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March 28, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Mr. Fields:

The Financial Services Roundtable ("FSR")[1] appreciates the opportunity to respond to the rule-making proposal in Release No. IC-31933 (Dec. 28, 2015) (the "Proposal")[2] issued by the Securities and Exchange Commission (the "Commission") and agrees with the Commission on the importance of prudent derivatives risk management.

The Commission proposes to adopt new Rule 18f-4 ("Proposed Rule") under the Investment Company Act of 1940, as amended ("1940 Act"). The Proposed Rule would operate as an exemptive rule, permitting a fund to enter into derivatives transactions provided that three conditions are met: (i) compliance with one of two alternative limitations on the fund's aggregate exposure obtained through derivatives and other

[1] As *advocates for a strong financial future*™, FSR represents the largest integrated financial services companies providing banking, insurance, payment, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 Fed. Reg. 80,884 (Dec. 28, 2015) ("Proposing Release"). Terms not defined herein have the meaning ascribed to them in the Proposing Release.

instruments; (ii) maintenance of qualifying coverage assets equal to at least the sum of the fund's aggregate mark-to-market and risk-based coverage amounts; and (iii) unless the fund's use of derivatives remains below certain thresholds, adoption and implementation of a derivatives risk management program as specified in the Proposed Rule. The Proposal is one of a series of rulemakings that the Commission is pursuing that are intended to address certain activities and practices, such as obtaining leverage through use of derivatives, that could pose systemic risks.

FSR appreciates the Commission's concerns regarding the increased use of derivatives by registered funds and its jurisdiction to impose related rules on the industry. However, as discussed in more detail below, FSR questions the Commission's efforts to redefine derivatives as senior securities and regulate derivatives as such under Section 18 of the 1940 Act. FSR is also concerned that the Commission has significantly underestimated the costs of the Proposal, including the impact that the Proposal would have on the current operations of existing funds besides those that are held out as "managed futures" funds or leveraged exchange-traded funds. FSR also believes that, by treating all derivatives – including those clearly utilized to manage or mitigate risks – in the same manner for purposes of exposure limitations, the Commission misses an opportunity to better tailor any proposed regulation to address perceived systemic risks and instead puts forward an inappropriately restrictive framework.

Accordingly, if the Commission moves forward with this rulemaking, FSR recommends that the Commission adopt a final rule that strikes a better balance between the ability of funds to use derivatives for hedging, risk-mitigation, common portfolio management techniques and other investment purposes and the imposition of reasonable restrictions and costs that address related risks to investors.

I. Executive Summary

A. We believe the long-standing regulatory framework permitting funds' use of derivatives and other instruments where funds enter into offsetting transactions or segregate assets to cover exposures has served funds and fund investors well. We are unaware of specific events relating generally to funds' use of derivatives or changes in the nature of the derivatives markets that warrant a reversal of the Commission's and Commission staff's long-held policy. We believe that a targeted, incremental approach that focuses on addressing issues that have actually arisen is more appropriate than the more dramatic policy shift contained in the Proposal.

B. We generally support the proposed derivatives risk management program ("DRM Program"). However, we request that funds not be required to adopt and implement a DRM Program if the fund complies, and monitors compliance, with a portfolio limitation under which: (i) as proposed by the Commission, immediately after entering into any derivatives transaction

the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets ("50% Notional Threshold"); and (ii) the fund's aggregate exposure associated with the fund's complex derivatives transactions does not exceed 5% of the fund's net assets.

C. We generally support the Proposal's requirement to segregate, on a daily basis, the net amount payable by the fund under a derivatives transaction if the fund were to exit the derivatives transaction. However, we believe the Commission's concerns with respect to counterparty credit risk in the context of offsetting transactions are adequately addressed, and the Commission should permit offsetting transactions to be included among qualifying coverage assets. Additionally, in light of two decades of successful regulation based on Commission staff guidance in using liquid assets to cover exposures resulting from derivative transactions, to avoid imposing unjustified additional costs on funds and fund investors, and to avoid the application of dramatically inconsistent regulatory requirements to address similar risks, we strongly urge the Commission to expand the proposed definition of qualifying coverage assets to include all liquid assets and assets permissible to meet margin requirements under recently-adopted Commodity Futures Trading Commission ("CFTC") margin rules, with appropriate risk adjustments.

D. We strongly urge the Commission not to impose a new notional limit on funds' use of derivatives.

1. The inclusion of notional exposures in the calculation of a fund's overall exposure is unnecessary, as existing asset coverage requirements satisfy the investor protection purposes and concerns underlying Section 18.

2. The imposition of notional limits as proposed by the Commission would entail significant costs that would ultimately be borne by fund investors. Many funds simply could not comply with the proposed limitations and would be forced to liquidate or otherwise substantially alter their structure and regulatory status. Other funds would face significant revisions to portfolio and risk management practices.

3. The Commission has not justified these costs by, for instance, establishing that there would be any demonstrable benefit from an "exposure-based test based on notional amounts" in terms of risk reduction or systemic stability.

E. Instead of a new notional limit on funds' use of derivatives, we propose an alternative, principles-based requirement for limiting funds' leverage obtained from derivatives transactions.

F. If the Commission determines to proceed with adopting a new notional limit on funds' use of derivatives, we propose: (i) that the calculation of notional exposure be tailored to the specific instrument giving rise to the exposure through the use of risk-weighted adjustments; (ii) that the Commission adopt higher exposure limitations than originally proposed; and (iii) funds be permitted the flexibility to determine (a) what types of contracts may properly offset other contracts, and (b) which terms are "material" and thus must be the same between a contract and an offsetting contract.

II. Background

Funds' use of derivatives provides significant benefits to fund investors.[3] Through the use of derivatives, a fund can gain exposure to a benchmark, asset class, or other investment more quickly and cost-effectively than through the purchase of traditional securities.[4] Even where exposure may be possible through other means, for certain assets, access through derivatives may provide the only practicable manner by which a fund can gain exposure.[5] Derivatives also provide investment managers with the ability to hedge and refine the level of risk to which a fund is exposed.[6] Although a fund may be able to achieve a certain level of risk mitigation through traditional securities, hedging risk through the use of derivatives is often faster, more cost-effective and tax-efficient, and may disrupt a portfolio's long-term investment strategies to a lesser extent.[7] In addition to investment

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3 *See, e.g.*, Proposing Release at 80,885 ("Funds employ derivatives for a variety of purposes, including to: Seek higher returns through increased investment exposures; hedge interest rate, credit, and other risks in their investment portfolios; gain access to certain markets; and achieve greater transaction efficiency") (citing *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, 76 Fed. Reg. 55,237 (Sept. 7, 2011) ("Concept Release")).

4 *See id.* at 80,886-87; Concept Release at 55,240-41; Comment Letter of BlackRock on Concept Release (Nov. 4, 2011) (File No. S7-33-11) ("BlackRock Comment Letter"); Comment Letter of AQR Capital Management on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("AQR Comment Letter"); Comment Letter of Loomis, Sayles and Company on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Loomis Concept Letter"); Comment Letter of Investment Company Institute on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("ICI Comment Letter"); *Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008) ("2008 IDC Report") at 7-9.

5 *See* 2008 IDC Report at 8; BlackRock Comment Letter at 2; ICI Comment Letter at 4; AQR Comment Letter at 2.

6 Proposing Release at 80,886-87 & n. 23; Concept Release at 55,240-41; 2008 IDC Report at 8, 11; ICI Comment Letter at 4; BlackRock Comment Letter at 2.

7 Proposing Release at 80,886-87; Concept Release at 55,240-41; 2008 IDC Report at 11; BlackRock Comment Letter at 2.

exposure and the ability to hedge risks, funds' use of derivatives provides fund investors with other benefits. These include increased liquidity[8] and the ability to transact more quickly, precisely and cost effectively,[9] to profit from price differences between cash securities and related derivatives,[10] to more efficiently manage a portfolio's duration,[11] and to create synthetic positions.[12]

As discussed below, we believe that certain aspects of the Proposal would significantly curtail legitimate, beneficial uses of derivatives by funds without concomitant benefits to fund investors.

III. Comments on Proposed Rule

A. Long-Standing Commission and Commission Staff Policy Regarding Asset Segregation and Senior Securities under Section 18

For many years, Commission and Commission staff interpretive positions have permitted funds to use derivatives and other instruments despite concerns that such transactions may implicate the prohibition in Section 18 of the 1940 Act on the issuance of senior securities. This guidance was premised upon the use of offsetting transactions or funds segregating assets to cover some portion of the fund's potential liabilities arising from the use of derivatives or other instruments.[13]

We believe this regulatory framework has served funds and fund investors well. Despite isolated instances identified by the Commission where funds' use of certain high-risk derivatives and financial commitment transactions may have played a role in funds incurring losses,[14] we are unaware of specific events relating generally to funds' use of derivatives or changes in the nature of the derivatives markets that warrant a reversal of the Commission's and Commission staff's long-held policy. We understand that the Commission may consider it necessary to update this policy after three decades,[15] but we

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8 BlackRock Comment Letter at 2; ICI Comment Letter at 4; Loomis Comment Letter at 2.

9 *See* BlackRock Comment Letter at 2; ICI Comment Letter at 4; AQR Comment Letter at 2; 2008 IDC Report at 8-11.

10 2008 IDC Report at 8.

11 Loomis Comment Letter at 2

12 BlackRock Comment Letter at 2.

13 *See, e.g.*, *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, ABA Committee on Federal Regulation of Securities (July 6, 2010) ("ABA Report") at 11-13 (discussing *Securities Trading Practices of Registered Investment Companies*, SEC Rel. No. IC-10666, 44 Fed. Reg. 25128 (Apr. 18, 1979) ("Release 10666") and *Dreyfus Strategic Investing and Dreyfus Strategic Income*, SEC No-Action Letter [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 48,525 (June 22, 1987) ("Dreyfus Letter")).

14 *See* Proposing Release at 80,895 – 96.

15 *See, e.g., id.* at 80,897.

believe that a targeted, incremental approach that focuses on addressing issues that have actually arisen is more appropriate than the more dramatic policy shift contained in the Proposal.

At a minimum, the Commission must more clearly demonstrate that the Proposed Rule, and in particular, the proposed portfolio limitations, would have mitigated previous issues arising from funds' use of derivatives or would comprehensively address problems that the Commission anticipates may arise from funds' use of derivatives. Additionally, the Commission must demonstrate that the real and substantial costs associated with the Proposed Rule, which would ultimately be borne by fund investors, are justified by demonstrable gains in risk reduction. These costs include, but are not limited to, the costs of a number of funds being forced to liquidate or substantially alter their structure and regulatory status because of an inability to comply with the proposed portfolio limitations and the costs of significant revisions to portfolio and risk management practices undertaken in order to comply with the proposed portfolio limitations and other aspects of the Proposed Rule.

B. DRM Program and Portfolio Limitation Recordkeeping Requirements

1. Support for DRM Program Proposal

We generally support the Commission's proposal to require that funds engaging in more than a limited amount of derivatives transactions, or using complex derivatives transactions (as defined in the Proposal), adopt and implement a DRM Program. We believe that the Commission's proposal would help funds assess and manage risks arising from the use of derivatives, and we endorse the Commission's view that DRM Programs should result in more robust monitoring of risks related to funds' use of derivatives and a reduction in the risk of a fund suffering unexpected losses in connection with its use of derivatives.[16] As noted by the Commission, many managers already implement derivatives risk management programs generally similar to the DRM Program proposed to be required by the Commission,[17] and we believe a standardized approach to derivatives risk management would benefit investors.

2. Proposed Revisions to DRM Program

a. *De Minimis* Threshold for Complex Derivatives Transactions

Under the Proposal, a fund would not be required to adopt and implement a DRM Program if the fund complies, and monitors its compliance, with a portfolio limitation under which: (i) immediately after entering into any derivatives transaction the aggregate

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16 *See id.* at 80,969.

17 *See id.* at 80,935.

exposure associated with the fund's derivatives transactions does not exceed the 50% Notional Threshold; and (ii) the fund does not enter into complex derivatives transactions.[18] We believe that the 50% Notional Threshold represents an appropriate threshold for determining which funds must adopt and implement a DRM Program. However, we believe a *de minimis* threshold for a fund's use of complex derivatives transactions should be implemented. For example, we believe a fund should not be required to adopt and implement a DRM Program if the fund does not exceed the 50% Notional Threshold and the fund's aggregate exposure associated with the fund's complex derivatives transactions does not exceed 5% of the value of the fund's net assets. Such a *de minimis* threshold would be helpful in avoiding the application of more rigorous and costly derivatives risk management compliance requirements to funds where the use of derivatives and complex derivatives transactions represents a demonstrably insignificant portion of the fund's overall investment program and risk profile.

b. Permit Third-Party Program Administrators

The Proposal would require that any fund adopting and implementing a DRM Program designate an employee or officer of the fund or the fund's investment adviser responsible for administering the DRM Program.[19] We believe that funds should be permitted the flexibility to choose whether to designate such fund or fund adviser personnel or to use a third party administrator for their DRM Programs. This would permit funds to determine the most efficient approach to achieving proper implementation of their DRM Programs. It would also allow smaller fund complexes, which may not employ personnel with sufficient expertise in both derivatives risk management and compliance matters to effectively administer DRM Programs, to engage experts that could more appropriately administer their DRM Programs.

3. Portfolio Limitation Recordkeeping Requirements

Under the Proposal, a fund would be required to maintain a written record demonstrating that, immediately after the fund entered into any senior securities transaction, the fund complied with the applicable portfolio limitation, which record would be required to reflect the fund's aggregate exposure, the value of the fund's net assets and, if applicable, the fund's full portfolio VaR and its securities VaR.[20] We believe that the proposed requirement to immediately create or update such records after entering into any senior securities transaction would represent a tremendous administrative burden on fund complexes that frequently enter into such transactions. Indeed, some fund complexes typically enter into hundreds of senior securities transactions each business day, and creating or updating the required records following each such transaction would be

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18 *See* Proposed Rule 18f-4(a)(4).

19 *See id.* at 18f-4(a)(3)(ii)(C).

20 *See id.* at 18f-4(a)(6)(iv).

impractical. Instead, we propose that this recordkeeping requirement be structured so that creating or updating these records is required at the end of each business day.

In our view, the minimal sacrifice in up-to-the-minute data that such an approach would represent is far outweighed by the efficiency gained and the reduction in administrative burden and expense. Moreover, this proposed revision would bring the timing of portfolio limitation recordkeeping requirements into line with the timing of records relating to funds' mark-to-market and risk-based coverage amounts and records relating to funds' qualifying coverage assets maintained with respect to financial commitment obligations.[21]

C. Asset Segregation

As proposed, the Rule 18f-4 exemption would require that a fund maintain qualifying coverage assets, determined at least once each business day, with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts.[22] The mark-to-market and risk-based coverage amounts may be reduced (i) to the extent the fund has entered into a netting agreement permitting the fund to net its payment obligations with respect to multiple derivatives transactions and (ii) by the value of assets that represent variation margin or collateral.[23]

We support the Proposed Rule's requirement to segregate, on a daily basis, the net amount payable by the fund under a derivatives transaction if the fund were to exit the derivatives transaction. We believe this is a reasonable requirement that will help ensure that funds have assets sufficient to meet their obligations under derivatives transactions[24] and will, accordingly, help protect fund investors. We also agree with the Proposed Rule's approach to calculating the coverage amounts whereby each of the mark-to-market and risk-based coverage amounts may be reduced according to net payment obligations under netting agreements and by the value of assets representing variation margin or collateral. These provisions would aid funds in determining coverage amounts that more accurately reflect current net amounts payable under derivatives transactions and that acknowledge assets funds have posted to cover obligations under derivatives transactions,[25] thereby benefitting fund investors by permitting more efficient uses of fund assets.

For reasons discussed in more detail below, requiring funds to segregate risk-based coverage amounts in addition to mark-to-market coverage amounts may not be necessary in order to ensure that funds have assets sufficient to meet their obligations under

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21 *See id.* at 18f-4(a)(6)(v) and 18f-4(b)(3)(ii).

22 *See id.* at 18f-4(a)(2).

23 *See id.* at 18f-4(a)(6) and 18f-4(a)(9).

24 *See* Proposing Release at 80,927.

25 *See id.*

derivatives transactions. Nonetheless, we support the Proposed Rule's requirement that funds segregate risk-based coverage amounts in light of the approach permitting funds to reduce this amount by the value of assets representing variation margin or collateral.

As the Commission stated in the Proposing Release, we agree that "funds may be best situated to evaluate and determine the appropriate risk-based coverage amount . . . based on a careful assessment of their own particular facts and circumstances" and that the Commission should not prescribe specific segregation amounts or methodologies.[26] However, we believe funds would benefit from a clearer description of permissible approaches to determining the risk-based coverage amount. For example, would a VaR-based approach be appropriate in determining a fund's risk-based coverage amount?[27]

1. Reduction of Coverage Amounts by Offsetting Transactions

Since 1987, the Commission staff has taken the view that funds may use offsetting transactions to cover potential liabilities arising from the use of derivatives or other instruments.[28] The industry has employed this practice for many years. However, under the Proposal, qualifying coverage assets would not include a transaction that provides offsetting exposure. The Commission reasons that the counterparty credit risk associated with the offsetting transaction warrants this exclusion.[29]

In our view, offsetting transactions should be included among qualifying coverage assets. We understand the Commission's concerns with respect to counterparty credit risk, but we believe these concerns are already addressed in several ways. First, funds commonly enter into exchange-traded derivatives that are centrally cleared and subject to margin and collateral requirements applicable to both parties in the transaction. Also, over-the-counter ("OTC") derivatives transactions are typically accompanied by credit support agreements with margin requirements applicable to both parties. Additionally, other regulators have implemented margin requirements and other rules as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Commission will soon adopt similar rules for security-based swaps. Moreover, funds would engage in the same counterparty credit risk analysis when entering into an offsetting transaction as when entering into any other derivatives transaction.

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26 *Id.* at 80,929.

27 Additionally, the Proposal defines "risk-based coverage amount" by reference to the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. *See* Proposed Rule 18f-4(c)(9). If the Commission retains this definition as proposed, the Commission should provide additional guidance on the proper interpretation of "stressed conditions." Further, the Commission should consider whether any future Commission proposal regarding stress testing would be relevant to this definition and, if so, whether it is appropriate to adopt a definition that depends upon a Commission proposal not yet put forward for public comment.

28 *See* Dreyfus Letter.

29 *See, e.g.*, Proposing Release at 80,933.

Accordingly, we believe the Commission's concerns with respect to counterparty credit risk in the context of offsetting transactions are addressed, and the Commission should permit offsetting transactions to be included among qualifying coverage assets. Indeed, in light of the protections discussed above, offsetting transactions are equally appropriate for addressing the asset coverage requirements' "primary concern" of a fund's ability to meet its obligations arising from derivatives transactions.[30] Moreover, funds should be permitted to determine which types of transactions properly offset exposures arising from derivatives transactions.

2. Expanding Qualifying Coverage Assets

Under the Proposed Rule, with respect to derivatives, qualifying coverage assets include only cash and cash equivalents and, where the fund may satisfy its obligation by delivering a particular asset, that particular asset.[31] We strongly urge the Commission to expand this proposed definition to include all liquid assets and assets permissible to meet margin requirements under recently-adopted CFTC margin rules, with appropriate risk adjustments.

For two decades, the industry has followed Commission staff guidance in using liquid assets to cover exposures resulting from derivative transactions,[32] and the Proposing Release does not identify instances of investor harm resulting from funds' use of liquid assets to cover exposures resulting from derivative transactions. Limiting qualifying coverage assets essentially to cash and cash equivalents would reverse this long-standing Commission staff position and industry practice. Limiting qualifying coverage assets in this manner would also introduce significant new costs on funds (and, ultimately, fund investors), as a requirement to maintain additional assets in cash would decrease the efficiency of funds' portfolio management by preventing funds from remaining "fully invested" in assets consistent with their investment objectives.

Limiting qualifying coverage assets essentially to cash and cash equivalents also would be inconsistent with the Commission's proposed rules regarding assets for

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30 *See id.* at n.374.

31 *See* Proposed Rule 18f-4(c)(8). The Proposal cites current U.S. generally accepted accounting principles for the definition of "cash and cash equivalents": "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." Proposing Release at 80,932.

32 *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter, 1996 WL 429027 (July 2, 1996) ("Merrill Lynch Letter") ("We believe that it would be consistent with the language and policy of Section 18(f) and Release 10666 to permit a [f]und to place any asset, including equity securities and non-investment grade debt, in a segregated account, so long as the asset is liquid and marked to the market daily.").

collateralizing non-cleared security-based swaps[33] and similar collateral requirements of other regulators, including the CFTC. Indeed, in its recently-adopted margin rules, the CFTC broadened the scope of collateral eligible to post as margin.[34] Additionally, as noted previously, under the Proposed Rule, a fund would be required to maintain qualifying coverage assets, determined at least once each business day, with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts. It would be an odd result if, on the one hand, both the mark-to-market coverage amounts and risk-based coverage amounts could be reduced by the value of assets representing variation margin or collateral (in the case of mark-to-market coverage

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33 *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 Fed. Reg. 70,214 (Nov. 23, 2012).

34 Under the CFTC's rules, eligible collateral includes: (i) Immediately available cash funds denominated in: (A) U.S. dollars; (B) A major currency; (C) A currency of settlement for the uncleared swap; (ii) A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury; (iii) A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, a U.S. government agency (other than the U.S. Department of Treasury) whose obligations are fully guaranteed by the full faith and credit of the U.S. government; (iv) A security that is issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator; (v) A publicly traded debt security issued by, or an asset-backed security fully guaranteed as to the timely payment of principal and interest by, a U.S. Government-sponsored enterprise that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the U.S. Government-sponsored enterprise's eligible securities; (vi) A security that is issued by, or fully guaranteed as to the payment of principal and interest by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank; (vii) Other publicly-traded debt that has been deemed acceptable as initial margin by a prudential regulator; (viii) A publicly traded common equity security that is included in: (A) The Standard & Poor's Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the Commission; or (B) An index that a covered swap entity's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction; (ix) Securities in the form of redeemable securities in a pooled investment fund representing the security-holder's proportional interest in the fund's net assets and that are issued and redeemed only on the basis of the market value of the fund's net assets prepared each business day after the security-holder makes its investment commitment or redemption request to the fund, if the fund's investments are limited to the following: (A) Securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and immediately-available cash funds denominated in U.S. dollars; or (B) Securities denominated in a common currency and issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator, and immediately-available cash funds denominated in the same currency; and (C) Assets of the fund may not be transferred through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, or other means that involve the fund having rights to acquire the same or similar assets from the transferee, or (x) Gold. *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636, 701-02 (Jan. 6, 2016).

amounts) or initial margin or collateral (in the case of risk-based coverage amounts), but on the other hand, if the assets that could be used for margin could not count as qualifying coverage assets if they were not used as margin.[35]

Accordingly, in light of two decades of successful regulation based on Commission staff guidance in using liquid assets to cover exposures resulting from derivative transactions, to avoid imposing unjustified additional costs on funds and fund investors, and to avoid the application of dramatically inconsistent regulatory requirements to address similar risks, we strongly urge the Commission to expand the proposed definition of qualifying coverage assets to include all liquid assets and assets permissible to meet margin requirements under recently-adopted CFTC margin rules, with appropriate risk adjustments.

D. Notional Limits

Under the Proposed Rule, funds would be required to comply with one of two portfolio limitations such that, immediately after entering into any senior securities transaction: (i) the aggregate exposure of the fund does not exceed 150% of the value of the fund's net assets; or (ii) the fund's full portfolio VaR is less than the fund's securities VaR and the aggregate exposure of the fund does not exceed 300% of the value of the fund's net assets. The term "exposure" is defined under the Proposed Rule to include the aggregate notional amounts of the fund's derivatives transactions, reduced by any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.[36] For the reasons discussed below, we strongly urge the Commission not to impose a new notional limit on funds' use of derivatives.

1. Asset Segregation Requirements Address Section 18 Policy Concerns

For nearly three decades, the fund industry has followed Commission guidance that the asset coverage requirements set forth in Release 10666, and reaffirmed in subsequent Commission staff positions, will satisfy the investor protection purposes and concerns underlying Section 18 because such requirements will "function as a practical limit on the amount of leverage which [funds] may undertake and on the potential increase in the speculative character of" an investment in the fund, and will "assure the availability of adequate funds to meet the obligations arising from such activities."[37] We are aware of no instances since the publication of Release 10666, including during the global financial crisis of 2008-2009, of a fund being unable to satisfy its derivatives obligations when in compliance with the Commission's asset coverage requirements. As noted previously, the

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35 *See* Proposed Rule 18f-4(c)(6), (8) and (9).

36 *See id.* at 18f-4(a)(1) and 18f-4(c)(3).

37 Release 10666.

isolated instances identified by the Commission of funds incurring substantial losses in connection with certain derivatives or financial commitment transactions[38] demonstrate the risks of such investments.[39] They do not, however, demonstrate changes in the nature of the derivatives markets or funds' use of derivatives that undermine the rationale behind the asset segregation approach of Release 10666 as an appropriate and sufficient means, when combined with adequate disclosures, of satisfying the investor protection purposes and concerns underlying Section 18.

Commissioner Piwowar has echoed these points, stating:

> [T]he proposed asset segregation requirements should function as a leverage limit on funds and ensure that funds have the ability to meet their obligations arising from derivatives. Therefore, absent data indicating that a separate specified leverage limit is warranted there is no justification for imposing any additional requirements or burdens on funds. This is particularly the case given that our current guidance to funds concerning their derivatives transactions rests solely on asset segregation.[40]

2. The Proposed Notional Limits Impose Additional Costs Without Demonstrable Benefit

The imposition of notional limits as proposed by the Commission would entail significant costs that would ultimately be borne by fund investors. Many funds simply could not comply with the proposed limitations and would be forced to liquidate or otherwise substantially alter their structure and regulatory status. Other funds would face significant revisions to portfolio and risk management practices. The Commission has not justified these costs. It has not established, for instance, that there would be any demonstrable benefit from an "exposure-based test based on notional amounts" in terms of risk reduction or systemic stability. Moreover, the Commission fails to address the fact that notional exposure is not a measure of true economic leverage.[41] Indeed, under the

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38 *See, e.g.*, Proposing Release at 80,895 – 96.

39 All investments, whether in derivatives, cash securities or otherwise, carry the risk of loss. Moreover, losses during the financial crisis from cash securities far exceeded losses from derivative trades.

40 Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission, *Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies* (Dec. 11, 2015).

41 As the Commission acknowledges, an

> exposure-based test based on notional amounts . . . could be viewed as a relatively blunt measurement in that different 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 80,903.

Commission's proposal, risk-mitigating derivatives transactions would be subject to the same limitations as derivatives transactions entered for investment exposure.

3. Proposed Alternative to Proposed Notional Limits

We believe funds and fund investors would be better served by a Commission approach that preserves funds' investment flexibility, and thus fund investor choice, with respect to derivatives exposures within the confines of the asset segregation regime. The Commission could achieve this by adopting a principles-based requirement that funds adopt and implement written policies and procedures reasonably designed to limit fund leverage obtained from derivatives transactions and require funds to maintain assets available to meet obligations arising from derivatives transactions. This could be complemented by Commission or Commission staff guidance regarding derivatives risk management and oversight.

Such an approach would permit funds and fund complexes of all sizes to determine the most efficient approach to managing derivatives risk within the framework set forth by the Commission, taking into consideration their particular circumstances, investment objectives, strategies and investor base. Because funds' written policies and procedures adopted under this alternative approach would be subject to Commission staff examination, this approach would permit the Commission to obtain additional data regarding industry approaches to limiting fund leverage from derivatives transactions and the efficacy of such approaches. This data could serve to inform future Commission guidance or rule proposals that could more appropriately and precisely address any areas of demonstrated weakness in funds' risk management.

4. Proposed Revisions to Notional Limits if Adopted

a. Risk-Weighted Adjustments for Underlying Assets

If the Commission adopts the proposed notional limits, we believe the calculation of notional exposure should be tailored to the specific instrument giving rise to the exposure. For example, the Commission may permit funds to determine risk weights using a proprietary model or a schedule prepared by the Commission. If the Commission prescribes certain risk weights under this approach, the Commission should take into consideration the percentages and weightings adopted by other regulators in similar contexts. Less risky assets or assets that are used for hedging purposes (and, thus, reduce risk) should receive risk weights that reduce their impact on any notional limit.

b. Higher Notional Limits

The Commission has not justified the specific notional limits it proposes and, if it determines to adopt notional limits, should adopt higher exposure limitations than originally proposed. Such higher exposure limitations could be conditioned upon the

fund's full portfolio VaR being less than, or within a range of, an appropriate broad-based securities market index. They may also be imposed at a later date in a subsequent rulemaking that is informed by data gathered from industry approaches to limiting fund leverage from derivatives transactions and the efficacy of such approaches.[42]

c. Expanding Permissible Offsetting Transactions

Under the Proposed Rule, a fund is permitted to net from its calculation of exposure any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. We believe funds are best positioned to determine (i) what types of contracts may properly offset other contracts, and (ii) which terms are "material" and thus must be the same between a contract and an offsetting contract.[43] Accordingly, funds should be permitted the flexibility to make these determinations. We further believe that permitting offset only where the contract has the same underlying reference asset is overly narrow and difficult to implement. A more reasonable limitation would be to require that offsetting contracts have a reference asset in the same asset class as the reference asset of the contract being offset.

E. Disproportionately Negative Impact on BDCs

All of the concerns expressed above regarding the potential negative consequences of the Proposed Rule on fund investment activities apply equally to business development companies ("BDCs"), but for the reasons discussed below will have an even more negative impact on the activities of BDCs. Indeed, the Proposed Rule would directly undermine BDCs' ability to fulfill their Congressional mandate to provide much-needed financing to small- and medium-sized companies.

BDCs are a specialized form of closed-end management investment company authorized by Congress in 1980 to encourage increased investment in the securities of small- and medium-sized companies that are less able to raise capital in the public capital markets. In exchange for a commitment to invest at least 70% of their assets in securities of eligible portfolio companies (generally private U.S. operating companies), BDCs were granted relief from certain of the 1940 Act's restrictions, including notably Section 18's 300% asset coverage requirements that are applicable to most registered investment companies. Instead, BDCs are subject to a 200% asset coverage requirement, which

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42 *See* Section III.D.3.

43 For example, consistent with existing guidance, a fund may determine that an offsetting instrument's strike price need not be identical to the strike price of the instrument it is offsetting. *See, e.g.*, Dreyfus Letter ("For example . . . a fund that has a long position in a futures or forward contract could purchase a put option on the same futures or forward contract *with a strike price as high or higher than* the price of the contract held by the fund. A fund that has sold a put option could sell short the instruments or currency underlying the put option *at the same or higher price than the strike price of* the put option. Similarly, the fund could purchase a put option, if the strike price of the purchased option *is the same or higher than the strike price of* the put option sold by the fund.") (emphasis added).

effectively permits BDCs to incur twice the amount of leverage as most registered investment companies.[44]

Because the Proposed Rule's portfolio limitations do not distinguish among types of investment companies,[45] BDCs will be subject to the same overall limitations on leverage as registered investment companies. In order to avoid undermining the clear Congressional intent that BDCs be permitted greater leverage than registered investment companies, we recommend that the Commission consider revising the portfolio limitations to restore the distinctions authorized by Congress.

BDCs are also disproportionately negatively affected by the Proposed Rule's treatment for the first time of unfunded commitments as financial commitment transactions subject to both the portfolio limitations and asset segregation requirements.[46] While unfunded commitments are not utilized exclusively by BDCs, many BDCs enter into revolving credit and other loan commitments with portfolio companies in which they invest. Significantly, such loan commitments typically do not involve a leveraging effect. In this respect, it bears mentioning that Release 10666 specifically distinguishes between "[c]ommitments to purchase securities whose yields are determined on the date of delivery with reference to prevailing market interest rates" and concludes that such commitments "are not intended to be included in this general statement of policy. Such commitments neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage."[47] Moreover, unfunded loan commitments often may not be drawn upon, and, if the portfolio company's financial condition has deteriorated materially, the BDC may not be required to fund the commitment when it is drawn. Accordingly, we recommend that the Commission revisit the treatment of unfunded commitments as financial commitment transactions, with the view to eliminating or at a minimum better tailoring the Proposed Rule's applicability to unfunded commitments.

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44 *See, e.g.*, Proposing Release at 80,887 ("A BDC is also subject to the limitations of section 18(a)(1)(A) to the same extent as if it were a closed-end investment company except that the applicable asset coverage amount for any senior security representing indebtedness is 200%.").

45 *See* Proposed Rule 18f-4(a) ("A registered open-end or closed-end company *or business development company* (each, including any separate series thereof, a 'fund'), may enter into derivatives transactions . . . provided that: (1) The fund complies with one of the following portfolio limitations . . . .") (emphasis added).

46 *See* Proposing Release at 80,900 and Proposed Rule 18f-4(c)(4).

47 Release 10666 at n.12.

F. Scope of Rule and Transition Period

We request that the Commission clarify that purchased options and structured notes are not within the scope of the rule, as neither requires a fund to satisfy a future obligation that would otherwise require segregating assets. In effect, these instruments are already "covered" and need not be subject to additional regulation under the Proposed Rule.

As discussed in the Proposing Release, should the Commission determine to adopt the Proposed Rule in any form, we support the Commission providing the industry with a substantial "transition period during which [the Commission] would permit funds to continue to rely on Release 10666, [Commission] staff no-action letters, and other guidance from [Commission] staff, including with respect to derivatives transactions and financial commitment transactions." In this regard, we urge the Commission to consider that funds and fund boards will be simultaneously preparing for compliance with not only the Proposal, but also several other substantial new compliance regimes relating to fund liquidity, stress testing, reporting and succession planning. We propose that, in order to allow funds sufficient time to update compliance systems, revise policies and procedures and properly train those responsible for compliance, such a transition period be at least 30 months from the date of publication of the final rules in the Federal Register. Moreover, large asset managers should not be subject to an accelerated compliance timeline relative to smaller asset managers.

IV. Conclusion

We appreciate the Commission's concerns regarding the increased use of derivatives by registered funds. However, we question the Commission's efforts to redefine derivatives as senior securities and regulate derivatives as such under Section 18 of the 1940 Act. We are also concerned that the Commission has significantly underestimated the costs of the Proposal, including the impact that the Proposal would have on the current operations of existing funds besides those that are held out as "managed futures" funds or leveraged exchange-traded funds. We believe that a targeted, incremental approach that focuses on addressing issues that have actually arisen is more appropriate than the more dramatic policy shift contained in the Proposal.

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If it would be helpful to discuss our specific or general views on the Proposal, please contact Richard Foster at [redacted]; or Felicia Smith at [redacted]. We appreciate your consideration and look forward to working with you on this important matter.

Sincerely yours,

Richard Foster

Senior Vice President and Senior Counsel
for Regulatory and Legal Affairs

Financial Services Roundtable

With a copy to:

The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Members, ***United States Securities and Exchange Commission***

Adam Bolter, Senior Counsel
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