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March 28, 2016

**VIA ELECTRONIC DELIVERY**

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

**Re: Investment Company Act Release No. IC-31933 (File No. S7-24-15)**

**Use of Derivatives by Investment Companies and Business Development Companies (collectively, "Funds")**

Dear Mr. Fields:

Dechert LLP, on behalf of Altegris Advisors, LLC, Campbell & Company, Inc., LoCorr Asset Management, LLC, Millburn Ridgefield Corporation, Steben & Company, Inc., Welton Investment Partners and several other of the industry's leading managed futures investment managers, welcomes the opportunity to comment on the proposed rulemaking of the Securities and Exchange Commission ("**Commission**" or "**SEC**") regarding its proposed rule on the "Use of Derivatives by Investment Companies and Business Development Companies" (the "**Proposed Rule**").[1]

We generally support the Commission's efforts to provide an updated and more comprehensive approach to the regulation of Funds' use of derivatives and other transactions that raise "senior securities" issues under Section 18 of the Investment Company Act of 1940 (the "**1940 Act**"). However, we have significant concerns with certain aspects of the Proposed Rule, particularly the notional-based exposure limits,

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1 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf (the "**Proposing Release**").

which have the potential to substantially restrict, or eliminate altogether, the ability of Funds to offer managed futures strategies to retail and other non-accredited investors in the regulated and board-supervised format of a mutual fund (such Funds, "**Managed Futures Funds**"). As discussed below, Managed Futures Funds, which primarily invest in exchange-traded, centrally cleared derivatives, have been an increasingly important choice for investors seeking returns that historically have not been correlated with other asset classes.

## 1. Executive Summary

We strongly believe that the combination of the Mark-to-Market Coverage Amount and Risk-Based Coverage Amount (as defined below) requirements in the Proposed Rule, together with the impending initial and variation margin requirements for over-the-counter ("**OTC**") derivatives, the long-standing exchange-mandated initial and variation margin requirements for futures and other exchange-traded contracts, and the increased derivatives reporting requirements for Funds, represents a robust, comprehensive regulatory framework wholly sufficient to protect investors and Funds from the risks attributed to the use of derivatives.

If the Commission does proceed with adopting some form of the proposed notional-based exposure limits, we believe these limits would unnecessarily restrict or eliminate investor choice and deprive retail investors of a valuable portfolio diversification tool. The scope of the Proposed Rule with these limits would be unnecessarily broad when a more tailored approach could achieve an equivalent purpose without adversely affecting investors and their portfolios. As we discuss more fully below, investors have been increasingly turning to Managed Futures Funds, as managed futures offers a source of liquid return historically and typically not correlated to other investment classes. Not only would the notional-based limits harm investor choice, but they may actually serve to increase risk in fund portfolios. Once subject to these limits, funds would likely exchange investments in derivatives that have relatively low risk per dollar of notional value (*e.g.*, bond futures) for derivatives that have relatively high risk per dollar of notional value (*e.g*. equity index futures) to generate returns while complying with the notional limits.

We strongly believe such notional-based limits are unnecessary and suggest and explain below our proposals for more risk-sensitive alternatives to limiting leverage. We offer a margin-based approach, in which a Managed Futures Fund – in addition to complying

with the Proposed Rule's new asset segregation requirements – would segregate additional assets equal to the initial margin of the derivatives in its portfolio. If the Commission chooses to adopt a notional-based limit, we set out below a framework for appropriately adjusting the calculation of notional exposure to account for the specific risks associated with a Managed Futures Fund's derivatives transactions.
Our recommended alternatives are intended to provide Commission Staff with leverage limits that would be simple to administer and enforce. We offer our recommendations to assist the Commission in developing informed regulations for Funds' use of derivatives that address investor protection concerns under Section 18, but not in a manner that we believe will cause undue harm.

## 2. Background – Managed Futures Funds and Strategies

We generally refer to Managed Futures Funds as those funds that typically take long and short positions in futures, options, swaps and foreign exchange contracts, both listed and over-the-counter. A majority of Managed Futures Funds follow trend-following or price-momentum strategies. Other Managed Futures Funds follow strategies including systematic mean-reversion, discretionary global macro and commodity index tracking, among others. Typically, more than 60% of Managed Futures Funds' investment exposure – and often up to100% – is obtained through derivatives contracts.[2]

Managed Futures Funds use futures and other derivatives to gain access to commodity, currency, interest rate and equity markets in more than 150 markets around the world. Futures and other derivatives used by these funds, in contrast to other types of alternative mutual funds, are primarily exchange-traded and guaranteed by a central clearinghouse. Futures contracts are also the most liquid types of derivatives instruments, characterized by daily, and sometimes intra-day margining, and transparent, continuous pricing throughout each trading day. Moreover, all futures contracts, whether traded on exchanges in the United States or around the world, must be approved by the Commodity

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2 This description of Managed Futures Funds and their investment strategies is based on Morningstar's criteria for its "Managed Futures" fund category, *available at* http://www.morningstar.com/InvGlossary/managed-futures.aspx.

Futures Trading Commission ("**CFTC**") before a Managed Futures Fund or any other U.S. person may purchase or sell these contracts.[3]

The returns of managed futures strategies generally do not display correlation to traditional equity or fixed-income investments. In 2008, when U.S. and international equities dropped 38% and 45%, respectively, managed futures experienced 13% positive returns.[4] More recently, for the first two full months in 2016, managed futures, as measured by the SG CTA Index (formerly the Newedge CTA Index), returned 7.27%, while the S&P 500 Index generated a negative return of -5.46%. We do not assert that managed futures strategies will perform well in all periods of decline for equity or fixed-income markets. However, the statistics above are just two examples that demonstrate the value of managed futures strategies as a tool for investors to maintain a balanced and diversified portfolio, which can facilitate the ability of investors to diversify their portfolios, thus providing a measure of protection against losses during market downturns.

The appeal of liquid, transparent and uncorrelated returns has been a significant factor in the tremendous growth of managed futures strategies, including offerings through Managed Futures Funds. Assets managed by the managed futures industry increased from approximately $300 million in 1980 to more than $200 billon by the end of 2008.[5] This rapid pace of growth continued after the financial crisis in 2007 and 2008, as indicated by the surge in investment in alternative strategies mutual funds (many of which use futures and other derivatives) increasing from $58 billion to $170 billion between 2009 and 2014.[6]

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3 *See* "Approval of New Contracts" by the CFTC, available at http://www.cftc.gov/industryoversight/contractsproducts/index.htm

4 Figures cited reflect the returns of the S&P 500 Total Return Index, MSCI EAFE Developed Markets Index and the SG CTA Index (formerly the Newedge CTA Index), respectively.

5 *See* "Understanding Managed Futures," Man Investments, *available at* https://www.maninvestments.com.au/files/default/file/research/200902-understanding-managed-futures.pdf.

6 Investment Company Institute, "2015 Investment Company Fact Book," 55th ed., at p. 44.

The Commission states that Funds, including Managed Futures Funds, that are unable to comply with the Proposed Rule may wish to consider deregistering under the 1940 Act, with the Fund's sponsor offering the Fund's strategy as a private fund or as a public (or private) commodity pool, which do not have statutory limitations on the use of leverage.[7]

However, we believe investing through a mutual fund may provide certain advantages over investing in a public commodity pool for retail investors, including: (1) typically lower fees, (2) third-party custody requirements, (3) daily liquidity, (4) daily pricing that is easily and publicly accessible on the internet, (5) transparency, (6) accessibility and (7) investor protection resulting from regulatory disclosures and substantive operating requirements, including supervision by a majority independent board of directors and strict limits on affiliated transactions, portfolio concentration and the holding of security-related issuer securities.[8] Further, investors seeking to include managed futures exposure in their portfolios may prefer the ease and simplicity of filing a Form 1099-DIV, which is a feature of investing in managed futures strategies via a mutual fund structure. Managed futures strategies offered through a private fund or as a public (or private) commodity pool typically require investors to file a Form K-1 partnership tax form which can take months to obtain and can result in non-tax-deductible expenses.[9]

When a retail investor buys shares in a mutual fund that invests in commodity futures, commodity options and swaps, the investor is buying a product that is highly-regulated by the Commission under both the Securities Exchange Act of 1933 ("**1933 Act**") and the 1940 Act. If that same investment program is offered instead as a 1933 Act-registered commodity pool that is not also registered under the 1940 Act, these valuable regulatory protections simply will not be available to retail investors. Of course, retail investors may not be able to subscribe for interests in privately offered funds at all and would be unable to obtain any exposure to managed futures through these funds.

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7 Proposing Release at 80912.

8 *See, e.g.*, 15 U.S.C. §§ 80a-17(f), 18(f) and 22.

9 Morningstar Paper, "Managed Futures Category Hand-book," by Samuel Lee and Nadia Papagiannis, CFA, at 9, *available at* http://advisor.morningstar.com/uploaded/pdf/Alt_Managed-Category.pdf.

As discussed in further detail below, we are concerned that while we believe the Commission is only seeking to ensure investor protection, finalization of the Proposed Rule as currently proposed will produce the unintended result of limiting investment choices available to investors without providing a clear and discernible benefit for doing so.

## 3. Comments on the Proposed Rule

### A. Notional Portfolio Limits for Derivatives Transactions

We are fundamentally concerned with the Proposed Rule's limits on a Fund's derivatives notional exposure. The Proposed Rule would require Funds to comply with either one of two portfolio limitations immediately after entering into each derivatives transaction.

Under the first limit, the "**Exposure-Based Portfolio Limit**," the aggregate exposure of a Fund could not exceed 150% of the value of its net assets. "Exposure" would mean, in relevant part, the aggregate notional amounts of the Fund's derivatives transactions.[10] The notional amount is defined generally as the market value of an equivalent position in the underlying reference asset, or the specified or principal amount on which payment obligations under a derivatives transaction are calculated. For purposes of calculating exposure, a Fund would be permitted to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. Funds could net substantially similar transactions across different counterparties.

Under the second limit, the "**Risk-Based Portfolio Limit**," a Fund's exposure could increase to 300% of net assets if its derivatives exposure reduces the Fund's exposure to market risk. The Proposed Rule would permit a Fund to maintain the 300% notional exposure if the value-at-risk ("**VaR**") of a Fund's portfolio with derivatives were less than the portfolio VaR without any derivatives. As the Proposing Release states, a Fund's VaR is an estimate of potential losses on an instrument or portfolio, expressed as

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[10] In addition to derivatives notional exposure, the "exposure" definition also includes the aggregate obligations under a Fund's repurchase agreements and other similar financial commitment transactions, as well as a Fund's aggregate indebtedness with respect to any other transaction that raises senior securities issues under Section 18 (such as bank borrowings or issuance of senior debt).

a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level, subject to certain minimum requirements for the VaR analysis. The netting concepts noted with respect to the Exposure-Based Portfolio Limit would also apply to the Risk-Based Portfolio Limit.

### B. Notional Portfolio Limits Should be Unnecessary Due to Proposed Rule's Asset Segregation Requirements

If the notional-based limits are adopted as proposed, certain funds, including Managed Futures Funds, may not be able to continue operations as they exist today. As acknowledged by the Commission, these funds would need to liquidate or deregister as investment companies and operate as public or private commodity pools. Investors in such funds would no longer have the opportunity to obtain their desired investment exposure or portfolio diversification benefits through a registered investment vehicle that is subject to the robust regulatory oversight of the Commission, and may not be able to replace such exposure through other investment vehicles. In addition, notional-based limits may have the unintended effect of increasing risk in Funds that use derivatives. The Proposed Rule makes notional value a scarce resource, and funds would be incentivized to allocate this resource to its highest value use. Funds would likely shift their derivatives exposures away from low-risk asset classes to higher-risk asset classes to deliver performance while remaining under the hard notional limits.[11]

We instead strongly believe that the asset segregation requirements under the Proposed Rule, as augmented by the Mark-to-Market Coverage Amount and Risk-Based Coverage Amount, if adopted, would be entirely sufficient to address the Commission's concerns over derivatives transactions risks.

The Proposed Rule would require a Fund to segregate on its books each day "qualifying coverage assets" ("**Qualifying Coverage Assets**") equal to the sum of a "**Mark-to-Market Coverage Amount**", which reflects the Fund's net obligations if the Fund exited its derivatives positions on such day, plus a "**Risk-Based Coverage Amount**", which is designed to capture additional losses the Fund would suffer if it exited its derivatives

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11 For a more fulsome discussion of this analysis, *see* Delta Strategy Group White Paper, "Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies, Data and Economic Analysis," by James A. Overdahl, Ph.d. at 46-47.

transactions under stressed market conditions. These combined asset segregation requirements would be a significant enhancement in investor protection by requiring Funds to earmark a greater amount of assets than has been required by the Commission over the past 40 years.

In 1979, the Commission set forth in Investment Company Act Release No. 10666 ("**Release 10666**")[12] a segregated account approach to address certain types of transactions that raise "senior securities" issues under Section 18. As described in Release 10666, this approach requires a Fund to segregate liquid assets sufficient to meet potential obligations arising from the Fund's investment in reverse repurchase agreements, firm commitment agreements and standby commitment agreements. The Commission reiterated and refined this approach through a series of more than twenty subsequent no-action letters, in which the Commission addressed how Funds must segregate assets against, or enter into cover transactions to offset, obligations arising under a wide array of derivatives transactions.[13]

The SEC's segregated account approach has been in effect for nearly four decades, throughout extreme market conditions, including the 1994 Mexican Peso crisis, the 1997 Asian crisis, the 1998 Russian crisis, the September 11th attacks, the dot-com equity collapse and most recently the 2008-9 global financial crisis. We are unaware of any adverse impact on Managed Futures Funds during or due to the events of any such crises, and the Commission does not discuss or identify any concerns with respect to a single Managed Futures Fund over the past 40 years. We note that, while the Commission does cite extensive losses suffered by a private fund investing in futures contracts, private funds are not subject to the SEC's asset segregation requirements or other SEC derivatives regulations and, thus, this rule would provide no protection with respect to those types of funds. We are further unaware of any other material event or occurrence, or series of events or occurrences, related to the operation of Managed Futures Funds and their use of derivatives to justify why the SEC would abruptly cease relying on its successful, long-standing asset segregation policy. Many firms have spent large amounts of time and resources and have made strategic business decisions based upon this long-

12 Investment Company Act Release No. 10666 (Apr. 18, 1979).

13 Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) at 23.

standing approach of the Commission. We also believe that the asset segregation requirements in the Proposed Rule would not only preserve the Commission's traditional segregated account approach but also improve it by requiring Funds to segregate the new Risk-Based Coverage Amount. In addition, the Proposed Rule's asset segregation requirements would be supplemented by margin requirements for OTC derivatives that have been adopted, or will soon be adopted, by the Comptroller of the Currency, the Federal Reserve Board and certain other prudential regulators (collectively, the "**Prudential Regulators**"), as well as the CFTC and the SEC itself (the "**OTC Margin Rules**"). Based on the foregoing, there appears to be no need or justification for the imposition of the notional exposure limits.

We note finally that we share this view with Commissioner Piwowar and strongly support his dissenting statement on the Proposed Rule.[14] Commissioner Piwowar stated that he believes the Mark-to-Market Coverage Amount and Risk-Based Coverage Amount that Funds would be required to segregate, together with the newly implemented regulatory oversight for derivatives, including the OTC Margin Rules, and the enhanced mutual fund reporting requirements, should be sufficient to address the investor protections as they relate to Funds' use of derivatives.

### C. We Recommend Replacing the Notional Approach with a Margin-based Approach for Enhanced Risk Sensitivity and Ease of Implementation

Nevertheless, if the Commission does require additional investor protections beyond its asset segregation requirements (as enhanced by the proposed Mark-to-Market Amount and Risk-Based Coverage Amount, if adopted), we urge the Commission to consider replacing the notional-based portfolio limits with a much simpler margin-based approach that, in our view, better quantifies and addresses the specific risks posed by a wide array of derivatives contracts.

Under this approach, Managed Futures Funds that use derivatives would be required to segregate on their books and records cash, cash equivalents or other liquid assets in an

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[14] Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies, issued December 11, 2015.

amount equal to, and in addition to, the exchange-required initial margin for each futures contract traded, or in the case of OTC derivatives, the initial margin required under the OTC Margin Rules. This proposal would effectively force Funds to over-collateralize by 100% the initial margin requirements of their futures and other derivatives positions. This approach would require Managed Futures Funds to maintain significant cash or other liquid assets to meet this enhanced asset segregation requirement, while at the same time allowing Funds to engage in appropriate levels of derivatives activity.

This approach is built upon the well-established use of margin that has successfully governed risk on the exchange-traded derivatives markets for decades. We note first that futures exchanges determine and review margin requirements and continuously adjust these requirements to reflect risk and current market conditions. Exchanges increase margins during volatile, riskier time periods across a wide range of futures contracts, including fixed income, stock index and energy contracts. These margin amounts already reflect, account for and protect against market risk and they are continuously monitored and adjusted by the exchanges. We note that under our margin-based approach, Managed Futures Funds would segregate additional assets for OTC derivatives based on the collateral requirements required by multiple regulatory bodies, including the CFTC and the Prudential Regulators in their respective final OTC Margin Rules, as well as the Commission itself in its proposed OTC Margin Rules. In response to OTC margin requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, these regulatory bodies have conducted extensive reviews and analyses of the appropriate initial and variation margin levels for OTC derivatives. Our proposed margin-based approach builds upon these important risk-reducing regulations to provide an even greater degree of protection to investors in Managed Futures Funds.

In addition, risk limits based on margin amounts address the Commission's concerns about overstating risks of large dollar value notional fixed income contracts such as the CME Eurodollar contract.[15] Our margin-based approach also avoids the uncertainty and inconsistencies that may arise when different Funds use different methods of calculating VaR, and is more responsive to evolving market conditions than VaR, which is based on a look-back period that may not capture spikes in volatility.

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15 Proposing Release at 80908.

We acknowledge that the Commission may have certain concerns over this margin-based approach. However, we believe that this approach is time-tested, monitored continuously, simple in application, enforcement and testing, and narrowly tailored so as to reduce undue speculative trading activity. Under this approach, Funds would have fewer complicated formulas to apply and less flexibility for interpretation, reducing possible market manipulation or abuse. This approach also addresses the Commission's concerns regarding investor protection, while preserving the ability of investors to allocate to Managed Futures Funds and other affected Funds.

### D. If the Commission Proceeds with Implementing Portfolio Limitations, We Recommend Risk-Adjustments to Exposure Calculations

If, instead, the Commission does proceed with implementing some form of notional-based exposure limits, we urge the Commission to subject these limits to certain adjustments based on the type of the derivatives transactions involved. The Commission is seeking comment on whether certain derivatives, such as Euribor and Eurodollar futures, should be adjusted to avoid overstating a Fund's derivatives investment exposure.[16] We believe that if the Commission implements notional-based portfolio limitations, the Commission should adjust the exposure calculations to more carefully identify and address the specific risks of different types of derivatives contracts.

The Commission will likely receive a wide array of suggested methods of adjusting notional exposure. We recommend that these adjustments be based on the standardized initial margin requirements for non-cleared swaps and non-cleared security-based swaps adopted in the final rule for Margin and Capital Requirements for Covered Swap Entities by the Prudential Regulators (the "**PR Final Margin Rules**").[17] A Fund's notional exposure would be multiplied by a risk weighting based on the Prudential Regulators' haircut schedule. Because the Prudential Regulators identified "Commodity" and "Equity" as the riskiest Asset Classes, as set out in Table A below, we use equities and commodities as a baseline for determining the haircuts for the other margin assets.

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16 Proposing Release at 80908.

17 *See* Prudential Regulators, Margin and Capital Requirements for Covered Swap Entities, Final Rule, 80 Fed. Reg. 74840 (November 30, 2015), *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf.

TABLE A—STANDARDIZED MINIMUM GROSS INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS[1]

| Asset Class | Gross initial margin (% of notional exposure) |
| --- | --- |
| Credit: 0–2 year duration | 2 |
| Credit: 2–5 year duration | 5 |
| Credit: 5+ year duration | 10 |
| Commodity | 15 |
| Equity | 15 |
| Foreign Exchange/Currency | 6 |
| Cross Currency Swaps: 0–2 year duration | 1 |
| Cross-Currency Swaps: 2–5 year duration | 2 |
| Cross-Currency Swaps: 5+ year duration | 4 |
| Interest Rate: 0–2 year duration | 1 |
| Interest Rate: 2–5 year duration | 2 |
| Interest Rate: 5+ year duration | 4 |
| Other | 15 |

A Fund's notional exposure would be equal to the notional amount of a particular derivative multiplied by an adjustment factor derived from Table A. Taking the relative risk of each Asset Class based on the margins in Table A, and scaling the riskiest Asset Classes of Commodity and Equity to 100%, produces the 'Risk Adjustment Factors' set forth in Table B below.

Table B
Risk Adjustment Factors – Riskiest Asset Classes Scaled to 100%

| **Asset Class** | **Gross Initial Margin per Table A** | **Risk Adjustment Factor** |
|---|---|---|
| Credit: 0–2 year duration | 2 | 13.3% |
| Credit: 2–5 year duration | 5 | 33.3% |
| Credit: 5+ year duration | 10 | 66.7% |
| Commodity | 15 | 100.0% |
| Equity | 15 | 100.0% |
| Foreign Exchange/Currency | 6 | 40.0% |
| Cross Currency Swaps: 0–2 year duration | 1 | 6.7% |
| Cross-Currency Swaps: 2–5 year duration | 2 | 13.3% |
| Cross-Currency Swaps: 5+ year duration | 4 | 26.7% |
| Interest Rate: 0–2 year duration | 1 | 6.7% |
| Interest Rate: 2–5 year duration | 2 | 13.3% |
| Interest Rate: 5+ year duration | 4 | 26.7% |
| Other | 15 | 100.0% |

In our view, this approach identifies and adjusts for specific risks generated by a particular type of underlying asset. The Prudential Regulators, the CFTC and, in its related proposed rule, the Commission have all similarly adopted this general approach in identifying and adjusting for asset-specific risks related to derivatives transactions. This approach, and the haircuts set forth above, also correspond with those jointly prepared by the Basel Committee on Banking Supervision ("**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**") and included in their final policy framework that established minimum standards for margin requirements for non-centrally cleared derivatives.[18]

We note that our approach could be reasonably modified further so that all Asset Classes receive an additional adjustment to account for their risk being less than their

18 *See* Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissioners, Margin Requirements for Non-Centrally Cleared Derivatives (March 2015) , *available at* http://www.bis.org/bcbs/publ/d317.pdf .

notional value. Such reductions could readily be done in proportion to the margin percentages set forth in Table A. For example, if the Table A haircut for the Equity and Commodity Asset Classes is 15%, then to provide an extra measure of protection, this amount could be doubled to 30% which would then be multiplied by notional value for purposes of calculating the 150% notional exposure limit.

We expect the Commission will receive numerous proposed risk adjustment approaches, and we recommend the Commission consider such proposals carefully in adopting any final rule.

### E. Additional Practical Adjustments Should be Made to the Calculation of Notional Exposure

The Commission asks for comment on whether the Proposed Rule's netting provisions for calculating a Fund's notional exposure appropriate are appropriate, and if there are other circumstances under which netting should be permitted.[19] The Proposed Rule limits netting of derivatives contracts to those that that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.[20] With respect to the requirement for the same type of instrument, we believe that the Proposed Rule should instead allow netting across different types of instruments if those offsetting instruments indeed reduce notional exposure. For example, a total return swap that provides a Fund with long exposure to an equity index should be permissibly netted against a short futures contract referencing the same equity index.

As a related point, we also recommend that a Fund be permitted to net across contracts that are part of a single transaction, such as a collar, spread or other paired investment positions. The Commission notes that there may be difficulties for Funds in determining whether these paired transactions reduce risk.[21] We respectfully disagree and believe that the boards of Funds could readily adopt clear and reasonable policies and procedures that address this issue. The Proposed Rule requires Fund boards under the Risk-based

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19 Proposing Release at 80908.

20 *See* Proposed Rule 18f-4(c)(3)(i).

21 Proposing Release at 80906.

Coverage Amount to approve policies and procedures designed to determine the level of potential risk posed by derivatives contracts in stressed market conditions. Fund boards that have the ability to understand and approve policies that analyze and quantify risk across the entire universe of derivatives contracts in all manner of stressed market conditions would certainly be capable of addressing the relatively basic issue of when one type of contract may mitigate risk posed by a second contract. We further note that many Managed Futures Funds may temporarily increase their notional exposure when rolling expiring futures contracts into new contracts. Because this additional notional exposure is only temporary – and may in some cases last only two to three trading days – and not intended to increase the Managed Futures Fund's targeted market exposure, we request that the Proposed Rule exclude these additional amounts of market exposure from the Proposed Rule's notional calculations.

The Commission also restricts netting to contracts with the same maturity date. In our view, provided that the maturity date of a derivative contract occurs on or prior to the maturity date of a second contract that otherwise may be netted against the first contract, the Proposed Rules should permit netting across these contracts. Market exposure under the first contract will offset the market exposure under the second contract until the first contract matures. Thereafter, the notional exposure calculation would include the exposure under the second contract. Offsetting contracts of this type are commonly entered into for risk management purposes. Funds also enter into offsetting contracts as a more cost effective method of eliminating or reducing market exposure under the first contract in lieu of terminating it altogether. We suggest that the Proposed Rule permit Funds to net across these contracts for purposes of calculating notional exposure, rather than penalizing Funds for entering into offsetting, risk-reducing contracts.

### F. Qualifying Coverage Assets Should Include all Liquid Assets

The Proposed Rule limits Qualifying Coverage Assets solely to cash and cash equivalents. The Commission requested comment on whether other types of assets should be eligible for asset segregation. Limiting Qualifying Coverage Assets to cash and cash equivalents is a reversal of twenty years of prior Commission policy and established market practice.[22] The Commission's own proposed rules with respect to eligible assets

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

available to collateralize non-cleared security-based swaps allows for a reasonably broad range of asset classes.[23] The Prudential Regulators, the CFTC and the BCBS/IOSCO OTC margin framework all similarly allow for a wider array of asset classes. Each of these regulatory bodies subjects qualifying assets to standardized haircuts to reflect appropriate asset-specific risks, and we suggest that the Commission adopt this approach as well. We note, in addition, that limiting Qualifying Coverage Assets to cash and cash equivalents would likely require Funds to maintain cash investments, incur a cash drag on these holdings and reduce investor returns.

We strongly urge the Commission to expand the definition of Qualifying Coverage Assets to include all liquid assets, which could be reasonably limited to those assets constituting three-day liquid assets under the Commission's proposed rule 22e-4(a)(8).[24] We suggest that the Commission, consistent with the approach taken by the other regulatory bodies above, apply standardized haircuts to any Qualifying Coverage Asset other than cash or cash-equivalents.

## 4. Request for Re-proposal of the Proposed Rule Following Receipt of Comments and Recommendations

We support the Commission's efforts to protect investors in mutual funds and other retail products from excessive risks related to derivatives transactions. The Proposed Rule is an important first step in addressing the extended, regulatory patchwork of Commission policy and guidance on these issues for nearly forty years.

We expect that the Commission will receive numerous recommendations, proposals and other comments on the Proposed Rule. After the Commission has reviewed and taken into account these comments, given the profound and unprecedented impact a final rule will have on the U.S. mutual fund industry, including Managed Futures Funds, we

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23 *See* 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, *available at* http://www.sec.gov/rules/proposed/2012/34-68071.pdf.

24 *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, 80 Fed. Reg. 62273, *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf.

strongly urge the Commission to re-propose the Proposed Rule, along with an additional comment period after the rule proposal has been amended to reflect comments received.

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Thank you for considering our views on this important topic. If you have any questions or if we can provide any additional information that may assist the Commission and its Staff, please contact Matthew K. Kerfoot at [redacted] or [redacted] or Farmun Farahmand at [redacted] or [redacted].

Respectfully submitted,

/s/ Dechert LLP

Dechert LLP

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Diane C. Blizzard, Associate Director
Division of Investment Management