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Filed Electronically: rule-comments@sec.gov
Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (December 11, 2015)

File No. S7-24-15

Dear Mr. Fields:

Credit Suisse Asset Management, LLC ("Credit Suisse," "we," "us" or "our") would like to take this opportunity to comment on the above-referenced release issued by the U.S. Securities and Exchange Commission (the "Commission"). As set out in the release, the Commission is proposing a new rule designed to address the investor protection purposes and concerns underlying Section 18 of the Investment Company Act of 1940, as amended (the "1940 Act"), and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives (the "Proposed Rule"). This letter highlights our concerns with respect to the effectiveness and appropriateness of the Proposed Rule with respect to registered investment companies ("registered funds") and business development companies ("BDCs" and together with registered funds, "funds").

We support the Commission's objectives of establishing uniform and comprehensive guidance relating to the use of derivatives by funds and protecting fund investors. However, for the reasons set forth below, we believe that the Proposed Rule would not be effective in achieving those objectives. This letter addresses and highlights our concerns with respect to the proposed portfolio limits and asset segregation requirements under the Proposed Rule. This letter does not seek to address certain other parts of the Proposed Rule or to reiterate comments which we understand other fund or industry groups intend to address in comment letters to the Commission.

Credit Suisse is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") and as a commodity pool operator and a commodity trading advisor with the Commodity Futures Trading Commission (the "CFTC") under the Commodity Exchange Act. As of December 31, 2015, we managed approximately $51.2 billion of client assets. Our clients include registered funds, a BDC, foreign investment companies, private investment funds and separately managed accounts for public and private pension plans, corporations, not for profit and other business entities.

The U.S. registered funds that we manage follow a variety of traditional and alternative investment strategies, including managed futures, commodities, long-short equity, event driven, global macro and emerging markets investing and combinations of those strategies. Many of these strategies use derivatives as an efficient means of obtaining exposure to a particular asset and/or to reduce exposure to certain risks. The U.S. registered funds that follow alternative investment strategies are designed to be a complement to an existing portfolio of equity and fixed income investments by serving as an alternative investment component within an investor's portfolio. The returns generated by these funds are generally expected to provide a low correlation to the returns of equity and fixed income investments and as such, an investment in these funds may provide investors with a way to achieve diversification and reduce volatility in their overall portfolio. We believe that the Proposed Rule could cause these types of funds to be unable to implement their strategies without being substantially restructured (in some cases), which would result in less diversified, less liquid and more expensive investment options. This would have the unintended consequences of being harmful to, rather than protective of, investors.

As discussed in greater detail below, we believe that the Commission should first strengthen and standardize asset segregation requirements for funds and then, at a later date, consider the benefits and costs of adopting portfolio limits. However, if the Commission is determined at this time to implement portfolio limits, the limits should not be calculated based on notional amounts of derivatives but on risk-adjusted amounts which correlate to the underlying reference asset of the derivative and which take into account appropriate offsets.[1] Additionally, the proposed exposure and risk-based portfolio limits should be modified to create a regime that allows registered funds to use both in tandem as their portfolios change.

<u>The Commission Should Strengthen Asset Segregation Requirements and Not Adopt Portfolio Limits</u>

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[1] We direct the Commission to the recently published white paper entitled "Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies: Data and Economic Analysis" as support for certain of our comments.

Approximately thirty-five years ago, the Commission adopted an asset segregation approach beginning with Investment Company Act Release No. 10666 ("Release 10666") which required funds to segregate liquid assets in sufficient amounts in order to meet their potential obligations in connection with reverse repurchase agreements, firm commitment agreements and standby commitment agreements. The Commission essentially acknowledged that if a fund "covered" its obligations under those transactions, the fund would not be deemed to have issued a senior security under Section 18 of the 1940 Act. Subsequent to Release 10666, the Commission staff issued a series of no-action letters over the years relating to the maintenance of segregated assets to cover potential fund obligations in connection with various derivatives transactions. The regulatory approach taken in Release 10666 and the subsequent guidance provided by the staff in the various no-action letters have successfully continued to serve funds and investors by limiting fund leverage and its accompanying risks.

The Commission's Proposed Rule would depart from many years of established practice by imposing portfolio limits using notional amounts and by limiting qualifying coverage assets for the purposes of asset segregation to cash and cash equivalents only, notwithstanding that various liquid assets have been permitted and used by funds for asset segregation for many years without issues. We understand the Commission's concerns that certain segregated assets may decline in value over the course of their use as cover for a fund's derivatives contracts with the result that funds may not have sufficient assets to meet their potential obligations under those contracts. We believe, however, that the use of cash and cash equivalents (e.g. Treasury bills, bank deposits, commercial paper, money market fund shares) is unduly limiting for a number of reasons.

The goal of portfolio management is to fully and prudently invest fund assets consistent with a fund's investment objective and strategies, thereby avoiding cash drag and negative performance impact. This portfolio management goal is an expectation of a fund's shareholders when they invest in a fund. Requiring funds to hold large amounts of cash or low interest rate instruments to cover potential obligations under derivatives transactions will leave funds with a diminished ability to invest and maintain investments in other types of liquid assets that can contribute to potential return. In addition, under this requirement, most funds will try to avoid holding cash because of cash drag and therefore will look to a suitable cash equivalent as the next best option. (Money market fund shares may not be viewed as an optimal cash equivalent due to the underlying fund fees and expenses.) This may give rise to limited availability of certain cash equivalents in the market at a given point in time and create liquidity issues in the market. We note that the Dodd-Frank Wall Street Reform and Consumer Protection Act has caused many banks to shrink their risk weighted assets, thereby reducing the amount of fixed income securities investments they are able to hold on their balance sheets. With banks unable or unwilling to provide liquidity in certain instruments due to capital constraints, requiring funds to use cash instruments to cover their derivatives may further reduce liquidity options for fund managers.

As noted above, the Commission's rationale for limiting qualifying coverage assets to cash and cash equivalents is its concern with a decline in asset values for securities set aside as cover. Currently, funds address the issue of a potential decline in the value of coverage assets through the daily mark to market of a fund's derivatives positions along with the daily pricing of its securities holdings. Any decreases in the prices of securities or positions used for cover will result in the segregation of additional assets in order to bring coverage back to the amount required to address a fund's current exposures or potential payment obligations. This current practice can be strengthened further by the Commission if it adopts uniform and standardized asset segregation practices that would codify the staff's no-action positions and guidance and incorporate risk discounts or "haircuts" to various assets used for cover based on their respective risks and tendencies to fluctuate in value. There is already established precedent for this in the market with the Prudential Regulators Margin Rules and the CFTC Margin Rules which set forth discounts on various assets used for initial and variation margin. This approach would appear to address the Commission's concerns that funds have sufficient assets to meet their obligations with appropriate risk parameters while at the same time preserving flexibility and market liquidity and providing fund managers and compliance officers with uniform, understandable and administrable standards that can co-exist with other regulatory schemes.

The proposed portfolio limits would change the way fund portfolio managers normally choose to implement the fund's goals, forcing them to purchase actual securities once the respective required limits have been reached. This may have the effect of actually decreasing the liquidity of a fund's portfolio as certain derivatives have more liquidity than the underlying securities themselves. The proposed portfolio limits also may result in increased fund costs in gaining exposure to particular markets or investments, as it may be more cost effective to gain exposure to the same markets or investments through a derivative instrument, which can also be hedged. In some emerging markets, derivatives are the only practical way to access the market due to the need for licenses or special arrangements to invest. Finally, the proposed portfolio limits may have the effect of causing funds to invest less in low-volatility derivatives (which use up large amounts of notional exposure) and more in high-volatility derivatives (which use up less). Instead of taking an approach that can have a number of serious, unintended consequences for funds and their investors, we urge the Commission to focus on strengthening asset segregation requirements by adopting more uniform risk adjusted standards that will be clear and straightforward to monitor and implement.

<u>The Portfolio Limits Should Not Be Based on Notional Amounts</u>

The Proposed Rule would require funds that invest in derivatives transactions to comply with either a 150% exposure limit (the "Exposure Limit") or a 300% risk-based limit (the

"Risk-Based Limit") which would require funds to limit their derivatives transactions to specified percentages of their net asset value based on aggregate notional exposure.

We have significant concerns with the proposed imposition of portfolio limits calculated by simplistically summing up the notional amounts of the derivative exposures. Such limits would effectively prevent a significant group of bond funds and alternative funds either from operating as registered funds, thereby forcing them to deregister with the Commission, or requiring them to substantially revise their investment strategies in ways that increase costs, reduce liquidity and lessen returns. This could potentially deprive mutual fund investors of sound investment options. For many other funds, portfolio limits based on a sum-of-the-notionals approach will impose constraints on portfolio management in a number of ways. Fund managers use a variety of derivatives in combination to achieve hedging, exposure, return, liquidity and risk management. The Commission's proposed portfolio limits equate leverage with risk, which is not the way fund managers address this in practice. Under the Proposed Rule, different derivatives contracts are treated the same if they have the same notional exposure, notwithstanding that the actual risk of the underlying reference assets may be very different. For example, similar contracts of the same type but with different durations will result in different amounts of risk to a fund. A more dramatic example would be a comparison between an S&P 500 Index future and a U.S. Treasury bond future with the same notional exposures. Ample data supports the position that the S&P 500 Index future is more risky than the U.S. Treasury bond future. Under the Proposed Rule's portfolio limits which use notional exposure, however, the two contracts in both examples would be weighted the same if their notional amounts are the same, which is not the way the two contracts would be treated from a risk perspective.

<u>If Adopted, Exposure and Risk-Based Limits Should Be Significantly Modified</u>

Notwithstanding our significant concerns, should the Commission nonetheless determine to impose notional based portfolio limits, we recommend that the Commission consider revising its approach along the following lines:

1. <u>Increase the 150% Exposure Limit to 250% and Apply Risk-Based Adjustments.</u> We believe that the Commission's proposed 150% Exposure Limit based on notional exposure is too low and overly restrictive and will seriously impact a larger group of funds than the Commission cites in the proposing release. As noted above, this will result in a number of funds either having to deregister as registered funds or having to significantly alter their investment programs and strategies by reducing their use of derivatives for hedging, risk management, exposure and investment return – all of which work together in an investment program. This will prove costly and disruptive to implement, and may affect millions of shareholders and intermediary fund platforms, impacting all manner of investment accounts including IRAs and 401(k) plans. We think that a modest

increase to 250% could ameliorate some of this impact without harming investors. An increase in the 150% limit should be accompanied with a standardized calculation or uniform schedule or method of calculating exposure based on risk, which would be applied to the gross notional amount of the derivative. An approach based on summing up all notional amounts regardless of the risk of the underlying reference asset may result in a large exposure calculation that is not correlated to the risk the derivative creates for the fund. Increasing the 150% limit and risk adjusting the gross notional amount to reflect the underlying risk of the reference assets would afford additional flexibility to all funds and would permit a larger number of funds to continue to operate as registered entities, something which, given the benefits of these funds to retail investors, should also be a goal of the Commission's regulatory program.

2. <u>Revise the VaR Test for the 300% Risk-Based Limit and Apply Risk-Based Adjustments.</u> We believe that the Commission should replace its VaR test in the Proposed Rule with an absolute VaR test. Under our proposal, a fund could have notional exposures up to a 300% limit if the VaR of a fund's portfolio is equal to 20% or less of the fund's net assets, using the risk based adjustments to notional amount as discussed herein along with the Commission's proposed VaR parameters in terms of confidence level and time horizons. This absolute VaR test would be an easier test to monitor, calculate and implement and could provide a more consistent and accurate measurement of risk by taking into account how a fund's entire portfolio is operating (including both derivatives and investments). We believe 20% is an appropriate absolute VaR limit as it represents the approximate VaR of the S&P 500 Index over time. Consequently, the "cap" would result in funds that use the 300% test having less volatility than a proxy for an accepted equity securities index.

3. <u>Expand Netting Across Portfolio Instruments</u>. The Proposed Rule would permit funds to net notional amounts from any directly offsetting derivatives transaction that is the same type of instrument with the same underlying reference asset, maturity and other material terms. We urge the Commission to expand the use of netting to permit funds to eliminate exposure through the use of different instruments from the one the fund is holding so long as the maturities and material terms are the same. This should address the Commission's concerns about market risk while still providing additional flexibility.

4. <u>Exclude Direct Hedges From the Portfolio Limits of Both Tests.</u> We recommend that the Commission exclude certain direct hedging transactions from the calculation of the Exposure Limit or the Risk-Based Limit. Hedges that provide direct offsets which reduce or eliminate the economic exposure of a particular portfolio security or currency and that are related to such currency or security should be permitted to be excluded from the calculation of portfolio limits so long as the excluded amount is limited to the amount of the long position of the security held by the fund.

5. Incorporate and Consolidate Both Limits. Instead of having to choose between the Exposure Limit and the Risk-Based Limit, funds should be able to use either limit at any particular time by combining the Risk-Based Limit with the Exposure Limit, separating the derivatives providing leverage exposure from those providing a hedge. If a fund exceeded the Exposure Limit, then the amount of the fund's derivatives transactions above this limit would have to be risk reducing such that the portfolio VaR is still below the securities VaR and the Risk-Based Limit is not exceeded. When a derivative is added to the fund's portfolio and the VaR of the fund's portfolio, including the new derivative, is less than the securities VaR, the derivative would be treated as a hedge and would be excluded from the Exposure Limit. A fund therefore could invest in any derivative as long as it does not exceed the Exposure Limit or falls within the exceptions discussed above. This would afford fund managers the flexibility they need as well as reduce the operational constraints of having to convene the fund's board when the fund needed to change from reliance on one portfolio limit to the other due to changing market conditions. In terms of disclosure to fund shareholders, a fund would still provide meaningful disclosure about its use of derivatives and its expected Risk-Based and Exposure Limits. This disclosure could occupy a more prominent place in the fund's prospectus in addition to the sections of the registration statement that currently address the fund's use of derivatives.

Toward A Balanced Approach

We urge the Commission to carefully weigh all of the variables and possible ramifications of the Proposed Rule and consider a regulatory framework that would enable most if not all funds to continue to operate under the registered funds tent and at the same time be able to provide retail investors with investment strategies that utilize derivatives to achieve investment objectives. This may call for a more balanced approach than the one reflected in the Proposed Rule, one that would incorporate or meld different aspects of the Proposed Rule with certain recommendations and approaches put forth by fund managers and the fund industry. While this may involve more complexity, as opposed to the Commission's self-described "blunt measurement," it would also provide a new framework that could address some or all of the Commission's concerns while recognizing changes that have occurred in the markets over the last forty years and the way derivatives are used today by funds in ways that benefit investors. Derivatives comprise a significant component of the global financial system and are utilized by registered and unregistered investment funds worldwide. Investors, including retail investors, have come to recognize the role derivatives may play in providing hedging, exposure, liquidity, returns and risk reduction with respect to their portfolios. Adopting the Proposed Rule without modifications that incorporate the way funds actually operate today may serve to reset the fund industry backward to an investment period where derivatives were less or sporadically used. We believe that the clock should not be turned back, thereby denying mutual fund investors the benefits of innovation using derivatives. This type of innovation is a core strength of the mutual fund industry and, in our view, should be encouraged, subject to reasonable regulatory limits. Adopting the Proposed Rule in its current form will harm, rather than protect investors, by restricting retail shareholders from access to investments that they have selected in accordance with their return objectives and risk tolerances in order to achieve their investment goals and diversify their investment portfolios.

We thank the Commission for the opportunity to comment on the Proposed Rule and its consideration of the views and concerns expressed in this letter. We are available to further discuss our comments or to provide any additional information that the Commission may find useful.

Sincerely,

William W. Johnson
Managing Director, Credit Suisse
Deputy Head, Asset Management