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MFS®

March 28, 2016

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

File Reference: File Nos. S7-24-15: Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

MFS Investment Management ("MFS")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("the " Commission's") proposed new rule under Section 18 of the Investment Company Act (the "1940 Act"), relating to the Use of Derivatives by Registered Investment Companies and Business Development Companies (the "Proposal").[2]

As the Commission is aware, the objective of the Proposal is to address the investor protection purposes and concerns underlying section 18 of the 1940 Act and to modernize the regulation of funds' use of derivatives and other transactions that implicate section 18.[3] The Proposal seeks to regulate the use of derivatives and other financial commitment transactions by registered investment companies and business development companies ("Regulated Funds") by establishing limits on exposures created by derivatives and other senior security positions ("Portfolio Limits Requirements"), codifying asset segregation requirements ("Asset Segregation Requirements") and requiring funds having large positions in derivatives to establish a derivatives risk management program ("Risk Management Requirements"). In the Proposal, the Commission states that these requirements are designed to meet two central investor protection purposes and concerns underlying section 18: (i) to impose limitations on leverage that a Regulated Fund may achieve through use of derivatives, financial commitment transactions and other senior securities transactions, and (ii) to assure that a Regulated Fund will have assets available to meet its obligations arising from those transactions.[4]

Our Comments on the Proposal

MFS strongly supports the SEC's objective of consolidating and updating its guidance regarding the use of derivatives by Regulated Funds and we agree that Regulated Funds should be subject to certain limitations on their use of derivatives and financial commitment transactions. However, we believe that there are certain elements of the Proposal that should be refined, and that these refinements can be

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[1] MFS Investment Management traces its history to 1924 and the creation of the country's first open-end mutual fund, Massachusetts Investors Trust. Today MFS is a global investment manager managing approximately 395 billion in assets through a variety of collective investment vehicles and separate account, including approximately 208 billion managed in registered investment companies for which MFS serves as the primary investment adviser.

[2] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC 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.

3 See Proposal at 80885

4 See Proposal at 80885 and 80886

implemented in a way that does not detract from the Commission's dual objectives of imposing limits on leverage and ensuring that Regulated Funds have sufficient assets to meet their obligations. Below, we focus on four targeted revisions that we believe should be reflected in a final rule, while also briefly referencing several other elements of the Proposal that will be commented on by other industry commentators and are of importance to MFS.

1) <u>Comments on Revisions to Calculating Notional Exposure for the Portfolio Limits Requirement</u>

a) <u>Exclude Currency Forward Transactions that Directly Hedge Portfolio Securities</u>

We strongly believe that, a Regulated Fund that holds a security denominated in a currency other than the fund's base currency (referred to herein as a "foreign security"), should exclude from the calculation of exposure for purposes of the 150% Portfolio Limits Requirement the notional value of a currency forward transaction in which the fund agrees to (i) deliver to a counterparty the currency of the foreign security, and (ii) receive from the counterparty the fund's base currency, up to the notional value of the foreign security.[5]

By way of context, with respect to the Portfolio Limits Requirement, the Proposal includes in the calculation of notional exposure all derivatives used by a Regulated Fund without regard to whether a derivative is used for hedging purposes or speculation purposes. As such, the Proposal currently does not permit a fund to reduce its calculated exposure for purposes of the Portfolio Limits Requirement with regard to derivatives transactions that are specifically entered into for hedging or risk mitigation purposes or that may constitute so-called "cover transactions." On this point, the Proposal states that it would be too difficult to develop an objective standard for determining whether a transaction is for hedging purposes and that confirming compliance with any such standard would be challenging, both for fund compliance personnel and Commission staff.[6]

While we appreciate the Commission's concerns in this regard, and agree that an all-encompassing hedging definition may be difficult to craft and monitor because there are subjective elements that come into play, we think that the type of currency forward transaction described above – i.e., a currency forward that directly hedges the currency risk of a portfolio security – does not implicate these concerns and can be easily identified and defined. Use of currency forward transactions to hedge the currency risk of foreign securities is a necessary risk mitigation tool that can, for some funds (e.g., global strategy funds), consume a significant portion of the 150% Portfolio Limit Requirement. Specifically, this hedging practice involves a fund denominated in one currency (e.g., U.S. Dollars), holding securities denominated in another currency (e.g., Euros) and entering into a currency forward transaction under which the fund agrees to deliver the currency that the security is denominated in (in our example, Euros) and receive the fund's base currency (in our example and generally, U.S. Dollars.) This type of hedging practice is objectively identifiable, easy to monitor, and straightforward to capture in the final Rule. We therefore recommend that the Commission permit the notional value of a currency forward transaction to be excluded from the calculation of exposure for purposes of the Portfolio Limits Requirement in the narrow circumstance where a fund agrees to (i) deliver to a counterparty the currency in which a foreign security is denominated in, and (ii) receive from the counterparty the fund's base currency, up to the notional value of the foreign security.

This modification to the Proposal will prevent the Proposal from having a disproportionate impact on Regulated Funds whose strategy is to invest in non-US securities while not impeding the

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[5] As discussed below, we propose that the exposure test be calculated once a day. This means that the notional amount of the currency forward will be compared each day to the value of the foreign security as of that day. If the value of the foreign security on that day is lower than its value on the trade date of the forward, the fund will only exclude from the exposure calculation the amount that is equal to the value of the foreign security.

[6] *See* Proposal at 80909 and 80914.

Commission's stated goal of establishing a consistent and effective approach with regard to the regulation of Regulated Funds' use of derivatives.[7] Regulated Funds that, due to their investment strategy, invest a significant amount of their assets in non-US securities will be disproportionally and unfairly fettered by the Portfolio Limits as compared to other Regulated Funds that invest in securities denominated in the fund's base currency. This is the case because these Regulated Funds may "exhaust" a significant portion of their 150% limit by putting in place simple currency hedges, leaving relatively little capacity to engage in derivatives, financial commitment and other senior security transactions that are in furtherance of their stated investment objectives. For example, a Regulated Fund may invest close to 100% of its net assets in currency forwards entered into to hedge the foreign securities held in the portfolio and be left with as little as 50% of net assets to measure against other derivatives transactions, financial commitment transactions, and other senior securities. So, in fact, the Proposal would only allow such a Regulated Fund to trade derivatives, financial commitment transactions and senior securities in aggregate notional amount of 50% of its net assets (before such a Regulated Fund would be required to comply with the risk-based limitation) while other Regulated Funds with strategies that do not require a substantial investment in foreign securities, would be allowed a bucket of 150% of their net assets to achieve their investment objective.

b) Permit Netting across Currency Forward Transactions with Slightly Different Maturities

We also propose a further adjustment to calculating exposures created by currency forward transactions. We believe the Commission should permit currency forward transactions to offset each-other for purposes of the exposure calculation in the Portfolio Limits Requirements if the transactions have the same materials terms but slightly different (for example, within a month of each-other) maturity dates.

The Proposal currently allows a Regulated Fund to net notional amounts from different derivatives transactions as long as the derivatives are of the same type and have the same underlying reference asset, maturity and other material terms.[8] However, there are cases when Regulated Funds may hold multiple offsetting currency forward transactions with slightly differing maturity dates. A Regulated Fund may need to offset an existing currency forward position with an opposing position with a slightly different maturity date because there may be a liquidity/cost advantage to transacting in a forward contract that is closer to "on-the-run" one month contract rather than a specific date (for example a contract with a maturity of 3 weeks). We believe that the notional amounts of these currency forward transactions that are opposing in every other way but have slightly different maturity dates (for example, within one month of each-other) should nonetheless be netted for purposes of the exposure calculation during the period of time when they are both outstanding since the fund's exposure to the underlying currency is, in fact, offset during that time period. We believe that permitting netting in this narrow circumstance does not compromise the goal of the Portfolio Limits Requirements to reduce leverage since, for that time period, the Regulated Fund is simply not exposed to the currency risk and basis risk between the transactions is extremely low given the high liquidity of the FX market and the gap between the maturity dates being slight. We further note that, under the Undertaking for Collective Investments in Transferable Securities ("UCITS") derivatives risk framework, netting of derivatives transactions with similar material terms but different maturity dates is allowed for purposes of the calculation of exposure.[9]

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[7] *See* Proposal at 80914.

[8] *See* proposed Rule 18f-4(c)(3)(i).

[9] *See* Committee of European Securities Regulators, CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, Committee of European Securities Regulators (July 28, 2010), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_108.pdf.

2) Comments on the Asset Segregation Requirement

a) Expand the Types of Assets Eligible as Qualifying Coverage Assets

For derivatives transactions, we believe the Commission should expand the types of assets that meet the definition of "qualifying coverage asset" to include those assets that are eligible to serve as margin under the Prudential Regulators Margin Rule and the CFTC Margin Rule (including relevant haircuts).

In its current form, the Proposal would generally limit qualifying coverage assets for derivatives transactions to cash and cash equivalents.[10] While the Proposal gives a Regulated Fund the ability to (i) net each of the mark-to-market coverage amount and the risk-based coverage amount across derivatives transactions subject to the same netting agreement, and (ii) deduct certain collateral posted to the counterparty for each of the mark-to-market coverage amount and the risk-based coverage amount, the total required derivatives coverage amount for a Regulated Fund, on any one day, even taking into account these carve-outs, can still be large and unpredictable. This is especially true since the risk-based coverage amount may be adjusted upward to as high as the full notional amount of the derivative.[11] As a result, Regulated Funds may now be required to hold an unduly high percentage of cash and cash equivalents in order to meet their coverage obligations for derivatives transactions. For many Regulated Funds whose investment strategies do not contemplate significant investments in cash and cash equivalents, holding significant quantities of cash and cash equivalents may conflict with their investment objectives, defeat investor expectations, and, over time, cause a performance drag on the fund.

In the Proposal, the Commission suggests that it is not proposing to include a broader universe of assets that constitute qualifying coverage assets because of concerns that such assets could decline in value at the same time a Regulated Fund's potential obligations under its derivatives transactions increase, resulting in assets insufficient to cover its obligations.[12] However, in relation to margin for uncleared derivatives, the Prudential Regulators and the CFTC (as well as the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, of which the SEC is a party), were faced with this same concern and, after review, determined that limiting eligible collateral to cash and cash equivalents was not necessary since other liquid assets, subject to appropriate haircuts, would maintain sufficient value in times of financial stress.[13]

b) Clarify Definition of Netting Agreement, Allow for Netting when Regulation or Clearinghouse Rules Provide for It, and Broaden It to Apply to Financial Commitment Transactions

We believe that the Commission should allow the coverage amount to be calculated on a net basis for derivatives transactions and financial commitment transactions if: (i) there is an agreement between the parties that provides for amounts owed to be paid on a net basis upon an event of default or other early termination of the agreement; or (ii) regulation or clearinghouse rules provide for netting of certain transactions.

Under the Proposal, if a Regulated Fund has entered into a "netting agreement" that allows it to net its payment obligations under multiple derivatives transactions, that Regulated Fund can calculate both its mark-to-market coverage amount and its risk-based coverage amount on a net basis with respect to all

[10] *See* proposed Rule 18f-(c)(8)

[11] *See* Proposal at 80929-80930

[12] *See* Proposal at 80932.

[13] *See Margin requirements for non-centrally cleared derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (September 2013), at 4, available at http://www.bis.org/publ/bcbs261.pdf

transactions covered by such netting agreement. While we strongly support this concept, we believe that the Proposal should be clarified in certain respects.

First, we believe the Commission should more clearly define the type of agreement that constitutes a "netting agreement" since most industry master netting agreements do not necessarily provide for netting of payments on a daily basis but, rather they provide for netting of payments upon an event of default or other termination of the agreement. In this regard, we believe that it should be made clear that any agreement between a Regulated Fund and its counterparty that provides for amounts owed to be paid on a net basis upon an event of default or other early termination of the agreement should be considered a netting agreement. This would include the standard uncleared derivatives agreement used in the industry, the ISDA Master Agreement.

Second, the Commission should allow for the coverage amount to be calculated on a net basis where, either by regulation or clearinghouse rule, netting is ultimately required across certain transactions. For example, with respect to futures and cleared swaps, any transactions cleared by the Regulated Fund through a clearing broker are netted between the Regulated Fund and such clearing broker. Moreover, even in the event of an insolvency of the clearing broker, CFTC rules requires the net equity amount for each customer (i.e., in this case, the Regulated Fund) to be calculated on a net basis.[14]

Lastly, we see no reason why the netting described above should not be allowed with respect to financial commitment transactions as well. Financial commitment transactions are subject to agreements with similar rights to net amounts owed in an event of default or termination of the agreement and clearing solutions may be possible in the future for certain of these transactions as well.

<u>Other Areas – Adding Our Voice to Industry Comments</u>

We also support the following points raised in the comment letter to be filed by the Investment Company Institute (the "ICI"):

c) <u>Portfolio Limits Requirements</u>

   i) Raise the exposure based limit to 200%

   ii) Permit Regulated Funds to satisfy either the exposure-based limit or the risk-based limit at any time

   iii) Permit Regulated Funds to compute the tests in the Portfolio Limit Requirements once each business day

   iv) Permit duration weighting for interest rate derivatives

d) <u>Asset Segregation Requirements</u>

   i) With respect to financial commitment transactions, clarify that, any asset that may be converted, sold or otherwise disposed of in return for cash or cash equivalents received by a Regulated Fund prior to the date on which its financial commitment obligation is due can serve as a qualifying assets

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[14] CFTC Party 190 Rules

e) <u>Risk Management Requirements</u>

i) Limit the role of the Board to one of oversight

ii) The derivatives risk manager should not be subject to liability as long as the his/her decisions are made in good faith

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We appreciate the opportunity to comment on the Proposal. If you have any questions regarding this comment letter I would be happy to discuss. I can be reached at [redacted].

Sincerely,

Mark Polebaum

cc: The Honorable Mary Jo White
Chair
Securities and Exchange Commission

The Honorable Kara M. Stein
Commissioner
Securities and Exchange Commission

The Honorable Michael S. Piwowar
Commissioner
Securities and Exchange Commission

David W. Grim
Director
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