American Federation of Labor and Congress of Industrial Organizations

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March 28, 2016

Via Electronic Submission to: rule-comments@sec.gov

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

Re: Support for Proposed Rule on Use of Derivatives by Registered Funds; File Number S7–24–15

Dear Mr. Fields,

I'm writing on behalf of the American Federation of Labor and Congress of Industrialized Organizations (the "AFL-CIO") to support the Securities and Exchange Commission (the "Commission" or the "SEC") rulemaking on the use of derivatives at Registered Investment Companies ("RICs" or "funds"). Although mutual fund investors will continue to be exposed to unacceptable levels of risk from derivatives holdings in their portfolio, the rule represents an important step towards modernizing the regulation of derivatives exposure and risk at mutual funds. The proposed caps on derivatives exposures are very generous and the rule still affords funds broad discretion in how to manage the risks. We believe the rule would be improved by eliminating the secondary 300% VaR based derivatives exposure limit but are still supportive of the Commission finalizing the rule as is, without weakening any elements of the proposal.

The AFL-CIO is the umbrella federation for U.S. labor unions, including 56 unions, representing 12.5 million union members. Union-sponsored and Taft-Hartley pension plans hold more than $587 billion in assets. Union members also participate in pension plans sponsored by corporate and public-sector employers. Given the heavy investment in mutual funds by retirement accounts, our members, along with other working American families saving for retirement, have considerable exposure to mutual funds and whatever derivatives risk they carry. This rule takes an important step towards reining in the riskiest actors and putting some common sense limits in place.

1. **After decades of a patchwork quilt of derivatives regulation for mutual funds, it is time for the SEC to finalize rules to cover their use of both derivatives and financial commitment transactions.**

Although financial products like derivatives and financial commitment transactions did not exist at the time the Investment Company Act of 1940 (the "Act") was passed, the text clearly envisions restricting such activities. The Act prohibits RICs from issuing "senior securities" specifically to limit the situations in which RICs "by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities."[1]

Derivatives and financial commitment transactions both give rights to parties ahead of the investors in the mutual fund and are thus inherently senior to investor shares. This creates serious risks for investors and, without regulation, opens the door for precisely the type of excessive borrowing and unduly speculative behavior by funds that the Act seeks to avoid. Limits set on such actions by the Act have been replaced with risk management requirements through the piecemeal regulatory approach of no-action letters and staff opinions relied on to date. That framework leaves considerable gaps in coverage and still lags far behind contemporary understanding of derivatives.

This lack of guidance has enabled registered funds to increase their use of derivatives and financial commitment transactions sharply in recent years, growing their leverage excessively and posing ever greater risks to investors. It is essential that the SEC finalize this rule as proposed to address the current gaps in the regulatory framework and fulfil the intention of the 1940 Act.

2. **The rule is a moderate restriction that will mostly impact the riskiest actors while providing the industry broad flexibility and discretion; it should not be weakened in any way.**

The rule provides generous allowances for derivatives use: 150% and 300% caps on derivatives exposure, based on the notional value of the derivatives exposure or the Value-at-Risk ("VaR") estimate of potential derivatives exposure respectively. It also allows funds substantial discretion in how they manage the risks of the derivatives they do have. Those caps were selected with reference to the white paper "Use of Derivatives by Registered Investment Companies" ("DERA White Paper"), based on the consideration that many funds that did not presently comply with the 150% exposure-based portfolio limitation could use derivatives in a way that would satisfy the VaR test.[2]

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[1] The Investment Company Act of 1940 §1(b)(1)

[2] SEC Division of Economic Risk and Analysis, "Use of Derivatives by Registered Investment Companies" (December 7, 2015). Available at: https://www.sec.gov/dera/staff-papers/white-papers/11dec15_derivatives.html

Importantly, the primary effect of the rule is to rein in the riskiest use of derivatives and excessive leverage in RICs, like managed futures funds where derivatives exposure has reached amounts as high as 950% of net asset values ("NAV").[3] Funds that are not able to bring their strategy into compliance with the proposed rule have the option of not registering under the Act and finding another regulatory regime to operate within instead. It is essential for the effectiveness of this modest protection that the Commission maintain the caps and the rule as proposed.

Derivatives and financial commitment transactions both put investors' money at risk and must be covered by the final rule. Both create senior obligations allowing funds to lever up significantly, adding risk and fueling speculative strategies – in direct opposition to the intention of the Act.

It is also crucial that the final rule maintain the measurement of derivatives exposure as gross exposure. To allow the derivatives exposure to be measured based on the hedged or netted position would be to ignore the complexity of those instruments and would seriously undermine the purpose of the caps. Furthermore, allowing funds to rely on net or hedged exposure would create an unreasonable burden on the SEC with respect to oversight and enforcement, would invite funds to game the metrics and again could potentially undermine the objectives of the rule.

Requiring funds to maintain segregated assets to cover risk-based exposure in addition to the mark-to-market coverage amount is similarly crucial for an effective rule and should be preserved in the final version. Current mark-to-market valuation of a fund's derivative exposure provides only a limited view of potential liquidity problems for a fund and could still allow funds to be too highly leveraged and face severe liquidity crises in stressed market conditions.

Finally, the formal derivatives risk management program is another essential element of the rule and must also be maintained in the final version. Given that the funds retain such broad discretion in estimating exposures and managing risks, it is crucial for investors and regulators both to have access to a formal and documented risk management program that clearly lays out what risks are potentially created by the derivatives held in a fund and how those risks are being managed.

Each of the aforementioned features of the rule are vital for the effective impact and implementation of the rule. Again, this rule will not eliminate the often hidden risks mutual fund investors face when it comes to derivatives but it is an important improvement to an outdated and incomplete regulatory regime. Thus we urge the SEC

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[3] Morgan Lewis, "Understanding the SEC's Proposal on Registered Funds' Use of Derivatives and Financial Commitment Transactions" (March 2016), p15. Available at: https://www.morganlewis.com/~/media/files/publication/morgan%20lewis%20title/white%20paper/understanding-sec-proposal-on-funds-use-of-derivatives_23march16.ashx

to resist any pressure to weaken any of these elements and to finalize the rule as proposed.

3. **The rule should be strengthened by eliminating the option to rely on a 300% VaR based derivatives exposure limit and clarified where the discretion provided to funds creates the opportunity to game the metrics and/or an unreasonable amount of work to monitor or enforce.**

This rule would be considerably stronger without the secondary exposure limit, based on the VaR estimate of a fund's derivatives exposure. Reliance on VaR provides too much opportunity to manipulate the metrics; funds can either modify their internal VaR models in ways that may conceal risk, or take advantage of the fact that VaR models do not reflect tail risk at all. These issues make enforcement more complicated than necessary and reduces comparability between funds.

Relying exclusively on the notional exposure-based portfolio limit of 150% of NAV is a much clearer and safer standard. There is less opportunity to manipulate the underlying models and accordingly less complexity for the Commission to unpack in order to monitor funds and enforce the rule. Furthermore, as the DERA White Paper identified, 96% of the sample funds *already* comply with the 150% exposure-based portfolio limit.[4] Clearly, eliminating the 300% VaR based limit would impact only a very small subset of funds which are already operating outside the norms of the industry.

Codifying the 300% limit could also potentially encourage – or at least eliminate disincentives – for other funds currently in compliance with the 150% limit to stay away from these more highly leveraged and riskier strategies. Conversely, very little would be lost by eliminating the 300% limit from the final rule.

The reliance on a "stressed VaR" model to establish the risk-based coverage amount also invites manipulation. There is not sufficient clarity around what those "stressed market conditions" might look like. This provides an avenue for the outlier, risky funds to manipulate the impact and application of the rule. The final rule would be improved by addressing these concerns.

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The rule is an essential and overdue investor protection clearly mandated by the Investment Company Act of 1940 and needed in an industry where the use of derivatives has grown so much and so quickly at such great risk to investors. The existing patchwork of guidance and regulation has not been effective at limiting excessive leverage and speculative activity in the industry. While the rule does not fully

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[4] SEC Division of Economic Risk and Analysis, "Use of Derivatives by Registered Investment Companies" (December 7, 2015), p2. Available at: https://www.sec.gov/dera/staff-papers/white-papers/11dec15_derivatives.html

address excessive and often hidden derivatives risks mutual fund investors face, it takes an important step in the right direction. The proposed rule affords funds a high degree of flexibility and discretion in how they structure their derivatives strategies but reins in the riskiest actors and establishes some common sense protections and boundaries.

For all of the reasons listed above, we urge the Commission to finalize the rule as proposed, as soon as possible. It will provide greater security to investors and to our financial markets. If the AFL-CIO can be of further assistance please do not hesitate to reach out to Corey Klemmer at [redacted] or [redacted].

Sincerely

Heather Slavkin Corzo
Director, Office of Investment

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opeiu #2, aflcio