

Appendix.

Table 1.

Proposed notional haircuts, as derived from the "Standardized Initial Margin Schedule" of the BCBS/IOSCO Margin Policy Framework[29]

Standardized Initial Margin Schedule		Proposed adjustments
Asset class	**Initial margin requirement (% of notional exposure)**	**Multiplier to calculate "risk-adjusted" notional amount for purposes of the portfolio limit calculation[30]**
Credit: 0–2 year duration	2	13%
Credit: 2–5 year duration	5	33%
Credit 5+ year duration	10	67%
Commodity	15	100%
Equity	15	100%
Foreign exchange	6	40%
Interest rate: 0–2 year duration	1	7%
Interest rate: 2–5 year duration	2	13%
Interest rate: 5+ year duration	4	27%
Other	15	100%

[29] BCBS/IOSCO Margin Policy Framework at 29.

[30] We suggest multiplying the BCBS/IOSCO initial margin requirement by 6 2/3 to obtain the risk-adjusted notional amount for purposes for the portfolio limit calculation. Using a factor of 6 2/3 would result in a multiplier of 100% for commodities, equities, and other asset classes; other asset classes would be scaled appropriately and would maintain relative differences.

J.P.Morgan
Asset Management

Table 2.

Qualifying coverage assets for purposes of asset segregation, as finalized in the U.S. Prudential Regulators Margin Rule and the CFTC Margin Rule[31]

Asset Class	Haircut (%)
Cash in same currency as swap obligation	0
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, U.S. Government-sponsored enterprise ("GSE") securities as defined in the final rules): residual maturity less than one-year	0.5
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity between one and five years	2
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity greater than five years	4
Eligible GSE debt securities: residual maturity less than one year	1
Eligible GSE debt securities: residual maturity between one and five years	4
Eligible GSE debt securities: residual maturity greater than five years	8
Other eligible publicly traded debt: residual maturity less than one year	1
Other eligible publicly traded debt: residual maturity between one and five years	4
Other eligible publicly traded debt: residual maturity greater than five years	8
Equities included in S&P 500 or related index	15
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25
Gold	15
Additional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset[32]	8

31 *See* U.S. Prudential Regulators Margin Rule at Section 23.156(a); CFTC Margin Rule at Appendix B.

32 Finalized only in the CFTC Margin Rule.