March 28, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies
Release No.: IC-31933; File No.: S7-24-15

Dear Mr. Fields:

I appreciate the opportunity to comment on the proposed rule, and I support the Commission in making much-needed strides toward greater investor protection and market integrity with respect to the highly leveraged investment strategies of hedge funds and their use of derivatives transactions. While derivatives transactions provide many valuable benefits to funds and investors in the short-term, they also carry disproportionate levels of risk and thus should not be left to create in hedge funds the highly leveraged capital structures that existed in financial institutions in the run-up to 2007-2008 market crisis, the aftermath of which the global economy is still absorbing. As proposed, rule 18f-4 is well-tailored to suit its goals of addressing the undue speculation and asset sufficiency concerns of section 1(b)(7) and 1(b)(8) of the Investment Company Act, and I support the passing of this rule.

I. Discussion of Proposed Rule's Portfolio Limitations Requirement

a. General support for the portfolio limitations requirement

Requiring a fund that engages in derivatives transactions to comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through such transactions is a sensible way to address the undue speculation concern of Investment Company Act and reflects the realities of the asset management industry today. The Commission has provided two alternatives from which a fund must choose as best suits its investment strategy, and thus allows a measure of flexibility and freedom to investment managers. This permits an investment manager to use his professional expertise, experience, and knowledge of the fund's investment strategy and portfolio in choosing the best mode of compliance, *i.e.*, whether to limit the fund's exposure to 150% of the its net assets or to 300% of its net assets with the provision of a variance-at-risk based (VaR) test. Significantly, the Commission has foregone establishing a one-size-fits-all rule of capping all funds' exposure levels at 150%, thus acknowledging funds' common and prudent practice of managing market risk by hedging derivatives transactions with countervailing transactions. The provision of two alternatives balances the legislative concern of undue speculation with the private concern of business judgment.

b. Suggestions for improving the portfolio limitations requirement

1. **Set the lower exposure limit of 100% of the fund's net assets.** The first portfolio limitation alternative allowing exposure to reach up to 150% of the fund's nest assets makes a policy choice regarding how much exposure to allow without requiring the fund to perform a VaR test. The proposed rule discusses why 150% has emerged as the settled-upon limit, citing numerous commenters who make the point that funds may use derivatives for a range of purposes other than specifically to obtain leverage, including hedging or risk-mitigation. However, this point parallels the argument for the second portfolio limit alternative that allows exposure at up to 300% of a fund's net assets but only if accompanied by a VaR test. Because funds are permitted to increase their exposure levels for the purpose of hedging and risk-mitigation with the provision of the more nuanced second portfolio limit alternative, it seems unduly permissive to also allow funds to do so within the first portfolio limit alternative which does not require a VaR test. If that is the only reason for allowing an exposure limit of 150% of net assets as opposed to lower limits such as 100% or 50%, I do not find such a reason compelling in light of the undue speculation concerns of section 1(b)(7).

Instead of a 150% exposure limit, the lower limit of 100% of net assets is more appropriate. Most funds are likely to be under the 100% mark already in this pre-rule 18f-4 climate and would not have to change its exposure level, as reflected in the DERA white paper's finding that the 32% of funds holding derivatives had an average gross notional amount of 20% of the net asset value, with a 68% standard deviation.[1] A lower limit of 100% would thus maintain the desired effect of not requiring most funds to change in order to comply with the new rule, which would incur costs, but also would be adequately tight so as not to encourage funds not presently leveraged at exposure levels beyond 100% of net assets to increase exposure up to 150% without needing to perform a VaR test. In addition, the 100% limit would still target the handful of funds that are exposed at up to ten times the value of their net assets. In light of the August 2009 Investor Alert regarding leveraged ETFs, the Commission's ongoing concerns regarding funds' use of derivatives, and the second portfolio limitation allowing higher exposure limits but requiring VaR tests, the first portfolio limitation should set a lower exposure limit of 100% of net assets.

2. **Enable an evolving definition of "notional amount."** To the extent that notional amount is a reasonable method for calculating a fund's exposure, the Commission should include as many relevant types of derivatives transactions as possible based on comments regarding what types of instruments ought to be included in the definition of notional amount. However, the Commission should also leave sufficient room for future amended rulemaking or Commission adjudicatory discretion to address new instruments that may and likely will emerge. The assets management industry capitalizes on novelty of instrument, on the ability to forge new ways to

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[1] Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Investment Companies*, Division of Economic and Risk Analysis (2015) ("DERA White Paper") at Table 6, Panel A.

bundle risks and beat the market before competitors and regulation can undo an advantage gained. In such a context, rules are endangered by obsolescence upon their issuance.

II. Support for Proposed Rule's Asset Segregation Requirement

I support the proposed rule's asset segregation requirement. The Commission sets forth a sensible solution to 1(b)(8) asset sufficiency concerns in its requirement to segregate qualifying coverage assets sufficient to cover the fund's mark-to-market obligations under a derivatives transaction and an additional amount determined in accordance with policies and procedures approved by the fund's board. Allowing the additional amount to be determined in accordance with board-approved policies and procedures strikes the right balance between a bright-line rule of requiring assets sufficient to cover mark-to-market obligations and deference to the funds' business judgment. In addition, the requirement of cash or cash equivalents for qualifying coverage assets enables liquidity while also curtailing the danger of the asset declining in value at the same time the fund experiences losses on the derivatives transaction.

III. Discussion of Proposed Rule's Formalized Derivatives Risk Management Program Requirement

a. General support for the formalized derivatives risk management program

The proposed rule's formalized derivatives risk management program requirement for all funds engaging in derivatives transactions amounting to an aggregate exposure beyond 50% of net assets is generally a good idea in consideration of the varied risks that arise from funds' use of derivatives transactions and the benefits that come from improved investor confidence. In particular, the 50% exposure threshold, below which a fund must still manage risks arising from derivatives transactions pursuant to the other requirements of the rule but would not be compelled to perform formalized derivatives risk management, is reasonable in consideration of the costs that would arise from implementing a formalized program.[2] As the proposed rule states, such costs might be disproportionate to the benefits that would arise from implementing a formalized program for an exposure level that is under 50% of the value of the fund's net assets.

b. Questions raised by the formalized derivatives risk management program

The proposed rule outlines with considerable specificity the requirements for funds' board of directors with respect to approval and review under the formalized derivatives risk management program, in contrast to its deference elsewhere in the proposed rule to the board's choice of approved policies and procedures. This level of involvement under the program raises the question of whether this constitutes acceptable agency reach into business practice. The proposed rule cites "other exemptive rules" under the Investment Company Act similarly

[2] The proposed rule cites the statutorily defined limit established by Congress for senior securities transactions as another reason for the 50% of net assets exposure limit, but this is not consistent with the reality that the risks that arise from derivatives transactions are generally different in kind from those arising from securities transactions, which the proposed rule itself maintains elsewhere.

requiring the fund's board to take certain actions in order for the fund to rely on the exemption, giving as examples rules 2a-7, 10f-3, 17a-7, and 18f-3. On the one hand, the previous construction of similar rules creating affirmative duties on the part of fund boards lends persuasive weight to the Commission's asserting authority in this area of business judgment. On the other, Commission rules must not be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.[3] Because agencies are entitled to deference by the courts where legislative history of a statute is silent as to an issue and agency interpretation of the statute is a permissible construction,[4] the Commission can strengthen its claim to authority over the management of hedge funds by reference to interpretations of the Securities and Exchange Act of 1934 and the Investment Company Act of 1940.

IV. Conclusion

I support this rule as a necessary and much-needed protection against the disproportionate risks that arise from derivatives transactions in relation to their short-term benefits. I appreciate the opportunity to comment on this very important rulemaking by the Commission.

Respectfully submitted,

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[3] Securities and Exchange Act of 1934, Sec. 25(b)(4); *see* Goldstein v. SEC, 451 F.3d 873, (D.C. Cir. 2006) (vacating the SEC's Hedge Fund Rule for arbitrariness).
[4] Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837 (1984).