MANAGED FUNDS ASSOCIATION

Alternative Investment Management Association

March 28, 2016

Via Electronic Submission: rule-comments@sec.gov

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

Re: Proposed Rule on the Use of Derivatives by Registered Investment Companies and Business Development Companies (File Number S7-24-15)

Dear Mr. Fields:

Managed Funds Association ("**MFA**")[1] and the Alternative Investment Management Association ("**AIMA**")[2] (together, "**we**") are pleased to have the opportunity to provide comments to the U.S. Securities and Exchange Commission ("**Commission**" or "**SEC**") on its proposed rule on the "Use of Derivatives by Registered Investment Companies and Business Development Companies" (the "**Proposed Rule**").[3]

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[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] Founded in 1990, AIMA represents the global hedge fund industry. AIMA's membership is corporate and comprises over 1,600 firms (with over 10,000 individual contacts) in more than 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than $1.5 trillion in assets. See www.aima.org.

[3] 80 Fed. Reg. 80884 (Dec. 28, 2015) ("**Proposing Release**").

I. Executive Summary

MFA and AIMA generally support portions of the Proposed Rule but take strong exception to certain aspects of it. Although we acknowledge the Commission's investor protection concerns regarding the use of derivatives by mutual funds and other registered investment companies (collectively, "**Funds**"),[4] we question whether it is necessary to redefine and then regulate derivatives as "senior securities" under Section 18 of the 1940 Act. We also have serious concerns that the Proposed Rule's notional-based leverage limits are too blunt a risk mitigation tool for most derivatives used by Funds.

Despite our concerns, we generally support the Commission's activities-based approach in providing an updated and more comprehensive framework to regulate Funds' use of derivatives. As summarized below, we agree with several key aspects of the Proposed Rule, including requirements as to: asset segregation, a formalized derivatives risk management program (a "**DRM Program**"), and recordkeeping. In our view, these key pillars of the Proposed Rule render the imposition of any new notional-based limit unnecessary and inappropriate to address the policy objectives of Section 18 of the 1940 Act. More specifically, we believe the proposed asset segregation requirements would function as an effective leverage limit on Funds' use of derivatives as well as ensure Funds' ability to meet their payment obligations stemming from derivatives transactions. The combined effect of the DRM Program and the proposed recordkeeping requirements would reinforce and support the proper application of the proposed asset segregation requirements.

<u>Policy Concerns with Redefining Derivatives as Senior Securities</u>. We are fundamentally concerned with the Commission's view in the Proposed Rule that derivatives transactions entered into by a Fund, in compliance with the SEC's long-standing policy and staff no-action guidance on asset segregation, should now be considered "senior securities" under Section 18 and, in turn, become subject to the substantial conditions and restrictions in the Proposed Rule. As discussed more fully below, for over three decades the SEC and its staff have repeatedly expressed and applied the policy that derivatives transactions do not raise senior securities issues if a Fund daily segregates assets equal to, or otherwise covers, its net obligations arising from these transactions. In our view, the Commission's sudden proposed reversal of its long-established policy on the treatment of derivatives under Section 18 of the 1940 Act lacks sufficient justification. However, if the Commission proceeds with redefining derivatives transactions as senior securities in a final rule, we agree with the Commission's view in the Proposed Rule that a derivative that does not impose a future payment obligation on a Fund would not involve a senior security transaction for purposes of Section 18 of the 1940 Act, because there would be no evidence of indebtedness.[5]

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[4] The Proposed Rule would apply to "mutual funds, exchange-traded funds ('ETFs'), closed-end funds, and companies that have elected to be treated as business development companies ('BDCs')" under the Investment Company Act of 1940 (the "**1940 Act**"). Proposing Release at 80884.

[5] Proposing Release at 80892.

Notional-Based Leverage Limits are Unjustified. In addition to our threshold policy concerns, we have serious concerns with the Proposed Rule's alternative notional-based leverage limits. We believe such an overall leverage limit is both unnecessary and inappropriate because it lacks sufficient justification, given the practical effect of the Commission's proposed asset segregation requirements and the potential reinforcing effect of the Commission's other related regulations after their adoption.[6] We note additionally that the notional-based limits are too insensitive to risk to be effective tools for gauging a permissible level of risk and leverage. We suggest and explain below our proposals for more appropriate and risk-sensitive alternatives for limiting leverage.

We provide both qualitative and quantitative support to facilitate the Commission's consideration of our proposals. We also offer our recommendations to assist the Commission in developing informed regulations for Funds' use of derivatives that address investor protection and undue speculation concerns under Section 18. Our recommended alternatives are intended to provide Commission staff with leverage limits that would be simple to administer and enforce.

If the Commission does proceed with adopting leverage limits and certain other aspects of the Proposed Rule, we respectfully urge the Commission to consider our proposed recommendations for modifications to the final rule. We suggest that the Commission's policy objective to protect investors would be well-served by establishing a better balance between authorizing Funds to use derivatives for hedging, risk-mitigation and investment purposes, and imposing reasonable, practical restrictions that address the risks derivatives may present to Funds and their investors.

A. Summary of Our Recommended Alternatives to Notional-Based Portfolio Limits

As we discuss in Section IV of our letter, we believe that notional amount has inherent problems as a measure of risk and leverage. Basing Funds' portfolio exposure limits on the aggregate notional amounts of derivatives transactions is too blunt a measure, and will force many Funds that do not, in fact, have a material amount of risk due to leverage to substantially alter their strategies or de-register without good reason. This outcome will have the potential unintended effects of limiting investor choice and undermining investor protection by depriving investors of opportunities to invest in alternative mutual fund strategies and their potential benefits. We believe these outcomes are not warranted, and accordingly, in our letter:

- We explain why we believe that the notional-based exposure limitation is unjustified and why we believe that a risk-based coverage amount and the mark-to-market coverage amount would be sufficient on their own. More specifically, we believe that a Fund's board

[6] More specifically, we note the Commission's pending regulatory reforms under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), and the other pending proposals cited in Commissioner Piwowar's dissenting statement concerning the Proposed Rule. *See* Commissioner Michael S. Piwowar Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies, issued December 11, 2015 (the "**Piwowar Dissent**").

should be authorized to base the proposed risk-based coverage amount on no less than the required initial margin for each of the derivatives transactions in the Fund's portfolio.

- We suggest that the Commission provide managed futures Funds with the option to use a margin-based approach in lieu of both a notional-based limit and the risk-based coverage amount, pursuant to which the Fund would segregate on its books and records an amount equal to, and in addition to, the initial margin requirement that the Fund is otherwise required to satisfy in respect of each of its derivatives transactions.

- Alternatively, should the Commission proceed with adopting a notional-based exposure limitation in its final rule, we recommend that such limits be subject to certain risk-based adjustments or notional exposure "haircuts" based on the asset class of the derivatives transaction. We believe that such haircuts, together with a modified value-at-risk ("**VaR**") test, would account more effectively for the risk of the underlying asset class and reflect more accurately the actual risk of the derivatives transaction.

- We recommend that, if the Commission decides to adopt a notional-based exposure limit, the Commission authorize Funds to recalculate their notional-based exposures and applicable portfolio and securities VaR limits at the end of each business day, consistent with the timing standard for asset segregation, rather than on an immediate basis with respect to each of the multiple derivatives transactions that a Fund may enter into throughout the trading day.

- We also recommend that, for purposes of netting notional amounts to calculate derivatives exposure, Funds should have the flexibility to determine which types of derivatives transactions may properly offset other derivatives transactions. For example, a Fund should be permitted to offset a futures contract against an option, if the offset reduces exposure and risk.

- We further recommend that if the Commission retains a notional-based approach, the exposure-based limit and the risk-based limit should be increased and subject to our recommended risk-based adjustments.

B. Summary of Our Views on Other Key Aspects of the Proposed Rule

Despite our fundamental concerns with imposing a new notional-based leverage limit, we generally support, with modest modifications, most of the Commission's other proposed requirements in the Proposed Rule. As we explain further below:

- While we agree with the Commission's approach to asset segregation, we are concerned with the Proposed Rule's limitation of qualifying coverage assets for derivatives transactions to cash and cash equivalents. Such a limitation could lead to potential adverse consequences, such as a "cash drag" on Funds and resulting strains on the availability of sufficient cash equivalents for Funds. To avoid these adverse consequences, we request that the rule permit Funds to use a broader scope of liquid assets with appropriate haircuts.

- We support the use of variation margin and initial margin posted by a Fund in connection with a derivatives transaction as an appropriate reduction to the amounts a Fund would be required to segregate under the Proposed Rule.

- We appreciate the Commission's proposal to authorize a Fund to calculate the proposed segregation amounts on a net basis for derivative transactions, *i.e.*, subject to netting agreements that allow for payment obligations to be netted across multiple transactions. However, we believe that the Commission also should authorize netting across different counterparties, which is consistent with prior long-standing Commission guidance that Funds have been relying on without incident.[7]

- We generally support the Proposed Rule's written derivatives risk management program requirements to provide protective benefits to Funds and their shareholders.

- We also support the adoption of the recordkeeping provisions in the Proposed Rule.

II. Background – Investor Benefits of Alternative Mutual Funds and their Use of Derivatives

Private investment funds have long used a diverse array of alternative investment strategies involving the use of derivatives[8] to generate returns and protect against losses in all market conditions and environments. While no strategy is perfect in all market conditions, many of these strategies provided substantial benefits to investors during the global financial crisis from November 2007 to February 2009. When measured against global equity indices, for example, alternative strategy funds were able to mitigate losses during this period of unprecedented market volatility.[9] As shown in Chart 1 below, managed futures strategies,[10] in particular, performed particularly well during the financial crisis, in many instances providing positive returns while global equities suffered extensive losses.

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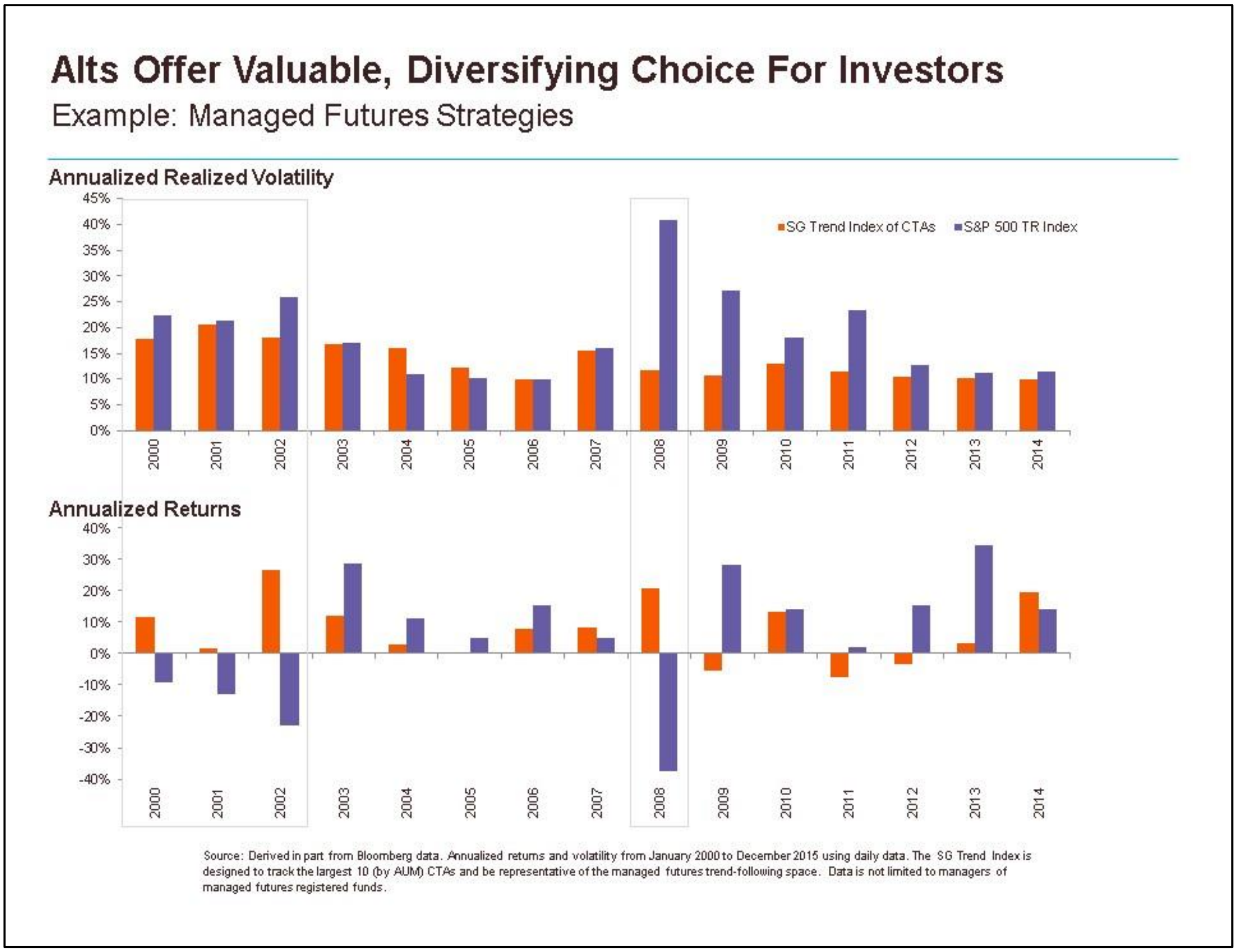
[7] Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) ("**Dreyfus Letter**").

[8] Alternative strategy funds are also known as "liquid alternatives" to traditional fund strategies that primarily invest in stocks and bonds.

[9] BNY Mellon Paper, "Redefining Absolute Returns in the Liquid Alternative Era", by Svein Floden, Head of Liquid Alternatives Insight Investment, at 3.

[10] The alternative strategies of managed futures funds are managed by regulated commodity trading advisors ("**CTAs**") and use global futures and other derivatives transactions as the primary investment instruments.

Chart 1
Performance of the SG Trend Index of CTAs and the S&P 500 TR Index



In recent years, increased investor demand has resulted in private fund managers offering alternative strategies through regulated investment vehicles that are readily available to non-accredited investors. Both institutional and retail investors have increasingly sought the non-correlated returns of alternative strategies,[11] while also benefiting from the increased liquidity, transparency, diversification and regulatory oversight that come with mutual funds and other types of regulated investment funds. Investment allocations to alternative funds registered under the 1940 Act have grown dramatically since the financial crisis, with recent research indicating that

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[11] Generally, the returns of alternative strategies do not display correlation to traditional equity or fixed-income investments. For a discussion of the historical non-correlated performance of managed futures strategies during periods of stress and negative performance in the equities markets, *see* March 28, 2016 Letter from Millburn Ridgefield Corporation Re: "Proposed Rule on the Use of Derivatives by Registered Investment Companies and Business Development Companies", Investment Company Act Release No. IC-31933 (File No. S7-24-15), to Brent Fields, Secretary of the Securities and Exchange Commission, pp. 2-5.

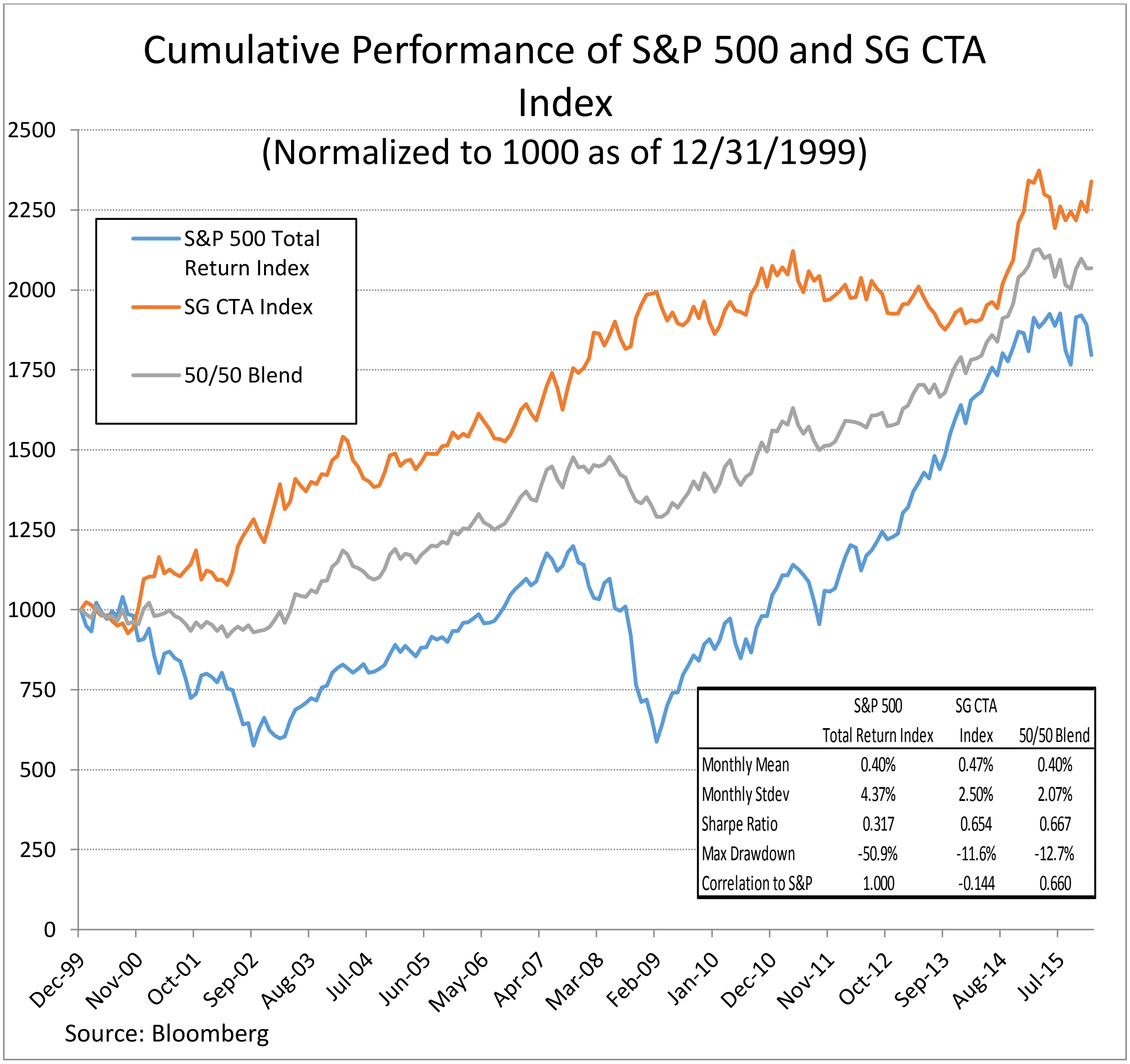
the amount of assets in alternative strategy mutual funds has tripled between 2009 and 2014, growing from $58 billion to $170 billion.[12]

Registered investment vehicles use derivatives for a variety of risk-reducing and other beneficial purposes, including achieving greater transaction efficiencies and accessing certain markets that may not otherwise be available through traditional investment strategies. Derivatives also allow registered funds to hedge or mitigate interest rate, foreign exchange and other portfolio risk, as well as to obtain investment leverage. Derivatives are also frequently used to manage the liquidity of portfolios. Many securities and other direct holdings are less liquid than their derivative counterparts, so prudent portfolio construction in line with the liquidity constraints imposed under the 1940 Act often result in registered funds using derivatives, rather than cash. Derivatives regulation that has the effect of driving funds to move toward less liquid cash alternatives could run counter to some of the liquidity risk management practices the SEC has proposed.

Chart 2 below highlights the benefits of alternative mutual fund strategies by comparing the performance of the S&P 500 Total Return Index to the SG CTA Index over the past 15 years, as well as a 50/50 blend. The SG CTA Index provides the market with a daily performance benchmark of major CTAs. It calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment. A committee of industry professionals monitors the methodology of the index on a regular basis. Notably, the correlation of the S&P 500 to the SG CTA Index is effectively zero with a value of -0.144, and the SG CTA Index produced greater returns with less downside and lower volatility than the S&P 500. While the performance of individual managers and funds will vary, the SG CTA Index is the broadest based and most representative measure of CTA performance.

[12] Investment Company Institute (ICI), "2015 Investment Company Fact Book", 55th ed., at p. 44. Of course, during other time periods, managed futures strategies have suffered losses. *See* Chart 1 above.

Chart 2
Performance of the S&P 500 Total Return Index and the SG CTA Index
With Comparative Metrics



Moreover, as the Commission has previously stated, the activities of registered funds, including their use of derivatives, are regulated extensively under the 1940 Act, Commission rules, and formal Commission guidance.[13] Notwithstanding the current extensive set of statutory and regulatory prohibitions and restrictions on the use of derivatives by registered funds, the SEC,

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[13] *See* Concept Release, "Use of Derivatives by Investment Companies under the Investment Company Act of 1940", Investment Company Act Release No. 29776 (Aug. 31, 2011), 76 Fed. Reg. 55237 (Sept. 7, 2011) ("**Concept Release**").

through the Proposed Rule, seeks to impose additional conditions and restrictions on the use of derivatives to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act.

We appreciate that Funds are designed to be retail products, and as a result often have a different investor base than that of private funds. We also acknowledge the Commission's policy objective to protect investors from the potential risks of leverage from Funds' use of derivatives.[14] However, if adopted without modification, we are concerned that the notional-based portfolio limits and certain other aspects of the Proposed Rule will limit investor choice needlessly. We also believe that the proposed limitations lack sufficient justification under the Commission's rulemaking standards.[15] The Proposed Rule's portfolio limits alone could have a much broader impact on the U.S. mutual fund industry than presented by the study conducted by the Commission's Division of Economic and Risk Analysis (DERA).[16] According to a more recent study conducted by ICI, at least 471 Funds with $613 billion in assets would exceed the Proposed Rule's 150% exposure-based portfolio limit, and at least 173 Funds with $338 billion in assets would exceed the Proposed Rule's risk-based portfolio limit.[17] ICI's study also confirmed the DERA White Paper's finding of the disproportionate impact of the proposed portfolio limits on alternative strategy funds. ICI found that 47% or 221 of the 471 Funds with notional values greater than 150% relative to their assets were alternative funds.[18] These alternative funds represented 13% or $79 billion of the $613 billion in assets over the 150% exposure limit.[19]

We believe the disproportionate impact on alternative funds and the broader impact on other mutual funds provide a compelling reason for the Commission's reconsideration of the Proposed

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[14] Proposing Release at 80885-86.

[15] We acknowledge that Section 6(c) of the 1940 Act allows the Commission to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest, and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." However, Section 2(c) of the 1940 Act requires that whenever the Commission is engaged in rulemaking under the 1940 Act and is required to consider or determine whether an action is in the public interest, the "Commission shall also consider, <u>in addition to the protection of investors</u>, whether the action will promote efficiency, competition, and capital formation" (emphasis added).

[16] *See* 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**") (estimating that about four percent (4%) of the existing funds would exceed the 150% exposure limit and about one percent (1%) would exceed the 300% exposure limit).

[17] *See* March 28, 2016 Letter from Investment Company Institute Re: *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15) to Mr. Brent J. Fields, Secretary of the Securities and Exchange Commission (the "**ICI Letter**"), at p. 35 and Appendix A.

[18] *Id.* at 38.

[19] *Id.*

Rule's portfolio limits under its rulemaking standards. A rulemaking that imposes unjustified portfolio limitations would deprive retail investors, as well as institutional investors that prefer investing in more regulated products, of investment choice and the benefits of mutual fund strategies that use derivatives. An additional unintended consequence of the Proposed Rule may be that some Funds would cease using certain derivatives in their strategies, resulting in less diversified investment portfolios for their investors. These outcomes would arguably undermine investor protection, and may stifle efficiency, competition and capital formation in the U.S. mutual fund markets.

In our view, we believe that the SEC needs to more clearly demonstrate that the Proposed Rule, and in particular, the proposed portfolio limitations, would have mitigated previous problems caused by Funds' use of derivatives, or would solve for anticipated problems caused by their use of derivatives. As we explain below, we do not believe that either the record of the past 40 years or any reasonably foreseeable circumstances exist to warrant such changes. Indeed, a decision by the Commission to adopt a rule that could cause a portion of the mutual fund industry to cease offering strategies that use derivatives to retail and institutional investors, or to cease their operations altogether, demands clear rulemaking justification.[20]

III. Notional Portfolio Limitations for Derivatives Transactions are Unjustified

For the reasons we explain below, we are primarily concerned with the Proposed Rule's new limits on aggregate derivatives notional exposure. The Proposed Rule would require Funds engaging in derivatives transactions to comply with one of two portfolio limitations immediately after entering into each derivatives transaction.

Under the first limit, referred to as an "**Exposure-Based Portfolio Limit**", the aggregate exposure of a Fund may not exceed 150% of the value of its net assets. "Exposure" would mean, in relevant part, the aggregate notional amounts of the Fund's derivatives transactions.[21] The notional amount under the Proposed Rule would be defined generally as the market value of an equivalent position in the underlying reference asset, or the specified or principal amount on which payment obligations under a derivatives transaction are calculated. For purposes of calculating exposure, a Fund would 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. Funds could net substantially similar transactions across different counterparties.

[20] For a fuller discussion of these concerns based on a data and economic analysis, please see White Paper on "Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies", Data and Economic Analysis, by James A. Overdahl, Ph.D., Delta Strategy Group, dated March 24, 2016, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2754153.

[21] In addition to derivatives notional exposure, the "exposure" definition also includes the aggregate obligations under a Fund's repurchase agreements and other similar financial commitment transactions, as well as a Fund's aggregate indebtedness with respect to any other transaction that raises senior securities issues under Section 18 (such as bank borrowings or issuance of senior debt).

Under the second limit, referred to as the "**Risk-Based Portfolio Limit**", a Fund's permitted exposure could increase to 300% of net assets if its derivatives exposure reduces the Fund's exposure to market risk. The Proposed Rule would permit a Fund to maintain the 300% notional exposure if the VaR of a Fund's portfolio inclusive of derivatives transactions were less than the VaR of the portfolio without any derivatives. As the Proposed Rule states, a Fund's VaR is an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level, subject to certain minimum requirements for the VaR analysis. The netting concepts noted with respect to the Exposure-Based Portfolio Limit also would apply to the Risk-Based Portfolio Limit.

<u>If Retained in the Final Rule, the Limits Should be Increased and Risk-Adjusted to Avoid Adverse Consequences</u>. The Proposing Release does not explain clearly how the Commission determined the 150% Exposure-Based Portfolio Limit or the 300% Risk-Based Portfolio Limit as the appropriate limits. Based on our reading of the examples on page 80909 of the Proposing Release, we understand that the 150% and 300% limits would authorize a Fund to have gross exposure limits of 250% and 400%, respectively, consisting of 100% direct exposure and 150% and 300% notional exposure, respectively. Based on the ICI survey results showing a broader impact of the proposed limits,[22] we believe the Exposure-Based Portfolio Limit and Risk-Based Portfolio Limit are unworkable and, without the risk adjustments we discuss below, would cause a significant percentage of funds to adjust their investment strategies or to de-register, potentially to the detriment of investors.

1. The Portfolio Limitations Impose Unjustified Restrictions on Funds' Use of Derivatives Based on Policy Grounds

The Commission requests comment on whether the use of notional amounts as the basis for calculating a Fund's exposure under a derivatives transaction is appropriate.[23] We strongly believe that imposing the proposed notional-based limits on a Fund's derivatives activity is both inappropriate for purposes of addressing investment risk and unjustified under the Commission's own longstanding policy regarding the application of Section 18 of the 1940 Act to derivatives.

a. SEC Policy on Senior Securities and Asset Segregation

Section 18 imposes various requirements on the capital structure of Funds and governs the extent to which a Fund may issue senior securities. The requirements are intended to prevent: (i) potential abuse by the purchasers of senior securities, (ii) excessive borrowing and issuance of senior securities by Funds and (iii) Funds from operating without adequate assets and reserves to meet their obligations. The Proposed Rule would reverse the Commission's long-standing guidance

[22] *See* ICI Letter, *supra* n. 17 (finding that at least 471 Funds with $613 billion in assets would exceed the Proposed Rule's 150% exposure-based portfolio limit, and at least 173 Funds with $338 billion in assets would exceed the Proposed Rule's risk-based portfolio limit).

[23] Proposing Release at 80907.

that derivatives, properly covered by a Fund in compliance with this guidance, are not treated as senior securities for purposes of Section 18 of the 1940 Act.

i. Release No. 10666

Beginning with Investment Company Act Release No. 10666, issued in 1979 ("**Release 10666**")[24] and continuing in a series of subsequent no-action letters, the Commission and its staff interpreted Section 18 and developed a "segregated account approach," which requires a Fund to segregate liquid assets sufficient to meet potential obligations arising from, or to enter into offsetting positions against, the Fund's investment in certain types of instruments, including reverse repurchase agreements, firm commitment agreements and standby commitment agreements.

The Commission has taken the position that derivatives may raise senior securities issues under Section 18 and would be subject to this asset segregation approach. However, through a series of no-action letters, the Commission's staff has taken the position that these transactions would not be senior securities if Funds were to "cover" their obligations under the instruments or enter into offsetting positions, consistent with Commission guidance.

As initially stated in Release 10666,

> In circumstances involving similar economic effects, such as short sales of securities by investment companies, the Division of Investment Management has determined that *the issue of compliance with Section 18 will not be raised with the Commission by the Division if the investment company "covers" the senior security by establishing and maintaining certain "segregated accounts*." (emphasis added).

In Release 10666, the Commission explicitly confirmed the position of the Division of Investment Management in the form of a formal General Statement of Policy. Following the Commission's issuance of Release 10666, the Commission staff issued more than 20 no-action letters to Funds related to the maintenance of segregated accounts or otherwise covering their obligations in connection with various derivatives transactions, including interest rate futures, equity index futures and related options.[25]

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[24] Investment Company Act Release No. 10666 (Apr. 18, 1979).

[25] *See* Concept Release at 55243.

ii. Derivatives No-Action Relief under Section 18

In the Dreyfus Letter,[26] Commission staff stated that, in respect of the derivatives transactions entered into by the funds, "[w]e agree that, if a fund meets the segregation requirements, *a 'senior security' would not be present* and, therefore, the 300-percent asset-coverage requirement of Section 18(f) would not apply" (emphasis added). In 1995, Commission staff again addressed the issue in the context of short sales, stating that if the funds segregated an amount that, when combined with the amount deposited with their broker as collateral, is equal to the "current" market value of the underlying instrument as it varies over time, there would be no senior security concerns related to the transaction.[27] In a 1996 letter issued to Merrill Lynch Asset Management, Commission staff again addressed the matter by issuing relief to a fund engaged in derivatives trading, stating the staff would not recommend enforcement under Section 18 provided the "[f]und covers its obligations *that may otherwise be deemed to be senior securities…*" (emphasis added). In 2011, the SEC set forth its asset segregation approach to derivatives under Section 18 of the 1940 Act in the Concept Release. Accordingly, it is well-settled under both the actions of the Commission itself and of the staff, that when a fund complies with the segregation requirements, the Section 18 senior securities concept does not apply to derivatives transactions.

b. Reversing Established SEC Policy Lacks Sufficient Justification

The newly-proposed imposition of notional limits would be a significant departure from nearly 40 years of Commission guidance and no-action letter relief. We are unaware of any material event or occurrence, or series of events or occurrences, related to the use of derivatives by Funds to justify the SEC's reversal of this long-standing policy. In the Proposing Release, the SEC identifies two affiliated mutual funds that invested in total return swap contracts and suffered extensive losses in 2008. The SEC also identifies two closed-end funds and a private fund that also suffered losses in part from derivatives. We respectfully disagree that the losses suffered by these three funds' investors in the midst of a global financial crisis justify sufficiently the reversal of four decades of established SEC policy. The 1940 Act and the rules and regulations thereunder have historically not been, and should not now be construed as, the basis for establishing investor suitability standards and determinations.

Instead of imposing a new notional limit, we explain below that the asset segregation requirements under the Proposed Rule would be wholly sufficient to address and ameliorate concerns over the risks of derivatives transactions and the Commission's concerns with the insufficiency of mark-to-market segregation alone for limiting a Fund's leverage from the use of derivatives transactions, a view that is shared within the Commission as well.[28] We respectfully suggest that the

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[26] *See supra* n. 7.

[27] Robertson Stevens Investment Trust, SEC No-Action Letter (Aug. 24, 1995).

[28] In his dissenting statement on the Proposed Rule, Commissioner Piwowar stated he believes the "mark-to-market coverage amount" and "risk-based coverage amount" (as such terms are defined in the Proposed Rule) that Funds

Commission should authorize Funds' boards to base the "risk-based coverage amount" on a Fund's initial margin requirements for its derivatives transactions to enhance the functional leverage limit that we believe the Proposed Rule's asset segregation requirements would provide. Moreover, we believe that such an approach would make the asset segregation requirements sufficiently robust that an additional notional-based exposure limit should not be necessary.

IV. The Proposed Rule's Asset Segregation Requirements Would Function as an Effective Leverage Limit, Rendering a Notional-Based Limit Unnecessary

The Proposed Rule would require a Fund to segregate daily on its books and records cash and cash equivalents as "qualifying coverage assets" for derivatives transactions ("**Qualifying Coverage Assets**"). Such Qualifying Coverage Assets would be equal to the sum of a "**Mark-to-Market Coverage Amount**" which reflects the Fund's net obligations if the Fund exited its derivatives positions on such day, plus a "**Risk-Based Coverage Amount**" which is designed to capture additional losses the Fund would suffer if it exited its derivatives transactions under stressed market conditions.

The Mark-to-Market Coverage Amount would be reduced by the value of variation margin. Variation margin could not reduce the Fund's Mark-to-Market Coverage Amount for other transactions except as otherwise permitted under a netting agreement.[29] The Risk-Based Coverage Amount would be reduced by initial margin, but only for the specific transaction for which the Fund posted initial margin.[30]

We support the use of both a mark-to-market and risk-based approach to asset segregation. We believe the daily segregation requirement is a reasonable and appropriate restriction on a Fund's ability to use derivatives transactions. The mark-to-market approach is also largely consistent with the Commission's prior guidance in Release 10666, which requires a Fund to segregate assets – dollar-for-dollar – against the Fund's outstanding liabilities in respect of reverse repurchase agreements, firm commitment agreements and standby commitment agreements. We also support the SEC's proposal that initial and variation margin posted by a Fund in connection with a derivatives transaction should further reduce the Risk-Based Coverage Amount and Mark-to-Market Coverage Amount, respectively, for such transaction.

The Commission seeks comment on how the Risk-Based Coverage Amount should be calculated, while listing several alternative methods for consideration such as specifying a percentage of the

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would be required to segregate, together with the newly implemented regulatory oversight for derivatives and enhanced mutual fund reporting requirements, should be sufficient to address the investor protection and related concerns underlying Section 18 of the 1940 Act. *See* Piwowar Dissent, *supra* n. 6.

[29] Proposing Release at 80928 n. 342.

[30] *Id.* at 80930.

derivative's notional value or basing it expressly on initial margin requirements.[31] We believe a Fund should be authorized, pursuant to board-approved policies and procedures, to determine the Risk-Based Coverage Amount by using a minimum threshold amount equal to the initial margin requirement for each derivatives transaction. More specifically, a Fund would determine the minimum initial margin amount by using the exchange-mandated amount for a futures contract or any other exchange-traded derivatives transaction; the clearinghouse-mandated amount for a cleared derivatives transaction that may not be exchange-traded; or, in the case of a non-cleared, over-the-counter ("**OTC**") derivatives transaction, the standardized minimum margin requirements for non-cleared swaps and non-cleared security-based swaps adopted in the final rule for "Margin and Capital Requirements for Covered Swap Entities" by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and certain other prudential regulators (collectively, the "**Prudential Regulators**") with jurisdiction over certain registered swap dealers and security-based swap dealers (the "**PR Final Margin Rules**").[32]

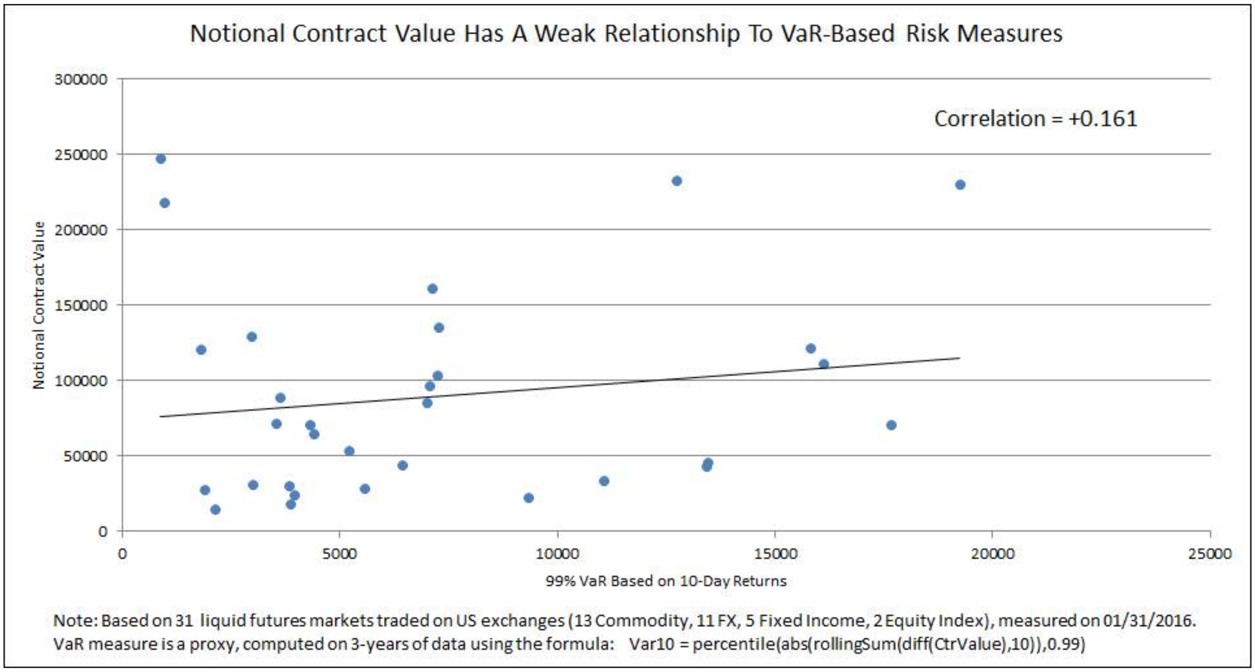
As we demonstrate below, the initial margin required to be posted by a Fund in connection with its derivatives transactions more accurately reflects the risks associated with such trades than the notional amount. Across a variety of futures contracts, in particular fixed income, a notional approach significantly overstates the risk of the contract. For example, the CME Eurodollar contract has a notional value of $1 million, with initial margins ranging from $300 to $700 depending on the contract expiration. CME sets higher margins on contracts with later expirations, due to their higher volatility. The Proposed Rule's notional-based limits do not distinguish between or capture these risks.

Chart 3 below highlights the flaws in using a notional approach to quantify and regulate leverage, primarily because it bears little relationship to and is a poor proxy for risk. Chart 3 shows these flaws visually by presenting a scatterplot of notional value versus VaR for 31 futures contracts across the four major sectors of commodity, fixed income, equity and currency.

[31] *Id.* at 80931-32.

[32] 80 Fed. Reg. 74839 (Nov. 30, 2015) at 74909.

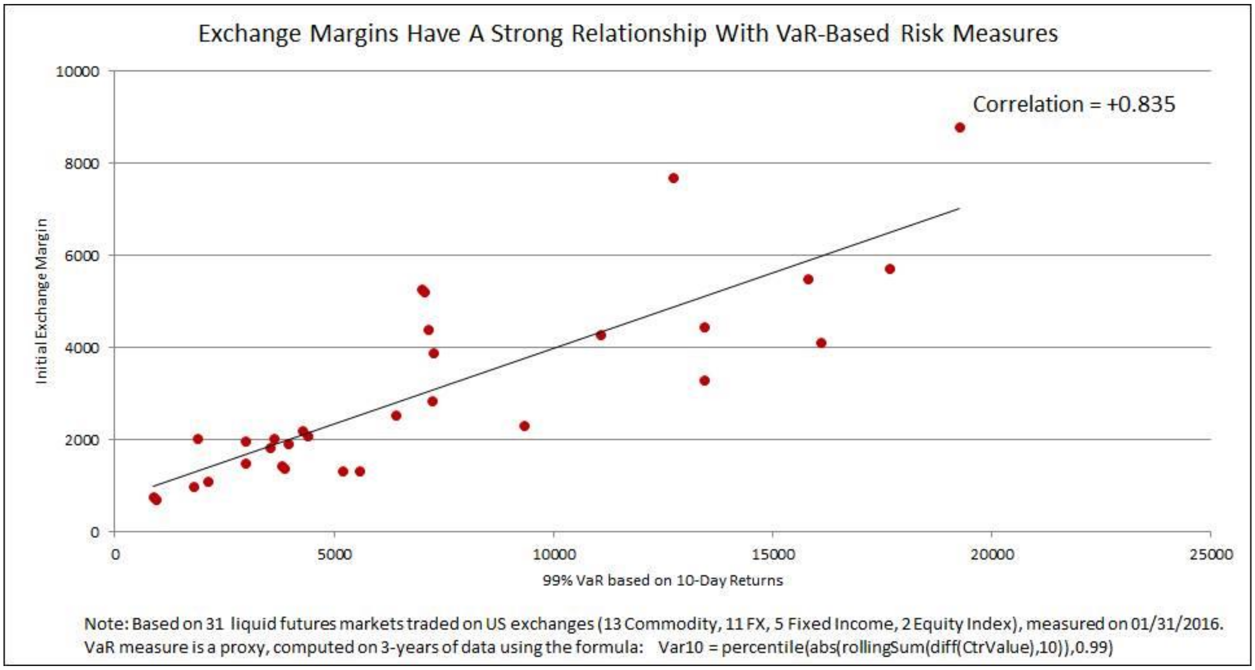
Chart 3 - Scatterplot of Notional Contract Value vs. VaR for 31 Futures Contracts



(Source: Bloomberg, Campbell & Company, LP)

However, as shown below in Chart 4, when exchange initial margins are compared to VaR for the same representative futures contracts, there is a strong and meaningful relationship.

Chart 4 - Scatterplot of Exchange Initial Margin vs. VaR for 31 Futures Contracts



(Source: Bloomberg, Campbell & Company, LP)

Even inside a sector, we note that there is no reliable relationship between notional contract value and either exchange initial margin or VaR. As shown in Chart 5 below, which covers U.S. Treasury instruments ranging in maturity from two years to 30 years, there is significant variation as the initial margin and VaR increase with the maturity of the instrument.

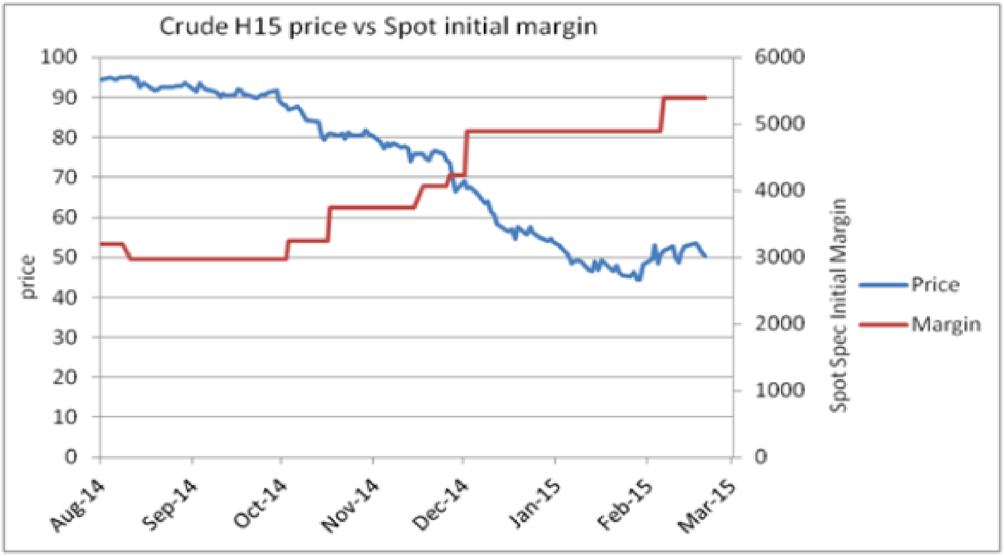
Chart 5
Notional Value and Initial Margin for U.S. Treasury Futures
as of 01/31/2016 (Source: Bloomberg, Campbell & Company, LP)

	Notional Contract Value	Initial Margin	Note: 99% VaR 10-day returns
2-Year Note	218,609	715	896.6
5-Year Note	120,695	990	1750.5
10-Year Note	129,625	1485	2844.8
Long Bond	161,313	4400	7146.6

Note: VaR measure is a proxy, computed on 3-years of data using the formula: Var10 = percentile(abs(rollingSum(diff(CtrValue),10)),0.99)

Our concerns with notional amount as an accurate measure of risk are further highlighted in Chart 6 below. Even with regard to one futures contract in isolation, as the absolute price of the contract, and therefore its notional value changes over time, its risk may bear little or no relationship to its notional value. As can be seen in Chart 6, which shows the price of crude oil from August 2014 through March 2015, the exchange (NYMEX – CME Group) initial margin for the spot contract, based on its assessment of risk, increased as the price decreased, the opposite of what would happen with notional value as a measure of risk.

Chart 6
Crude Oil: Initial Margin v Price



(Source: CME Group data derived by Millburn)

Based on our demonstrable concerns with notional amount as an accurate measure of risk, we suggest that authorizing a Fund to determine the Risk-Based Coverage Amount based on required initial margin would be a more accurate measure of risk that would allow a Fund to ensure that it has segregated sufficient assets to cover any potential costs the Fund might incur if it were to exit the derivatives transaction under stressed conditions. For futures contracts and other exchange-traded derivatives, margin amounts are determined and continuously reviewed by the exchanges and clearinghouses and are adjusted to reflect risk. For example, futures exchanges have historically increased initial margins during volatile, riskier time periods across a wide variety of futures contracts, including fixed income, stock index and energy. For non-cleared OTC derivatives, margin amounts will soon be calculated in accordance with the PR Final Margin Rules or other analogous rules from the Commodity Futures Trading Commission ("**CFTC**") and the SEC. These minimum requirements are based on extensive review and analysis of appropriate collateral requirements for non-cleared OTC derivatives undertaken by the Prudential Regulators, the CFTC, and the SEC, both individually and collectively, under the auspices of the Working Group for Margining Requirements for the final international framework issued by the Basel Committee on Banking Supervision ("**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**").[33]

[33] BCBS-IOSCO "Margin Requirements for non-centrally cleared derivatives," issued on Sept. 2, 2013 (the "**BCBS-IOSCO Framework**"), as revised on March 18, 2015, available at: http://www.bis.org/bcbs/publ/d317.htm.

Using a minimum threshold amount equal to the initial margin requirement for each derivatives transaction to determine the Risk-Based Coverage Amount would also permit Funds and their shareholders to benefit from:

- The dynamic nature of initial margin requirements, which are modified in response to market conditions and often on a daily basis. As a particular market becomes more volatile, initial margin requirements typically increase, which in turn would require a Fund to decrease its exposure and the risk of its portfolio.

- Using initial margin helps to solve the problem of large dollar value notional fixed income contracts with low risk, such as the CME Eurodollar contract example highlighted above.

- Using margin avoids the possible ambiguities associated with the various ways to calculate VaR.

- Margin is more responsive to current conditions than VaR, which is based on a look-back period that may be slow to incorporate spikes in volatility.

- Using margin sets an overall leverage limit.

- Margin is independently set,[34] easy to comply with, and easy to track.

- For futures contracts, margin takes advantage of and harmonizes methods honed by the CFTC over the past four decades.

- Margin is auditable in real time and easily enforceable through current relationships. There would be no drain on the SEC's enforcement resources.

We believe that a Risk-Based Coverage Amount that is based on mandatory initial margin, combined with the mark-to market asset segregation requirements proposed by the Commission, would provide a Fund with the flexibility needed to manage its portfolio, yet effectively address the concerns of the Commission regarding a Fund's derivatives activity and the related risk to investors. We discuss below our suggestions for two important modifications to the proposed asset segregation requirements that would enhance a Fund's ability to manage the risks associated with its derivatives transactions.

[34] Initial margins are generally determined by a third party such as an independent clearinghouse or, in the case of a non-cleared derivatives transaction, the counterparty to such trade.

1. Calculations of the Risk-Based Coverage Amount and Mark-to-Market Coverage Amount Should be Subject to Netting Across Different Counterparties

The Proposed Rule would permit a Fund to calculate the Mark-to-Market Coverage Amount and Risk-Based Coverage Amount on a net basis for those derivative transactions for which the Fund has entered into a netting agreement that allows netting of payment obligations across multiple derivatives transactions.[35] We appreciate and support this beneficial use of netting arrangements and request that the Commission clarify that the netting provisions in standard industry documentation, such as the 1992 or 2002 ISDA Master Agreement, constitute a "netting agreement" for purposes of the Proposed Rule.

However, unlike the broader scope of netting permitted for the calculation of notional exposure under the Proposed Rule, the requirement of a netting agreement for purposes of calculating the coverage amounts effectively prevents netting across different counterparties. We believe that netting exposures across different counterparties – consistent with SEC guidance since the 1987 Dreyfus Letter[36] – should be available to Funds calculating either coverage amount. In our view, Funds should have some flexibility under their respective analyses of counterparty credit risk to determine which types of derivatives transactions may properly offset other derivatives transactions to achieve risk reduction.

While the Commission has not explained the rationale for prohibiting cross-counterparty netting in the Proposed Rule, we understand that Commission staff members have expressed concerns about counterparty credit risk during Fund audits and inspections. We note that there are ample protections afforded to Funds that would justify cross-counterparty netting. First, Funds regularly engage in the same counterparty risk analysis with offsetting derivatives transactions as they do when considering initially to enter into a derivatives transaction with a counterparty. Second, many Funds enter into exchange-traded derivatives guaranteed by a clearinghouse that are subject to daily margining. Third, for non-cleared OTC derivatives, Funds typically enter into credit support documents requiring daily, mark-to-market margining. In addition, the final margin rules adopted by other regulators will soon require mandatory minimum initial and variation margin exchange for non-cleared OTC swaps. Fourth, Funds and their boards typically have counterparty credit review procedures for the implementation and ongoing monitoring of these counterparty relationships. Given these protections afforded to Funds, we respectfully urge the Commission to authorize Funds to net exposures across counterparties for purposes of calculating both the Risk-Based Coverage Amount and Mark-to-Market Coverage Amount.

[35] Proposed Rule 18f-4(c)(6)(i) (for Market-to-Market Coverage Amount) and 18f-4(9)(i) (for Risk-Based Coverage Amount).

[36] *See* Dreyfus Letter, *supra* n. 7.

2. Qualifying Coverage Assets Should be Expanded to Include all Liquid Assets with Appropriate Haircuts

Under the Proposed Rule, Qualifying Coverage Assets for derivatives transactions would generally be restricted to cash and cash equivalents. The Commission requests comment on whether a Fund should be permitted to segregate other types of assets.[37] We strongly believe so. Limiting Qualifying Coverage Assets to cash and cash equivalents is in conflict with 20 years of prior Commission policy and established market practice.[38] The Commission's proposed new policy is also at odds with its own proposed margin rules with respect to eligible assets available to collateralize non-cleared security-based swaps.[39] The proposal is also at odds with comparable collateral requirements for non-cleared OTC derivatives in the final margin rules adopted by the Prudential Regulators and the CFTC as well as in the final BCBS-IOSCO Framework. Each of these regulatory bodies authorizes a broader range of qualifying assets with appropriate standardized haircuts to reflect the specific risks of the relevant asset. From an investor protection standpoint, we are not aware of any investor harm over the past two decades that was caused by Funds' authorized use of a broader category of liquid assets for asset segregation, including through the 2008 financial crisis.

We are also very concerned that limiting Qualifying Coverage Assets to cash and cash equivalents would likely require Funds to maintain cash investments and to under-invest in order to keep the requisite cash on hand. Funds would thus incur a "cash drag" on these segregated holdings, which diminishes their ability to diversify their portfolios, and reduces investor returns. We respectfully urge the Commission to expand the definition of Qualifying Coverage Assets to include all liquid assets. We suggest that the Commission impose the standardized haircuts to assets that are riskier than cash as set forth in Table B – "Margin Values for Eligible Noncash Margin Collateral" of the PR Final Margin Rules.[40] For the Commission's reference, we present that table below:

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[37] Proposing Release at 80934.

[38] *See* Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996).

[39] SEC Proposed Rule, "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. 70214 (Nov. 23, 2012) (in addition to cash, the Commission would authorize securities and money market instruments with prescribed haircuts).

[40] PR Final Margin Rules at 74910.

Appendix B to [Part]—Margin Values for Eligible Noncash Margin Collateral.

TABLE B—MARGIN VALUES FOR ELIGIBLE NONCASH MARGIN COLLATERAL

Asset class	Discount (%)
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in § __.6(a)(2)(iv) or (b)(5) debt: residual maturity less than one-year	0.5
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in § __.6(a)(2)(iv) or (b)(5) debt: residual maturity between one and five years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in § __.6(a)(2)(iv) or (b)(5) debt: residual maturity greater than five years	4.0
Eligible GSE debt securities not identified in § __.6(a)(2)(iv) or (b)(5): residual maturity less than one-year	1.0
Eligible GSE debt securities not identified in § __.6(a)(2)(iv) or (b)(5): residual maturity between one and five years:	4.0
Eligible GSE debt securities not identified in § __.6(a)(2)(iv) or (b)(5): residual maturity greater than five years:	8.0
Other eligible publicly traded debt: residual maturity less than one-year	1.0
Other eligible publicly traded debt: residual maturity between one and five years	4.0
Other eligible publicly traded debt: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0

[1] The discount to be applied to an eligible investment fund is the weighted average discount on all assets within the eligible investment fund at the end of the prior month. The weights to be applied in the weighted average should be calculated as a fraction of the fund's total market value that is invested in each asset with a given discount amount. As an example, an eligible investment fund that is comprised solely of $100 of 91 day Treasury bills and $100 of 3 year US Treasury bonds would receive a discount of (100/200)*0.5+(100/200)*2.0=(0.5)*0.5+(0.5)*2.0=1.25 percent.

V. We Support an Optional Margin-Based Limit for Managed Futures Funds to Replace the Notional-Based Limit and the Risk-Based Coverage Amount Component of the Asset Segregation Requirements

Should the Commission proceed with implementing an additional portfolio limit in its final rule in addition to the Risk-Based Coverage Amount in the asset segregation requirements, we believe that a margin-based portfolio limit would be more appropriate for certain Funds as opposed to a notional-based limit. Specifically, the Commission requested comment on whether managed futures funds should be permitted to obtain exposure in excess of the Exposure-Based Portfolio Limit and if so, asked how it could permit such funds to obtain additional exposure while also imposing an effective limit on leverage and the speculative nature of such Funds.[41] So long as the Qualifying Coverage Assets that a Fund may segregate include not just cash and cash equivalents, but all liquid assets with appropriate regulatory haircuts as suggested in Section IV.2 above, we believe that a margin-based limit would allow managed futures[42] Funds to effectively manage their use of derivatives and not be forced into de-registration. As discussed above, a new notional-based limit represents a significant departure from three decades of precedent and market practice; moreover, we believe it has inherent problems in addressing risk and leverage. In our view, the

[41] Proposing Release at 80913.

[42] We generally refer to managed futures Funds as a fund category in which a fund typically takes long and short positions in futures, options, swaps and foreign exchange contracts, both listed and OTC, based on market trends or momentum. A majority of managed futures Funds pursue trend-following, price-momentum strategies. Other managed futures Funds pursue systematic mean-reversion, discretionary global macro and commodity index tracking strategies, among other futures strategies. Typically, more than 60% of managed futures Funds' investment exposure – and often up to 100% – is obtained through derivatives transactions. This description of managed futures Funds and their investment strategies is based on Morningstar's criteria for its "Managed Futures" fund category, *available at* http://www.morningstar.com/InvGlossary/managed-futures.aspx.

objective of protecting investors should be to limit risk, not simply to limit an overall investment or exposure.

Based on our demonstrable concerns with using a notional approach for leverage limits, we ask the Commission to consider providing the boards of managed futures Funds with the option of instead using a margin-based approach that would be relatively simple to apply and would better address the Commission's concerns regarding undue speculation and the need to retain adequate assets in reserve to protect investors. This approach would also address the Commission's concerns with investor protection, while avoiding the potential unintended consequence of limiting investor options.

Under our proposed margin approach, managed futures Funds that use derivatives would maintain a reserve of segregated cash, cash equivalents, and/or liquid securities subject to regulatory haircuts in an amount equal to, and in addition to, the required initial margin for each derivatives transaction involved. A managed futures Fund would segregate on its books and records an amount equal to the exchange initial margin for each futures contract or other exchange-traded derivatives transaction; the clearinghouse initial margin for each cleared OTC derivatives transaction that may not be exchange-traded; or in the case of non-cleared OTC derivatives, an amount equal to the initial margin required pursuant to the PR Final Margin Rules. In each of these cases, we refer to such amount as the "**Margin Assets**". For example, if a managed futures Fund were to purchase a derivatives contract that requires $100 initial margin to be posted with its Futures Commission Merchant ("**FCM**"), under our approach the Fund would post $100 to its FCM and then segregate on its books and records an additional $100 in connection with such derivatives contract. In our view, the use of segregated Margin Assets by managed futures Funds would function as an enhanced asset coverage test that would both reinforce the Commission's proposed asset segregation requirements and address the Commission's concerns with the insufficiency of mark-to-market segregation alone for limiting a Fund's leverage from the use of derivatives transactions. We do note, however, that Funds which adhere to different strategies may not possess sufficient assets in order to segregate such additional amounts. Accordingly, we propose it as a realistic and workable alternative approach for the investment strategies of managed futures Funds only (as described in footnote 42), provided that the final rule permits such Funds to use an expanded scope of Qualifying Coverage Assets beyond cash and cash equivalents.

In our view, a margin-based approach that would require the segregation of an amount equal to required initial margin would have many of the same advantages and benefits discussed above with respect to using the mandatory initial margin amount as a basis for calculating the Risk-Based Coverage Amount.

VI. If New Notional Leverage Limits are Required, We Propose Risk-Adjusted Exposure Calculations for Portfolio Limitations

If the Commission decides to proceed with implementing some form of notional-based exposure limits, we ask the Commission to subject these limits to certain risk adjustments based on the type of the derivatives transactions into which the Fund enters. Application of risk adjustments to notional exposure would achieve more accurate measures of derivatives exposure and would be relatively easy to calculate across all Funds, regardless of strategy. Without appropriate risk adjustments, a straight notional test would encourage Funds to concentrate their portfolios in derivatives transactions with the highest levels of risk per notional dollar and decrease a portfolio manager's ability to offer a diversified portfolio across market sectors. In application, we fear that a straight notional test could have unintended adverse effects on the attainment of the Commission's policy goals to enhance investor protection and asset sufficiency. We respectfully urge the Commission to authorize Funds' use of notional risk adjustments in the final rule as a prudent risk management practice.

Based on these concerns, we suggest risk adjustments to notional exposure in response to the Commission's request for comment on whether there are other appropriate adjustments for determining a fund's exposure to certain derivatives, such as Euribor and Eurodollar futures, that the Commission should consider to avoid overstating a Fund's derivatives investment exposure.[43] We believe that if the Commission adopts a notional limit, the calculation of notional exposure for a wide variety of derivatives transactions, and particularly fixed-income derivatives, throughout the Proposed Rule should be subject to certain risk-adjustment factors or notional exposure "haircuts" to more appropriately address the specific risks arising from each underlying asset class. We refer to this adjusted notional exposure calculation as the "**Risk-Adjusted Exposure.**" We recommend that the calculation of the Risk-Adjusted Exposure be based on the initial margin requirements of the PR Final Margin Rules. Using the PR Final Margin Rules provides an attractive approach in this context that would be subject to less discretion for interpretation, reducing possible market manipulation or abuse.

A Fund's Risk-Adjusted Exposure would be equal to the notional amount of a particular derivatives transaction multiplied by a risk-adjustment factor derived from the Prudential Regulators' Table A – "Standardized Minimum Gross Initial Margin Requirements For Non-Cleared Swaps and Non-Cleared Security-Based Swaps" of the PR Final Margin Rules.[44] For the Commission's reference, we present that table below:

[43] Proposing Release at 80908.

[44] PR Final Margin Rules at 74909.

TABLE A—STANDARDIZED MINIMUM GROSS INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS[1]

Asset Class	Gross initial margin (% of notional exposure)
Credit: 0–2 year duration	2
Credit: 2–5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Currency Swaps: 0–2 year duration	1
Cross-Currency Swaps: 2–5 year duration	2
Cross-Currency Swaps: 5+ year duration	4
Interest Rate: 0–2 year duration	1
Interest Rate: 2–5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

We suggest using equities and commodities as a baseline for determining haircuts for the other asset classes, as the Prudential Regulators identified equities and commodities as the riskiest assets in their schedule of eligible collateral, as outlined in the following table:

Asset Class	**Gross Initial Margin per Table A**	**Risk Adjustment Factor**	
Credit: 0–2 year duration	2	13.3%	= 2/15
Credit: 2–5 year duration	5	33.3%	= 5/15
Credit: 5+ year duration	10	66.7%	= 10/15
Commodity	15	100.0%	= 15/15
Equity	15	100.0%	= 15/15
Foreign Exchange/Currency	6	40.0%	= 6/15
Cross Currency Swaps: 0–2 year duration	1	6.7%	= 1/15
Cross-Currency Swaps: 2–5 year duration	2	13.3%	= 2/15
Cross-Currency Swaps: 5+ year duration	4	26.7%	= 4/15
Interest Rate: 0–2 year duration	1	6.7%	= 1/15
Interest Rate: 2–5 year duration	2	13.3%	= 2/15
Interest Rate: 5+ year duration	4	26.7%	= 4/15
Other	15	100.0%	= 15/15

Gross initial margin for a non-cleared swap referencing commodities or a portfolio of equities is 15% of notional exposure. For purposes of determining the Risk-Adjusted Exposure for a Fund's portfolio, the notional amounts of derivatives referencing equities or commodities would receive no notional exposure haircut and would attract a 100% risk-weighting. The notional amounts of derivatives referencing other assets presenting less risk would accordingly receive smaller risk-weightings, as a percentage of the risk presented by equities or commodities. For example, a Fund's non-cleared swap referencing credit with a duration of up to two years would require 2% gross initial margin. We would determine the appropriate risk-adjustment factor for this swap by dividing 2 by 15, resulting in a 13.3% risk-adjustment factor. A $100 million notional swap referencing credit with a two-year duration would have a Risk-Adjusted Exposure of $13,300,000. Each derivatives transaction that the Fund enters into would receive a risk-weighting through the same basic calculation.

If the Commission is going to adopt a notional leverage limit model, we recommend this approach because it more accurately identifies and calculates the particular risks raised by derivatives referencing a wide variety of assets. Our suggested approach is based on asset-specific risk analyses for derivatives that have been studied and adopted by the Prudential Regulators, the CFTC, as well as the SEC in its related proposed rule. These percentages also correspond with those in the BCBS-IOSCO Framework that established minimum standards for margin requirements for non-centrally cleared derivatives.[45] Moreover, the calculations are relatively simple to perform and not subject to discretionary input from a Fund, its board, or its manager.

The Commission also requested comment on whether it should consider requiring or permitting the notional amounts for interest rate futures and swaps to be adjusted so that they are calculated in terms of 10-year bond equivalents.[46] We support this alternative risk-adjustment method and believe that the Commission should authorize this alternative option for Funds in calculating their exposures with respect to both bond and interest rate derivatives. For example, we would determine the adjusted notional exposure for a 3-month Eurodollar contract with a $1,000,000 notional amount by dividing the contract duration in months by the 10-year duration in months and multiplying that quotient by the contract notional amount, as follows: $1,000,000 * (3/120) = $25,000. The result would be an adjusted notional exposure of $25,000, as opposed to $1,000,000. We believe this result would provide a better and more accurate assessment of a Fund's exposure to interest rate risk, as the full notional exposure of such derivative significantly overstates the Fund's actual exposure. Moreover, authorizing this risk-adjustment method is consistent with the SEC's Form PF, which provides for the calculation of exposures of interest rate derivatives in terms of the 10-year equivalent duration-adjusted value for such positions.

The Commission also requests comment on whether the netting provision for calculating a Fund's exposure is appropriate.[47] While we appreciate the ability to net offsetting derivatives transactions in proposed Rule 18f-4(c)(3)(i), we believe the restriction on netting only directly offsetting transactions that are the same type of instrument is too limited and should be eliminated. Funds should have flexibility to determine which types of derivatives transactions that have the same material terms may properly offset other derivatives transactions, for example, a futures contract to offset an option, if such offset reduces market risk. A Fund would adopt policies and procedures to ensure that such offsets are reasonably equivalent.

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[45] *See supra* n. 33.

[46] Proposing Release at 80908.

[47] *Id*.

VII. We Recommend Alternative Portfolio VaR Tests

To the extent that the Commission adopts a notional-based portfolio limit, we would also recommend modifying the conditions that would authorize a Fund to maintain up to 300% notional exposure under the Risk-Based Portfolio Limit, subject to the risk adjustments to the notional amounts of derivatives transactions by asset class, as described above in Section VI. In our view, the Risk-Based Portfolio Limit, as proposed, would not be a viable alternative limit for most Funds. Funds generally do not use derivatives exclusively for risk-mitigation, but seek to obtain exposure in a more cost-effective way than by a direct investment in the underlying assets of a derivatives transaction.

For these reasons, we respectfully ask the Commission to consider modifying the conditions under which a Fund may adhere to the Risk-Based Portfolio Limit and instead impose an absolute portfolio VaR limit of 20% of a Fund's net asset value in order to qualify for the Commission's 300% Risk-Based Portfolio Limit. A Fund's portfolio VaR would have to be less than 20% of its net asset value after entering into a derivatives transaction in order for the Fund to increase its derivatives exposure up to the 300% limit. We believe an absolute VaR test would incentivize Funds to maintain risk control by virtue of the absolute 20% limit. Our proposed absolute VaR test would be subject to SEC-approved parameters that would require a Fund to use a minimum 99% confidence interval, a time horizon of 20 trading days, and a minimum of three years of historical data. SEC-approved parameters for the absolute VaR test would provide consistency across Funds, regardless of strategy, to facilitate the SEC staff's compliance oversight and enforcement. As an additional benefit, an absolute VaR test would subject a Fund's portfolio to both a limit on VaR with a 20% cap and on risk-adjusted exposure by preserving the 300% cap. We believe the imposition of such hard limits would be easier for the Commission's staff to administer and enforce, and would be less prone to interpretation and potential manipulation.

As an alternative to a 20% limit, we note that mutual funds and exchange-traded funds that track the S&P 500 Index have long been a popular choice for retail and institutional investors. To our knowledge, the SEC has not expressed concerns over the risks posed to investors from S&P 500 Index Funds. Accordingly, we suggest that the Commission consider imposing a VaR limit that corresponds to the VaR for S&P 500 Index Funds. We believe that a Fund that limits its use of derivatives to a level of risk that is comparable to the level of risk presented by a basic S&P 500 Index Fund does not present undue risk to investors.

If the Commission determines not to authorize an absolute VaR test, we suggest an alternative that would permit a Fund to maintain up to 300% notional exposure if the VaR at this level did not exceed the VaR at the 150% level. Under this alternative VaR test, a Fund would compare the VaR of its total portfolio with the VaR of a subset portfolio that includes securities and derivatives exposure of up to 150% exposure. A Fund's use of derivatives in excess of 150% must be risk reducing to the Fund's portfolio in order for the Fund to qualify for the higher 300% limit. We refer to this as the "**Modified VaR Test**". Under the Proposed Rule, a Fund could maintain an aggregate exposure up to 150% of its net assets regardless of its VaR. To the extent that the Commission adopts a notional-based portfolio limit, under the Modified VaR Test a Fund could obtain up to 150% exposure (subject to the risk adjustments to notional amounts of derivatives by asset class, as described above in Section VI), and then become subject to the 300% limit on an exposure amount in excess of 150%. We believe it would be reasonable for the Commission to authorize a Fund to maintain exposure of up to 300%, but only if the Fund's VaR does not exceed the VaR at 150%. Requiring a Fund to determine whether the VaR of its portfolio would increase or decrease as a result of any derivatives exposure added to its portfolio in excess of the Exposure-Based Portfolio Limit would act as an incentive for risk reduction beyond the 150% level. A Fund would apply the Modified VaR Test in a consistent manner to both portfolios, while preserving both the Commission's 150% Exposure-Based Portfolio Limit and the 300% Risk-Based Portfolio Limit.

VIII. We Also Recommend End of Business Day Calculations of Portfolio Limits and Grace Periods for Passive Breaches

The Commission has requested comment on whether requiring a Fund to comply with the Proposed Rule's portfolio limitations immediately after entering into any senior securities transaction poses any operational challenges.[48] If the Commission decides to adopt a notional-based exposure limit, we recommend that Funds be permitted to recalculate their notional-based exposures and applicable portfolio and securities VaR at the end of each business day, as the Proposed Rule provides for determining a Fund's compliance with its asset segregation requirements. Considering the frequency with which many Funds enter into derivatives on a daily basis, performing this exercise throughout a trading day would be operationally challenging, if not impossible, for many Funds.

In response to the Commission's comment request,[49] we suggest that the Commission provide Funds with a 30-day grace period, as the Commission suggests,[50] to cure a breach of the applicable portfolio limit should such a breach unintentionally occur. A grace period would provide Funds the opportunity to liquidate or unwind from transactions in a responsible manner in order to comply with the applicable exposure limit and to minimize potential for forced portfolio liquidations as Funds are closed down, which could ultimately result in unwarranted harm to investors.

IX. Our Views on Other Key Aspects of the Proposed Rule

1. We Generally Support the Proposed Derivatives Risk Management Program

Despite our concerns with the need and justification for the proposed portfolio limitations and the narrow scope of Qualifying Coverage Assets, we generally support other aspects of the Proposed Rule. In particular, we support the Proposed Rule's requirement for a Fund to adopt a written

[48] Proposing Release at 80925.

[49] *Id.*

[50] *Id.*

DRM Program unless the Fund complies with prescribed limitations on its use of derivatives, as discussed below.

A Fund's DRM Program would consist of written policies and procedures reasonably designed to, among other things, assess and manage risks associated with its derivatives transactions, including leverage, market, counterparty, liquidity and operational risks. The Commission believes that this requirement would serve to establish a standardized level of risk management for applicable Funds.[51] We agree with the Commission that to the extent DRM Programs result in more robust monitoring of the risks related to derivatives, the DRM Programs may reduce the risk of a Fund suffering unexpected losses. We further agree with the Commission that DRM Programs may also reduce adverse repercussions for others in the market, such as Fund counterparties. Many Fund managers have already implemented similar risk management programs that provide protection to shareholders, but we believe a standardized and consistent level of risk management for Funds would provide further benefit to investors. To facilitate more efficient implementation of DRM Programs by all affected Funds, we ask the Commission to authorize the use of third parties to administer Funds' DRM Programs.

The Proposed Rule would require a Fund to adopt a DRM Program unless the Fund complies, and monitors compliance, with a portfolio limitation under which: (i) 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 (the "**50% Limitation**"); and (ii) the Fund does not enter into *any* complex derivatives transaction ("**Complex Derivatives Limitation**").

The 50% Limitation measures only derivatives transactions exposure and does not include exposure under financial commitment transactions or other transactions such as bank borrowings. We agree with the Commission's proposal to exclude these types of senior securities transactions from the 50% Limitation, because it would provide an important measure of investment flexibility for Funds. We also agree that setting the threshold at 50% of the value of the Fund's net assets is reasonable given that it corresponds with the Section 18 threshold for permitted leverage in respect of bank borrowings. However, for the reasons we explained in Section VIII above, we are concerned with the proposed requirement that a Fund "immediately" update its aggregate exposure, net asset value, and applicable portfolio and securities VaR. Performing this exercise throughout a trading day would be operationally challenging, if not impossible, for many Funds. We believe it would be more reasonable for the Commission to require Funds to perform this exercise at the end of each business day, consistent with the timing standard for asset segregation.

We also concerned that a Fund may inadvertently and temporarily cross the 50% Limitation during the course of a trading day. In such cases, we suggest that the final rule provide Funds with a grace period of 30 days to cure the inadvertent violation. Otherwise, a temporary and inadvertent violation could trigger a Fund's required adoption of an ongoing DRM program.

[51] Proposing Release at 80936.

With respect to the Complex Derivatives Limitation, we believe it would be reasonable for the Commission to authorize a *de minimis* notional exposure to a complex derivatives transaction, for example, 1% to 5% of a Fund's net asset value, before a Fund would become subject to the DRM Program requirements and their related implementation costs.

2. We Also Support the Proposed Derivatives Recordkeeping Requirements

The Proposed Rule would require a Fund to maintain a written record of each determination made by its board with respect to the portfolio limitations under which the Fund could operate in accordance with the Proposed Rule. Written records with respect to the initial determination of applicable limitations, as well as determinations to change such limitations, would be required to be maintained for a period of at least five years, the first two years in an easily accessible place.[52]

We support the Commission's rulemaking efforts regarding a Fund's recordkeeping requirements, and view the inclusion of such recordkeeping provisions in the Proposed Rule as being appropriate. We agree that such records will assist both Commission staff and the Fund's own board or compliance personnel in evaluating the Fund's compliance with the final rule. We also believe the recordkeeping provisions strike an appropriate balance with respect to the recordkeeping-related burdens on a Fund.

3. We Recommend an Extended Transitional Period for all Funds

The Commission seeks comment on whether providing a transition period after the effective date of the final rule would be appropriate, during which Funds could continue relying on past Commission guidance.[53] We firmly support the inclusion of a transition period of 30 months for all Funds that would allow Funds to come into compliance with the conditions of the final rule past its effective date. We see no reason to differentiate Funds based on their size or assets under management in providing a transition period. We believe a 30-month transition period would provide Funds with sufficient time to restructure their investment portfolios in a responsible and efficient manner and to develop and receive Board and shareholder approvals of new investment strategies as necessary in order to ensure their compliance with the final rule's new requirements. In addition, many Funds and/or their managers will likely be required to implement significant changes to their operational and administrative infrastructure to comply with notional-based portfolio limits or any other requirements in the Proposed Rule. During the transition period, other Funds may determine that they will have to de-register and thus would need the additional time to manage the complexities of that process.

[52] Proposed Rule 18f-4(a)(6)(i); *see* Proposing Release at 80994.

[53] Proposing Release at 80953.

4. We Question the Commission's Authority to Regulate Derivatives under Section 18

While we support and agree with certain provisions of the Proposed Rule, we have reservations about the Commission's general authority to regulate the use of derivatives by Funds. As discussed above, the Commission has long held the view that, provided a Fund covers its obligations arising from derivatives transactions, such transactions would not be considered senior securities under Section 18 of the 1940 Act. Under the Proposed Rule, the Commission all at once rejects this long-standing policy, defines derivatives as senior securities, and by virtue of their newly-defined status, proposes substantial restrictions on their use by Funds. We are very concerned that the Commission has not clearly demonstrated the justification for imposing the significant restrictions and conditions in the Proposed Rule. Funds, along with the Commission, have been operating under the less-restrictive asset segregation approach for nearly four decades with no material adverse consequences.

Given the potential disproportionate impact on Funds that offer alternative strategies to retail and institutional investors, we believe there are potential opportunity costs to such investors that the Commission needs to carefully consider. In our view, investor protection is undermined if the unintended consequence of the Proposed Rule, particularly its notional-based portfolio limitations on Funds' derivatives exposure, is a significant reduction in regulated, diversified investment opportunities for retail and institutional investors. Given those opportunity costs and the potential costs for restructuring or liquidating billions of dollars of Funds and Fund assets, we request that the Commission either re-propose its rulemaking after considering industry comments, including holding industry roundtable meetings, or provide a more comprehensive explanation of the need and justification for imposing a new notional-based limit on the use of derivatives by Funds in the adopting release for the final rule. In our view, the discussion of the Proposed Rule's quantifiable benefits and costs in the Proposing Release falls short in demonstrating meaningful benefit to investors.

5. Scope of the Definition of a Senior Security

The Commission has requested comment on whether exposure calculations should exclude derivatives that would not generally be considered to involve senior securities, because they do not involve a future payment obligation.[54] As discussed at the outset of this letter, we respectfully recommend that the Commission retain its well-established position that a derivatives transaction for which a Fund has appropriately segregated assets should not be classified as a "senior security" issued by a Fund in any event. However, to the extent that the Commission does seek to reclassify derivatives involving a future payment obligation as senior securities, we strongly recommend that the Commission exclude any derivative or other similar transaction, such as a purchased option or a structured note, that does not require any further payment or delivery obligation by a Fund, thus lacking any evidence of indebtedness, from any notional exposure or other similar calculation under the Proposed Rule.

[54] Proposing Release at 80908.

We are also concerned that there are unintended consequences that could result from the Proposed Rule's classification of derivatives transactions and financial commitment transactions as senior securities issued by a Fund. In particular, we are concerned that deeming such transactions as securities issued by a Fund could have unintended effects with respect to Section 3(c) of the 1940 Act or other provisions of the 1940 Act that use the term "security", as defined in Section 2(a)(36) of the 1940 Act. We would be concerned, for example, if derivative transactions entered into by a private investment fund were deemed to impact the analysis of whether that fund could rely on one of the exclusions from the definition of "investment company" found in Section 3(c) of the 1940 Act. We encourage the Commission to consider how best to mitigate these unintended consequences and to provide clarity that, to the extent that the Commission ultimately decides to classify derivatives transactions and financial commitment transactions as senior securities for purposes of Section 18 of the 1940 Act, any final rule will not affect provisions of the 1940 Act that are unrelated to the policy goals underlying Section 18. We would be happy to have further discussions with the Commission and its staff regarding how best to achieve this goal.

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We thank the Commission for the opportunity to provide comments on the Proposed Rule. We would welcome the opportunity to schedule meetings with the Commission and its staff to discuss our responses and views in greater detail. Please do not hesitate to contact Stuart J. Kaswell, Laura Harper Powell, or Jennifer Han of MFA at [redacted] and Jiří Król or Jennifer Wood of AIMA at [redacted] with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell	/s/ Jiří Król
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cc: The Hon. Mary Jo White, Chair
The Hon. Kara M. Stein, Commissioner
The Hon. Michael S. Piwowar, Commissioner

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