MORNINGSTAR®

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; Release No. IC-31933; File No. S7-24-15

Dear Mr. Fields:

Morningstar, Inc. appreciates the opportunity to comment on the SEC's proposed rule on the Use of Derivatives by Registered Investment Companies. As the world's largest provider of mutual fund data and ratings, Morningstar has a long history of advocating for transparency in global financial markets. We believe that, with some modifications, the SEC's proposal would standardize permitted leverage across senior securities, derivatives, and financial commitments. We applaud the SEC's effort to ensure that registered investment companies do not engage in undue speculation or exceed the maximum senior commitments as defined under the Investment Company Act.

We strongly support standardizing derivative and financial commitment treatment under a new rule. During the past 38 years since release 10666, as the number of no-action letters, exemptive relief orders, and other staff guidance has increased, it has become unclear to both investors and investment companies which standards apply. Codification of rules relating to derivatives holdings should provide additional transparency to both fund managers and investors.

We further support the Commission's goal of promoting appropriate controls and transparency relating to funds' derivatives holdings. Investors and the Commission should have confidence that investment companies using derivatives have appropriate controls in place to monitor portfolio risk levels.

In certain instances, we differ with the Commission's approach to achieving these laudable goals. First, we recommend that the Commission expedite its work to finalize reporting requirements for derivatives and other fund holdings. With complete standardized portfolio holdings available on a monthly basis, financial market participants can assist the Commission in monitoring portfolio risk. Second, in the final rule we urge the Commission to ensure that portfolio leverage is treated the same way regardless of the financial instruments used. As detailed in the appendix to this letter, the Commission's proposal does not currently treat sources of leverage equitably, which could increase costs to investors as fund managers execute routine changes in duration and credit quality. Third, we urge the Commission to coordinate work across various portfolio-related proposals, ensuring consistency in terminology and reporting conventions where possible. Variations on these related definitions increase costs to investment companies and their investors and increase the possibility of an unintentional error by market participants. Finally, we urge the staff to enhance proposed changes to forms N-CEN and N-PORT to provide portfolio snapshots as viewed through the lens of the risk manager. This reporting should provide investors, advisors, and researchers with information about the amount of effective leverage produced by derivatives and other transactions.

Morningstar shares the Commission's goal of improving portfolio transparency, standardizing reporting elements, and most importantly, protecting investors' interests. Our suggestions for enhancing the Commission's proposal follow in the attached appendix.

Sincerely,

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Appendix

Although we applaud the Commission's effort to adopt a simplified 150% exposure limit that is consistent with the direct leverage limit featured in the Investment Company Act, the proposal would benefit from certain refinements. Direct borrowing, financial commitments, and derivatives all may contribute leverage to a portfolio, and they should be treated similarly. The current proposal does not do that.

The proposed calculations of exposure from derivatives highlights how leverage and exposure should not be directly equated. For example, the proposal effectively makes interest-rate swap exposures appear to engender more portfolio leverage than they actually create. In short, relying on a measure of notional exposure would exaggerate portfolio leverage. An example will illustrate this problem: A fund could enter an interest-rate swap for one year in which it receives a fixed payment and pays a floating rate. If a highly unusual shock were to occur, thereby raising interest rates by 5 percentage points (assuming no further movements in the floating rate), the fund would incur a loss of only 5% of the notional value. This extreme example creates an obligation only 1/20 of the proposed measure of exposure. Moreover, we note that for short-term interest rate futures, both academic finance and industry convention support the downward adjustment to notional value based upon the declining fraction of a year that the underlying term represents.

Although we concur with the proposal's treatment of total return swaps (and other derivatives) that reference the leveraged performance of an asset, as well as look-through to managed account portfolios, we believe that the rule may create some uncertainty. Based upon the rule's language, it is unclear whether complex derivatives would be able to reduce notional exposure by the amount of partially offsetting embedded transactions. (This type of netting is otherwise prohibited unless there is ownership of the deliverable asset to a transaction.) If this interpretation of the treatment of exposure for complex derivatives is correct, it is easy to imagine a new market for relatively illiquid, bespoke, complex derivatives emerging to assist funds to avoid breaching asset coverage. In addition to being less transparent, the use of such bespoke derivatives would likely lead to increased costs for fund investors.

The netting provisions in the proposal are clear and align with the UCITS framework in the European Union. When determining whether a fund has breached senior securities leverage provisions, it is appropriate to exclude purchased options. Purchased options can both increase and reduce a fund's volatility; using exposure alone will not inform the Commission of whether a fund is breaching the measure of undue speculation.

The Commission requests discussion of the potential for certain alternative strategy funds to deregister under the act and operate as commodity pools or private funds. This would be a reversal of recent trends, as many of the advisors managing these funds only recently began offering registered products. Many of these funds have established themselves as investment companies primarily for the ease of ownership for investors, providing both daily liquidity and more of an investor-friendly approach to tax reporting. This trend has been good for investors because of the protections afforded by the mutual fund structure. We fear that many of these funds would find it impractical to continue operating if the Commission's proposal is adopted, largely because they will likely be unable to adhere to the proposed 150% exposure limit.

For these investment options, we suggest that the Commission consider a modified risk-based approach using an absolute VaR limit. Our experience leads us to believe that varying exposure limits on the commitment approach based upon strategy, or prior exemptive relief, would likely cause confusion for investors. Modifying the proposed VaR rule and exposure limits would more effectively regulate effective risk in portfolios. Grandfathering funds that are currently operating in excess of the rule would create an inconsistency similar to the present state of different funds operating under different rules. This could create a situation in which some funds have more liberal investment policies than others, and those funds may be advantaged over their peers. This would be difficult for investors to navigate.

In regards to the discussion of whether additional indirect cover and hedging transactions should be allowed, we agree with the Commission. As the 150% exposure method, also known as a commitment approach, permits only nearly identical cover positions, it removes subjectivity. In our opinion, funds using sophisticated efficient portfolio-management techniques, with complex and indirect derivatives, should be required to have risk management practices in place that are required under the Risk-Based Portfolio Limit approach proposal.

Section III.B.2. of the proposal discusses the use of a risk-based limit. This approach has been generally successful, albeit imperfect, under the European UCITS framework. Derivatives have become part and parcel of many traditional strategies already operating under the 1940 act. Despite the DERA report's evidence that few funds exceed the proposed 150% level, the complete exclusion of a risk-based approach would push a larger percentage of assets into less-regulated private funds and separately managed accounts. This move would reduce the ability of the Commission to provide needed investor protections.

In response to the request for discussion of strategies that may not meet the proposed commitment tests, we note that there are a variety of strategies that would likely exceed the 150% exposure measure but comply under the current risk-based limit. Within multiasset funds, there are "risk-parity" strategies, which tend to maintain a high percentage of their assets in equities but extend their fixed-income exposure through government bond futures. These portfolios would potentially have a lower portfolio VaR than securities VaR.

However, we are concerned that the proposal may have unintended consequences: Namely, we believe that in some instances, fund managers would respond to the rule by increasing the securities risk of their portfolios. For example, imagine a core bond fund with a mandate to target duration between 3.5 and 6 years. The rule, as proposed, would give the portfolio manager incentive to maintain the highest risk permitted under the fund's mandate. The fund would then have the ability to lower VaR by entering into derivatives transactions. Since longer duration always leads to higher VaR, the fund could not let its duration fall by the aging of its securities holdings because the rule eliminates the ability to increase duration tactically through derivatives. This approach to portfolio management would allow fund managers to comply with the rule but would increase securities turnover, transaction costs, and potentially tax liabilities for investors. Separately, all futures-based commodities, managed futures, global macro strategies, and a number of popular portable alpha strategies would not be possible under the current risk-based proposal.

In general, we believe the VaR test should be less restrictive or restructured. In many respects, the current proposal’s risk-based measure is more restrictive than the 150% senior securities limitation in the Investment Company Act. Under the act, a fund can borrow 50% of its net assets and invest 150% in a concentrated small-cap emerging-markets portfolio, and this would pass muster. But a portable alpha strategy with an active core bond portfolio paired with 100% exposure to a broad equity index would never be possible. If the Commission intends to ensure that derivatives-based portfolios do not generate additional risk and leverage relative to funds using true senior securities, or the commitment approach, a relative VaR level of 150% of a securities portfolio would be aligned to the risk generated by direct borrowing.

Our preferred approach would be an absolute VaR test. It provides a measure that can be easily observed by both the Commission and investors. Using UCITS as an example, a 99% confidence interval of maximum biweekly loss of no more than 20% implies that this loss (while random) should not occur any more than once every four years. Additionally, the Commission can align the absolute level of VaR with its opinion of the risk permitted under section 1(b)(7) of the Investment Company Act. This type of limit, while somewhat more complicated than current disclosure, can easily be made clear to interested investors through enhancement to fund prospectuses. We also recommend enhancing funds’ disclosure of their contemplated risk levels. In the spirit of investor protection, funds’ one-month VaR should be disclosed monthly in item B.3 of form N-PORT. A specific period would provide the Commission and investors a consistent and comparable risk measure.

In addition to VaR measures, the Commission has requested comment on the inclusion of a 300% exposure limit in conjunction with a risk-based approach. Our experience leads us to conclude that a maximum exposure limit, as proposed, would mitigate the weaknesses of VaR as a single risk measure. We do not have data to facilitate an opinion on the specific level of exposure that would align with the Commission’s mandate to ensure that funds do not violate section 1(b)(7) of the act. As the rule is written, our primary concern is not the absolute level of commitment approach exposure. We are concerned that the current proposal provides incentive for additional risk in a fund's securities portfolio to facilitate derivatives-based efficient portfolio management. This would certainly reduce investor protections. We greatly prefer a specific maximum VaR tied to what is considered acceptable for a fund operating with senior securities-based leverage.

As for the implementation of a risk-based approach, we do not believe the current proposal reflects the realities of day-to-day risk management. Based on discussions with portfolio managers, we understand that most risk-management software models require some intervention and do not generate trade-by-trade VaR. In our experience, VaR is typically calculated daily for sophisticated users of derivatives, who should be regulated under the risk-based approach.

With respect to the Commission's request for comment on remedying a breach of a VaR or exposure limit, it is undesirable and impractical to require portfolios to immediately divest when exceeding a threshold. However, persistent or large excess exposure seems to contradict the purpose of the proposed rule. Limiting the exception to a specific period of time (for example, two weeks), or a maximum excess exposure or maximum loss owing to market movements would align with the investor-protection goals of this proposed rule.

The Commission requested comment on whether there should be a specific investment guideline on the use of derivatives related to the risk-management program. The risk-based approach, as proposed, is a quite specific, and restrictive, investment guideline. Under the proposal, fund managers would be unable to inexpensively execute many common portfolio management tactics because of the rule's requirement that all derivatives transactions should reduce VaR. There are many appropriate derivative uses that provide liquidity and reduce transaction costs without unduly creating leverage or speculation that would no longer be available. In this area, the proposed approach is not in the best interests of investors.

Morningstar agrees conceptually with the approach that a fund's board of directors, representing investors, should approve all asset coverage and risk-management policies. In December, Commission Luis A. Aguilar stated, "As the spectrum of risk increases, the overall supervision of risk management will become even more crucial to fulfilling a board's obligations." As boards are required to oversee the performance and compliance of funds, we believe it is also appropriate for boards to oversee the risk-management function. Boards and the investors they represent are not experts in complex portfolio construction. It is imperative that a risk manager, representing an advisor, clearly communicate risk levels so that investors, financial advisors, and boards can make informed decisions. However, we urge the Commission to refrain from adopting a final rule that would require boards of directors to become involved in granular, day-to-day operating matters. We do not believe that boards should be required to become derivatives experts; rather, their proper role should be to provide oversight ensuring that fund managers have appropriate risk-management policies in place and appropriate risk-management personnel to implement them.

We also have concerns with respect to the Commission's approach to asset segregation. As the rule is proposed, users of financial commitments, derivatives, and borrowings are treated very differently. Direct borrowers have limited constraints related to assets covering borrowed funds; most derivatives allow mark-to-market asset segregation, while others require full coverage; and short sellers always have to maintain qualifying coverage assets in the full amount of their borrowing. Inconsistency across these coverage approaches can lead to regulatory arbitrage. A fund may choose to enter into a bespoke basket swap receiving the inverse of the return of an equity portfolio, for example, rather than selling securities short, because of the lower cash drag otherwise created by covering assets.

We are concerned about the investment decision implications of different asset coverage measures for derivatives that deliver risks similar to those of financial commitment transactions. For example, under the current approach, a fund selling an equity-index future would have much lower coverage requirements than a similar strategy choosing to hedge through the short sale of an ETF on the same index. Under the current proposal, a fund using physical portfolio construction would be required to segregate significantly more capital than a derivatives-based fund, despite the two positions featuring equivalent leverage, exposures and VaR contributions. As financial commitments and derivatives can be constructed to provide identical exposures, consistency would suggest an aligned limit between derivatives and financial commitments. Firms using a risk-based approach, and financial commitment transactions rather than derivatives, should be able use similar VaR model-based thresholds to manage their portfolios. The requirements for derivative and financial commitment covering assets should be aligned, although we acknowledge that the relative amount of coverage assets for financial commitments would approach or exceed the face values of the securities sold short or obligated for repurchases. Additionally, a limitation such that a fund could not enter into either derivative or financial commitment transactions without available covering assets would create a practical limit on leverage, which in our opinion would align with release 10666.

There are a number of effective regulatory and industry frameworks that permit return-generating assets to be segregated as coverage assets. A typical framework permits segregation of deposits and the most liquid securities, but other securities are subject to a "haircut," which the Commission prescribed for security-based swap transactions. This type of asset segregation requirement would permit a more investor-friendly use of derivatives. We support aligning the qualified covering assets rules for derivatives and financial commitments with the rules for security-based swap transactions.

With respect to provisions relating to when a fund is required to have a formalized risk management program, Morningstar supports the Commission's proposal. We believe that most firms engaging in sophisticated derivatives use already have many of the proposed procedures in place. The flexibility permitted for funds, advisors, and boards to adopt procedures that are specific to a fund's strategy and derivatives activity should allow sufficient customization of procedures. The current proposal provides two tiers: funds engaging in noncomplex derivatives at less than 150% exposure, and funds using a higher level of sophisticated derivatives. Establishing additional tiers and thresholds would not serve the interests of investor protection.

As the proposal reads in its current form, it is unclear what an acceptable policy, procedure, or documented level of risk could be. Is it acceptable for a policy to identify that a risk manager is responsible for ensuring that these factors are considered in a fund's risk model and that it is discussed quarterly with its board? Or would fund companies be required to isolate the risk analysis and include it in the risk model output, presently proposed to be on a transactional basis? Investors' interests would be served by ensuring that these factors are considered without a prescribed format or report, except for periodic analysis by the risk manager reporting results to the portfolio manager and the board. The Commission asks whether additional specific guidance should be provided for the risk management duties. In general, we believe a principles-based approach would be most effective. The risk manager and portfolio manager would establish policies and procedures specific to the fund, with periodic review and board oversight focusing on risk and leverage information that could be communicated to investors who lack specific derivatives knowledge.

Morningstar supports the Commission's proposal to segregate risk-management and portfolio-management functions. Indeed, we believe this approach is already considered a best practice in the industry. Therefore, as it is already a best practice to have a chief risk officer who is an employee independent of fund's portfolio manager, we do not believe that naming a derivatives risk manager as an employee is unduly burdensome, in light of the added protections this should provide investors. We also support the Commission's proposal that the board approve the risk manager and that the board possess the sole authority to remove the risk manager.

We believe that, in addition to the proposed inclusions of gamma and vega, form N-PORT should also include the adjusted exposure of a portfolio on the reporting date. This should be in item B.3, slotted alongside the reporting of the DV01. For funds under a VaR approach, we support reporting a month-end VaR in terms of the percent of net assets under a 95% or 99% confidence interval for 20 days. Inconsistencies in values for those calculated measures owing to model assumptions concern us less than the added investor protection additional transparency provides.

As we suggested in our comment on the Commission's original, 2015 proposal on reporting modernization, monthly N-PORT forms should all be released to the public on a 45-day lag. This would provide a number of benefits to investors, including allowing sophisticated parties to evaluate funds' forward-looking estimates of VaR. In addition, we reiterate our comments on the 2015 proposal suggesting that additional terms and conditions data would facilitate calculation of standardized measures by investors and their service providers.

Whether a fund uses the 150% exposure commitment approach or a risk-based approach is a key piece of information that should be available to investors and advisors. We believe this information would assist investors in evaluating a fund versus its peers. We therefore support its inclusion in N-CEN, and it also may be suitable for inclusion with prospectuses' disclosure of principal risks.

The Commission requests discussion around consistency between the proposals relating to derivatives. In our opinion it is imperative that the definitions of terms within rule 18f-4 and form NPORT be aligned. Differences between these values will create immediate difficulties for investors using N-PORT in trying to independently evaluate periodic exposures, as well as additional costs to investment companies and their shareholders.

Compliance dates of N-PORT, N-CEN, and rule 18f-4 should be aligned if possible. The measurement of exposure, before offsetting transactions, should reconcile to the information within N-PORT. This will allow the Commission and investors to monitor the risk and management's description of risk.

The Commission requested comments regarding the definition and measurement of derivatives exposure and financial commitment values. The proposed rule is sufficiently clear that funds would be able to classify these transactions as derivatives or financial commitment causing the creation of a senior obligation. The definition within this proposal, however, does not fully reconcile the derivative types required to be reported under item C.11.a of proposed form N-PORT. We believe that final guidance should include a mapping between N-PORT and rule 18f-4.

The inconsistency of the description of derivatives extends to Table 1 of the proposal, where the Commission does not provide specific guidance for highly common interest-rate swaps, or a number of liquid but less commonly used derivatives.