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February 7, 2017

VIA ELECTRONIC DELIVERY

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Investment Company Act Release No. IC-31933 (File No. S7-24-15) Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

We appreciate the opportunity to respond to the request by the U.S. Securities Exchange Commission ("Commission") for comments regarding the economic analysis from the Department of Economic and Risk Analysis ("DERA"), dated November 1, 2016 ("DERA Analysis"),[1] in connection with the above-referenced release ("Proposing Release").[2] The Proposing Release has introduced a novel approach to regulating funds' use of derivatives that raise "senior security" concerns under Section 18 of the Investment Company Act of 1940 ("1940 Act") by proposing a new rule 18f-4 thereunder ("Proposed Rule").

We submit this letter on behalf of Altegris Advisors, L.L.C., Campbell & Company, LP, Catalyst Capital Advisors LLC, LoCorr Fund Management, Millburn Ridgefield Corporation, Welton Investment Partners and certain other advisers to registered investment companies ("funds") likely to be significantly and adversely impacted by the adoption of the Proposed Rule. The new restrictions in the Proposed Rule would affect how the funds operate, the investment strategies the funds pursue and the manner in which the funds manage portfolio risks. As with the vast majority of the market participants, academics and investors that have responded to the Commission's

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1 Risk Adjustment and Haircut Schedules, SEC Division of Economic and Risk Analysis (Nov. 2016), available at https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

2 Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015) [hereinafter *Proposing Release*].

request for comments, we are concerned about the proposed one-size-fits-all approach to limiting funds' exposure to derivatives described in the Proposed Rule. While we generally support the Commission's rulemaking efforts to increase transparency and prevent funds from engaging in "unduly speculative" investment practices, we do not believe that exposure limits are a necessary or appropriate means of achieving such goals. For the reasons discussed below, we urge the Commission to reconsider imposing these exposure limits and to reformulate and repropose the Proposed Rule.

Under the Proposed Rule, a registered fund would be subject to either an exposure limit of 150% of the fund's net asset value on the aggregate notional amount of derivatives (plus the aggregate obligation amount of financial commitment transactions and the aggregate indebtedness under other senior securities transactions) ("150% Limit") or a risk-based limit of 300% of the fund's net asset value if such derivatives positions reduce the fund's value-at-risk ("VaR") ("300% Limit", and together with 150% Limit, the "Notional Caps").

We share the views of many others who have commented on the Proposed Rule who strongly believe that the uncalibrated, broad-based regulatory approach taken in the Proposed Rule, and the use of the Notional Caps in particular, which would be imposed regardless of the underlying asset class, are arbitrary and unwarranted. The DERA Analysis provided by the Commission itself illustrates the different risk levels that different types of derivatives give rise to.[3] Moreover, the Notional Caps reverse the Commission's successful, long-standing segregation-based approach to limiting the use of fund leverage through derivatives.

I. The Notional Cap on Derivatives Should Be Reconsidered

The Notional Caps appear to be determined arbitrarily, at minimum, because they do not appear to be supported by the Commission's review of industry data. The Commission openly acknowledged in the Proposing Release that it was "unable to quantify the economic effects [of the Proposed Rule] because [it] lack[ed] the information necessary to provide a reasonable estimate."[4] Nevertheless, the Commission relied on an earlier DERA white paper[5] issued alongside the Proposed Rule, which concluded that "[a]mong all funds, 96% had aggregate exposure below 150%" and that "only 3%

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[3] *See, e.g.,* DERA Analysis, p. 4.

[4] *Id*.

[5] Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (Dec. 2015), available at https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

… of the funds have aggregate exposures greater than 300%," to justify the numeric thresholds of the Notional Caps. However, the data may not have been properly illustrative of the industry to begin with, as registered investment companies do not generally operate by running up against the regulatory limits. Rather, these funds aim to operate within a comfortable margin in order to avoid inadvertent violations due to market movements or other factors not within their control. For this reason, we argue that the Commission's estimate of the economic effects of the Proposed Rule may have been significantly understated.

If the Notional Caps are implemented, many funds with notional exposure below 150% currently would opt to liquidate some of their positions and/or change their investment strategies to regain the comfortable margin against the exposure limits. In addition, the notional amount of a derivatives portfolio is not necessarily related to the actual level of leverage or riskiness in that portfolio. Not only do the cash flow obligations of most derivatives positions represent only a small percentage of the notional amounts, but the notional amounts (particularly with respect to the 150% Limit) do not reflect the effects of offsetting exposures of various derivatives positions. Further, different derivatives instruments with the same notional amount may have vastly different risk characteristics (*e.g.*, interest rate swaps versus equity swaps). As noted above, the DERA Analysis, and its discussion of differing risk levels based on different types of reference assets, supports this view.

The Notional Caps are also unwarranted because the historic asset segregation approach of the Commission has been highly useful in regulating a fund's use of derivatives. We are unaware of, and the Commission has not identified, any instances in which a fund has failed as a result of its use of derivatives. An asset segregation method is also consistent with the legal framework originally adopted in Investment Company Act Release No. 10666[6] and the long line of guidance provided by the Commission's staff. By imposing the Notional Caps, the Commission would be reversing its view originally expressed in Investment Company Act Release No. 10666 from nearly 40 years ago that "the issue of compliance with Section 18 will not be raised … if the investment company 'covers' the senior security by establishing and maintaining certain 'segregated accounts.'"

Perhaps most importantly, the Commission acknowledged in the Proposing Release that the Proposed Rule would disproportionately impact managed futures funds, currency funds and leveraged ETFs. Many of these funds may be forced to deregister or liquidate entirely because they would be inoperable under the 300% Limit. As a result, investors in such funds would be deprived of the opportunity to attain their desired investment exposure or obtain portfolio diversification

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[6] Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (Apr. 18, 1979).

benefits by investing in a registered investment vehicle that is subject to the Commission's robust oversight, and may not be able to replicate such exposure through other investment vehicles. The Commission, however, minimized the serious consequences of the Proposed Rule by generalizing its impact on the entire mutual fund industry rather than on a fund-by-fund basis. We recommend that the Commission carefully consider the potential business closings, workforce reductions and other adverse effects the Proposed Rule would have on managed futures funds, currency funds and leverage ETFs. It is worth noting that, in addition to threatening the on-going operations of managed futures funds and other alternative investment funds, the Proposed Rule may adversely affect a much greater number of other types of funds than the Commission realizes. The Commission should consider the research of the Investment Company Institute, which found that, as "lower bound estimates", "at least 471 funds with $613 billion in assets would exceed the 150 percent exposure limit and at least 173 funds with $338 billion in assets would exceed the 300 percent exposure limit."[7]

We urge the Commission to refrain from imposing the Notional Caps and instead opt for the existing asset segregation approach, which alone provides an effective limitation on undue speculation because it correctly captures the real risks created by a derivatives transaction. The existing use of dynamic margining, whereby exchanges increase or decrease margin requirements in response to market volatility, typically within 24 hours, has successfully controlled risk for decades and is readily enforced and implemented. If the Commission wishes to impose additional protections against undue speculation, we urge the Commission to consider replacing the Notional Caps with a simple margin-based approach that better mitigates the specific risks posed by derivatives contracts. This approach would require funds to segregate cash, cash equivalents or other liquid assets on their books and records in an amount equal to the exchange-required initial margin for each futures contract traded, or in the case of OTC derivatives, the initial margin required under applicable margin rules. This margin-based proposal would force funds to over-collateralize by 100% the initial margin requirements of their derivatives positions and require funds to maintain significant cash or other liquid assets to meet this enhanced asset segregation requirement, while at the same time allowing funds to engage in appropriate levels of derivatives activity.

In addition to this margin-based approach, the Commission could also impose heightened disclosure requirements whereby registered investment companies would make more prominent disclosures of risks pertaining to certain types of high-risk derivatives strategies that the respective fund pursues. If the Commission decides that an exposure limit is absolutely necessary and if the

[7] Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-114.pdf.

margin-based approach is not a viable solution, we believe a VaR-linked limit (such as one that is described in ICI's most recent comment letter[8]) would be more appropriate.

II. The Commission Should Repropose the Proposed Rule

We urge the Commission in any event to fully consider and provide appropriate responses to the many thoughtful comments received in opposition to the Proposed Rule. At a minimum, we encourage the Commission to attempt to quantify on a more thorough and comprehensive basis the far-reaching effects of implementing the Proposed Rule.

We echo the various other commenters that there may be more investment companies adversely impacted than what the Commission may be aware of, many of whom would need to substantially revise their investment strategies and/or liquidate and/or de-register as investment companies. We also agree with the views of commenters that have requested the exclusion of certain types of derivatives from the definition of "derivatives transactions."[9] Finally, we join those who have urged the Commission that the Proposed Rule be set aside until the full impact from other recently proposed rules (*e.g.*, the liquidity risk management rule[10] and data reporting modernization rule[11])

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8 Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated September 27, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-255.pdf.

9 *See* letter from Philip Weisberg, Managing Director, Global Head of Foreign Exchange, Thomson Reuters, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated April 8, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-190.pdf (requesting exclusion of FX derivatives in the Proposed Rule); see also letter from Edward T. Tilly, Chief Executive Officer, Chicago Board Options Exchange, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 31, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-185.pdf (requesting exclusion of listed options in the Proposed Rule).

10 Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization, Investment Company Act Release No. 3 I,835, 80 Fed. Reg. 62,274 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. pts. 210, 270, 274).

11 Investment Company Reporting Modernization, Investment Company Act Release No. 31,610; 80 Fed. Reg. 33,590 (June 12, 2015).

becomes known. At least one commenter has provided a specific date before which the Rules should not go effective.[12]

Ultimately, we believe the Commission should consider other less-intrusive approaches that would complement, rather than override, the existing asset segregation regime which we believe is, on its own, a superior method to limit undue speculation than any outright exposure limits. To that end, after full and careful consideration of all of the comments received in response to the Proposed Release and DERA analysis, we believe the Commission should re-propose the Proposed Rule, abandon the Notional Caps and instead consider adopting a more effective alternative (*e.g.*, the margin approach described above) to accomplish the Commission's objectives.

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Thank you for considering our views on this important topic. If you have any questions, or if we can provide any additional information that may assist the Commission and its staff, please contact Matthew K. Kerfoot at +1 [redacted] or Leonard Kim at +1 [redacted].

Respectfully submitted,

/s/ Dechert LLP

Dechert LLP

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

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12 *See* letter from Christopher L. Gust, Chief Investment Officer, Wolverine Asset Management, LLC, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated August 29, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-253.pdf (noting that compliance with the Rule should not be effective earlier than February 2018 to avoid negative impact to market integrity).