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Submitted Electronically

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

RE: File No. S7-24-15—Use of Derivatives by Registered Investment Companies

Dear Mr. Fields:

On behalf of Wells Fargo & Company and its subsidiaries, Wells Fargo Funds Management, LLC appreciates the opportunity to comment on proposed Rule 18f-4 under the Investment Company Act of 1940 ("1940 Act") issued by the Securities and Exchange Commission ("Commission") on December 11, 2015.[1] Subsidiaries of Wells Fargo & Company manage and distribute the *Wells Fargo Funds®*, which as of February 29, 2016, had a total of approximately $219 billion in assets under management, making Wells Fargo the 15th largest U.S. mutual fund provider in the industry. Our fund family offers a diverse set of funds across multiple distribution platforms that include retail and institutional investors.

Proposed Rule 18f-4 would replace several decades of Commission and staff guidance with a comprehensive rule regarding registered investment company use of derivatives and related transactions. While we suggest specific changes to the proposed rule in this letter, we support the Commission's efforts to limit derivatives-related risks in fund portfolios. We strongly believe that use of derivatives largely benefits fund shareholders by providing an efficient and relatively inexpensive means to gain or hedge exposures to various asset classes, but we also agree with the Commission that without appropriate limitations, derivatives and other senior securities transactions may expose funds and shareholders to significant leverage, liquidity, and counterparty risks. We also commend the Commission for addressing fund use of derivatives anew through the rulemaking process in particular. Rulemaking, through solicitation of public comments, affords the Commission with a greater range of views and perspectives than other less formal regulatory processes, including issuance of staff interpretative guidance and no-action letters.

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[1] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015) ("Release").

I. Summary of Proposal

The proposed rule has three main components. First, it would limit a fund's aggregate exposure to derivatives contracts, financial commitment transactions,[2] and other senior securities transactions. Specifically, the proposed rule would provide that funds that enter into derivatives transactions would be required to comply with one of the two following limits on their aggregate exposures to derivatives transactions, financial commitment transactions, and other senior securities transactions ("Portfolio Limitations): (i) funds whose derivatives transactions reduce their aggregate portfolio value-at-risk ("VaR") would be required comply with a "Risk-Based Portfolio Limitation" of 300% of the value of a fund's net assets; and (ii) all other funds would be required to comply with an "Exposure-Based Portfolio Limitation" of 150% of the value of a fund's net assets.

The proposed rule also would require segregation of specified amounts of high quality assets to cover exposure to derivatives contracts and financial commitment transactions ("Qualifying Coverage Assets"). For derivatives, the proposed rule would only include cash and cash equivalents among Qualifying Coverage Assets and would require segregation of such assets in an amount equal to the sum of a fund's mark-to-market obligation under a derivatives contract and a reasonable estimate of the potential amount payable by the fund if it were to exit the derivatives transaction under stressed conditions. For financial commitment transactions, the proposed rule would provide a less stringent definition of Qualifying Coverage Assets. Specifically, such assets would include: (i) cash and cash equivalents, (ii) the particular asset required or permitted to be delivered in the transaction (*e.g.*, the security sold short), and (iii) assets that are convertible to cash or that will generate cash equal to the financial obligation under the transaction prior to the date when the obligation is due. The proposed rule would require a fund to segregate Qualifying Coverage Assets with a value equal to at least the amount of the full financial obligation associated with the financial commitment transaction.

Finally, with respect to funds that engage in a more-than-minimal amount of derivatives transactions and/or use certain complex derivatives, the rule would require establishment of a formalized derivatives risk management program. This program would be administered by a derivatives risk manager designated by the fund and approved by its board of directors.

II. Discussion

We generally support proposed Rule 18f-4 and the derivatives risk-limiting purposes behind it. However, in this letter we respectfully suggest certain changes to the proposed rule that we believe will better tailor it to the Commission's purposes while reducing potential costs and unintended consequences for funds and shareholders. First, and as described in greater detail below, we urge the Commission to adopt an Exposure-Based Portfolio Limitation of 200% of net

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[2] Financial commitment transactions include reverse repurchase agreements, short-sales, firm and standby commitment agreements, and any similar agreements.

assets, rather than 150% to avoid significant and unnecessary strategy changes to liquid alternative funds that make reasonable use of derivatives. In addition, we encourage the Commission to allow a fund to eliminate derivatives transactions intended to hedge other exposures or to "cover" other derivatives positions or financial commitment transactions from calculation of its total notional derivatives exposure for purposes of any Portfolio Limitation. We further advocate expanding the proposed narrow standard for netting derivatives transactions (same instrument, underlying asset, maturity date, etc.) to allow funds to net *effectively* off-setting derivatives transactions. Relatedly, we also urge the Commission to allow netting of offsetting mortgage to-be-announced transactions ("TBAs"), which are technically financial commitment transactions, but trade much like derivatives. We oppose the Commission's proposal to limit Qualifying Coverage Assets for derivatives transactions to cash and cash equivalents, and would instead suggest a graduated approach permitting use of a greater range of assets, with specific "haircuts" for asset classes based on their relative market and liquidity risks.

A. Portfolio Limitations

1. *We support an Exposure-Based Portfolio Limitation of 200% of net assets rather than the proposed 150%*

We generally support the Commission's proposal to limit total fund derivative, financial commitment, and other senior securities transaction exposure through an aggregate notional exposure limit relative to net assets. However, based on our experience in managing liquid alternative funds, we believe that the proposed 150% Exposure-Based Limitation could force some liquid alternative funds with reasonable derivatives risk profiles to make significant investment strategy changes that may frustrate the objectives of these funds and their shareholders.[3] We believe that a slightly higher Portfolio Limitation of 200% would better strike a balance of preserving liquid alternative funds that make significant, but responsible, use of derivatives, while justifiably requiring significant investment strategy changes to those funds that present out-size derivatives risk.

2. *We urge the Commission to allow funds to account for hedging and "cover" transactions in calculating aggregate notional derivatives exposure*

The Commission presents two major rationales for forgoing consideration of individual cover and hedging transactions in a fund's calculation of aggregate notional derivatives exposure. The first is that identifying hedging and cover transactions would prove difficult for compliance professionals and Commission staff. However, in our experience, identifying such transactions does not pose significant difficulty in the vast majority of instances. In fact, the Commission staff ably described a number of examples of cover transactions in a 1987 no-action

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3 We believe that many of these funds would not meet the VaR test necessary to qualify for the proposed higher 300% Exposure-Based Limitation.

letter.[4] Furthermore, other financial regulators, including the Committee of European Securities Regulators and the Commodity Futures Trading Commission, allow identification of derivatives transactions that are for hedging purposes in complying with regulatory limits.[5]

We acknowledge, however, that reasonable people may disagree about the risk-mitigating vs. risk-seeking nature of certain derivative transactions on the margins. This, however, does not necessarily lead to the conclusion that the rule should disregard hedging and cover transactions altogether. Rather, fund board-approved policies and procedures should govern determination of the nature of such transactions. Furthermore, if the Commission staff identifies what it believes to be errors or abuses in categorizing cover and hedging transactions, it may correct those errors or abuses through examinations and/or interpretative guidance. Because a regulatory problem does not have an easy, one-size-fits-all solution, that does not mean that a solution is entirely unavailable; rather, such a regulatory problem begs for the tolerance for nuance inherent in a principles-based approach, to be further fleshed out through the work of fund boards, derivatives risk officers, and Commission staff.

The Commission's second major rationale for disregarding cover and hedging transactions is that the proposed 150% Exposure-Based Limitation will accommodate most funds without the need to consider hedging and cover transactions. The Commission bases this conclusion on a study by the Division of Economic and Risk Analysis ("DERA"), which, among other things, surveyed Form N-CSR filing data concerning derivatives usage for a relatively small sample of registered funds (approximately 10%).[6] According to the study, 96% of sampled funds had notional derivatives exposure below 150% of net assets. Even assuming that the DERA sample is representative of the industry as a whole, the fact that an aspect of a rule will only affect a subset of funds does not demonstrate that it is good policy. As the Commission staff and other regulators have recognized, hedging and cover transactions reduce exposure to derivatives risks, but the proposal simply avoids addressing this fact in favor of the relatively blunt instrument of exposure calculations without exception or qualification.

Rather than adopt a rule that disregards the effects of hedging and cover transactions, we suggest that the Commission adopt a rule that would require portfolio managers to designate, prior to entering into a derivatives transaction, whether the transaction is intended: (i) for hedging or cover purposes; or (ii) for speculative purposes or for a mix of hedging/cover and speculative purposes. If it is for the former purposes, we suggest that the notional exposure created by the transaction should not count toward any Portfolio Limitation. If the transaction is intended for the latter purposes—which include mixed purposes—it should count. We believe

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4 *See*, Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987).

5 *See Release* at note 236; *see also* CFTC Rule 4.5.

6 *See* Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (Dec. 2015), available at http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

that portfolio managers could responsibly make these designations in accordance with policies and procedures adopted by fund boards and with close oversight of derivatives risk officers administering those policies and procedures.

3. *We urge the Commission to adopt a principles-based approach to netting derivatives and mortgage TBAs*

We support the Commission's proposal to allow netting of certain derivatives transactions in calculating a fund's exposure. However, the Commission's proposed standard (*i.e.*, that a fund may only net directly offsetting transactions that are of the same type of instrument and that have the same underlying reference asset, maturity and other material terms) would prove overly stringent. Funds often enter into effectively offsetting derivatives positions that do not fit these criteria. For example, many funds have a common practice of offsetting exposure to a foreign currency forward two days prior to maturity by entering into an offsetting transaction. However, because currencies typically settle over two days, the offsetting transaction would be deemed a spot transaction rather than an offsetting forward. Despite the fact that these trades represent effectively offsetting exposures by any reasonable standard, the proposal would require the notional exposure created by both to count toward Portfolio Limitations.

Ultimately, netting derivatives transactions, like identifying hedging and cover transactions, would benefit from a principles-based approach by the Commission focused on the net economic effect of derivatives transactions. Essentially, the rule should stand for the proposition that where a derivatives transaction would reasonably be considered to effectively wholly or partially offset exposure provided by another derivatives transaction, a fund's aggregate derivatives notional exposure calculation may be reduced by the amount of that offset. We believe that portfolio managers, fund boards, compliance officers, and derivatives risk officers have the capability and expertise to interpret such a standard and adopt and enforce policies and procedures necessary to satisfy it.

Separate and apart from issues of netting derivatives transactions, we note that the proposal does not make any provision for netting financial commitment transactions, which poses a particular problem with regard to mortgage TBAs. In particular, funds often hedge exposure to a particular TBA by entering into a directly offsetting contract that meets the Commission's proposed netting standard applying solely to derivatives (same type of instrument, same underlying asset, maturity and other material terms).[7] As we interpret the proposal, it would require the full value of both TBAs to be counted toward Portfolio Limitations--a result that we believe makes little sense given the directly offsetting nature of the transactions. In addition, under the proposal, Funds that engage in the common practice of "rolling" a long TBA

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[7] We support the fact that the Commission's proposed netting standard for derivatives would not require that two offsetting derivatives contracts be with the same counterparty. This flexibility is also necessary for TBAs because funds often enter into effectively offsetting TBA transactions with different counterparties.

position by taking an offsetting position in the maturing contract and also purchasing a later-maturity contract would temporarily triple their notional exposure prior to the maturing of the original contract, despite there being no net increase in economic exposure.

B. Qualifying Coverage Assets

1. *Restricting Qualifying Coverage Assets for derivatives transactions to cash and cash equivalents conflicts with well-reasoned staff guidance and may have unintended consequences*

We oppose the Commission's proposal to restrict Qualifying Coverage Assets for derivatives transactions to cash and cash equivalents. This represents a radical departure from long-standing industry practice based on prior Commission staff guidance. Specifically, the industry has relied for decades on the sound reasoning in a staff no-action letter issued to Merrill Lynch Asset Management, LP ("Merrill Letter"). [8] The Merrill Letter provided that the staff would not recommend an enforcement action under Section 18 of the 1940 Act if a fund covers derivatives transactions with liquid assets, without limiting such assets to cash and cash equivalents. According to the staff, assurance of the availability of adequate funds to meet obligations under derivative contracts "will be satisfied so long as only liquid assets are maintained in the segregated account, and the value of those assets is marked to market daily."[9]

While we believe that the standard for segregated assets stemming from the Merrill Letter has proven adequate in the 20 years following its issuance, we do not discount the Commission's concern that a standard permitting *any* liquid asset to be a Qualifying Coverage Asset may potentially prove problematic during periods of market turmoil, when declining asset values coupled with increasing derivative obligations could cause significant losses for a fund or even cause its failure to meet derivative obligations. However, this concern does not necessitate a return to the circa 1979[10] approach of limiting Qualifying Coverage Assets to cash and cash equivalents. Both regulators and market participants have developed means of risk-weighting collateral or coverage assets, applying "haircuts" based on assets' relative liquidity and potential volatility. The Federal Reserve, for example, accepts a range of collateral for loans through the discount window, applying haircuts in accordance with collateral quality.[11] Similarly, the CFTC

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

[9] *Id.*

[10] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 (Apr. 18, 1979).

[11] *See* Federal Reserve Discount Window and Payment System Risk Collateral Margins Table (Aug. 3, 2015, *available at* https://www.frbdiscountwindow.org/Articles/2015/06/22/23/32/New%20Collateral%20Margins%20Table.aspx.

adopted a rule in January 2016 addressing margin requirements for uncleared swaps that provides for a range of eligible margin asset types accompanied by risk-weighted haircuts.[12]

The Commission's proposed Qualifying Coverage Asset standard may also entail unintended consequences, including fund underperformance due to the need to hold greater amounts of cash and cash equivalents to cover derivatives transactions—so called "cash drag." However, many portfolio managers will be loath to create cash drag and thus may drastically reduce their use of derivatives. To the extent these portfolio managers would otherwise use derivatives to hedge or manage investment risk, the proposal could lead to heightened risk for funds and shareholders. (This potential consequence of a cash and cash equivalent requirement formed the basis of the successful argument for no-action relief granted in the Merrill Letter.) Alternatively, for those portfolio managers of funds that simply cannot significantly reduce derivatives use because, for example, to do so would conflict with a fund's investment strategies, the cash and cash equivalent standard may cause portfolio managers to take more significant risks with the fund's derivatives portfolio to counteract cash drag.

2. *The Commission should clarify that Qualifying Coverage Assets for financial commitment transactions include assets that may be sold for an amount equal to the financial commitment obligation prior to the date the fund is required to pay such obligation*

We fully support the Commission's more expansive proposed standard for Qualifying Coverage Assets for financial commitment transactions. Specifically, we support the proposal to allow funds to segregate those assets that are convertible to cash or that will generate cash in an amount equal to a financial commitment transaction obligation prior to the date that the obligation comes due. Furthermore, we believe that the Commission intended that assets "convertible to cash" would include assets that may be *sold* for cash. However, when discussing the Qualifying Coverage Asset standard in the Release, the Commission only included among examples of such assets fixed income securities that will mature or that will generate sufficient income prior to the financial commitment due date.[13] The Commission's example has created what we believe to be unintended ambiguity about the meaning of the standard. We believe it is unintended because limiting non-cash Qualifying Coverage Assets to those that will mature or pay sufficient income prior to the financial obligation coming due would cause significant problems for funds that engaging financial commitment transactions but do not invest substantially in fixed-income securities (*e.g.*, equity and alternative funds that engage in short sales).

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12 *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 2, 2016).

13 *See* Release at 240.

3. *The Commission should allow for the netting of offsetting positions when determining asset segregation amounts for mortgage TBAs*

We generally agree with the Commission's proposal regarding the amounts of assets required to be segregated for financial commitment transactions, with the exception of the proposal's application to mortgage TBAs. While firms entering into TBAs may choose to take delivery of the underlying pool of mortgage-backed securities, they most often choose to take an offsetting position near the end of a TBA's maturity and simply settle the net amount owed. Thus, TBAs, in settling on a net basis, trade much like many derivatives, including treasury futures and currency forwards. And yet the proposal does not account for this fact and instead requires a fund to segregate Qualifying Coverage Assets equal to the full potential obligation under a TBA. Thus, a fund following the common practice of entering into an offsetting TBA near maturity of another TBA would be required to segregate Qualifying Coverage Assets in an amount equal to the full obligation under *both* TBAs, despite the fact that the amount segregated would not at all reflect the fund's economic exposure. Thus, the proposal could have significant negative effects on funds that engage in this relatively efficient means of trading TBAs and on the agency mortgage-backed securities market.

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Derivatives have become a critical part of registered funds' investment strategies for good reason: they provide an efficient means to gain and hedge exposures to different asset classes. However, we recognize that when used improperly, derivatives may expose funds to significant and unjustifiable risks. For that reason, we fully support the Commission's efforts to limit derivatives risk in registered funds and generally support the proposed rule, with the exception of the matters raised in this letter. We appreciate the opportunity to comment on the proposal and look forward to continue working with the Commission to assure that registered funds and shareholders avoid unnecessary and unreasonable risks.

Very truly yours,

/s/ Aldo A. Ceccarelli

Aldo A. Ceccarelli
Head of Investments
Wells Fargo Funds Management, LLC