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March 28, 2016

Re: **File No. S7-24-15**

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

Dear Mr. Fields:

We are writing in response to the request by the Securities and Exchange Commission (the "**Commission**") for comments regarding Investment Company Act Release No. IC-31933, Use of Derivatives by Registered Investment Companies and Business Development Companies (the "**Proposal**"), which would add a new Rule 18f-4 (the "**Proposed Rule**") under the Investment Company Act of 1940 (as amended, the "**Investment Company Act**" or the "**Act**").[1] We recognize and support the ongoing efforts of the Commission and its staff (the "**Staff**") to provide guidance regarding the use of derivatives by investment companies registered with the Commission under the Act and the Commission's efforts toward a more comprehensive and systematic approach to derivatives-related issues under the Act. We appreciate the opportunity to comment on the issues raised in the Proposal.[2]

The Proposal notes that the Commission and the Staff have long been concerned with registered funds' use of derivatives. Beginning with Release 10666[3] in 1979 and continuing in a series of no-action letters and comments to fund registration statements in the years following

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf. Terms defined in the Proposed Rule and used herein have the meanings ascribed to them in the Proposed Rule.

[2] The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.

[3] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25,128 (Apr. 27, 1979) (hereinafter "Release 10,666").

the release, the Commission and the Staff have provided guidance on how registered funds may use derivatives. However, because the guidance in this area was developed in stages, and sometimes informally, there has frequently been confusion among funds as to how to apply the guidance and we appreciate that the Proposal will provide more clarity on many of the issues.[4] We support in particular:

- eliminating the distinction between physically settled and cash-settled derivatives, and
- allowing all pledged assets (regardless of settlement date) to be used as qualifying coverage assets for financial commitment transactions.

We believe however that there are still issues that the Commission should address prior to finalizing the Proposal, including:

- reducing the burden on a fund's board,
- clarifying the role of the derivatives risk officer versus the role of a fund's chief compliance officer,
- revising the exposure limits for business development companies,
- eliminating the cap on exposure for risk-reducing transactions,
- clarifying the interaction with other Section 18 indebtedness,
- clarifying certain definitions in the Proposal, and
- clarifying the treatment of to-be-announced mortgage-backed securities under the Proposal.

We address each of these points below, but first we would like to make two points about items in the Proposal that we believe are particularly important to retain in the final rule.

We Support the Proposal's Elimination of the Distinction Between Physically Settled and Cash-Settled Derivatives

We support the Proposal's elimination of distinctions between cash-settled and physically settled derivatives.[5] The current distinction causes many funds to hold cash-settled instruments rather than physically settled instruments even though the cash-settled instruments may be more expensive. By treating derivatives with economically similar exposure the same, regardless of the specific method of settlement, the Proposal recognizes the underlying economic reality of the instruments and removes incentives that often pushed funds to select certain instruments over others without a valid economic reason. This rationalization of the regulatory approach helps investors by allowing fund managers to select the appropriate instrument for their funds without arbitrary regulatory distinctions.

We Support the Proposal's Allowing All Pledged Assets (Regardless of Settlement Date) to Qualify as Qualifying Coverage Assets for Financial Commitment Transactions

[4] *See* Proposal, *supra* note 1 at 80,888-89.

[5] We note that the Proposal appropriately allows the asset to be delivered under a physically settled instrument to be used as a qualifying coverage asset for a physically settled transaction and we support this treatment. *See* Proposed Rule at (c)(8)(ii).

In order to satisfy its obligation to maintain qualifying coverage assets for a financial commitment transaction, the Proposal allows a fund to count assets "that have been pledged with respect to the financial commitment obligation" without regard to settlement date.[6] We agree that it is important not to require that pledged assets generate cash prior to the date on which the obligation is due because such a requirement could prevent a fund from using liquid securities that have a T+2 settlement date from being used to satisfy the coverage test for a short position that settles in one day—thus making it difficult to run, for example, a "130/30" fund.

We believe that the Proposal should be clarified or amended to address the items below.

The Proposal Should be Amended to Reduce the Burden on the Board of the Fund

In addition to the many oversight responsibilities a fund board already has, the Proposal adds a new set of requirements for derivatives, including approval of the derivatives risk officer ("**DRO**"), approval of the particular portfolio limitation a fund will comply with, approval of the fund's derivatives risk management program, and approval of policies and procedures for maintenance of qualifying coverage assets. Even boards of funds that do not use significant amounts of derivatives – or any at all – will have additional requirements as they will need to approve and monitor the policies and procedures necessary to keep the fund from being required to have a derivatives risk management program. We understand that, by placing these responsibilities on the fund board, the Commission intended to highlight how important derivatives risks are, but we are concerned that certain of these requirements may be beyond the board's expertise and will require new and expensive compliance operations without a corresponding increase in investor protection. Instead, we propose shifting certain of these responsibilities onto other parties who have the expertise necessary to handle them and placing the board in a more traditional oversight role.

First, we believe that the requirement that the board approve the DRO should be removed. We believe that the DRO should be treated in the same manner as the portfolio managers and the regular risk officer of a fund. The personnel who perform these functions are considered by the board when the contract with the adviser is reviewed. To single out the DRO as opposed to the portfolio manager or regular risk officer seems unwarranted and starts down a path of having the board approve all employees, which is both outside the board's traditional role and not an efficient use of scarce board resources. A board will be able to assess the quality of all of an adviser's key personnel during the annual contract review process, and there appears to be no reason to treat the DRO differently.[7]

Second, the Proposal will require fund boards to approve the specific portfolio limit for a fund. While the Proposal does not provide specific guidance on the process a fund board should use to set the limit, we assume it will be generally similar to the process a board engages in when it approves a fund's investment objective. If the Commission imagines a different or higher standard of review by the board when approving the portfolio limit, we are opposed to such a requirement as it injects the board into management functions it is not equipped to carry out. To eliminate any confusion over the board's role, we suggest eliminating the requirement in the

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[6] Proposed Rule at (c)(8)(iii).

[7] We believe that CCOs represent a unique circumstance where direct reporting to, and approval by, the board are appropriate due to the nature of the CCO's job, which is in part to manage the potential conflicts between the fund and its adviser.

Proposal that the board approve the limit as it suggests a requirement for the board to do something beyond the process already in place to approve a fund's investment objective and guidelines.

Third, the proposal requires that the board approve the derivatives risk management program as well as policies and procedures designed to provide for the maintenance of qualifying coverage assets. We believe the Commission should eliminate these requirements as the board already has the responsibility under Rule 38a-1 to approve a fund's compliance policies. The Proposed Rule's singling out of the procedures relating to derivatives for board approval could be interpreted to mean that a board has a higher or different obligation with respect to derivatives policies and procedures than with respect to other compliance procedures such as those relating to conflicts of interest or disclosure. We believe imposing such an obligation with respect to derivatives procedures is particularly unwarranted given the technical nature of the required derivatives rules, such as developing the specific formulas for calculating VaR and detailed models to forecast economic conditions (to ensure that a fund's risk-based coverage amount is sufficient). We urge the Commission to consider the cumulative effect of these additional requirements in light of the many responsibilities a board already has. Moreover, placing a special duty on boards with respect to derivatives could cause boards to hire experts who are more versed in the technical area of derivatives management, the costs of which will be passed on to investors in the form of higher fees or expenses. We urge the Commission to eliminate the specific requirement that the board approve the policies and procedures with respect to qualifying coverage assets and with respect to approval of the derivatives risk management program. The board would then be able to oversee the program and procedures with respect to derivatives in the same manner that the board oversees the policies and procedures with respect to other requirements of the Act.

The Proposal Should be Amended to Clarify That the CCO is Not Responsible for Derivatives Policies, Procedures, and Compliance

It is clear in the Proposal that the DRO will be responsible for all the policies and procedures called for by the Proposal, including the policies and procedures for maintaining the proper amount of qualifying coverage assets, monitoring the amount of derivatives, ensuring segregation between portfolio management and risk management, and periodically reviewing and updating the policies and procedures. The Proposal, however, is silent on the role the chief compliance officer ("**CCO**") will play with respect to derivatives. For example, is the CCO also responsible for administering the compliance procedures with respect to derivatives risk management and maintenance of qualifying coverage assets? We believe that having two people responsible for these tasks could cause confusion over who is ultimately responsible for the proper implementation of the derivatives risk management program and would add additional unnecessary costs. We propose that the Commission add language in the final release making clear that the CCO is not also responsible for these areas or that the CCO may rely on a representation from the DRO about the sufficiency of the fund's derivatives-related policies and procedures rather than requiring the CCO to duplicate the DRO's work. Given the technical nature of a derivatives risk management program, which may well be outside a CCO's expertise, we believe it would be unfair to ask CCOs to independently assess these policies.[8]

[8] There may be cases where the CCO does have the technical expertise and is made the DRO. In these cases, the CCO, in its capacity as DRO, will be able to oversee the derivatives program.

The Proposal Should be Amended to Allow Business Development Companies to Have Exposure of 200% Rather than 150%

We believe the Proposal should provide that the requirement that a fund limit its exposure to derivatives to 150% when the derivatives are not risk-reducing should not apply to business development companies ("**BDCs**"). Instead, BDCs should be permitted to have derivatives exposure of up to 200%. BDCs currently are able to issue senior securities so long as they maintain 200% asset coverage, rather than the 300% asset coverage generally required of other registered funds.[9] We believe that applying an increased exposure limit to business development companies would be consistent with Congress's intent to allow BDCs greater flexibility than other funds when incurring leverage (whether through issuing securities or entering into derivatives).

The Proposal Should be Amended to Eliminate the 300% Exposure Limit on Risk-Reducing Hedging Transactions

We believe the 300% exposure cap on risk-reducing derivatives transactions should be eliminated. In many cases, funds will become *more* risky when they comply with the rule, rather than less risky, because derivatives are often used to hedge risks and funds will now be limited in the amount of hedging in which they can engage. Funds will still be able to hold the underlying risky assets, but may not be able to fully hedge their exposure, which ultimately could lead to greater investor losses. Because the 300% exposure cap for risk-reducing derivatives seems arbitrary and will ultimately result in some fund investors bearing more, not less, risk, we believe it would be appropriate to remove the cap for risk-reducing derivatives transactions altogether. Such an approach would be consistent with other Commission rules where otherwise prohibited transactions are allowed so long as they are made with the bona fide intent to reduce risks.[10]

The Proposal Should be Amended to Clarify That "Senior Securities" Are Not "Securities" for All Purposes of the Act

Although the Commission has long regulated funds' holdings of derivatives by reference to § 18 of the Act, which governs funds' use of "senior securities," we believe the Proposal marks the first time the Commission has ever expressly held that derivatives and financial commitments are senior securities.[11] We are concerned that defining derivatives and financial commitments as senior securities may raise questions about whether they are also "securities" for the purposes of other parts of the Act, including the status test, which generally requires companies that hold more than 40% of their assets in "securities" to register as investment companies.[12] Under current guidance, we believe it is clear that the Commission believes that characterization as a "senior security" for purposes of § 18 does not necessarily imply that an instrument is also a

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[9] *See, e.g.*, 15 U.S.C. § 80a-60(a)(1).

[10] *See, e.g.*, 17 C.F.R. 255.5(a) (exempting certain "risk-mitigating hedging" transactions from the requirements of the Volcker Rule.)

[11] Proposal, *supra* note 1 at 80,889 & n.62 ("The trading practices described in Release 10666, as well as short sales of securities for which the staff initially developed the segregated account approach we applied in Release 10666, all impose on a fund a conditional or unconditional contractual obligation to pay or deliver assets in the future to a counterparty and thus involve the issuance of a senior security for purposes of section 18.")

[12] 15 U.S.C. § 80a-3(a)(1)(C).

"security" for the purposes of other parts of the Act or other federal securities laws,[13] but when the Proposal is adopted, that guidance will be rescinded.[14] As such, we request that the Commission reiterate that a § 18 senior security will not necessarily be considered a security for purposes of other parts of the Act or other federal securities laws. If the Commission does not take this step, the status under the Act of many operating companies that use derivatives for bona fide business purposes could be called into question, which we believe the Commission does not intend.

The Proposal Should be Amended to Clarify that Derivatives Are Not Subject to Section 18 Asset Coverage Requirements When a Fund has Issued Other Senior Securities[15]

The Proposal exempts derivatives from the asset coverage requirement in § 18(a), meaning a fund engaging in derivatives transactions in compliance with the Proposed Rule need not maintain 300% asset coverage with respect to such derivatives transactions merely as a result of entering into such transactions. This is consistent with what we understand to be the Commission's intent to create a separate regime to govern derivatives transactions. We believe this intent, however, is undermined by the Proposal's apparent classification of derivatives and financial commitment transactions as senior securities representing indebtedness, as this classification will, instead of creating separate regimes, commingle the regime under the Proposal with the Section 18 asset coverage regime for any fund that *also issues other senior securities*.

This commingling of the regimes is caused by a technical issue related to the Commission's decision only to exempt derivatives from § 18(a) and not from § 18(h), which contains the definition of "asset coverage."[16] When a fund borrows from a bank or otherwise issues senior securities not exempt under the Proposed Rule from § 18(a), the fund must generally have at least 300% asset coverage. Under § 18(h), a fund's asset coverage is calculated as a fraction, the numerator of which is the amount of total assets of the fund minus its liabilities and indebtedness not represented by senior securities, and the denominator is the value of the aggregate amount of "senior securities representing indebtedness." Because the Proposal defines derivatives as "senior securities," we believe the Proposal will require them to be counted in the denominator of the equation. As such, a fund that computes its asset coverage ratio for the purpose of entering into transactions such as bank loans would have its derivatives holdings counted as senior securities requiring 300% coverage. In contrast, if a fund only entered into derivatives and not bank loans, the fund would not be required to have 300% asset coverage of its derivatives.

For example, if a fund had $100 in total assets and no bank loans or other traditional senior securities, the Proposal will allow it to have derivative obligations of up to $100.[17] No asset coverage requirement under § 18(h) would be implicated. If, however, the fund borrows

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[13] *See, e.g.*, Release 10,666, *supra* note 3 at 25,131 (noting special legislative purpose of § 18).

[14] Proposal, *supra* note 1 at 80,953 ("If we adopt proposed rule 18f–4, we would rescind Release 10666 and our staff's no-action letters addressing derivatives and financial commitment transactions.")

[15] This discussion applies equally to financial commitment transactions.

[16] 15 U.S.C. § 80a-18(h).

[17] The aggregate mark-to-market value of the derivatives and financial commitments will not be able to exceed $100 due to the asset segregation requirement. In practice, the risk-based coverage amount will reduce this further, but for the sake of simplicity we assume here that no risk-based coverage amount is segregated.

one dollar from a bank the formula in § 18(h) will be triggered for determining the appropriate amount of asset coverage for the fund and the fund will only be able to have $32.66 in derivative obligations[18] because it will need to have 300% coverage for the derivative obligations as well as for the one dollar bank loan.

The fact that a one dollar bank loan can so dramatically change the amount of permissible derivatives exemplifies the need for clarification of the interplay between § 18 and derivatives. Otherwise, we believe the Proposal will have the incongruous result of causing registered funds to make derivatives a *larger* part of their capital structure, rather than reducing their use, as we believe was intended. The Commission could fix this issue by providing in the final rule that "derivatives transactions and financial commitment transactions entered into by a fund in compliance with this section shall be deemed not to be senior securities representing indebtedness for purposes of § 18(h) of the Investment Company Act."

Under this approach, derivatives transactions and financial commitment transactions would be excluded from the denominator of the asset coverage formula in § 18(h), such that merely borrowing from a bank or issuing other senior securities would not trigger 300% asset coverage for derivative or financial commitment transactions. Derivative and financial commitment transactions would, however, constitute "indebtedness not represented by senior securities," for purposes of the numerator of the formula and thus assets representing derivatives could not be used for asset coverage of other senior securities.

The Proposal Should be Amended to Clarify the Definition of Risk-Based Coverage Amount

Under the Proposal, a fund must maintain qualifying coverage assets whose value is "equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts,"[19] Because the risk-based coverage amount is defined as an amount "in addition to" the mark-to-market amount, the Proposal is ambiguous as to whether the mark-to-market amount should be counted twice. Is "in addition to" intended only to mean the extra amount payable to exit in stressed conditions rather than normal conditions or does it mean that extra amount plus the mark-to-market amount? In order to correct this ambiguity, we suggest that the Commission amend the definition of risk-based coverage amount by inserting the following <u>underlined</u> language and deleting the following ~~stricken~~ language: "*Risk-based coverage amount* means, for each derivatives transaction, an amount~~, in addition to the derivative transaction's mark-to-market coverage amount,~~ that represents, at any time of determination under this section, a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions <u>and that is not already included in the mark-to-market coverage amount for such derivatives transaction</u>. . . ."

The Proposal Should be Amended to Clarify the Treatment of To-Be-Announced Securities

A number of our clients have asked us whether to-be-announced mortgage-backed securities ("**TBAs**") will be treated as financial commitments under the Proposal. We assume that they will be treated as financial commitments during the period between the trade date and

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[18] $101 (total assets after loan) divided by three (asset coverage requirement) equals $33.66 of permissible senior securities. If there is a $1.00 bank loan, there would be $32.66 available for other senior securities such as derivatives.

[19] Proposed Rule at (c)(2).

settlement date. The TBA market allows purchasers of mortgage-backed securities ("**MBS**") to treat the securities as fungible even when they do not know the exact mortgage pools that will make up the MBS at the time the trade is initiated.[20] Typically, a fund buying a TBA commits to purchasing an MBS a period of weeks or months prior to the anticipated closing of the MBS. All material terms of the transaction are agreed to at that time, including the issuer, maturity, coupon, face value, price, and settlement date of the MBS.[21] Then, 48 hours prior to the settlement date, the buyer is informed of the specific pools that will be part of the transaction, which is settled on the settlement date.

Because the commitment to buy is made on the trade date, but no money changes hands until the settlement date, we believe it would be appropriate for funds purchasing TBAs to treat them as financial commitments between the trade date and the settlement date. If the Commission disagrees with our analysis, we think it would be appropriate to be more explicit about how TBAs should be treated in the final rule.

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We appreciate the opportunity to respond to the Commission's request for comments, and we hope that these comments and observations contribute to the important work of the Commission. If you would like to discuss any of the matters raised in this letter, please do not hesitate to contact Nora Jordan at [redacted] or Gregory Rowland at [redacted].

Very truly yours,

Davis Polk + Wardwell LLP

DAVIS POLK & WARDWELL LLP

[20] *See* Chris Killian, *SIFMA TBA Market Fact Sheet*, SEC. INDUS. & FIN. MKTS. ASSOC. (2015) https://www.sifma.org/WorkArea/DownloadAsset.aspx?id=23775.

[21] *Id.*