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VIA EMAIL

March 28, 2016

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

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

Dear Mr. Fields:

We appreciate the opportunity to provide comment to the Securities and Exchange Commission (the "Commission") on the Commission's above-referenced proposal to regulate the use of derivatives by registered investment companies and business development companies (the "Proposal"). The Capital Group Companies is one of the oldest asset managers in the United States. Through our investment management subsidiaries, we actively manage assets in various collective investment vehicles and institutional client separate accounts globally. The vast majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies distributed through financial intermediaries and held by individuals and institutions across different types of accounts.

As an initial matter, we believe that funds have generally been successful in appropriately managing the risks associated with the use of derivatives and we note that many fund organizations, including the American Funds, already employ thorough derivatives risk management practices. Indeed, we do not believe that there is evidence of widespread losses, or risk of losses, precipitated by the use of derivatives, nor do we believe that there is evidence of widespread failures, or risk of failures, of funds to meet their financial obligations under derivatives and financial commitment transactions (as defined in the Proposal). Although the Proposal cites three specific examples of derivatives-related losses suffered by registered investment companies, each of the referenced examples predates the extensive regulation of the derivatives industry in light of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Nonetheless, we generally support the Proposal and the Commission's goals of (1) reducing undue speculation by funds that use leverage and (2) mitigating the risk that funds might operate without adequate assets to meet their derivatives obligations, particularly for those funds that currently dedicate significantly fewer resources to managing derivatives risks in a formalized way.

We also strongly believe that the Commission, as the primary regulator of open-end funds, closed-end funds, exchange-traded funds and business development companies, is the appropriate regulator to address such concerns. We applaud the Commission in its recent efforts to strengthen and modernize the regulation of the asset management industry consistent with the Commission's statutory mission. In addition to the Proposal, the Commission has proposed rules to modernize and enhance reporting and disclosure by investment companies and advisers and to promote effective liquidity risk management throughout the open-end fund industry. We believe that this set of comprehensive initiatives will strengthen the fund industry, reduce risk and provide increased investor protection, and we urge the Commission to continue asserting its authority to fairly and effectively oversee the asset management industry.

In light of the above, we offer the following comments on specific aspects of the Proposal. Our comments are organized in Sections A through E of this letter based on whether they relate to (A) the definitional structure and scope of the Proposal; (B) the proposal to set portfolio-level limits on senior securities transactions; (C) the proposal to require the segregation of assets to cover a fund's obligations under derivatives and financial commitment transactions; (D) the proposal to require regulated funds to establish derivatives risk management programs; or (E) other matters relating to the regulation of derivatives and financial commitment transactions, respectively.

A. Definitional Structure and Scope of the Proposal

1. Although we generally support the proposed distinction between "derivatives transactions" and "financial commitment transactions," the Commission should refine the definition of "financial commitment transaction" to more clearly distinguish such transactions from derivatives instruments.

The Proposal distinguishes between derivatives transactions and financial commitment transactions. On the one hand, proposed rule 18f-4(c)(2) would define "derivatives transaction" to mean "any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination...."[1] According to the Proposal, this definition is designed to describe those transactions that involve a potential future payment obligation, which, in our view, would include, among other things, swaptions, trades of mortgage-backed securities in the to-be-announced forward market and commodity derivatives. On the other hand, proposed rule 18f-4(c)(4) would define "financial commitment transaction" to mean "any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement...."[2] Although this definition is similarly designed to describe certain transactions that "involve conditional or unconditional contractual obligations to pay or deliver assets in the future," the definition also describes a specific subset of contractual obligations, pursuant to which a fund will be required "to pay in the future for consideration presently received."[3]

We generally support this proposed distinction. Whereas derivatives transactions and financial commitment transactions may both entail future payment obligations, financial commitment transactions can be functionally equivalent to borrowings. Unlike derivatives instruments, only financial commitment transactions require future payments in exchange for consideration received by a fund at

1 See *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Release No. IC-31933, 80 Fed. Reg. 80903 (Dec. 28, 2015), at 80899.

2 *Id.*

3 *Id.*, at 80899.

the outset of the transaction. However, because the definition of "financial commitment transaction" does not clearly identify that such transactions are characterized by an initial exchange of consideration, the Commission should refine the definition of "financial commitment transaction" to eliminate ambiguity and to ensure consistency in application of the Proposal across fund families. By way of example, we would propose that the Commission redefine "financial commitment transaction" to mean:

> any reverse repurchase agreement, short sale borrowing, standby commitment agreement or any similar agreement under which the fund is or may be required to make any payment or delivery of cash or other assets during the term of the agreement (or at maturity or early termination thereof) in exchange for consideration received by the fund on the effective date of the agreement (including, for the avoidance of doubt, an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner).

As reflected in the proposed definition above, we would also recommend striking the reference to "firm ... commitment agreement[s]" from the definition of "financial commitment transaction" proposed by the Commission, as, in practice, the reference is ambiguous in meaning and may have the effect of blending the delineation between derivatives transactions and financial commitment transactions. On its face, the Proposal is clear that "derivatives transactions" include any forward contract. However, in Investment Company Act Release No. 10666, an official statement of Commission policy on which the Commission's presently proposed definition of "financial commitment transaction" is based, the Commission acknowledges that "[t]he firm commitment is known by other names such as 'forward contract.'"[4] In effect, defining "financial commitment transaction" to include firm commitment agreements results in a framework pursuant to which certain forward contracts might qualify as, and be subject to contradictory treatment under varying regulatory regimes applicable to, both derivatives and financial commitment transactions.

B. Portfolio-Level Limits on Senior Securities Transactions

1. Although we generally support the imposition of portfolio-level limits on leverage, we urge the Commission to reconsider its proposal to adopt broadly applicable portfolio limits based solely on notional exposure.

The Proposal would require funds that engage in derivatives transactions to comply with one of two alternative limitations. Normally, a fund would be required to limit its aggregate exposure to derivatives transactions, financial commitment transactions and other senior securities (collectively referred to in the Proposal as "senior securities transactions") to 150% of the fund's net assets. Alternatively, if a fund's use of derivatives reduces its exposure to market risk, the fund may instead elect to comply with a risk-based portfolio limit, pursuant to which the fund must limit its exposure to senior securities transactions to 300% of the fund's net assets. In each case, a fund's "exposure" to senior securities transactions would generally be calculated as the aggregate notional amount of its derivatives

4 See *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 10, 1979) ("Release No. 10666"), at fn. 10.

transactions, together with its obligations under financial commitment transactions and other senior securities.

The Commission states that such portfolio limitations are designed primarily to limit the exposure of funds to potential leverage and, in effect, to ensure that funds are not unduly speculative. As a general matter, we support the imposition of portfolio-level limits to constrain leverage and to prevent undue speculation by regulated funds. However, because a fund's notional exposure to derivatives does not adequately measure leverage or risk, we strongly disagree with the Commission's proposal to use notional amounts as a basis for limiting undue speculation.

There are several significant shortcomings of using notional amounts as the basis for any portfolio limit. Most importantly, the use of portfolio limits based on notional exposure is fundamentally inconsistent with the Commission's stated intent of employing limits to counter undue speculation. By definition, the determination of whether a fund's use of derivatives is unduly speculative requires an assessment of risk: a fund's investment portfolio is "speculative" if it involves a high risk of loss and the portfolio is "unduly speculative" if such risk of loss is extreme, unreasonable or unnecessary. However, the Commission recognizes that "a derivative's notional amount ... is not a risk measure."[5] If that is the case (and we agree that it generally is), notional exposure is not an appropriate metric by which to assess the relative risk profile of a fund's investment portfolio in determining whether or not the portfolio is unduly speculative.

That said, though, for certain derivatives, notional amount does represent a measure – albeit, a limited and imperfect measure – of risk. Yet, when applied broadly to all derivatives transactions, portfolio limits based solely on notional exposure are nevertheless inappropriate, as such limits fail to account for the wide variances in the risk profiles of various classes of derivatives. The term "notional amount" has different connotations when applied to different types of derivatives. As is the case with credit default swaps, for which the notional amount represents the maximum potential loss of the protection seller, the notional amount of certain derivatives instruments effectively reflects the relative risk position of one party to the transaction. However, for the counterparty to the same transaction, the notional amount of the trade may have little to no relationship whatsoever to the potential scope of such other party's loss. Continuing with the example of a credit default swap, the potential scope of loss of a protection buyer in a credit default swap has little relation to the instrument's notional amount.

For yet other derivatives, including certain futures contracts and interest rate swaps, the notional amount is a completely arbitrary metric, which does not directly reflect the relative risk positions of either party to the transaction or the potential losses to which those parties are subject. Instead, for such instruments, the notional amount serves only as a reference point for the calculation of the parties' contractual payment amounts. For instance, the level of risk associated with a $100 million notional amount of a futures contract on a thirty-year treasury bond, measured in terms of dollar duration and interest rate sensitivity, is substantially greater than the level of risk associated with a $100 million notional amount of a futures contract on a two-year treasury bond.

As stated in the Proposal, "different derivatives transactions having the same notional amount but different underlying reference assets – for example, an interest rate swap and a credit default swap having the same notional amount – may expose a fund to very different potential investment risks and

[5] Proposal at 80903.

potential payment obligations."[6] Accordingly, a fund with high notional exposure to certain derivatives, such as interest rate swaps, is not inherently more speculative than a fund that uses riskier derivatives more sparingly. Conversely, a fund with little to no derivatives exposure may be more speculative than a fund that uses derivatives to a greater extent. Because there is no standard connection between notional exposure and the risk profile of a derivative, there is likewise no sensible connection between broadly applied portfolio limits based on notional exposure and the speculative (or non-speculative) nature of a fund's portfolio. The application of such limits could, in practice, result in a fund that invests in derivatives being unfairly characterized as "unduly speculative" when it has essentially identical economic risks and rewards as another fund that does not invest in derivatives.

Although the Commission acknowledges the inherent weaknesses of portfolio-level limits on notional exposure, the Commission concludes that, on balance, "a notional amount limitation would be a more effective and administrable means of limiting potential leverage from derivatives"[7] than a limitation which relies on other unspecified measures of leverage. In support of this determination, the Commission notes that notional amounts are used in numerous other regulatory regimes as a means of determining the scope of derivatives activities of various market participants. Notably, though, regulators have recognized the drawbacks of notional exposure calculations in providing any meaningful information regarding leverage and risk associated with derivatives investments. A recent report by the Office of Financial Research, for instance, discusses the weaknesses of data based on notional exposure, stating, among other things, that "the notional values of a credit default swap and an interest rate swap do not pose equivalent risk."[8] In some instances, regulators have begun reconsidering prior determinations to base regulatory thresholds on notional calculations. For example, the Commodity Futures Trading Commission (the "CFTC") has publicly questioned whether notional amounts, which are currently utilized in calculating compliance with a *de minimis* exemption for registration requirements, are appropriate measures for triggering regulatory oversight.[9]

2. **Given the weaknesses of broadly applied portfolio-level limits based solely on notional exposure, we instead urge the Commission to adopt margin-based portfolio limits alongside narrowly applicable limits based on risk-adjusted notional exposure.**

Although we are generally supportive of the Commission's proposal to impose portfolio-level limits on senior securities transactions to prevent undue speculation, because a fund's notional exposure to derivatives does not adequately measure risk or leverage, we strongly disagree with the proposal to use unadjusted notional amounts as a basis for any such broad-based limitations. Instead, we urge the Commission to consider adopting a two-pronged limit on senior securities transactions: on the one hand, cleared derivatives transactions should be subject to an absolute cap on initial margin posted with a fund's clearinghouse counterparties, while all other senior securities transactions (including uncleared derivatives transactions) should be subject to risk-adjusted notional exposure limits similar to those proposed by the Commission.

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6 *Id.*

7 *Id.*

8 Office of Financial Research, 2015 Financial Stability Report (Dec. 15, 2015), at 38.

9 Remarks of CFTC Chairman Timothy Massad before the 2016 P.R.I.M.E. Finance Annual Conference (January 25, 2016). See also Commodity Futures Trading Commission, *Swap Dealer De Minimis Exception Preliminary Report* (Nov. 18, 2015), at 18.

a. **The Commission should adopt margin-based portfolio limits on cleared derivatives transactions.**

Because the Commission seeks by its proposed portfolio limits to mitigate the risk of undue speculation by funds, such limits must be reasonably designed to assess the speculative risks of senior securities transactions rather than arbitrarily capping a fund's investments in senior securities transactions. As the Commission notes, any such limits must also be effective and administrable means of limiting potential leverage from derivatives transactions. In light of these considerations, we propose that the Commission consider and adopt a margin-based portfolio limit on cleared derivatives transactions, pursuant to which a fund must limit the amount of its net assets posted as initial margin on account of cleared derivatives transactions to a specified percentage – say, 5%.

The broad application of portfolio limits based on unadjusted notional exposure to the entirety of a fund's portfolio of senior securities transactions is fundamentally inconsistent with the Commission's express intent of employing limits to counter undue speculation. At best, notional amounts are a poor measure of risk and, because notional amounts often overstate a fund's obligation under, and the economic risks associated with, a derivatives transaction, notional exposure is an inaccurate and ineffective means of meeting the Commission's stated goal.

Alternatively, a margin-based portfolio limit applicable to the cleared derivatives transactions in which a fund invests (coupled with a risk-adjusted notional exposure limit for other senior securities transactions, as described below) would effectively cap, on a risk-adjusted basis, the fund's potential to incur excessive leverage or unduly speculative exposures. For derivatives transactions that are cleared through a central counterparty, a fund is required to post a performance bond in the form of initial margin with the applicable clearing organization. Initial margin amounts are set independently by clearinghouses using risk models and algorithms – with regulatory oversight but without input from funds, advisers or other third parties. With respect to cleared futures, swaps and options, initial margin is an amount intended to protect against potential volatility in the value of the position over a specified number of days, which amount is determined to a statistically targeted confidence level in accordance with the rules, regulations and conventions of the applicable clearinghouse. Importantly, clearinghouse risk models for determining initial margin amounts generally incorporate a method for simulating periods of significant financial stress, and clearinghouses adjust their margin requirements for individual derivatives transactions as those transactions are deemed to be more or less speculative. A fund that engages in cleared derivatives transactions, in other words, collateralizes those trades by posting initial margin with its clearinghouse counterparty, and any such amounts are dynamic, risk-adjusted amounts, which account, in real time, for both the speculative nature of an instrument and applicable market stressors. An appropriately tailored limit on such risk-based initial margin amounts would limit the extent to which a fund could invest in derivatives and, in turn, would effectively limit undue speculation.

Such a margin-based portfolio limit, pursuant to which a fund's investments in cleared derivatives would be limited by an absolute cap (e.g., no more than 5% of net assets) on the amount of initial margin the fund may post with clearinghouses, would draw from existing regulatory provisions. Under CFTC Rule 4.5, for example, a registered investment company that invests in derivatives need not register as a commodity pool operator if it limits the aggregate initial margin it posts on account of its derivatives positions to 5% of the liquidating value of its portfolio. In order to avoid such potentially burdensome registration requirements, many funds that engage in derivatives transactions presently monitor for compliance with this *de minimis* exception, suggesting that a margin-based portfolio limit would be easily administrable. Additionally, excluding cleared instruments from the Commission's proposed exposure- and risk-based portfolio limits is consistent with the enhanced regulation of cleared derivatives transactions by the Commission, the CFTC and other financial regulators under the Dodd-Frank Act and the robust regulatory framework for oversight of clearing agencies.

In light of the foregoing, we believe there is considerable merit to a margin-based approach to regulating leverage and we respectfully urge the Commission to adopt a portfolio limit on senior securities based, in part, on the amount of initial margin posted by a fund in connection with its positions in cleared derivatives transactions.

b. The Commission should apply risk-adjusted notional exposure limits to all senior securities transactions other than cleared derivatives transactions.

In conjunction with a margin-based limit on cleared derivatives transactions, we propose that the Commission adopt its proposed exposure- and risk-based portfolio limits; however, we recommend a modified framework, pursuant to which such limits apply to all senior securities transactions other than cleared derivatives transactions and the calculation of a fund's notional exposure in relation to such limits would be risk-adjusted. If adopted, such portfolio-level limits would retain the general structure and parameters of the limits set forth in the Proposal while accounting for the different risk profiles of varying derivative types and better preserving the benefits derivatives provide to fund investors.

As noted, we have significant concerns with the Commission's proposed use of unadjusted notional exposure, absent any adjustments for the relative risk profiles of various derivatives instruments, as the basis for any portfolio-level limits on senior securities transactions. Certain derivatives are inherently more speculative than others, and such variances are not necessarily reflected in the notional amounts of derivatives instruments. Accordingly, a limit based on aggregate notional exposure arbitrarily equates the relative risk values of all derivatives instruments and, in effect, fails to adequately limit undue leverage. To the contrary, such exposure-based limits may have the perverse effect of increasing a fund's speculative nature by encouraging a fund to take fewer positions with a greater speculative value. Because portfolio limits based on notional exposure might have the unintended effect of incentivizing the concentration of portfolios into derivatives contracts with the highest levels of risk per notional value, such limits may encourage risk-taking inconsistent with the goals of regulatory risk management. Additionally, such limits would systematically disadvantage certain types of funds that use classes of derivatives with high notional amounts but lower risk profiles, such as bond funds that use interest rate derivatives and global equity funds that hedge currency risk using currency derivatives.

There is no readily identifiable equivalent to initial margin that is applicable on a consistent basis to all uncleared senior securities transactions. As such, in order to address the dual concerns of inhibiting undue speculation while adequately accounting for variances in risk across different derivatives types, we urge the Commission to adopt the exposure- and risk-based portfolio limits described in the Proposal, to limit the application of such limits to all uncleared senior securities transactions, and to permit the adjustment of a fund's exposure calculation in respect of such transactions using standardized risk conversion factors. Regulators and market participants well understand the concept that different derivatives present different risk profiles, and regulators, including the Commission, have allowed for adjustment to notional exposures by an appropriate factor to address those concerns. Accordingly, for this purpose, the Commission might adopt any number of standardized schedules approved by regulators or self-regulatory authorities. We generally support each of the standardized risk-adjustment methodologies propounded by the Investment Company Institute and the Asset Management Group of the Securities Industry and Financial Markets Association in their respective comment letters relating to the Proposal and would urge the Commission to carefully consider those methodologies.

c. If the Commission adopts any portfolio-level limits on notional exposure, the Commission should, at a minimum, normalize the duration weightings for interest rate derivatives.

If the Commission adopts any portfolio-level limits on notional exposure to senior securities transactions, the Commission should, at a minimum, normalize the duration weightings for interest rate derivatives. As suggested by the Commission in the Proposal, notional amounts for interest rate derivatives should be normalized to ten-year bond equivalents. Normalizing interest rate derivatives in this manner would better reflect the relative risks of interest rate derivatives based on durations.

Relatedly, if the Commission adopts any portfolio-level limits based on notional exposure, we urge the Commission to permit notional amounts for short-term interest rate derivatives (i.e., one year or less) to be divided by an appropriate divisor for a twelve-month period. For example, if a fund held \$100 million in notional amount of three-month Eurodollar futures contracts, the notional amount would be divided by four, resulting in an adjusted notional exposure of \$25 million. As the Commission recognizes, calculating notional amounts for such short-term interest rate derivatives without adjusting to a twelve-month period could overstate the magnitude of a fund's investment exposure. Such a reduction in notional amount would again better reflect the risk of interest rate derivatives.

3. If the Commission adopts portfolio-level limits based on notional exposure, currency derivatives held as hedges against portfolio securities denominated in local currencies should be excluded from a fund's notional exposure calculation.

The Proposal would permit a fund, in determining its aggregate notional exposure to senior securities transactions, 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. By contrast, the Proposal would not permit a fund to net hedge or cover transactions with offsetting risk characteristics but that do not have the same underlying reference asset, maturity and other material terms or that involve different types of derivatives instruments. In the view of the Commission, many hedges are imperfect and, in any case, it would be too complicated to develop suitably objective standards for determining circumstances under which such transactions should be considered to have eliminated the market and leverage risks associated with the positions.

We believe that narrowly tailored exclusions could and should be crafted in an objective manner so as to alleviate the Commission's concerns. We therefore recommend that the Commission permit the notional amount of certain derivatives transactions entered into for very specific hedging purposes to be excluded from any calculation of a fund's notional exposure. Principally, the Commission should exclude currency derivatives, such as foreign currency forwards, from a fund's notional exposure calculation where such derivatives are held as hedges against portfolio securities denominated in local currencies. However, such exclusion should be permitted only to the extent that the exposure under the derivative does not exceed the value of the security being hedged. Such a hedge is equivalent to a directly offsetting transaction that reduces or eliminates economic exposure. Limiting the notional value reduction of a direct hedge to the value or principal amount of a security held by the fund further ensures that the derivatives instrument does not increase the fund's speculative exposure.

4. **The value-at-risk test proposed for purposes of the risk-based portfolio limit is operationally infeasible, but an absolute value-at-risk test would effectively and more efficiently limit undue speculation.**

The Proposal generally limits a fund's aggregate exposure to senior securities transactions to 150% of the fund's net assets. However, under proposed rule 18f-4(a)(1)(ii), a fund may invest up to 300% of the value of its assets in senior securities transactions so long as the fund's use of derivatives reduces its exposure to market risk, as evidenced by compliance with a value-at-risk test. Specifically, the value-at-risk of the fund's full portfolio must be less than the value-at-risk of the fund's portfolio exclusive of any senior securities transactions.

The value-at-risk test proposed by the Commission in connection with the risk-based portfolio limit is operationally infeasible. The Proposal requires real-time compliance by funds with applicable portfolio limits. Completing such calculations on a real-time basis throughout the trading day, particularly in the context of a very complicated set of value-at-risk calculations that may require a number of subjective determinations, would be operationally impossible at present. Many funds would have to update their internal systems in order to be able to run value-at-risk calculations in real time without vendor support. Additionally, the contributions of a fund's senior securities positions and other holdings to a full portfolio value-at-risk and a securities-only value-at-risk will constantly change throughout the course of the trading day, which may require the fund to run value-at-risk simulations numerous times each day. Such calculations would necessitate a fund to make the securities-only value-at-risk calculation using custom tagging or segregation of the fund's senior securities transactions from other portfolio holdings. Implementation of such processes would require a substantial build-out by funds in terms of software changes, addition of personnel and changes to operational flows. All such enhancements would be costly and would likely increase shareholder expenses significantly.

If the Commission adopts the value-at-risk test as set forth in the Proposal, the Commission should, at a minimum, permit funds to compute values-at-risk and confirm compliance with the test only once each business day. However, in lieu of imposing operational burdens on funds and, in effect, increasing shareholder expenses, we recommend that the Commission replace its proposed value-at-risk test with an absolute value-at-risk test. Drawing upon the UCITS regulatory scheme, under an absolute value-at-risk test, a fund would be permitted to maintain notional exposure to senior securities transactions of up to 300% of the fund's net assets if the value-at-risk of the fund's full portfolio is equal to 20% or less of the fund's net assets. An absolute value-at-risk test would effectively limit the amount of portfolio risk that funds could incur using derivatives, and funds would continue to be limited in the notional amount of exposure they could incur consistent with the Commission's risk-based portfolio limit. Funds – and particularly those funds with investment advisers or other affiliates with experience with the absolute value-at-risk test applicable under the UCITS regime – would also have familiarity with its operation and one common value-at-risk calculation could be used globally, which has the benefit of operational ease and administrative efficiency.

5. **Fund boards should not be required to approve which portfolio-level limit on exposure to senior securities transactions will apply to a fund; rather, both limits should apply simultaneously without the need for board preapproval.**

Proposed rule 18f-4(a)(5)(i) would require a fund's board, including a majority of directors who are not interested persons of the fund, to approve, in advance, which of the two alternative portfolio limitations – the 150% exposure-based portfolio limit or the 300% risk-based portfolio limit – will apply to the fund. According to the Commission, such requirement "would appropriately focus the board's attention on the nature and extent of a fund's use of derivatives and other senior securities transactions as part of its investment strategy."[10] Though not expressly stated in the Proposal, board approval is presumably also required in connection with a fund's shift from one portfolio limit to another.

It is not clear why a fund must choose to comply with one of the two alternative portfolio-level limits and why both limits could not apply simultaneously instead. At any point in time, a fund should be permitted to observe either limit without prior board approval so long as the fund's board-approved derivatives risk management program permits compliance with either limit. Eliminating the requirement to choose a portfolio limit in advance would enhance a fund's flexibility to adapt nimbly to changes in market conditions and, accordingly, would appear to be consistent with the general purposes of the Proposal. We therefore urge the Commission to remove the proposed requirement for funds to adopt one of the two portfolio limits and instead require that funds comply with either limit, so long as such flexibility is in accordance with the fund's derivatives risk management program. Relatedly, we urge the Commission not to adopt its proposal to require funds that engage in derivatives transactions to disclose on proposed Form N-CEN whether the fund relied on the exposure- or risk-based portfolio limit during a given reporting period. In the alternative, the Commission might require funds to disclose on Form N-CEN whether, during the reporting period in question, the fund observed the exposure-based portfolio limit, the risk-based portfolio limit or both.

If the Commission nevertheless requires a fund to choose in advance which of the two limits it will comply with, we ask that the Commission reconsider the requirement that a fund's board approve the applicable portfolio limitation, as such a requirement draws fund boards too deeply into a managerial role. A fund's investment adviser, which has the requisite experience relating to investment management, portfolio construction and the use of derivatives as an investment tool, is best positioned to determine which limit is most appropriate for a given fund. Fund boards do not have, nor should they be expected to have, the relevant expertise to analyze which of two portfolio limits is preferable.

C. Asset Segregation

1. **We strongly disagree with the limited scope of assets that may be used as qualifying coverage assets for derivatives and urge the Commission to expand the definition of "qualifying coverage assets" to include all liquid assets.**

The Proposal would require a fund that engages in derivatives and financial commitment transactions to maintain an amount of qualifying coverage assets designed to enable the fund to meet its obligations arising from such transactions. Under the proposed rule, for each derivatives transaction, a fund would be required to maintain qualifying coverage assets in an amount equal to the sum of (i) a mark-to-market coverage amount and (ii) a risk-based coverage amount, which would represent a reasonable estimate of the fund's exit cost with respect to the position under stressed market conditions. For a financial commitment transaction, a fund would be required to maintain coverage assets equal to the notional value of the fund's financial commitment obligation. To the extent it seeks to codify and enhance existing asset segregation requirements, we generally support the Proposal. However, the Commission also proposes substantial new limits on the types of assets that may be maintained to satisfy a fund's asset segregation requirements, which constitutes a significant departure from current regulatory requirements. Proposed rule 18f-4(c)(8) would limit the universe of qualifying coverage

[10] Proposal at 80924.

assets for derivatives transactions to cash and cash equivalents. Limiting qualifying coverage assets in this manner substantially narrows the categories of liquid assets that a fund may segregate to cover its obligations under current Commission guidance, which permits segregation of any liquid assets.[11]

We strongly disagree with the Commission's proposal to limit the scope of assets that may be used as qualifying coverage assets for derivatives transactions, and we appeal to the Commission to expand the definition of "qualifying coverage assets" to include all liquid assets. The proposed limit is unnecessary to ensure that funds are able to meet their obligations under derivatives transactions, and limiting segregable assets to cash and cash equivalents may require portfolio managers to reevaluate the construction of fund portfolios, which may unintentionally harm fund shareholders.

The Commission proposes to limit qualifying coverage assets for derivatives transactions to cash and cash equivalents, as "these assets are extremely liquid because they are cash or could be easily and nearly immediately converted to known amounts of cash without a loss of value."[12] The Commission worries that other types of assets, in contrast, may be more likely to experience price volatility or to decline in value in times of stress. Because other asset classes could lose value while a fund's potential obligations under derivatives instruments increase, the Commission did not propose including as qualifying coverage assets any asset types other than cash and cash equivalents. Notably, though, for nearly two decades, the investment management and financial services industries have followed Commission guidance in using a broad array of liquid assets to cover exposures resulting from derivatives transactions, and the Proposal identifies no instances of investor harm resulting from a fund's use of liquid assets to cover its derivatives exposure. Limiting qualifying coverage assets to cash and cash equivalents, as the Commission proposes, would unnecessarily reverse the Commission's longstanding position and would necessitate an abrupt shift in widespread industry practice.

Under certain circumstances, limiting qualifying coverage assets to cash and cash equivalents could harm shareholders. For funds that are able to hold large quantities of cash and cash equivalents, restricting qualifying coverage assets as proposed would cause a fund that engages in derivatives to have a larger portfolio of segregable assets concentrated in cash and cash equivalents. Such a portfolio would, in turn, harm investors by creating a cash drag on the performance of the fund that would otherwise be fully invested. Other funds, such as certain equity and high-yield bond funds, would find it difficult to employ derivatives-based strategies because such funds do not normally hold large quantities of cash and cash equivalents that could be used to cover derivatives transactions. In some cases, holding large amounts of cash and cash equivalents as segregable assets might conflict with a fund's investment objectives and strategies. In any such case, the proposed limitation on the scope of qualifying coverage assets would prevent a fund from utilizing derivatives where derivatives are the most efficient means of implementing a portfolio strategy, effectively disadvantaging shareholders.

In light of the foregoing, we strongly urge the Commission to expand the definition of "qualifying coverage asset" as applied to derivatives transactions to include all liquid instruments. Limiting segregable assets as proposed by the Commission does not reflect market practice. The permitted types of qualifying coverage assets for derivatives under the Proposal are substantially more limited than those recently approved by U.S. regulators for initial and variation margin for certain types of

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11 See Release No. 10666 (permitting segregation of cash, U.S. government securities and other high-grade debt obligations); Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) (permitting segregation of any "liquid assets," including equity securities and non-investment grade debt securities).

12 Proposal at 80932.

derivatives.[13] Similarly, although federal prudential banking regulators and the CFTC initially proposed margin rules that would have limited assets eligible for margin purposes to cash, both ultimately recognized in their respective rules that restricting the types of eligible collateral to cash and cash equivalents was inappropriate. Instead, the margin rules adopted by U.S. prudential regulators and the CFTC permit initial and variation margin for derivatives to include as eligible collateral any assets that "should remain liquid and readily marketable during times of financial stress."[14] If the Commission likewise adopts a broader definition of "qualifying coverage assets" for derivatives, we recommend that the Commission look to other regulatory regimes cited herein, including the CFTC margin rules, and adopt comparable definitions of liquid instruments eligible for segregation.

Further, if necessary to allay the concerns of the Commission in ensuring that sufficient assets are available to meet a fund's payment obligations, and if the definition of "qualifying coverage assets" is broadened as proposed herein, we would welcome the simultaneous adoption of sensible and standardized risk adjustments or haircuts to the value of non-cash assets in calculating the amount of a fund's qualifying coverage assets. Even though not required to do so, many investment funds have historically applied such haircuts to segregable assets as a matter of prudent risk management. Employing a broader group of qualifying coverage assets, combined with appropriate risk adjustments, would allow funds to continue to hold assets consistent with their investment strategies to minimize cash drag while also addressing the Commission's concern that funds have sufficient assets available to meet their obligations if their assets decline in value.

2. **For purposes of calculating asset segregation coverage amounts, the Commission should permit netting of cleared derivatives transactions in accordance with the netting practices of applicable clearinghouse counterparties.**

Under the proposed rule, if a fund has entered into a netting agreement that permits the fund to net its payment obligations with respect to multiple derivatives transactions, the fund can calculate both its mark-to-market and risk-based coverage amounts on a net basis with respect to all transactions covered by such agreement. Allowing a fund to segregate the net amounts owed to a counterparty (and the net risk-based coverage amount with respect to such counterparty) better reflects the actual economic exposure of the fund to the counterparty. We therefore support the proposed approach. However, we request that the Commission clarify what constitutes an eligible netting agreement.

On its face, the Proposal does not account for various common situations in which netting of payment obligations with respect to multiple derivatives is permitted. For instance, in compliance with CFTC rules, certain interest rate swaps and credit default index swaps are required to be cleared through a clearinghouse rather than held on a bilateral basis under an ISDA Master Agreement or similar

13 *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (Nov. 30, 2015) (final rule) and 80 Fed. Reg. 74915 (Nov. 30, 2015) (interim final rule); *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016) (final rule). Those rules generally permit the following asset classes, among others, to satisfy both initial margin and variation margin requirements: (i) high-quality government and central bank securities; (ii) high-quality corporate bonds; and (iii) equities included in major stock market indices.

14 For example, the CFTC's initial proposal would have limited the categories of eligible assets for variation margin to cash in the form of U.S. dollars or a currency in which payment obligations under the swap are required to be settled. See CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898 (Oct. 3, 2014) (proposed rule). Subsequently, the CFTC expanded the list of eligible collateral. See also *Margin requirements for non-centrally cleared derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013).

agreement. Though not mandated, funds may elect to clear other types of derivatives as well. Cleared positions held by a fund are typically governed by the rules of the applicable clearinghouse, as well as the terms of the fund's account documentation with a futures commission merchant that is a member of the clearinghouse and acts as the fund's agent with respect to the clearinghouse.

Although there is no "agreement" in place between the fund and a clearinghouse, payments to and from the clearinghouse are typically determined on a net basis, similar to the treatment under a netting agreement. Therefore, we request that the Commission clarify that positions held by a fund with the same clearinghouse through the same futures commission merchant or broker can be treated as transactions under a netting agreement for purposes of determining the mark-to-market and risk-based coverage amounts.

3. **Fund boards should not be required to approve specific and highly technical aspects of a fund's asset segregation policies and procedures.**

As noted above, the Proposal would require a fund to maintain a specified value of qualifying coverage assets for each derivatives transaction and financial commitment transaction to which it is a party. The Commission's proposed asset segregation framework would require considerable involvement of, and input from, a fund's board of directors. Proposed rules 18f-4(a)(5) and 18f-4(b)(2) would require a fund's board, including a majority of the fund's independent directors, to approve policies and procedures relating to the segregation of assets to cover the fund's derivatives transactions and financial commitment transactions, respectively. The Proposal would specifically require a fund's board to approve policies and procedures for determining the risk-based coverage amount for each derivatives transaction taking into account, as relevant, the structure, terms and characteristics of the derivative and its underlying reference asset. Additionally, for financial commitment transactions, a fund's board would be required to approve policies and procedures for determining whether an asset held by the fund constitutes a qualifying coverage asset because it is convertible to or will generate cash prior to the date on which the fund expects any financial commitment obligations to come due.

While we agree that a fund's board should be required to approve the fund's general asset segregation policies and procedures, we do not believe that boards should be required to approve very specific and highly technical aspects of such policies and procedures, including any methodologies for calculating risk-based coverage amounts for derivatives transactions or for determining whether portfolio holdings are convertible to, or will generate, cash within a specified time frame. In our view, such specific determinations should instead be made and approved by a fund's investment adviser, who has closer knowledge of, and visibility to, the nature of a fund's portfolio holdings and the dynamics of the investment-related factors applicable to calculating coverage amounts and designating qualifying coverage assets as such. Although we believe that fund boards should be given visibility to such determinations through written reports, we do not believe that it is appropriate to ask a fund's board to bear the responsibility and liability for approving specific technical aspects of the fund's asset segregation policies and procedures. The calculation of the risk-based coverage amount for a derivative instrument involves complex analysis of both broad market factors and specific characteristics of individual fund holdings and may vary for different funds. The same is true for the determination of whether an asset is convertible to, or will generate, cash within a specified time frame. That being the case, we believe the investment adviser or other officers responsible for administering a fund's asset segregation policies and procedures (including, if applicable, the fund's derivatives risk manager) are better equipped than the fund's board to make such determinations. Accordingly, the Commission should permit a fund's board to delegate to the fund's investment adviser, subject to continued oversight by the board, the responsibility of establishing appropriate methodologies for calculating risk-based coverage amounts and for designating fund assets as qualifying coverage assets.

D. Derivatives Risk Management Programs

1. **We strongly support the Commission's proposal to require certain funds to adopt and implement a formalized, principles-based derivatives risk management program.**

Depending on the scope and the nature of its derivatives usage, a fund may be required under proposed rule 18f-4(a)(3) to adopt and implement a board-approved, written derivatives risk management program reasonably designed to assess and manage the risks associated with the fund's derivatives transactions. We strongly support this aspect of the Proposal, which would require a fund to develop and maintain a formalized, principles-based risk management program if it engages in a significant amount of derivatives transactions or if it invests in any complex derivatives. Although we believe that many funds that invest in derivatives already employ comprehensive and effective risk management practices to manage risks associated with the use of derivatives, we also acknowledge that there may be funds that have not adopted sufficient practices in this regard and agree that there are substantial benefits to requiring all funds to address derivatives-related risks in a more standardized and consistent manner. We believe that such measures, coupled with an enhanced asset segregation framework, should ensure that funds meet their obligations under derivatives transactions while effectively addressing the Commission's concerns regarding undue speculation.

2. **The Commission should make clear that a fund's derivatives risk manager will not be liable for any reasonable decisions.**

Under the Proposal, if a fund is required to adopt a derivatives risk management program, the proposed rule would require the fund to designate, and the board to approve, a derivatives risk manager to administer the program. We strongly urge the Commission to make clear in any final rule that any reasonable decisions made by a fund's derivatives risk manager would not result in personal liability. As with risk management relating to investments generally, decisions regarding derivatives risk management are fundamentally forward-looking in nature. Accordingly, so long as a derivatives risk manager is qualified to serve in such capacity and performs his, her or its duties with a reasonable degree of care and diligence, the Commission should make clear that the derivatives risk manager would not be liable for the performance of derivatives transactions or their effects on a fund's portfolio, nor would the derivatives risk manager be a target of Commission enforcement actions, in the event that a reasonable decision, in hindsight, proves to be wrong.

3. **The Commission should require that reports regarding the adequacy and effectiveness of a fund's derivatives risk management program be prepared and submitted to the fund board, at a minimum, only annually.**

For those funds that adopt and implement a derivatives risk management program, proposed rule 18f-4(a)(3)(ii) would require that a fund's board review, at least quarterly, written reports prepared by the fund's derivatives risk manager regarding the adequacy of the program and the effectiveness of its implementation. The requirement to prepare and submit such reports to a fund's board on a quarterly basis is both operationally burdensome and unnecessary. The Commission proposes that the derivatives risk management program be reviewed and updated periodically, but at least annually. That being the case, it is unclear why a fund's derivatives risk management program should be reviewed and updated at least annually (with interim reviews and updates, if necessary), while the derivatives risk manager must report to the board more frequently – at least quarterly (with interim reports, if necessary). This seems even less necessary in light of the analogous requirements of rule 38a-1 that a fund review its compliance policies and procedures at least annually and that the fund's chief compliance officer prepare and submit to the fund board, at least annually, a written report on the operation of the fund's compliance policies and procedures. We ask that the Commission reconsider the proposed requirement that a fund's derivatives risk manager prepare and submit a written report to the board regarding the fund's derivatives risk management program on at least a quarterly basis. Instead, we urge the Commission to require such periodic reporting at least annually.

4. **The role of a fund board with respect to a fund's derivatives risk management program must be exclusively one of oversight, and we urge the Commission to confirm that fund boards need not approve specific aspects of a fund's derivatives risk management program and any material changes thereto.**

For those funds that are required to adopt and implement a derivatives risk management program, the Proposal would generally require that a fund's board of directors be responsible for general oversight of the program. Under proposed rule 18f-4(a)(3)(ii), each fund that is required to adopt and implement a derivatives risk management program would be required to obtain initial approval of its program, as well as any material change to the program, from the fund's board of directors, including a majority of directors who are not interested persons of the fund. The board would also be required to approve the designation (but not the compensation) of the fund's derivatives risk manager and to periodically review a written report from the derivatives risk manager concerning the adequacy and effectiveness of the program.

We believe that independent oversight of a fund's derivatives risk management program by the fund board is appropriate and, as a general matter, we agree with the Commission's framing the role of the fund board with respect to a fund's derivatives risk management program as one of oversight. However, we do not believe that boards should be required to approve specific aspects of a fund's derivatives programs and urge the Commission to clearly specify that it is not the role of a fund's board to approve specific limits on derivatives transactions, models for assessing risk (including any value-at-risk calculation models employed by the fund) and other measurement tools that are part of, or that are otherwise used in, the program. Instead, a fund's investment adviser should be exclusively responsible for making such determinations, subject to the board's oversight and the general principals and parameters set forth in the written program.

Further, we believe that the proposed derivatives risk management program should generally be integrated into a fund's existing compliance program requirements under rule 38a-1, such that the function of the fund's board is, by rule, one of oversight and not one of day-to-day management or administration. As a corollary to such integration, and to better accommodate the practical realities of the investment management process, we recommend that the Commission eliminate the requirement that a fund's board preapprove any material changes to the fund's derivatives risk management program. Under rule 38a-1, fund boards are not required to approve material changes to a fund's compliance policies and procedures, and, in the Proposal, the Commission provides no persuasive rationale for departing from the existing compliance framework. The proposed requirement that a fund's board preapprove amendments to a fund's derivatives program (even a requirement limited only to material amendments) could, as the Commission sought to avoid in adopting rule 38a-1, "inundate fund boards with review of minor changes and detract from their ability to address significant responsibilities committed to them by the [1940] Act and [the rules and regulations promulgated thereunder]. Moreover, such a requirement could delay funds ... from making needed changes,"[15] thereby raising the practical dilemma that an investment adviser may have to hold off implementing material amendments pending board approval. Since it could and should be expected that amendments (including amendments that may reasonably be deemed to be material) will be routinely required, the Proposal could make it more difficult to effect such amendments, as routine board approvals would require the repeated scheduling of ad hoc board meetings. Given the impracticalities associated with such a requirement, we suggest that the Commission clarify that, after the initial establishment of a derivatives program is approved by the board, any subsequent material amendments to the program could be implemented and subsequently reported in the derivatives risk manager's next written report to the board (which, as we propose above, would be delivered, at a minimum, on an annual basis). Rule 38a-1 simply requires that a board be notified of any material amendments to a fund's compliance policies and procedures in a compliance officer's annual report, and we suggest that a similar post-effective notification process be allowed for any requisite amendments to a fund's derivatives risk management program.

Finally, we urge the Commission to be mindful of the cumulative impact of its rulemaking initiatives on fund board responsibilities and on board effectiveness. We believe that the newly proposed board responsibilities, including required board determinations, under the Proposal and the Commission's recent proposal regarding open-end fund liquidity risk management programs[16] shift the role of fund boards from one of oversight to one of day-to-day management of matters best left to a fund's adviser. In many cases, fund boards do not have the experience, expertise or resources to undertake day-to-day fund management and such responsibilities could distract fund boards from focusing on important issues necessary to protect the interests of fund shareholders.

E. Additional Considerations

1. **In conjunction with the Proposal, the Commission should provide guidance on the impact of a fund's use of derivatives transactions and financial commitment transactions on other applicable provisions of the Investment Company Act of 1940.**

We commend the efforts of the Commission to modernize and standardize its decades-old guidance for the use by funds of derivatives and financial commitment transactions. We generally support the Proposal and believe that, with modifications, as detailed herein, the Proposal could meet the Commission's dual goals of reducing undue speculation by funds and ensuring that funds operate with adequate assets to meet their financial obligations. In particular, we believe that an enhanced asset segregation regime and a strong, principles-based risk management program, in each case subject to certain adjustments described in this letter, will work in tandem to protect the interests of fund shareholders. We note, though, that the Proposal does not address how a fund's use of derivatives and financial commitment transactions might impact such fund's compliance with other applicable provisions of the Investment Company Act of 1940, as amended (the "1940 Act"), including, among others, the diversification requirements of Section 5(b), the industry concentration limitations of Section 8(b)(1) and the names rule codified by rule 35d-1. In particular, the investment management industry stands to benefit from regulatory guidance as to the manner in which both long and short positions in derivatives and financial commitment transactions might impact a fund's compliance with the

[15] *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74717 (Dec. 24, 20013), at fn. 33.

[16] See *Open-End Fund Liquidity Risk Management Programs*, 80 Fed. Reg. 62274 (Oct. 15, 2015).

requirements of the 1940 Act. As the Commission moves forward with finalizing the exemptive rule described in the Proposal, we urge the Commission to simultaneously consider and provide guidance on the impact of derivatives and financial commitment transactions on other provisions of the 1940 Act and the rules and regulations promulgated thereunder.

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We truly appreciate the opportunity to comment on the Proposal. If you have any questions regarding our comments, please feel free to contact Erik A. Vayntrub at [redacted]

Sincerely,

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