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March 28, 2016

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

Re: File No. S7-24-15
Use of Derivatives by Registered Investment Companies and Business Development Companies
Release No. IC-31933 (the "Proposing Release")

Dear Secretary Fields:

Simpson Thacher & Bartlett LLP is pleased to submit these comments developed in consultation with certain clients that sponsor or advise registered investment companies and business development companies ("BDCs") that focus on alternative investment strategies.[1] We welcome the opportunity to comment on the new rule and amendments proposed by the U.S. Securities and Exchange Commission (the "Commission") with respect to the use of derivatives by registered investment companies and BDCs.[2]

I. Overview

We generally support the Commission's efforts to develop a formal framework for regulating the use of derivatives by registered funds and BDCs (referred to collectively herein as "funds"). Currently, funds operate pursuant to a patchwork of regulatory pronouncements and guidance received from the staff of the Commission (the "Staff") in the context of new fund registration. We believe that certainty with respect to regulation is positive for all market participants.

[1] The clients consulted include more than a dozen asset management firms that advise and/or sub-advise open- and closed-end investment companies, BDCs and exchange-traded funds (ETFs). While these clients collectively manage a range of funds that employ traditional investment strategies (i.e., investing in long-only equities, corporate and government fixed income securities and money market instruments), this letter focuses specifically on their alternative investment strategies, which we define as any strategy other than the traditional investment strategies referred to above. The views contained herein do not necessarily reflect the views of each of the firms consulted.

[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015), https://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

We also believe that existing derivatives guidance provides a useful product development framework for funds without unduly creating speculative risks for shareholders or systemic risks for the financial system. We believe the usefulness of the existing framework is demonstrated by the breadth of product offerings that have been made available to fund shareholders over the past several decades, including by our clients. The U.S. fund system is the envy of the world, in part because a predictable, rules-based regulatory system has enabled new innovation in all sectors of the industry.

Among the types of innovative funds that have been brought to market over the past few decades are funds that use derivatives to achieve cost-effective exposure to investments, to provide non-correlated returns to traditional, long-only products and for hedging and risk management purposes. Historically, many of these products were only available to wealthy individuals and institutions, but the framework that the Commission and the Staff have created over the past 35 years has enabled these products to be offered to the public at large. We need not look too far back in the history of the financial markets to see that access to non-correlated investment strategies and classes has significant benefits for investors and, consequently, for the economy as a whole.[3]

Put another way, we are not certain there is an issue that needs to be resolved by further regulation beyond codifying the patchwork of current regulatory guidance. We believe that, given the Commission's historical oversight of the use of derivatives by funds, the Commission is the federal agency best equipped to craft appropriate regulation on this topic. Our comments below are intended to strengthen the proposed Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act") by (1) highlighting certain unintended consequences of the Proposed Rule and (2) proposing alternatives that can meet the Commission's stated objectives without unduly harming existing products and constraining future product development.

II. Unintended Consequences

We have several concerns regarding the effects of the Proposed Rule. Our recommendations are intended to address these concerns, which are outlined below:

- The Proposed Rule, by the Commission's own estimate, disproportionately impacts alternative funds. Based on extensive discussions with our clients, however, we are concerned that the Commission understates that impact.[4] We believe that the Proposed Rule would not simply cause some alternative funds to alter their strategies, but would instead have the effect of forcing those funds to deregister as public investment companies. There are numerous funds that provide uncorrelated returns to broad markets and have a lower "Value at Risk," or "VaR," than funds that pursue long-only strategies

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[3] For example, the performance of the BarclaysHedge CTA Index, which represents the performance of commodity trading advisers (and is therefore a proxy for managed futures fund performance), gained 14.09% in calendar year 2008, while the S&P 500 Index lost 36.91%. *See* http://www.barclayhedge.com/research/indices/cta/sub/cta.html.

[4] We understand that the Investment Company Institute ("ICI") has conducted its own study, which indicates that 47% of all funds that could not operate under the Proposed Rule are alternative funds.

but could not operate under any notional exposure limit that was considered by the Commission.

- Because the Proposing Release understates the number of alternative funds that would be required to deregister, it concomitantly understates the impact on capital markets and capital formation. Deregistration would harm investors who have actively sought to invest in strategies that would no longer be available. The liquidation of such funds likely would have troubling secondary effects, including trying to conduct an orderly liquidation without giving institutional investors and other first movers an advantage to the detriment of smaller, less sophisticated investors. Those destabilizing effects would extend to broader markets as positions are exited, and/or typical buyers for assets evaporate. Some fund sponsors who have built their business around such funds likely would go out of business, and will certainly lose a great deal of their capital investment. The cumulative effects of these consequences would thus create uncertainty in the regulatory framework that could discourage other sponsors from entering the U.S. market, or encourage U.S. companies to relocate overseas.

- Certain funds may not liquidate but instead be offered in different “wrappers” or structures that do not have the protection of the 1940 Act for investors. Some may move towards private funds, although that is unlikely to be an option for most funds. Others may become commodity pools, subject to registration perhaps with the Commission but not subject to the other, protective provisions of the 1940 Act. Still others may be offered as structured notes, which provide returns based off of an investment strategy but are unsecured debt of the issuer, thereby magnifying greatly the amount of counterparty risk to investors and systemic risk to the economy.

- The treatment of revolving lines of credit provided by funds (including BDCs) to portfolio companies as “unfunded commitments” under the Proposed Rule would significantly decrease the amount of financing available to small and middle market private companies in the United States, at the same time that banking regulations have made it harder for such companies to obtain bank financing.

- Similarly, the treatment of commitments to private funds as “unfunded commitments” under the Proposed Rule would unduly diminish the ability of funds to invest in private funds, depriving investors of access to an asset class that the Commission has permitted such investors to access under certain strict conditions.

III. Alternatives

We have proposed below several alternatives, with a goal of avoiding these unintended consequences while preserving the Commission’s stated regulatory aims. We strongly believe that the Commission can effectively prevent undue speculation in funds and also avoid the unintended consequences described above. Our proposed alternatives include:

- Offering several potential approaches to measuring risk in a fund’s portfolio based on relative VaR, including by reference to a benchmark VaR, a multiple of securities VaR or the effect on VaR of derivatives use above a certain threshold;

- Using alternative methods of calculating notional exposure, including with respect to netting and risk adjustment and for financial commitments;

- Appropriately treating closed-end funds and BDCs differently from open-end funds with respect to Section 18 limits, consistent with the existing regulatory scheme for such funds;

- Expanding the category of assets that are available as "qualifying coverage assets" for asset segregation purposes, including through appropriate use of "haircutting";

- Treating contingent unfunded commitments differently than other unfunded commitments;

- Grandfathering funds that were in registration on or prior to December 11, 2015, the day the Proposing Release was issued;

- Creating an exemptive process with pre-set standards for appropriate exceptions to the regulatory framework ultimately adopted by the Commission; and

- Postponing consideration of the Proposed Rule until several other rules that would be useful in creating an overall framework are adopted by the Commission.

We believe that consideration of these proposals will also have the benefit of strengthening the Commission's basis for any proposed rulemaking in this area. In particular, we believe that we and many others are proposing reasonable alternatives that would not place as significant a burden on funds, sponsors and investors, while still achieving the Commission's regulatory goals. We also believe that consideration of the alternatives proposed herein and elsewhere would entail a further consideration of whether the Proposed Rule poses an unnecessary burden on competition, and whether the full cost of the liquidation of funds that cannot operate under the Proposed Rule has been adequately captured in the Commission's economic analysis. We note that the Proposed Rule should be weighed against alternatives in light of the effect of any rule upon "efficiency, competition, and capital formation," and encourage the Commission to seek further comment in that regard if necessary following the submission of comments to the Proposed Rule.[5]

A. Any portfolio limits, if retained, should be based on a more accurate assessment of risk

The Commission acknowledged in the Proposing Release that its proposal to limit funds' use of derivatives by placing a limit on the absolute notional amount a fund may achieve may be a "blunt measurement," as it fails to account for the varying degrees of risk among different derivatives and financial commitment transactions.[6] We recommend that the Commission

[5] *See* 15 U.S. Code § 80a–2. For the reasons discussed throughout this letter, we do not believe that the Commission has adequately assessed whether the Proposed Rule poses an unnecessary burden on competition, its costs, and the likely effect on efficiency, competition and capital formation.

[6] *See* Proposing Release, *supra* note 2, at 70.

consider alternatives to basing limits on pure notional amounts. As discussed below, notional exposure amounts often overstate a fund's obligations, are not good proxies for leverage and are even less reliable indicators of risk.

Historically, the Commission has regulated derivatives use by funds with an eye towards the concept of leverage, which is consistent with the statutory construct of Section 18 (which deals with capital structure of an investment company).[7] The proposed exposure-based limits depart from the Commission's historic interpretation of Section 18 and do not bear any direct relationship to the leverage in a fund's portfolio. With respect to leverage, consider, for example, an equity total return swap with a notional amount of $100 that is held by two funds. Fund A posts no margin, and therefore has leverage of $100. Fund B, however, places $100 in a margin account in connection with the swap and therefore has no leverage. Under a pure notional limit, these two scenarios would be treated identically.

We understand that the Commission has departed from its traditional focus on leverage in the context of funds' derivatives use towards a focus on the risk to fund portfolios from the use of derivatives.[8] While it is clear from the above example that notional exposure amounts do not measure leverage, it is even more certain that notional amounts do not adequately measure risk. In the equity total return example above, Funds A and B have assumed different risks, as Fund A has leverage risk that could magnify any negative performance of the underlying security. In another scenario, where two different derivatives have the same notional exposure but different underlying assets, the two positions can have very different risk profiles. Consider here an example comparing an equity total return swap on a single security and an interest rate swap. Both swaps may have notional amounts of $100. In the former, a long equity swap would expose the fund to a loss of the total notional amount of the swap, and at a minimum would expose it to losses equivalent to the volatility of the security underlying the swap. In the latter interest rate swap, a fund would be exposed to the difference between a fixed rate of interest and a floating rate of interest (such as LIBOR), while the notional amount serves as a basis for determining the amount of interest payments. A fund's investment in an equity total return swap has a very different effect on the risk of a fund portfolio than an interest rate swap, yet the Proposed Rule treats them identically. Ironically, this equivalence of risk, which decreases the ability for funds to obtain exposure through less risky derivatives, may incentivize funds to use more risky

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[7] *See, e.g.*, *Securities Trading Practices of Registered Investment Companies*, SEC Release No. IC-10666 (Apr. 18, 1979) ("Release 10666") ("The legislative history of the [1940] Act indicates that Congress intended Section 18, *inter alia*, to limit increases in the speculative character of junior securities issued by investment companies. Leveraging of an investment company's portfolio through the issuance of senior securities and through borrowing magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities.") We understand that several other commenters will raise the question of whether derivatives transactions meet the definition of "senior securities" transactions in Section 18 of the 1940 Act.

[8] *See* Proposing Release, *supra* note 2, at 55 ("Proposed rule 18f-4 . . . is designed both to impose a limit on the leverage a fund relying on the rule may obtain through derivatives transactions and financial commitment transactions, and to require the fund to have qualifying coverage assets to meet its obligations under those transactions, *in order to address the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8)*.") (emphasis added).

derivatives with their newly limited derivatives "budget," which would be inconsistent with the Commission's mission of protecting investors.

In reality, a fund with high notional derivatives exposure may be more, less or equally risky or leveraged as a fund with no derivatives exposure.[9] Different derivative instruments may provide uncorrelated or inversely correlated returns to one another. A strategy using long equity derivatives and short equity derivatives may be designed to reduce risk, but by taking the absolute value of notional exposure for both, a fund using a notional exposure test will be treated as having greater risk than if it only held long or short positions. As noted, the Commission acknowledges that relying on notional amounts is a "blunt measurement" in the Proposing Release. We believe that the Commission's assumption, that a fund that exceeds the proposed notional portfolio limits is unduly speculative, is fundamentally flawed. We refer the Commission to a recent white paper by James A Overdahl of Delta Strategy Group, which provides an economic analysis that reaches the same conclusion.[10]

If the Commission proceeds with its approach of imposing exposure- and risk-based portfolio limits, we have a number of suggestions for alternative approaches that we urge the Commission to consider in order to address our outlined concerns.

(1) <u>A note about the risk-based portfolio limit</u>

The Commission appears to have recognized that a limit based solely on pure notional exposure is not appropriate for all funds, as the proposed risk-based portfolio limit looks to a fund's VaR in addition to its notional exposure. In order to rely on the proposed risk-based portfolio limit, however, a fund's full portfolio VaR must be less than the fund's securities VaR. This effectively limits access to the risk-based test to funds that only use derivatives for hedging purposes. Further, by comparing portfolio VaR to securities VaR,[11] funds with portfolios solely made up of derivatives that provide market exposure and cash or cash equivalents are unable to rely on the risk-based limit because the VaR of cash and cash equivalents is effectively non-existent. Accordingly, while the Commission estimates that nearly 500 funds would fail the proposed exposure-based limit, we believe that the vast majority of those funds are unlikely to find relief in the risk-based limit as proposed. Based on feedback from our clients, we have reason to believe that many low-volatility alternative funds would both fail the exposure-based limit and be deemed ineligible for the risk-based limit. The spirit of the proposed exposure-based limit, however, would seem to support the proposition that such funds should be able to rely on a

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[9] For example, looking at the volatility of the S&P 500 Index futures contract vs. a Eurodollar futures contract from 2005 through 2015, a fund with 150% notional exposure through S&P 500 Index futures contracts would have had a volatility measure of 30%. A fund with ten times as much notional exposure (1500%) through Eurodollar futures contracts would have had a volatility measure of only 9.6%. *See* James A Overdahl, *Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies* (March 24, 2016) at 16 (Table 1), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2754153 ("Overdahl White Paper") (filed with the Commission on March 25, 2016).

[10] *See id.*

[11] The Proposed Rule defines "securities VaR" as "the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions."

risk-based limit. We therefore urge the Commission to consider expanding access to the risk-based portfolio limit to reduce the likelihood that the Proposed Rule will result in the liquidation of many alternative funds and the denial of access to alternative fund strategies for retail investors, including those that provide investors with lower volatility than more traditional funds.

We disagree with the Commission that a risk-based limit relying on a relative VaR test that uses a fund's own portfolio as a baseline is necessarily "more consistent" with the 1940 Act than a limit based on, for example, a benchmark index of securities.[12] The Commission correctly points out that Section 18 "generally does not impose limitations on a fund's ability to invest in risky or volatile investments, provided that such investments are consistent with the investment strategy described to investors."[13] Indeed, Section 18 does not provide a statutory basis for any risk-based limit. Instead, a risk-based limit appears to be grounded in the general policy reflected in Section 1(b)(7) and the Commission's public policy interest in preventing fund shares from taking on an unduly speculative character, which also does not provide a statutory basis for the Commission to impose such a limit. We believe that each of the alternative relative VaR approaches discussed below would add an inherent real-time flexibility to any regulation adopted by the Commission and provide investors with a more reliable comparison of the relative risk of investing in different funds.[14]

For all of the proposals outlined below, it is not a necessary precondition that the proposed 150%/300% framework in the Proposed Rule be deleted. These proposals are in addition to those other options, which may be more easily administered for "plain vanilla" funds.

(2) <u>Alternative One: Portfolio VaR vs. Multiple of Benchmark VaR</u>

In order to determine whether a fund's shares have taken on an unduly speculative character, we believe that two factors are important to consider: (i) the expectations of retail investors in the context of general prevailing market conditions; and (ii) the fund's disclosed investment objectives and strategies. Our first suggested relative VaR test is based on these reference points. Specifically, we propose that the Commission permit a fund to achieve a portfolio VaR no greater than a specified multiple of a benchmark VaR, and in order to limit the ability of funds to create extraordinarily risky portfolios we also propose that the Commission define the maximum benchmark VaR.

In particular, we first propose that the Commission adopt a rule that requires a fund's adviser, with fund board approval, to set an appropriate benchmark for the fund, against which its risk will be measured. Second, we propose that the Commission then set a multiple above which a fund's portfolio VaR could not exceed the benchmark's VaR. Finally, we propose that

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[12] *See* Proposing Release, *supra* note 2, at 125.

[13] *See id.*

[14] We believe that using a relative VaR approach does not raise the concern voiced by the Commission that VaR calculations may be subject of large period-to-period swings that could "potentially allow a fund to obtain very substantial amounts of leveraged exposures that the fund could then be required to unwind during stressed market conditions." *See* Proposing Release, *supra* note 2, at 346. Under a relative VaR approach, a fund likely would have greater flexibility because the reference VaR would increase in stressed conditions.

the Commission require that, regardless of the benchmark chosen by the fund, the fund's portfolio VaR may not exceed more than that same multiple of an index consisting of 500 or more large- and mid-cap U.S. securities (e.g., an index similar to the S&P 500 Index). Each of these three prongs is discussed below.

With respect to the first prong, we assume that the Commission does not intend to regulate risk out of investing in funds entirely. If the goal is to regulate undue speculation by a fund through use of derivatives, we believe that the best approach would be to compare the risk created by the fund's use of derivatives to the risk of investing more broadly in the asset class(es) that are disclosed in the fund's objectives and strategies.

With respect to the second prong, in practice this approach would use the basic approach proposed by the Commission—that there should be some practical limit on risk in a fund's portfolio—and substitute a portfolio VaR for a notional limit. Using the Commission's own numbers, for example, instead of a notional exposure limit of 150%, a fund would instead be permitted to have a portfolio VaR that is 150% of the VaR of the designated benchmark.[15] This approach would seem to be more closely aligned with the Commission's objectives of limiting risk in a fund portfolio than a notional exposure limit, which as we have discussed is a flawed measure of risk.

Finally, we acknowledge that simply using an index as a benchmark comparison may be unattractive to the Commission, because using a highly volatile underlying index could allow a fund keyed off of that index to be extremely risky. Thus, we propose that there be a separate outside limit on a fund's portfolio VaR, set by the Commission at a specified multiple (the same multiple as in prong two) of a broad-based securities index consisting of 500 or more large- and mid-cap U.S. securities.[16] That would mean that no fund could be more than, for instance, 1.5 times as risky as the U.S. equity markets generally. We would assume that certain types of funds would never approach this outside limit—e.g., short-term bond funds would likely set a benchmark index significantly less risky than the S&P 500 (for example). For other types of funds, this outside limit will be important, such that an emerging markets small-cap fund could not use derivatives to increase significantly the fund's risk above the risk already associated with the asset class in which it invests.

This type of relative VaR approach offers a rule with the flexibility to apply to funds of all types, while requiring a fund to select a benchmark tailored to its stated investment objectives and strategies.

The Commission's stated concern that a relative VaR limit would be viewed as a general limitation on risk or volatility would not be an issue under this approach, as the risk limit would

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[15] We note that the economic analysis underlying the proposed notional limits is based on a sampling of industry data. The Commission has proposed enhanced reporting by funds under the new Form N-PORT. We urge the Commission to assess, with the benefit of N-PORT reporting, the potential efficacy of a 150% notional exposure limit or a 150% of a benchmark's VaR limit over time before finalizing the Proposed Rule.

[16] To account for fluctuations in VaR over time, a fund would be required to calculate this test based on the lower of the VaR of the benchmark designated by the Commission or the VaR of the benchmark designated by the fund.

never be static and would not be specifically set by the Commission, but by current market conditions and approved by a fund's board.[17] Additionally, the Commission expressed concern in the Proposing Release that a relative VaR limit based on a hypothetical benchmark could result in funds selecting a leveraged benchmark, thus undermining the Commission's goal. Under our proposed relative VaR approach, the Commission would set conditions for a benchmark that would serve as an outside limit. If a fund's board elected to use a different benchmark that happened to be leveraged, its VaR could not exceed the VaR of the outside limit, so funds could not "game" the system as the Commission might fear.

For further discussion of this proposal, we refer you to the letter we understand will be submitted by Blackstone Alternative Investment Advisors LLC.

(3) Alternative Two: Portfolio VaR vs. Multiple of Securities VaR

If, after evaluating and considering the above proposal, the Commission nonetheless determines to maintain its position that any relative VaR limit should use a fund's own portfolio as a baseline, another alternative that has been endorsed by a subset of our clients would be to set a VaR limit for a fund's overall portfolio based on a multiple of the fund's securities VaR. This approach effectively limits a fund's ability to add speculative risk to a portfolio beyond the risk that would be taken on through investing directly in securities. The Commission endorsed this form of a relative VaR test in its proposed risk-based limit, although this approach looks at the degree to which portfolio VaR can be *increased* through derivatives, as opposed to Commission's proposal, which looks at how portfolio VaR is reduced by derivatives use.

As above, in practice, this approach would use the basic approach proposed by the Commission—that there should be some practical limit on risk in a fund's portfolio—and substitute a portfolio VaR for a notional limit. Using the Commission's own numbers again, for example, instead of a notional exposure limit of 150%, a fund would instead be permitted to have a portfolio VaR that is 150% of the securities VaR of the fund. As stated above, this approach would seem to be more closely aligned with the Commission's objectives of limiting risk in a fund portfolio than a notional exposure limit, which we believe is a flawed measure of risk.

We note that only a subset of our clients favors this approach as it would not solve the fundamental problem for funds that primarily use derivatives that have very low securities VaRs. Such funds often have the effect of reducing risk relative to broad market measures of risk. We urge the Commission to consider adopting this alternative at a minimum, but we note that this measure alone would not resolve many of the issues we have identified with the Proposed Rule.

For further discussion of this proposal, we refer you to the letter we understand will be submitted by OppenheimerFunds, Inc.[18]

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[17] For example, the Overdahl White Paper cites the historical volatility of the S&P 500 Index. The volatility of the S&P 500 from 2005 through 2015 was 20%, while the volatility from 2011 through 2015 was 15.5%. *See* Overdahl White Paper, *supra* note 9, at 16 (Table 1).

[18] We understand that the OppenheimerFunds, Inc. letter will propose an outside limit of 300% notional exposure in a fund's portfolio where portfolio VaR is less than or equal to 150% of securities VaR, as an additional limitation on risk and to align more closely to the Proposed Rule. We do not believe any notional limit is necessary to reduce risk

(4) Alternative Three: Portfolio VaR vs. Portfolio VaR below the exposure limit

As a third alternative, we support the proposal that we understand will be put forth by the ICI that would allow a fund's use of derivatives and financial commitment transactions to exceed the exposure-based limit so long as all such transactions entered into above the exposure-based limit have the net effect of reducing the VaR of the rest of the fund's portfolio. Again, this is similar to the risk-based limit proposed by the Commission, but the requirement that derivatives transactions have the effect of reducing VaR would only apply to derivatives that are entered into above the exposure-based limit.

Using the notional limits set forth in the Proposed Rule, this approach, like the Commission, would permit a fund to use derivatives that increase the fund's overall risk until it has reached 150% in notional exposure, and then permit an additional 150% notional exposure so long as that second tranche reduces the risk of the fund's portfolio taking into account the risk profile of the fund with the first 150% of notional exposure included. We would like to underscore that this approach should not raise concerns that a fund could engage in excessive speculation by including its riskiest derivatives in the first 150% bucket. There would still be a limit on overall risk in a fund's portfolio as a result of the notional cap, and the second bucket effectively is equivalent to permitting greater netting of derivatives that move in opposite directions. The existence of notional limits will achieve the Commission's regulatory aims, and we urge the Commission to request additional comment on this proposal if it has concerns about the way it would work in practice, rather than rejecting it on the basis of theoretical concerns.

(5) Alternative Four: Adjust Notional Exposure Limits

If the Commission fully evaluates the above proposals, but rejects the idea of using relative VaR as a viable alternative for measuring risk in a fund's portfolio and retains limits solely based on notional exposure amounts, we believe the Commission should take a more holistic view of a fund's net exposure by basing such limits on risk-adjusted notional amounts instead of absolute notional amounts.

(a) Increase Notional Exposure Limits

We understand that, based on data collected by the ICI, the Commission's estimate that only four percent of funds would fail the proposed pure notional exposure limit is incorrect. Instead, we understand that the ICI data indicates that four percent of funds would fail a pure notional exposure limit of 200%. In considering whether to increase the notional exposure limit from 150%, the Commission should consider the data presented by the ICI and other industry participants, and keep in mind that any notional exposure limit is an outer limit for funds, not a precise measurement of exactly the amount of notional exposure a fund will have at any given time. Funds generally do not manage their portfolios in a manner that runs up against regulatory limits, so as to avoid inadvertent violations due to market fluctuations or other factors that are outside of the control of a fund and its adviser. Therefore, we believe that the Commission should consider that funds are not currently managing to any defined notional exposure limit,

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effectively in a fund's portfolio if the first part of this proposal is adopted, but understand why an outside limit on notional exposure may be attractive to the Commission.

and thus the Commission should look at current data and "round up" to account for the buffer that funds will implement as a matter of regulatory compliance best practice.

We reiterate that for many funds, the notional limits do not represent an accurate measure of the risk in a fund's portfolio. We also would emphasize that our clients have informed us that simply permitting slightly higher notional exposure will not "save" funds that are otherwise marked for liquidation or deregistration if the Proposed Rule is adopted.

(b) Permit greater use of netting

For funds that use uncorrelated or inversely correlated instruments to achieve reduced risk, the Commission's proposed formulation for netting would be unduly restrictive. Under the Proposed Rule, funds would be permitted to net notional amounts of any offsetting derivatives transactions of the same type, with the same underlying reference asset, maturity and other material terms.[19] The Proposing Release indicates that the Commission purposefully limited the netting exception so that it would apply only to transactions that truly offset one another. We support this approach, but encourage the Commission to reexamine whether a difference in the form of two otherwise offsetting derivatives transactions should preclude netting of those transactions under a notional exposure limit. If material terms are otherwise the same, different types of derivatives can offer equivalent exposure to an underlying reference asset. We ask that the Commission remove the requirement that offsetting derivatives transactions be the same type of instrument in order to qualify for netting under a notional exposure limit, and consider proposed formulations that permit slightly greater ability to net transactions, in whole or in part.

Indeed, when combined with other alternatives proposed in this letter and by other industry participants, a reasonably expanded definition of netting, even when potentially combined with *lower* notional exposure limits, would have the effect of permitting certain types of funds to continue to operate. In particular, funds that primarily use derivatives to achieve their investment objectives, and thus have virtually no securities VaR but have significantly lower risk than broad market measures of risk, could effectively use a more flexible netting approach while permitting the Commission to achieve its goal of limiting undue speculation by funds. For further discussion of this proposal and how it would benefit particular funds, we refer you to the letter we understand will be submitted by Stone Ridge Asset Management LLC.

(c) Adjust notional exposure limits for risk

As we have discussed, notional exposure does not adequately measure risk in a fund's portfolio. That said, if one were to adjust notional exposure for the risk of the asset class to which a derivatives instrument provides exposure, one could arrive at a measure more closely aligned with the risk of the portfolio. Specifically, through use of the concept of "haircutting," which risk-weights different amounts of exposure for potential movement in value of underlying assets, the Commission could retain its notional exposure concept while more accurately limiting risk.

[19] The Proposed Rule would allow funds to offset derivatives transactions among different counterparties, so long as the transactions otherwise meet these requirements.

Under a haircutting methodology, a fund would assign the highest value of risk to long-only or short-only derivatives that are based on equities. For such instruments, 100% of the value of the notional exposure may be assigned to the numerator in calculating a notional exposure test. But for interest rate swaps, for example, the haircutting methodology would take into account that it is exceedingly unlikely that there would be a 100% difference between a fixed and floating rate of interest over time equal to 100% of the notional value (i.e., for a one-year time period, a difference in rates equal to 100 percentage points), and would assign only a portion of the notional value of such instruments to the numerator. In addition to being a more accurate measure of risk in a fund's portfolio, and thus more consistent with the regulatory aims of Section 18 and the Proposed Rule, we note that the Commission would be an outlier among other U.S. and global financial regulators if it proceeds with a rule designed to limit risk by focusing on notional exposure amounts without some adjustment for risk.

We do not have a view regarding which haircutting methodology the Commission should use, or whether it should propose one for comment. However, as you are aware, the Commission has blessed rules in other contexts that account for variations in risk with respect to derivatives transactions and there appears to be a generally accepted method of accounting for risk among other financial regulators.[20] Accordingly, one measure that the Commission should consider looking to is the initial margin requirements outlined in the table below, which have been adopted by the International Organization of Securities Commissions ("IOSCO"), the Financial Stability Board, the Office of the Comptroller of the Currency, the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation and the Commodity Futures Trading Commission in the context of initial margin requirements for swap transactions.[21]

[20] *See, e.g.*, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, SEC Release No. 34-68071 (Oct. 18, 2012) (proposed rule), https://www.sec.gov/rules/proposed/2012/34-68071.pdf; *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* SEC Release No. 34-66868 (joint final rule with the CFTC).

[21] *See, e.g.*, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf (adopted by the CFTC); *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74839 (Nov. 30, 2015), https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf (adopted by the Department of the Treasury, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, among other agencies); *Margin requirements for non-centrally cleared derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (March 2015), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD480.pdf (adopted by IOSCO and the Financial Stability Board) ("IOSCO Framework").

Asset Class of Reference Instrument	Initial Margin (% of Net Notional Exposure)	Risk-Adjusted Notional Amount (% of Net Notional Exposure)
Credit: 0-2 year duration	2	13.3
Credit: 2-5 year duration	5	33.3
Credit: 5+ year duration	10	66.6
Commodity	15	100
Equity	15	100
Foreign exchange/currency	6	40
Cross currency swap: 0-2 year duration	1	6.6
Cross currency swap: 2-5 year duration	2	13.3
Cross currency swap: 5+ year duration	4	26.6
Interest rate: 0-2 year duration	1	6.6
Interest rate: 2-5 year duration	2	13.3
Interest rate: 5+ year duration	4	26.6
Other	15	100

The consensus among multiple financial regulators illustrates that the weightings shown above represent generally accepted estimates of the risk involved with different types of reference asset classes. The Commission may disagree that these weightings are the appropriate ones for purposes of the Proposed Rule, and may seek comment on other methodologies for haircutting. To illustrate how this concept might work, however, we have noted in the table above how these initial margin weightings might translate for purposes of the Proposed Rule. To establish a baseline, 100% of the notional amount of any derivatives with underlying reference assets that would require the highest initial margin (e.g., equities, which require 15% initial margin) would count toward the notional exposure limit. This multiplies the generally accepted haircut by a factor of six and two-thirds. For derivatives with less risky reference assets (e.g., debt), the applicable haircut would be multiplied by the same factor of six and two-thirds, and that percentage of the notional amount would count against a fund's notional exposure limit (which would range from approximately 13.3% to 66.6% depending on the maturity of the debt).

We believe that this approach would avoid unfairly penalizing funds with derivatives transactions that provide exposure to less risky asset classes, instead imposing the greatest burden on the funds that seek exposure to the riskiest asset classes. While we reiterate that any notional exposure limit would remain a relatively blunt measurement compared to our alternative proposals, by incorporating the concept of haircuts described above, any notional limit imposed by the Commission would appropriately recognize generally accepted variations in risk among asset classes.

For further discussion of this proposal, we refer you to the comment letter that we understand will be submitted by the ICI and a recent white paper by James A Overdahl, which both suggest adjusting notional amounts to account for risk.[22]

(d) Financial commitment transactions should not count toward any limit

The Commission has long stated the view that regulation of the use of derivatives by funds should address twin concerns of undue speculation and ability to satisfy payment obligations.[23] Given these goals, there would not appear to be a reason that asset segregation alone would not adequately account for the risks associated with financial commitment transactions, as defined in the Proposed Rule. Under the Proposed Rule, a fund could not segregate the same assets to cover both its financial commitment transactions and derivatives transactions, and thus it would appear that investors would not receive any additional protection by including financial commitment transactions in any exposure- or risk-based limit, either as proposed or under any of the alternative formulations proposed above.[24]

(e) The notional limit calculation should be adjusted for closed-end funds and BDCs

Under the Proposed Rule, with respect to notional exposure limits, a closed-end fund or BDC would be required to adhere to a limit that would aggregate notional amounts of derivatives transactions, financial commitment obligations and aggregate indebtedness (as would open-end funds). The approach of treating closed-end funds and BDCs in the same manner as open-end funds is contrary to the express capital structure design of the 1940 Act, which permits a closed-end fund to maintain asset coverage of 200% when it issues preferred stock or 300% for other indebtedness, and a BDC to maintain asset coverage of 200% regardless of the type of indebtedness, but limits open-end funds to bank borrowings. The Commission has argued in the Proposing Release that the 150% notional exposure limit is derived from Section 18 (although of course such limit is not in the statute itself). If that is the case, it would appear to follow that closed-end funds and BDCs should be able to calculate their exposure in a different manner.

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[22] *See* Overdahl White Paper, *supra* note 9, at 33.

[23] *See generally* Release 10666, *supra* note 7.

[24] We argue below in Section III.B(2) that certain unfunded commitments by BDCs and funds of private funds should not be treated as such for purposes of asset segregation. For the same reasons expressed below, we believe that at a minimum such contingent unfunded commitments should not be counted towards any aggregate exposure limit adopted by the Commission.

We would propose that the Commission revise the Proposed Rule to exclude structural indebtedness from the calculation of a closed-end fund's or BDC's exposure. Closed-end funds and BDCs, by statutory design, history and operation, typically use leverage for investment purposes.[25] This structure is less common in open-end funds due to liquidity constraints that are not applicable to closed-end funds and BDCs.[26] Without such a change, the Proposed Rule would have the effect of limiting derivatives use by closed-end funds and BDCs in a much more significant manner than for open-end funds, and would deprive these vehicles of the relative advantage of leverage that they historically have enjoyed over open-end funds. From the perspective of systemic risk or risk to fund shareholders, closed-end funds are less likely, not more, to be subject to the types of issues that could result from speculative derivatives use (because they are not subject to a risk of a "run" on the fund in addition to risks associated with derivatives use). It seems counterintuitive to permit less derivatives use by such funds.

If the Commission were to provide for a different overall exposure limit for closed-end funds and BDCs to account for the lower asset coverage requirements required by Congressional design for such funds, we urge the Commission to maintain flexibility that would permit such amount to be adjusted in the future if Congress were to amend the asset coverage requirements in Section 18(a) (for closed-end funds) or Section 61 (for BDCs).[27]

B. The proposed asset segregation approach is appropriate, with a few adjustments

We support the Commission's approach with respect to asset segregation based on mark-to-market amounts plus risk-based buffers, which would adequately protect fund shareholders from situations where a fund does not have sufficient assets to satisfy its obligations. We appreciate the Commission's flexible approach in permitting funds to adopt appropriate risk-based buffers, which is not dissimilar to the approaches we have proposed above that would avoid treating all derivatives instruments the same, regardless of the risk associated with such instruments.

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[25] *See* SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, Part Three, p. 1582 ("The creation of leverage for the money invested by the common stockholders probably has been in many cases a most potent reason for attempting to secure part of the capital funds through the issuance of senior securities . . . . The larger the amount of senior securities issued relative to the funds contributed by common stockholders the greater the possible gain to common stockholders . . . ."); SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, Part Two, pp. 45-46 ("In the earlier years, leverage [closed-end] companies completely dominated the industry . . . . At the end of 1936, 82 of the 113 closed-end management investment companies . . . were leverage companies. . . .").

[26] *See* Comment Letter of Simpson Thacher & Bartlett LLP on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (Jan. 14, 2016), https://www.sec.gov/comments/s7-16-15/s71615-80.pdf; SEC, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, Part Three, p. 838 ("[O]pen-end investment companies almost invariably had only one class of shares of stock. . . .").

[27] In this regard we note that Congress recently held a hearing related to this topic. *See* Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities: Hearing Before the U.S. House of Representatives, Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, 114th Cong., 1 (June 16, 2015), http://financialservices.house.gov/uploadedfiles/114-33.pdf.

We note that the Commission, in Release 10666, stated that asset segregation "will function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock" and "assure the availability of adequate funds to meet the obligations" associated with the transactions described in Release 10666.[28] The Commission makes it clear in the Proposing Release that its discomfort with funds' current practices related to derivatives stems from how far funds have deviated from the asset segregation guidelines laid out in Release 10666, both by segregating only mark-to-market amounts (instead of notional amounts) and by segregating assets beyond the scope of high-quality assets outlined in Release 10666. It is clear that the Commission is seeking a solution that addresses both of these problems, and the combination of overall risk limits along with the proposed asset segregation requirements would seem to do so.

However, because the proposed asset segregation requirements generally would require a fund to segregate (i) cash and cash equivalents equal to the mark-to-market liability of its derivatives transactions plus a risk-based cushion amount and (ii) assets that are convertible to, or will generate, cash prior to the date on which the fund would need to pay for its financial commitment obligations, we believe that the Commission has gone beyond what it needs to accomplish its regulatory aims. We will address our concerns with each of (i) and (ii) in turn.

(1) <u>The types of assets that can be used for coverage are too limiting</u>

The Commission's proposed definition of "qualifying coverage assets" that may be used to satisfy asset segregation requirements differs from the standard set forth in Release 10666. Release 10666 allowed funds to segregate a wider range of low-risk, low-volatility assets to cover derivatives transactions—specifically, "liquid assets, such as cash, U.S. government securities or other appropriate high grade debt obligations."[29]

The Proposed Rule only allows funds to use cash and cash equivalents to satisfy the proposed asset segregation requirements. In addition to the "cash drag" issues associated with this approach (which we understand will be described in the ICI's comment letter), this proposal is significantly more limited than what other financial regulators permit in the margin context. IOSCO's margin framework, for example, allows assets that are "highly liquid" and, after accounting for haircuts, "able to hold their value in a time of financial stress" as eligible margin assets.[30] Assets that meet the margin requirements of IOSCO and other financial regulators include cash, high-quality government securities and corporate bonds and equities included in major stock indices.[31] Given the general consensus of other financial regulators with regard to the types of assets that are appropriate for margin purposes, the Commission should consider expanding the ability of funds to use assets other than cash and cash equivalents to satisfy asset segregation requirements.

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[28] See Release 10666, *supra* note 7, at discussion of "Segregated Account."

[29] *See id.*

[30] *See* IOSCO Framework, *supra* note 21, at 5.

[31] *See, e.g.*, *id.* at 17-18.

In permitting the use of assets other than cash or cash equivalents, we acknowledge that the standard of allowing funds to use any liquid asset, set forth in the Staff's 1996 Merrill Lynch no-action letter, may be too broad.[32] In times of market stress, certain assets may become less liquid.[33] Also, to the extent that coverage assets are correlated to the derivatives for which they serve as cover, the coverage assets may decline in value at the same time that a fund's mark-to-market obligation on the derivative increases. This issue should not result in such assets being disallowed from being considered for asset coverage, but rather the value of such assets should be haircut appropriately when used for asset coverage purposes, essentially creating a "cushion" for fluctuation in realizable value for the haircut asset. A haircutting approach, which we have described above with respect to potential adjustments to the notional exposure test, would appropriately adjust for the risks of illiquidity and correlation; indeed, that is what a haircutting approach is specifically designed to do, and why such approaches are recognized in various margin type requirements around the globe and throughout the U.S. financial system.[34]

We note that the Commission's approach would be appropriate if there were no other risk-based limits on fund portfolios beyond asset segregation and risk-based coverage amounts. However, the Proposed Rule does contain other risk-based limits that will prevent a fund from unlimited derivatives use, and all of our proposals with respect to risk-based limits would do the same. The limited asset segregation approach proposed by the Commission is effectively a "belt and suspenders" approach that would not advance the regulatory goals expressed in the Proposing Release. Accordingly, we urge the Commission to either adjust the asset segregation requirements or dispense with risk-based limits.

(2) <u>For certain types of financial commitments, requiring asset segregation will have deleterious effects on funds and on capital markets</u>

Under the Proposed Rule, the Commission proposes to treat any "agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner" as a "financial commitment transaction." Such treatment will have an unduly burdensome impact on BDCs, certain closed-end funds and on funds of private equity funds. This burden easily can be avoided without permitting undue speculation.

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[32] *See* Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996), https://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf.

[33] We note that the Commission has proposed a separate rule regarding the liquidity of investments held by open-end funds. *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release Nos. 33-9922; IC-31835 (September 22, 2015), https://www.sec.gov/rules/proposed/2015/33-9922.pdf ("Liquidity Management Release").We believe one reasonable approach would be to apply haircuts (discussed generally further below) based on liquidity categories that may be adopted by the Commission.

[34] We also note that cash and cash equivalents can be correlated to underlying derivatives, most obviously currency derivatives that are short the U.S. dollar.

BDCs are a significant source of financing for small- and medium-sized companies in the United States, and it is well documented that financing for such companies has generally become less available in recent periods from banks for a variety of reasons, including regulatory changes.[35] Much of this financing includes credit instruments such as delayed draw term loans, conditional bridge loans and revolving lines of credit (i.e., a commitment to make a loan to a company). These loans are typically contingent in nature, and may require the attainment of certain pre-established metrics of growth and sustainability by the borrower or the occurrence of certain events. The Proposed Rule would have the effect of drastically limiting the ability of BDCs and certain closed-end funds (including real estate closed-end funds that make similar types of loan commitments with respect to underlying assets) to provide such crucial financing. We assume that the Commission did not intend for the Proposed Rule to have this effect on efficiency, competition and capital formation.[36]

We believe that the Proposed Rule, appropriately interpreted, may provide one potential solution to this problem. Specifically, we note that the Proposed Rule requires segregation of "*assets* that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund *can be expected* to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, *determined in accordance with policies and procedures approved by the fund's board of directors*…." (emphases added). We believe that, were the Commission to confirm three points below, some of the negative effects of the proposed formulation with respect to BDCs and certain closed-end funds would be mitigated. In particular, we ask the Commission to confirm that:

- "Assets" include available lines of credit for the fund and any uncalled loan amounts whose obligations are treated as liabilities. As we have discussed above, closed-end funds and BDCs, by statutory design, history and operation, use leverage for investment purposes to a greater extent than open-end funds. A line of credit that is expressly permitted to be used for investment purposes should be considered an asset of a fund for purposes of satisfying its obligations.

  Also, we understand that BDCs typically calculate their asset coverage rations using the definition of "liability" under Generally Accepted Accounting Principles ("GAAP"), pursuant to which a commitment to make a loan that will not be called or funded unless several pre-conditions occur is not an expressed liability of a fund, because of its contingent nature. If the pre-conditions occur and the loan is called and funded, then the fund will immediately have a

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[35] Congress established the BDC structure in 1980 as a "means of making capital more readily available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing." *See* Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, SEC Release No. IC-27538 (October 25, 2006), https://www.sec.gov/rules/final/2006/ic-27538.pdf (citing H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980)).

[36] In this connection, we note that the financial commitments addressed in Release 10666 were not contingent obligations. We do not raise any objections to the Commission subjecting unconditional financial commitments, such as those discussed in Release 10666, to the requirements of the Proposed Rule.

corresponding asset under GAAP. Those contingent assets are also not shown on the books of a fund, but for purposes of the exposure calculations and asset segregation requirements, we see no reason to treat a contingent liability different than a contingent asset. Accordingly, we believe that both should be counted in calculating a fund's exposure under the Proposed Rule to avoid creating any inconsistency between the rule and GAAP.

- The amount of an obligation that a fund "can be expected" to pay, for a loan commitment, is a subjective assessment as opposed to a simple aggregation of outstanding commitments. This assessment is necessarily a complicated analysis based on an understanding of prevailing and expected market conditions, both on macro and micro levels, and it is highly unlikely to be the case that all loan commitments, in whole or in part, would become payable at any given point in time.

- The board may approve policies and procedures reasonably designed by the adviser to maintain assets sufficient to cover obligations that a fund may be expected to pay.[37]

Absent such interpretative guidance, we urge the Commission to exempt loans made by BDCs and closed-end funds to portfolio companies from any adopted rule with respect to notional limits or asset segregation, so as to avoid disruptive effects for U.S. capital markets that could frustrate the original Congressional intent underlying the enactment of BDC provisions in the 1940 Act.

A similar issue exists with respect to investments in private funds, including by funds of private funds, and particularly with respect to investments in private equity funds.[38] These underlying private equity funds typically call capital from their investors over an extended period of time, and we believe nearly all do not call all committed capital within the first year after the inception of the private equity fund. A registered fund of funds that invests in private equity funds may commit to investing in such private equity funds at the outset, or may commit to co-investments alongside new or existing private equity funds on a deal-by-deal basis, or may purchase private equity fund interests in a secondary market transaction (so-called "secondaries"). To facilitate exposure to private equity transactions, a registered fund of funds would normally maintain a robust portfolio of secondaries timed to return capital in a manner that would facilitate the satisfaction of capital calls from primary investments. Maintaining the entire amount of capital that may be called from primary investments[39] in liquid assets would

[37] We believe that it is unnecessary for the Commission to require a board to adopt any specific policies or procedures in connection with the Proposed Rule, as Rule 38a-1 under the 1940 Act automatically will require boards to approve any policies and procedures that a fund or its adviser adopt in connection with the rule.

[38] By private equity funds, we refer primarily to closed-ended "draw down" funds that have a finite life and call commitments from investors (usually limited partners) as investments consistent with the fund's investment objective become available.

[39] It is worth noting that many interests in private equity funds acquired in the secondary market typically have associated unfunded capital commitments, even if the funds being transferred are beyond their investment periods. By practice, general partners of private equity funds do not release capital commitments in the ordinary course, for a

completely frustrate the purpose of these investment vehicles, which have been approved by the Staff after extensive review and been made subject to certain special conditions, including that such funds only be made available to sophisticated investors. We again assume that the Commission did not intend for the Proposed Rule to have this effect on efficiency, competition and capital formation.

As with BDCs, Commission guidance that "assets" includes available lines of credit, that amounts "can be expected" to be paid are subjective assessments and that such subjective assessments may be made subject to policies and procedures approved by a board, would in our view greatly reduce the negative effects that may otherwise result. We understand that the Private Equity Growth Capital Council will submit comments addressing the effects of the Proposed Rules on registered funds of private funds, and we refer you to that letter for further comments on this important topic.

C. The Commission should provide for existing, innovative funds to continue to exist, and provide for future innovation.

(1) <u>Funds that were in registration prior to the Proposing Release should be permitted to continue to operate in accordance with current guidance.</u>

As we have noted, we believe that many funds that currently operate would be unable to do so if forced to comply with the Proposed Rule as formulated. If the Commission declines to adopt any proposals contained herein or proposed by others, we strongly urge the Commission to consider "grandfathering" certain funds that had filed initial registration statements prior to the publication of the Proposing Release.

For at least the last 35 years, funds have been created and have operated under a regulatory framework that permits the use of derivatives if compliant with a series of Commission guidance and Staff positions. One can believe that the framework was not perfectly designed but still acknowledge that a large number of funds have relied on that framework to invest money, devote time and other resources, hire people to perform portfolio, management, operational, legal, compliance and trading functions and meet investor demand. That reliance should be considered carefully, in our view, in crafting any final rulemaking. Congress and the Commission have considered this in the past, as there are several examples of grandfathering provisions throughout the 1940 Act and the rules promulgated thereunder.[40]

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variety of corporate and investment reasons. However, it is frequently the case that such unfunded commitments are not called in full or even in any material part after the investment period has passed. Under the Proposed Rule, even such latent commitments would potentially require asset segregation, absent the guidance we seek from the Commission.

[40] *See, e.g.*, 15 U.S. Code § 80a–3(c)(7)(B) (allowing a fund previously relying on the exemption under Section 3(c)(1) to instead rely Section 3(c)(7), which was added to the statute in the National Securities Markets Improvement Act of 1996 ("NSMIA")); 17 CFR 270.2a51-2 (grandfathering the beneficial ownership treatment of certain funds relying on Section 3(c)(1) in connection with NSMIA); 17 CFR 270.6c-6 (grandfathering exemptive orders that had been issued to certain insurance company separate accounts regarding creation of new accounts prior to enactment of the rule); 17 CFR 270.35d-1 (grandfather the names of certain unit investment trusts that had been in existence prior to the enactment of the rule).

We believe that a fund that operates under current rules and guidance and could not operate under the Rule should be permitted the option of electing to continue to operate its current investment strategy with prominent disclosure that the fund does not operate under Rule 18f-4. Funds would be required to file an election with the Commission, and include disclosure in offering documents that would make clear to investors that the fund may not comply with the aggregate exposure limits set forth in any final rule, allowing investors make an informed choice as to whether or not to invest or maintain an investment. To limit the ability of funds to simply opt out of any new rule, we suggest that the Commission grant a fund the ability to operate under the existing framework only if it can demonstrate in writing that it would have been unable to operate under the final formulation of the rule at some point in the one year period prior to the publication of the Proposing Release or, for a fund that is not yet in operation but began the registration process prior to the date of the Proposing Release, demonstrate by providing a model portfolio that it would not be able to operate under the final rule.

While we believe that the Commission should grandfather existing funds entirely, to permit orderly liquidations of funds that cannot operate under any final rule the Commission will at a minimum need to (i) grandfather such funds on a temporary basis or (ii) the provide for an expedited process for the formation of liquidating trusts, similar to an application granted earlier this year.[41] In particular, the Commission must provide for opportunities for closed-end funds to liquidate over time, so as not to force sale of illiquid assets at fire sale prices. One paradigmatic case the Commission should consider is an interval fund that has committed to redeeming up to 5% of its shares per quarter. Such a fund will have been set up to be able to liquidate 5% of its assets per quarter, but may have very little additional liquidity in its investment portfolio, and forcing a liquidation at a faster pace than anticipated may have other negative effects on the portfolio and the remaining shareholders. Such a fund needs to be permitted to have at least 5 years (at a rate of 5% per quarter) to liquidate.

(2) The Commission should acknowledge explicitly that it may grant exemptions to any final rule, and clarify the standards under which such exemptions will be considered.

In addition to the proposals we have set forth above, we ask that the Commission specifically provide for a mechanism that would allow a fund to apply for an order exempting the fund from some or all of the requirements of any final Rule 18f-4, if the fund can demonstrate that its strategy does not implicate the concerns identified by the Commission in the Proposing Release (i.e., excessive borrowing and undue speculation). The exemptive order mechanism is the means by which the Commission has enabled innovation in many respects during the past 75 years. Without this process, exchange-traded funds would not exist, many fund of funds arrangements would not be permissible and many manager of managers structures would be unduly burdensome to operate, to cite just a few examples. We have stated above that the Proposed Rule, if adopted, might have the effect of limiting future innovation in the fund industry. A robust exemptive order process would mitigate such effect to an important degree.

[41] *See* Third Avenue Trust and Third Avenue Management LLC, SEC Release No. IC-31943 (Dec. 16, 2015) (notice of application and temporary order), https://www.sec.gov/rules/ic/2015/ic-31943.pdf.

As we have stated several times, we anticipate that any final rule will have the effect of forcing some funds, even ones that do not raise any undue leverage or speculation concerns, to liquidate or deregister from the 1940 Act. We urge the Commission to (1) clarify that exemptions to the rule will be considered for funds that do not raise any undue leverage or risk concerns and (2) to delay implementation of any final rule until such time as timely exemptive applications may be considered.

To facilitate innovation, we recommend that the provision added to Rule 18f-4 that provides for the standards for considering exemptions incorporate provisions similar to other sections of the 1940 Act, such as Section 3(b)(2), that provide that exemptive applications filed in good faith will provide an exemption to the applicant while the application is pending.

We believe that the Commission has the authority to grant future exemptions from the rule pursuant to Section 6(c) of the 1940 Act, but we nonetheless recommend inclusion of a provision in the final rule so that the standards for review are clear, and so that the issue is free from doubt. If the Commission declines this approach, we respectfully request confirmation of our view that the Commission may exempt funds in the future from any final rule, and clarify whether the standards for such review will be other than as suggested herein.

D. The Proposed Rule should be reconsidered following adoption of related rule proposals.

In proposing a derivatives rule before finalizing and implementing new data reporting, liquidity management and stress-testing rules, we believe that the Commission has put the cart before the proverbial horse. The Proposed Rule provides for notional limits that are based in part on an economic analysis of fund holdings, but the Commission has yet to finalize its proposed rulemaking that will provide it with significantly more detailed and real-time access to fund holdings information.[42] The Proposed Rule provides for asset segregation requirements that are tied to the liquidity of the coverage assets, while the Commission is still considering a proposed rule that would redefine how funds assess portfolio liquidity.[43] The Proposed Rule contains a requirement to consider risk-based adjustments for asset coverage, yet the Commission has yet to release its forthcoming rule proposal regarding standards for stress-testing fund portfolios.[44]

The Proposed Rule intends to revise and reshape regulation of the contents of a fund's portfolio in a fundamental way. It draws upon other current rule-making initiatives, and should properly follow, not precede, those other initiatives. We strongly urge the Commission to re-propose a rule regulating derivatives use after it has determined an approach on these other

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[42] *See* Investment Company Reporting Modernization, SEC Release Nos. 33-9776; 34-75002; IC-31610 (May 20, 2015), https://www.sec.gov/rules/proposed/2015/33-9776.pdf.

[43] *See* Liquidity Management Release, *supra* note 33.

[44] *See* Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014), https://www.sec.gov/News/Speech/Detail/Speech/1370543677722 (announcing upcoming Commission rulemakings, including stress testing).

initiatives and has access to the data needed to make a more informed analysis of the economic consequences, costs and benefits of any proposed derivatives rule, as Commissioner Piwowar suggested in his dissent regarding the Proposed Rule.[45] The Commission's current derivatives regulatory framework has existed for 35 years without causing any significant systemic disruptions of the financial system and, accordingly, the Commission should proceed with care and due deliberation to ensure that the new framework is properly structured.

IV. Conclusion

We appreciate the opportunity to submit, and the Commission's consideration of, our comments. Should the Commission have any questions regarding these comments, please feel free to contact Rajib Chanda at [redacted] or [redacted].

Sincerely,

Simpson Thacher & Bartlett LLP

Simpson Thacher & Bartlett LLP

cc: Sarah E. Cogan, Esq.
Jonathan Lindabury, Esq.
Rafael Vasquez, Esq.
Benjamin Wells, Esq.
Christopher P. Healey, Esq.

[45] *See* Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015), http://www.sec.gov/news/statement/piwowar-dissentingstatement-use-of-derivatives-funds.html.