March 28, 2016

Via Electronic Filing

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

RE: Use of Derivatives by Registered Investment Companies and Business Development Companies; Release No. IC-31933; File No. S7-24-15

Dear Mr. Fields:

Affiliated Managers Group, Inc. ("AMG") appreciates the opportunity to comment on proposed rule 18f-4 under the Investment Company Act of 1940 (the "1940 Act"). Proposed rule 18f-4 was proposed for comment by the Securities and Exchange Commission ("SEC" or the "Commission") in Release No. IC-31933 (the "Proposing Release"). The proposed rule, if adopted, would provide an exemption for a management investment company ("fund" or "registered fund") from provisions of Section 18 of the 1940 Act with respect to its investments in derivatives and other "senior securities" as defined in the proposed rule.

AMG is a global asset management company with equity investments in leading boutique investment management firms (its "Affiliates"). AMG's innovative partnership approach allows each Affiliate's management team to own significant equity in its firm while maintaining operational autonomy. AMG's strategy is to generate growth through the internal growth of existing Affiliates, as well as through investments in new Affiliates. In addition, AMG offers centralized assistance to its Affiliates in strategic matters, marketing, distribution, product development and operations. As of December 31, 2015, AMG's aggregate assets under management were approximately $628 billion, pro forma for investments which have since closed, in more than 500 investment products across a broad range of investment styles, asset classes and distribution channels. For more information, please visit AMG's website at www.amg.com.

Many of AMG's Affiliates serve as advisers and sub-advisers to registered funds. Many of these funds follow traditional long-only investment strategies and do not use derivatives or use derivatives on a limited basis, such as to hedge interest rate or currency risks. Others employ innovative alternative investment strategies that make significant use of derivative instruments to obtain exposure to various types of assets in a liquid, efficient, cost-effective and flexible manner. As of December 31, 2015, the aggregate assets under management of these funds were approximately $25 billion.

AMG welcomes this Commission rulemaking to clarify the obligations that apply to funds' use of derivatives. Over the past 35 years, the derivatives markets have matured and the use of derivatives has become an important part of many asset management strategies, including strategies which are offered through funds. The Commission and its staff have addressed funds' use of derivatives largely on a case-by-case basis, in releases, no-action letters and comments on registration statements, resulting in numerous legal uncertainties and regulatory anomalies. The proposed rule would update, and in many cases replace, a patchwork of staff interpretations and industry lore. In this regard, we commend the Commission for seeking a more comprehensive approach, which will provide greater clarity and transparency to the obligations of registered funds.[1]

In this letter, we will not attempt to address all of the issues raised by the Proposing Release or to respond to all of the many requests for comments. Neither will we restate the evolving positions of the Commission on the applicability of the provisions of Section 18 of the 1940 Act, which restricts the issuance of senior securities rather than derivative contracts, including as set forth in its seminal 1979 Release 10666.[2] Instead, we will focus our thoughts on some of the larger questions presented by the Commission's proposals and provide suggested approaches for achieving the Commission's regulatory goals while maintaining the benefits that the use of derivatives provides to investors in funds.

1. *Derivatives are an important tool in managing funds, and funds' ability to implement strategy through derivatives should be preserved.*

Before we offer specific comments on the proposed rule, we would like to make some observations about funds' use of derivative instruments. While much of the Proposing Release focuses on the potential for creating leverage through investing in derivatives, it is important that the Commission understand that leverage is not the primary purpose for derivatives use by most fund managers. In addition to their utility for hedging portfolio risk, fund managers, including our Affiliates, use derivatives to more effectively gain exposure to various asset classes, in a manner consistent with the stated investment objectives and policies of the fund. For example, our Affiliates may use a swap contract to take a position in an equity index because the transaction costs are less than in the cash market or because the swap is more liquid.[3] Derivatives provide fund managers with greater flexibility to later increase, reduce or eliminate such positions without affecting the price of the reference asset. Without using derivatives it would be difficult if not

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[1] We support the scope of proposed rule 18f-4. In our view, the proposed rule reflects the proper interpretation of Section 18 of the 1940 Act by providing an exemption to only those types of derivatives, "financial commitment transactions," and other senior securities that create actual or potential indebtedness. The proposed rule properly excludes investments that do not implicate a fund's capital structure.

[2] *Securities Trading Practices of Registered Investment Companies,* Investment Company Act Release No. 10666 (Apr. 18, 1979).

[3] Importantly, we note that to the extent that the proposed rule reduces fund managers' ability to use derivatives to manage fund liquidity needs, the Commission will be working against its own regulatory initiative to improve fund liquidity management. *Open-End Fund Liquidity Risk Management Programs; Swing Pricing*, Investment Company Act Release No. 31835 (Sept. 25, 2015).

impossible for funds to obtain exposure to whole markets and asset classes, such as currencies and commodities.

Funds that use derivatives as a portfolio management tool have become increasingly prevalent in the retail investing marketplace. Though we have noted the utility of derivatives for managers, we strongly believe that the benefits of investing in derivatives primarily accrue to the thousands of retail investors who invest in these funds. To the extent that the Commission adopts rules that impose unnecessary restrictions on or impediments to the use of derivatives, it is the retail investors who will bear the costs associated with limited or lost access to these instruments and the efficiencies they bring. The impact will be sharply felt by investors in funds using derivatives as the primary means for achieving the funds' stated investment objective. These investors will suffer sub-optimal implementation of the funds' strategies, if not loss of access to these strategies altogether. And we are very concerned that the loss of efficiencies from using derivatives will adversely affect investors in many other types of funds offering a wide range of investment strategies.

2. *We agree in large part with the Commission's assessment of the inadequacy of the current regime limiting the use of senior securities.*

In its preamble, the Commission expresses in detail its dissatisfaction with the current regime governing use of derivatives and other senior securities. Although it has evolved over time, generally the Commission and its staff have taken the position that "senior security" concerns under Section 18 may be addressed when a fund covers its exposure either by holding the referenced security or segregating liquid assets in an amount necessary to cover the daily mark-to-market liability of the fund (in the case of cash-settled derivatives) or total potential liability or notional amount (in the case of physically-settled derivatives). Funds must cover the entire liability associated with other types of senior securities, including reverse repurchase agreements, forward commitment contracts and other "financial commitment transactions."

The current regime, the Commission concludes, fails to achieve the objectives of Release 10666 of imposing a practical limitation on the amount of leverage a fund could obtain through these types of transactions, and providing assurances that the fund would have a sufficient amount of liquid assets to meet its obligations under the senior security.

We share in large part the Commission's concerns. The ability of a fund to segregate the full value of *any* liquid asset to cover liabilities erodes the practical limitations on the ability of a fund manager to leverage the fund contemplated in Release 10666. Moreover, the two prevailing measurements of the amount of assets a fund must segregate are inadequate because they result in segregated amounts that are either too little or wildly excessive relative to the actual exposure of the fund. As the Proposing Release points out, segregating for only a fund's daily mark-to-market liability requires no segregation for derivatives positions when the derivative is in a gain position. On the other hand, and as discussed in more detail below, requiring cover in the amount of the notional amount of a derivative contract grossly overstates the real economic exposure of the fund to the derivative and results in the segregation of amounts beyond what is necessary to assure that the fund will have assets sufficient to meet its obligations.

Finally, and although this is not identified in the Proposing Release, the differentiation under the current regime between cash-settled and physically-settled contracts produces irrational results. The vast majority of physically-settled contracts are not settled by physical delivery but are closed by a fund by acquiring an offsetting position. The fund will never take possession of the reference assets unless it affirmatively determines it wants the assets. The actual economic exposures of funds to cash-settled and physically-settled contracts are not materially different to warrant substantially different segregation requirements.

3. *The Commission should abandon the exposure limits in favor of enhanced asset segregation requirements that will achieve the same goals.*

We urge the Commission not to adopt the proposed exposure limits, which suffer from many of the same weaknesses as the current asset segregation regime. Notional exposure limits impose restrictions based on assumptions that in some cases will overstate the economic exposure to losses to which funds investing in derivatives are subject. Instead, we recommend that the Commission adopt more robust asset segregation requirements that would impose *both* meaningful, practical limits on the use of derivatives based on the risk of loss to the fund, and assure that there is a source of liquid assets from which to satisfy claims of counterparties.

The proposed rule would require a fund that engages in derivatives transactions to comply with one of two alternative portfolio limitations designed to impose a limit on the aggregate amount of leverage the fund can obtain from all derivative contracts. Under the first alternative the aggregate notional amount of a fund's derivatives transactions, including financial commitment transactions, could not exceed 150% of its net assets. The second alternative permits a fund to have notional exposure of up to 300% of its net assets if the fund meets a relative value at risk ("VaR") test.

a. *Use of Notional Value Creates Anomalous Results.*

Our primary concern with both of these tests is that they rely on aggregate notional amounts as a yardstick of the fund's exposure to undue risk. Aggregate notional value is a measurement of the total amount of derivatives activity in which a fund is engaged rather than risk to which it is exposed.[4] The risk of loss to the fund is a function of a number of variables, such as the volatility of the underlying markets (*e.g.,* interest rates, currencies, commodities or securities), the maturity and liquidity of the contract and the creditworthiness of the counterparty.

As applied, the proposed rule would yield anomalous results, such as treating a derivative contract that references short-term government debt as presenting the same risk as a contract with the same notional value on an individual equity security. This is because the investment in any

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[4] *See* Bank of International Settlements Statistical Release, OTC Derivative Statistics at end-June 2015 (Nov. 15, 2015) at 2 ("Gross market value of outstanding derivatives contracts—which provides a more meaningful measure of amounts at risk than notional amounts. . . ."); Office of the Comptroller of the Currency's Quarterly Report on Bank Trading and Derivatives Activities (First Quarter 2015) ("The notional amount of a derivative contract is a reference amount that determines contractual payments, but is generally not an amount at risk.").

contracts that reference the same notional amount will count equally towards the fund's exposure limit. Therefore, funds would be permitted to invest in derivative positions that expose the fund to a high risk of loss so long as the notional amount remains under the threshold and, conversely, funds would not be permitted to invest in comparatively less risky derivatives if the notional amount exceeds the threshold.[5]

In addition, we are concerned that the use of notional value fails to recognize that derivative contracts are bilateral. A fund entering into a derivative contract receives, in turn, an obligation from its counterparty that itself has value so that the actual economic exposure of the fund at any time is the difference in the value of the two obligations. The use of notional value ignores this reality.

Finally, and as the Commission acknowledges, the proposed use of notional value ignores how a fund's derivatives will (or will not) interact with other investments held in the portfolio. Unless positions are entirely offset, the notional value of even a perfect hedge would count towards the 150% limit. Two funds that have reached the 150% exposure limit could, as a result, have very different risk characteristics.

b. *The 150% limit is not well-supported.*

We question the Commission's basis for the proposed 150% limit. Although we have read the Proposing Release very carefully, we do not comprehend how the Commission determined that a 150% limit would be appropriate but that a higher one would permit a registered fund to assume an undue amount of risk. Reading the Proposing Release for clues, one might surmise that the 150% threshold was chosen precisely because funds employing certain investment strategies would be forced to deregister. More specifically, the proposed rule actually identifies managed futures funds and leveraged exchange-traded funds as funds that will not be able to meet the requirements of the proposed rule. Apparently, the Commission determined that these funds were no longer welcome as registered funds because they are "too risky" for retail investors.

The Commission cites as a basis for its conclusion the amount of leverage assumed by these funds, but measures leverage by reference to the aggregate notional value of derivatives they hold, which as we have discussed above, is a flawed measure. It appears that the Commission is engaged in circular thinking to support its position—it has relied on the leverage yardstick to justify use of the yardstick. We fundamentally disagree that aggregate notional values of derivative contracts are indicia of leverage. The Commission fails to support its risk-based analysis with any hard data about how these funds, in particular, have presented undue risk or have been unsuccessful in achieving their investors' investment objectives.

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[5] The Commission acknowledges the anomalous results of its proposed 150% limitation in a sentence in the Proposing Release that explains that "[a]n exposure-based test based on notional amounts . . . may be viewed as a relatively blunt instrument." The release goes on to explain that the Commission is prepared to tolerate these anomalies because a yardstick based on notional value is easily administered by the Commission and can be flexibly applied to an evolving derivatives marketplace. Although we recognize these benefits, we strongly believe that ease of application does not justify use of an otherwise ill-suited approach.

If the Commission settled on the 150% limit as a judgment on the amount of risk appropriately assumed by funds, the proposal would mark a sharp departure from the Commission's historical practice of not attempting to regulate the investment objectives of funds or the risks taken by fully informed investors in funds. Such a path would place the Commission in an untenable position of defending not only the amount of risk it deems unacceptable, but also the level of risk it *does* permit, and of assuming responsibility for investor harm that may result.

Moreover, the proposed rule would impair or deny retail investors access to registered funds employing innovative, alternative investment strategies that make significant use of derivatives. Retail investors have successfully relied on such funds to diversify their investment portfolios, to manage downside risk and to seek investment returns uncorrelated with more traditional investment strategies. Having to materially alter a fund's investment strategy or even de-register would disrupt the operation of these funds if not threaten their commercial viability, potentially affecting thousands of investors who are content with their investments, and are currently free to redeem them at any time if they become unhappy. Rather than denying retail investors fulsome access to certain strategies because the Commission views them as too risky, the Commission should address such concerns by enforcing suitability standards such as those adopted by FINRA, which require broker-dealers to take into consideration the investor's investment needs, other investments, and ability to bear risk.

The Commission's history as one of the most successful financial regulators has arisen, in part, because it has not sought to make judgments on the appropriateness of investments made available to retail investors or to protect those investors from fully disclosed risks. Reversing course will do the Commission and retail investors a mutual disservice. The proposed rule will set the Commission up for failure as the Government's arbiter of investment risk and will unnecessarily deprive the American investing public of an important tool to meet the depth and diversity of their long-term financial needs.[6] The Commission should not begin to do so here simply because a senior security is involved.

c. *The Commission should pursue an alternative approach.*

As we have stated above, AMG understands and supports the Commission's goal of creating administrable rules limiting the exposures of funds to derivatives and other senior securities. We also understand that in doing so the Commission might impose limitations that permit less risk-taking than we and our Affiliates may view as desirable. But we cannot understand or support an approach that in so many ways fails to take into account the actual exposures of a fund to the derivatives in which it is investing simply because the method can be more easily applied and administered by the Commission.

Other industry commenters will, we understand, submit data that will demonstrate the extent to which the proposed rule, if adopted, would affect portfolio management of funds

[6] Nor has the Commission heretofore sought to allocate capital in the economy based on the amount of risk it found acceptable for investors to bear. If it had, some great enterprises that today employee thousands of people and whose products we all consume would never have gotten off the ground.

currently offered to investors.[7] In our view, this data should weigh heavily on the Commission in the resolution of these issues. The anomalies and lost efficiencies we have identified above will not operate solely in the abstract. We are very concerned that they will adversely affect both alternative and traditional investment strategies from being effectively employed.

We believe that the Commission may be able to achieve many if not all of its stated goals by returning to the concepts embodied in Release 10666 and relying on a more robust, risk-adjusted form of segregation requirement, based on margin practices that account for the risk characteristics of the derivative strategy together with "haircuts" applied to the value of segregated assets. We note that, notwithstanding the weaknesses the Commission has identified, the asset segregation approach has worked well for more than 35 years, including periods of extraordinary market turmoil. We would argue that the few market events involving funds, which the Commission cites for the proposition that a dramatic change in regulatory approach is necessary, supports the opposite position. Release 10666 should be considered a remarkably successful regulatory approach to be improved upon rather than abandoned.

Our approach, which we develop more in Section 5 below, would continue to permit funds to segregate liquid assets, but would require the fund to segregate an amount of assets reflective of the risk associated with the derivative. A fund investing in the lowest-risk derivatives instruments, with comparatively lower margin requirements, could thus acquire greater exposures than one investing in instruments with greater risks.

4. *If the Commission does impose exposure limits based on aggregate notional values it should exclude centrally-cleared derivatives.*[8]

As we read the Proposing Release, it struck us that the Commission has not given itself credit for the substantial amount of progress it and the Commodity Futures Trading Commission (the "CFTC") have made in implementing the swap provisions of the Dodd-Frank Act. These rules will reduce and in some cases have already significantly reduced the risks presented by swaps trading. In particular, rules mandating central clearing of swaps (like futures contracts) will effectively eliminate counterparty risk because both sides of a swap transaction will face a clearinghouse that will clear, margin and guarantee settlement of swap trades. In December, the CFTC adopted final rules establishing margin requirements for uncleared swaps that will, among

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[7] *See, e.g.,* James A. Overdahl, Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies (March 24, 2016).

[8] We understand that other commenters will suggest that the Commission risk-adjust notional values to achieve a similar purpose, which we also support. Our suggestion that the Commission exclude centrally-cleared derivatives from any exposure limits based on notional values should be viewed as complimentary, not as an alternative, to that approach.

other things, encourage swap arrangements to migrate to clearing houses.[9] The SEC's proposals are still pending.[10]

A fund holding centrally-cleared swaps is in a significantly better position to protect itself from losses by closing out a position that is moving against the fund. Mark-to-market pricing mandated by the 1940 Act forces funds to recognize such movements every day, and the requirement to post variation margin on many derivative contracts requires funds to maintain a cushion against future losses.

If the Commission does determine to impose exposure limits, we urge the Commission to recognize the improvements in these markets, and to consider the protections now provided to funds entering into swaps (and other derivatives) by excluding from any limit positions centrally-cleared derivatives. These would include the most liquid derivative contracts that do not involve significant counterparty risks. This approach would recognize that, at least with respect to these types of derivatives, amounts at risk reflect potential losses until the positions can be closed out by the fund's adviser, which the liquid assets held in segregated accounts, if properly constructed as discussed below, should be able to absorb.

Many swap trades are not yet centrally cleared, but because most swaps entered into by funds will likely be "standardized swaps" we expect that over time most will be. (Futures contracts, of course, are centrally cleared and trade on very liquid markets.) As an aside, we note that one salutary effect that our suggested approach would have is to further encourage swap transactions to standardize and migrate to central clearing houses.

5. *Asset segregation requirements should be made more robust, but segregated assets should not be limited to cash and cash equivalents.*

As discussed above, we support a more robust approach to asset segregation requirements. AMG agrees with the Commission that access to liquid assets is critical for managing the risks associated with leverage, and that a risk cushion should be built in to any asset segregation requirements. We applaud the Commission's decision to eliminate the meaningless distinction between cash-settled and physically-settled derivatives.

a. *Qualifying Coverage Assets*

We strongly oppose, however, limiting the "qualifying coverage assets" to cash and cash equivalents. We urge the Commission to instead permit funds to cover their derivatives and other senior securities using any type of liquid asset subject to an appropriate haircut for risks.[11] Such a

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[9] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 81 Fed. Reg. 635 (Jan. 6, 2016).

[10] *Capital, Margin, and Segregation Requirements of Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers,* Exchange Act Release No. 68071 (Oct. 18, 2012).

[11] Alternatively, the Commission could consider broadening the range of acceptable collateral along the lines of the types of assets the prudential regulators and the CFTC permit for initial and variation margin for derivatives, which

haircut could account for the relatively greater volatility of some liquid assets than cash, and could be based on an objective standard such as those set forth in swap dealer rules recently adopted by the prudential regulators.[12]

Our approach would avoid requiring that a portion of the fund's portfolio remain un-invested when the manager uses derivatives. And, our suggested approach would accommodate risk-based haircuts that would differentiate between less volatile and more volatile forms of collateral. The haircuts could apply *equally* across funds with respect to assets of similar volatility. They could decrease as the qualified coverage asset nears maturity and becomes less volatile. If a fund failed to maintain sufficient segregated amounts, it would be required to close out the position no later than the following business day.

Moreover, the approach we suggest is not very far off from the Commission's own proposal, which would permit advisers to reduce segregated accounts by amounts posted for initial or variation margin. Because posted margin may consist of a broader range of assets, the proposed rule's restrictions would only apply when no margin is required or the fund's board determines that additional segregated amounts are necessary. We read the proposed rule to permit a fund to post excess margin with its counterparty sufficient to meet the rule's risk-based asset segregation requirements and thus avoid the rule's restrictions on qualifying coverage assets. The Commission's rule should not force funds to pursue such a work-around in order to efficiently pursue fund investment strategies.

We believe that properly constructed haircuts will produce better results for fund investors by permitting the fund manager to more fully put their investments to work on their behalf. Should the Commission determine that the haircuts it initially imposes are too great or insufficient, it could alter them with little disruption of fund management.

b. *Risk Cushion*

AMG applauds the Commission's proposal to increase the current segregation requirements by providing an additional "risk-based coverage amount," the amount of which would be designed to address future potential losses. As we noted above, the current mark-to-market approach provides cover only for any current liability and fails to protect the fund from losses that could be expected to occur under reasonably anticipated conditions. We suggest a somewhat different approach to the construction of the risk-based coverage amount.

The Commission's proposal would retain the basic framework now in place, but require funds to add to the mark-to-market amount of segregated assets an amount that would represent a reasonable estimate of the potential payments the fund would be required to make to exit the

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include (i) cash; (ii) high quality government and central bank securities; (iii) high-quality corporate bonds; (iv) equities included in major stock indices; and (v) gold. *Margin and Capital Requirements for Covered Swap Entities,* 80 FR 74840 (Nov. 30, 2015); *Margin Requirements for Uncleared Swap Dealers and Major Swap Participants,* 81 FR 636 (Jan. 2, 2016).

[12] *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 7490 (Nov. 30, 2015).

derivatives transaction under stressed conditions. We would turn the approach around so that it operated much more like the existing market practices under which counterparties must post initial margin and make daily variation margin payments that reflect changes in the value and risk profile of the derivative. The variation margin payments operate to allocate gains and losses between the counterparties under the contract, but they also assure that sufficiency of the margin is maintained at all times.

Under the approach we suggest, a fund investing in derivatives would be required to segregate an amount of liquid assets sufficient to absorb losses that could be expected to occur under reasonably foreseeable stressed conditions. Thereafter, the fund would add (or subtract) liquid assets to or from that amount based on the daily mark-to-market changes in the value of the derivative in order to maintain, at all times, the sufficiency of the assets in the account. Each fund would be required to adopt policies and procedures documenting its approach. We would build upon existing practices in the derivatives markets under which counterparties post initial and variation margin sufficient to protect the counterparty (or clearing house) from the inability of the other counterparty to meet its obligations under the contract. In the context of proposed rule 18f-4, the segregated assets would protect the fund's capital structure by assuring to a reasonable degree the availability of liquid assets to pay the counterparty's claim on fund assets.

The segregated amount would be determined, pursuant to a fund's policies and procedures, based on the principles set forth in the proposed rule. Thus, the procedures would take into consideration the fund's cost of exiting a position under reasonably stressed conditions, and the availability of any margin or other form of collateral that could be used by the fund's counterparty to satisfy the fund's obligations under the derivative contract.

Alternatively, the segregated amount could be based on initial margin requirements established by derivatives exchanges or by the financial regulators for derivatives not traded on exchanges. The exchanges determine and review margin requirements and revise them to reflect current market conditions, which would help avoid the staleness of any margin or segregation amounts the Commission or fund board might set. It would harmonize the approaches developed by the CFTC and the futures markets over the years, while still permitting the Commission to set its own collateral requirements the effect of which would be to require derivatives to be "over-collateralized." Such an alternative would also have the added benefit of eliminating a task for already over-burdened fund boards.

The approach we are suggesting would be administratively simple in many respects, primarily because it would be built on the collateral practices now in place and operating at most funds. In addition, the Commission could, over time, easily adjust the segregated amount by revising the haircuts or apply them differently as its understanding of funds' use of derivatives develops. When the Commission begins to receive information about derivative exposures on proposed Form N-PORT it could revise any initial judgments about fund derivative exposures to increase or decrease them.

Our suggested approach to exposure limits would have significant advantages. First, it would eliminate the anomalies we identified associated with the use of notional values that could distort investment decision-making. Second, it would be risk-based, and would operate in such a way to permit fund managers to allocate the amount of risk in a manner designed to better achieve the fund's investment objectives and the manager's view of the markets. Third, our approach would impose meaningful practical limits on derivatives based on the amount of its qualifying coverage assets, as reduced by applicable haircuts.

c. *Treatment of Offsetting Positions*

We recommend one additional change from the Commission's proposal, which would not permit offsetting positions to be taken into account for purposes of the proposed asset segregation requirements. In the Proposing Release, the Commission expressed concern that a fund would remain exposed to the failure of its counterparty, potentially leaving funds without sufficient assets to satisfy obligations to another counterparty. This risk does not exist with respect to those futures, listed options and other derivatives that are centrally cleared, and we urge the Commission to permit offsets at least with respect to these types of derivatives.

d. *Financial Commitment Transactions*

The proposed rule would also address "financial commitment transactions," which include the types of non-derivative instruments discussed in Release 10666, such as reverse repurchase agreements, that obligate a fund to make future payments or delivery of assets to a fund's counterparty. The proposed rule would identify as financial commitment transactions capital commitments associated with investments in private funds whereby a fund obligates itself to later make a loan or provide capital to the private fund.

We agree that it is prudent for the adviser to a fund that invests in private funds interests with unfunded capital commitments to appropriately plan for capital calls. Indeed, failure to do so could result in a breach of the manager's fiduciary obligations to the fund and may violate the fund's investment policies. Regulating these arrangements under Section 18 raises significant difficulties, however, that we urge the Commission consider. This aspect of the Proposed Rule would severely impair portfolio management of registered funds that in the normal course invest in private equity funds with unfunded capital commitments. Here too, the impact of the Proposed Rule seems to reflect the Commission's judgment that these funds are not welcome as registered funds. Once again, the Commission fails to support its risk-based analysis with any hard data about how these funds of private funds are at risk for being unable to meet obligations associated with capital commitments.

Unlike other financial commitment transactions discussed in Release 10666, a significant portion of an unfunded capital commitment to a private fund is not a "current liability." A capital call, contingent upon the private fund's need for such capital, may not be made for an extended period (sometimes several years) if at all. Both market participants and fund accountants view unfunded capital commitments as contingent liabilities the fund's exposure to which is too uncertain to treat as a liability. Requiring asset coverage equal to the full callable value of such contingencies *at all times* grossly exceeds the amount a fund will actually need at any time to meet the fund's obligations. In addition, requiring the fund to maintain liquid assets against that callable amount unnecessarily limits the tools, including for example drawing on a line of credit, otherwise available to a fund adviser to satisfy the capital call.

We urge the Commission to reconsider whether unfunded capital commitments should be treated as senior securities. If the Commission determines to do so, we urge that it permit the fund to determine, on a risk-adjusted basis, the amount of assets appropriate to segregate against each outstanding commitment and to treat as liquid amounts the fund may borrow under a line of credit. Managing the portfolio and the capital structure of a closed-end fund investing in private funds involves managerial and financial skills that are not susceptible to mechanical application of a formula such as the one proposed by the Commission. Requiring a closed-end fund that is intentionally designed, and whose investors expect, will achieve its investment strategy by holding illiquid investments may severely interfere with fund's ability to achieve its investment objective.

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In closing, we are supportive of many aspects of proposed rule 18f-4, and believe that with the modifications we have suggested, the rule can be made to operate for the benefit of investors in mutual funds. We feel strongly, however, that some elements of the proposal would eliminate significant efficiencies in the management of funds and could be an impediment to the use of derivatives to efficiently manage fund portfolios. As discussed above, we are particularly concerned with the regulatory anomalies that would be created by the use of aggregate notional value as a tool to limit funds' use of derivatives.

We appreciate the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned at [redacted] or Christine Carsman, Senior Vice President and Deputy General Counsel, at [redacted] with any questions regarding these matters.

Respectfully submitted,

David M. Billings
Executive Vice President and General Counsel

cc: The Honorable Mary Jo White
The Honorable Michael S. Piwowar
The Honorable Kara M. Stein

David Grim, Director
Division of Investment Management