T. Rowe Price®
INVEST WITH CONFIDENCE

Via Electronic Mail
March 28, 2016

Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090
rule-comments@sec.gov

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Rel. No. IC-31933; File Number S7-24-15

Dear Mr. Fields:

T. Rowe Price Associates, Inc. ("**TRPA**")[1], as investment adviser to the T. Rowe Price family of funds ("**Price Funds**"), appreciates the opportunity to comment on the Securities and Exchange Commission's (the "**SEC**" or "**Commission**") above-referenced proposal (the "**Proposed Rule**" or "**Proposing Release**").[2] We support the SEC's objective of clarifying and updating its regulatory approach to the use of derivatives by mutual funds. Although we generally support the views expressed in the comment letters on the Proposed Rule filed by the Investment Adviser Association ("**IAA**"), the Investment Company Institute ("**ICI**"), and Securities Industry and Financial Markets Association – Asset Management Group ("**SIFMA**"), we are writing to express our specific concerns related to the potential impact of the Proposed Rule on mutual funds and to provide our recommendations for certain changes to address these concerns.

Mutual funds use derivatives for various purposes, including risk mitigation, liquidity management and efficient portfolio management. Derivatives allow mutual funds to mitigate risks by hedging interest rate, credit, inflation, and other market risks that may impact a mutual fund's investment strategy. In addition, derivatives may help to enhance the liquidity of a fund's portfolio, particularly a bond fund that uses Treasury futures or index derivatives that may be easier to sell than the underlying bonds. Derivatives act as an efficient market access tool by allowing mutual funds to gain exposure to asset types or markets in lower cost, more efficient transactions when compared to trading cash bonds and, in some cases, to provide access to markets or assets that may be difficult to purchase directly. Derivatives may also help mutual funds manage cash flows in order to maintain exposure to a fund's primary investment strategy. Therefore, we believe derivatives are an important investment tool, allowing portfolio managers to seek investment returns consistent with the best interests of fund investors.

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[1] TRPA and its affiliates serve as investment advisers to numerous individuals, institutions, and investment funds, including the Price Funds. As of December 31, 2015, TRPA and its affiliates managed approximately $763 billion in assets, and the Price Funds comprised 179 funds with assets of approximately $487 billion in the aggregate.

[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80883 (proposed Dec. 11, 2015) (to be codified at 17 C.F.R. §270.18f-4).

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Summary Recommendations:

While we support the SEC's goal of updating and consolidating its guidance on the use of derivatives by mutual funds, we recommend including the following key changes to the Proposed Rule:

Asset Segregation:

- Qualifying coverage assets[3] should be expanded beyond cash and cash equivalents. We believe that there are other types of liquid assets that could be used to satisfy a fund's future contingent obligations and are consistent with rules adopted by other regulators. We recommend that the list of qualifying coverage assets be expanded to include assets that are deemed eligible for collateral under the various margin rules for over-the-counter swaps (the "**Swap Margin Rules**").[4] In addition, if the SEC adopts a rule requiring mutual funds to maintain liquidity risk management programs, we believe that assets that are deemed liquid and appropriately monitored under a fund's liquidity risk management program should be categorized as qualifying coverage assets.[5]

- To-Be-Announced Securities ("**TBA**") should not require full notional coverage in light of the decisive move of this market towards collateralization and trading under Master Securities Forward Transaction Agreements ("**MSFTA**")[6] as well as the unique characteristics of TBAs when compared to other financial commitments.[7]

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[3] *Id.* at 80995-96.

[4] Margin and Capital Requirements for Covered Swap Entities: Final Rule, 80 Fed. Reg. 74839 (Nov. 30, 2015) and Interim Final Rule, 80 Fed. Reg. 74915 (Nov. 30, 2015) (the "**Prudential Regulators**") (the "**Swap Margin Rules Prudential Adopting Release**"); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (adopted by the Commodity Futures Trading Commission (the "CFTC")) (the "**Swap Margin Rules CFTC Adopting Release**"). The Swap Margin Rules will be effective on April 1, 2016. Mutual funds will begin posting variation margin, on or before the March 1, 2017 compliance date.

[5] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. IC-31835 (Sept. 22, 2015) *available at* www.sec.gov/rules/proposed/2015/33-9922.pdf (accessed Mar. 21, 2016) ("**Proposed Liquidity Rule**").

[6] Notice of Filing of a Proposed Rule Change to Amend Financial Industry Regulatory Authority ("**FINRA**") Rule 4210 ("Margin Requirements") to Establish Margin Requirements for the TBA Market, 80 Fed. Reg. 63603 (Oct. 14, 2015); Treasury Market Practice Group's ("TMPG's") Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "**TMPG Best Practices**") (Revised Feb. 2016) *available at* https://www.newyorkfed.org/tmpg/best_practices.html (accessed Mar. 16, 2016) (collectively "TBA Margin Requirements").

[7] *Proposed Rule* at 80995. ("Financial commitment means any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement (such as 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).")

Exposure Limits:

- We do not believe that new derivatives exposure limits are necessary because mutual funds will be adequately protected through consistently applied asset segregation requirements and a rigorous derivatives risk management program.

- If the SEC continues to require exposure limits, we support the approaches of the ICI and SIFMA, which seek to; (i) risk-adjust notional amounts; (ii) increase the 150% exposure limit to 200%, and (iii) redefine the VaR limit.

- In addition, we strongly believe that intraday testing, given the complexity of calculating compliance with the proposed exposure limits, should be modified to require testing once per day. Further, we would propose a cure period for funds that inadvertently breach an exposure limit intraday.

- The SEC should consider adopting a safe harbor that would provide mutual funds an exemption from all of the requirements in the Proposed Rule if a fund segregates full notional for all derivatives and senior security transactions.

Board Requirements:

We are supportive of fund boards providing oversight of a fund's derivatives risk management program but we do not believe that fund directors should be responsible for decisions and choices in constructing a fund's investment program or in managing a fund's derivatives investments – such decisions are more appropriately made by the fund's investment adviser as part of its investment management responsibilities. We do not believe it is appropriate for the fund board to approve specific limits on a fund's derivatives exposures or the measurement tools that are used as part of the derivatives risk management program.

I. Asset Segregation:

We support the SEC's Proposed Rule's general approach to the asset segregation requirement, which will promote uniformity across the industry and is preferable to the current framework of no-action letters and SEC releases on the topic. While the Proposed Rule seeks to clarify and consolidate asset segregation requirements, we believe that certain modifications may make the Proposed Rule more effective for managing fund portfolios while still protecting investors.

A. The qualifying coverage assets for derivative transactions should be broadened beyond cash and cash equivalents in order to avoid negatively impacting the management of mutual funds and constraining their ability to effectively utilize derivatives in ways that benefit investors.

Currently, a mutual fund is permitted to use any of its liquid portfolio holdings to "cover" (we refer to "cover" as the act of maintaining sufficient liquid assets) its outstanding derivatives obligations. While we understand the SEC's concern with the current framework, we think that the asset segregation requirements should allow for a broader range of instruments to be eligible as qualifying coverage assets beyond cash, cash equivalents, or the deliverable obligation of the derivatives transaction. The SECs original guidance on asset segregation in Release 10666 ("**10666**") provided that cover may consist of "liquid assets, such as cash, U.S. government securities or other appropriate high grade debt obligations" and through SEC guidance and no-action relief the scope of assets eligible for cover was expanded to include additional liquid assets.[8] We are concerned that limiting funds to cash and cash equivalents for asset coverage, which is more restrictive than the SEC's original asset segregation guidance from more than 35 years ago, may cause a "cash drag" on fund returns. For example, this may:

- require a fund to hold cash in excess of the amount of cash it would generally hold as part of its investment mandate;[9]
- require the fund to hold an outsized cash position versus a similar strategy that does not opt to use derivatives, ultimately impacting the investment return of the fund;[10] and

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[8] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 10, 1979) *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf (accessed Mar. 16, 2016). *See also* Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf (accessed Mar. 23, 2016) (concluding that the SEC "would not recommend…enforcement action under Section 18…if a Fund covers its…senior securities by maintaining…cash or liquid securities (regardless of type) having an aggregate value…equal to the amount of the covered obligations").

[9] For example, investment by a tax exempt mutual fund in cash and cash equivalents, if material in size, likely would be inconsistent with the investment objectives of the mutual fund and cause the investors, who invested in pursuit of tax-exempt income, to recognize taxable income.

[10] For example, an emerging markets bond fund that holds 100% non-U.S. dollar denominated bonds and hedges foreign currency exposure back to U.S. Dollars, thereby reducing currency risk, may be required to hold a significant amount of cash in order to comply with the asset coverage requirements. The potential investment return impact of holding sufficient cash to satisfy the asset coverage requirement could force a manager to abandon a

- force the fund to sell assets, raising cash to serve as qualifying coverage assets to meet the constantly changing risk-based coverage amount.[11]

Further, we are surprised that the Proposed Rule does not incorporate the framework that the SEC recently proposed for funds to adopt robust liquidity risk management programs.[12] We recommend that the SEC consider tying the use of qualifying coverage assets under the Proposed Rule to fund investments deemed liquid and appropriately monitored under the Proposed Liquidity Rule.

According to the Proposing Release, the SEC is concerned that the expansion of the types of assets available for segregation beyond cash and cash equivalents may create a situation where the potential obligation of a derivatives transaction increases while the segregated asset covering the position decreases in value, causing a fund to have insufficient assets to meet its obligations under derivatives transactions.[13] However, there are often scenarios where market conditions cause a derivative to increase or decrease a fund's potential obligation, while the segregated asset remains sufficient to meet a fund's obligations under a derivatives transaction. For example, the potential obligation of a typical fixed income fund that enters into a short Treasury futures contract to reduce the duration of its portfolio may decline during times of rising interest rates as would the value of a bond that is covering that futures position. At other times, the value of the portfolio assets eligible for segregation may increase in value as the potential obligation under a derivative rises. For example, in a "flight to quality" scenario, the value of highly-rated government bonds used in segregation will typically rise because of increased demand while the potential obligation under a sold protection credit default swap ("**CDS**") referencing the credit of an investment grade company will likely also increase as credit spreads widen.

Therefore, we believe that liquid, non-cash assets should be eligible for asset segregation, but the amount of non-cash assets covering a derivatives position should be determined based on how they may perform in a stressed market. We believe that this relationship has been appropriately addressed in the recently issued Swap Margin Rules, and the resulting assets deemed eligible for margin posting should inform the Commission in its present rulemaking. Both the Swap Margin Rules and the asset segregation requirement of the Proposed Rule have similar aims: to ensure that assets used to secure obligations under derivatives transactions can

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hedging strategy, thereby, exposing shareholders of the fund to the currency fluctuations of the underlying bonds. The derivatives serve to temper the effects of currency fluctuations on the fund's returns, reducing volatility and currency risk, which may be important features to some investors.

[11] For example, the Proposed Rule's risk-based coverage and mark-to-market coverage amounts are monitored on a daily basis and, as the risk-based coverage amount increases, the fund may be forced to sell bond holdings to satisfy the asset coverage requirements.

[12] *Supra* at 2 n. 5.

[13] *Proposed Rule* at 80932. ("We are not proposing to include as qualifying coverage assets other types of assets, such as equity securities or other debt securities, because we are concerned about the risk that such assets could decline in value at the same time the fund's potential obligations under the derivatives transactions increase, thus increasing the possibility that such assets could be insufficient to cover the fund's obligations under derivatives transactions.")

retain their value in a variety of stress scenarios and ultimately serve to protect market participants (Swap Margin Rules) or fund investors (Proposed Rule). The SEC has acknowledged as much in the Proposed Rule by allowing funds to use assets posted as margin towards their asset segregation requirements. Under the Swap Margin Rules, eligible collateral is limited to "high–quality, liquid assets that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based 'haircut' or 'discount' during a severe economic downturn."[14] While the qualifying coverage asset may at times decline in value, the haircut is intended to act as a buffer, ensuring sufficient assets to meet the fund's obligations even under the most stressed market conditions.

We believe, therefore, that the qualifying coverage assets should be expanded to include the instruments provided in the Swap Margin Rules and similar haircuts should be adopted taking into consideration the correlation between the asset being segregated and potential future market deterioration. The expansion of asset types eligible for asset segregation will not impose additional risks on funds. First, funds will still be required to cover at least 100% of their mark-to-market and risk-based coverage amounts, which are calculated daily. In addition, if during stressed conditions the value of the coverage assets decline, the buffer provided by the appropriately determined haircuts prescribed in the Swap Margin Rules may insulate the fund from any deficiency in coverage until the fund segregates additional assets to account for such decline.[15] The similar outcomes thus achieved by the Proposed Rule and the Swap Margin Rules would provide consistency across regulatory regimes, resulting in greater efficiencies for mutual funds, lower costs for investors, and more opportunity for portfolio managers to hold the most appropriate investments to meet a fund's investment objectives.

B. TBAs should be permitted to use the mark-to-market plus risk-based liability for asset coverage.

According to the Proposed Rule, certain transactions included in the SEC's guidance in 10666 would be categorized as financial commitments, which require full notional asset coverage.[16] Although it appears that TBAs would be included within the financial commitments category, we believe that they are sufficiently different from other transactions in 10666 and should not require full notional asset coverage.

A common feature of all 10666 transactions – reverse repurchase agreements, short sales, and standby commitments – is the obligation of one party to deliver the full notional value at settlement. For example, under a reverse repurchase agreement, a party has to deliver the cash in the full amount; in a short sale, the fund has to deliver the borrowed stock; and in a standby commitment, the fund has to deliver the full committed amount when called. The repayment or delivery obligation in these transactions is similar to a borrowing and the party receiving the proceeds is counting on the full notional amount at settlement. A corollary to this feature is that

[14] *Swap Margin Rules Prudential Adopting Release* at 74844-45.

[15] *Swap Margin Rules CFTC Adopting Release* at 667.

[16] *Supra* at 4 n. 8.

it is not possible to net cash settle any of these transactions. Because of this characteristic, it is reasonable to require funds that enter into repurchase agreements, short sales, and standby commitments to segregate the full notional amount, if they are in fact the delivering party.

In contrast to repurchase agreements, short sales, and standby commitments, TBAs are forward transactions that the contracting parties predominantly use as price guarantees. The parties agree on a future price for the underlying asset and the gain or loss is calculated by the difference between the agreed price and the prevailing spot price. With TBAs, the practice is to cash settle (or enter into an offsetting transaction prior to settlement) and pay only the difference between the spot and forward price, even though they actually require the exchange of payment and delivery of the physical security at settlement. In other words, TBA transactions are very similar to forward transactions, and they should be treated the same for purposes of asset coverage.

In addition, the TBA market is one of the most liquid secondary markets for mortgage loans.[17] Investing in TBAs provides certain benefits over holding actual mortgage-backed security pools, primarily to gain exposure more efficiently to the mortgage-backed security sector without the administrative burdens of trading, settling and monitoring investments in physical mortgage pools. The FINRA proposed margining rules and TMPG Best Practices have created a market place where TBAs are now primarily traded under MSFTAs, which allow for netting in a similar manner to other derivatives netting agreements, with variation margin being exchanged between counterparties to the trade.[18] We believe that because TBAs are very similar to other forwards, are subject to increased scrutiny of margin practices by various regulators, and are traded in a highly liquid market, segregation of full notional is unnecessary. The Proposed Rule should be modified to allow for segregation based on the mark-to-market and risk-based coverage amounts in a manner similar to derivatives and, as previously suggested, with an expanded list of eligible qualifying coverage assets.

II. <u>Exposure Limits:</u>

The SEC, for the first time, proposes to condition compliance with Section 18 of the Investment Company Act of 1940 (the "**Investment Company Act**") on three separate requirements (i) asset segregation, (ii) the cumulative portfolio exposure of all of a fund's derivatives transactions, financial commitments and other indebtedness, and (iii) a formalized derivatives risk management program (when a fund's aggregate notional derivative exposure exceeds 50% of the fund's net assets or the fund enters into a complex derivatives transaction).[19]

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[17] Chris Killian, Joseph Cox & Zachary Krueger, *SIFMA TBA Market Fact Sheet: The TBA Market, 2015*, SIFMA TBA Market Fact Sheet: The TBA Market, 2015 (copy on file with SIFMA, http://www.sifma.org/issues/item.aspx?id=23775) (accessed Mar. 16, 2015) ("The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans…[A]n average of $184 billion of agency MBS was traded each day in June 2015 …").

[18] *Supra* at 2 n. 6.

[19] We believe that while the rule does not require all funds to implement a derivatives risk management program, we believe most large fund complexes that utilize derivatives will implement such a program, if not already implemented, even when the fund is not engaging in complex derivatives or complies with the 50% derivatives

The decision to propose exposure limits on derivatives is historic and marks a significant shift from the decades of guidance provided by the SEC on fund usage of derivatives. Further, we are troubled by the precedent the Proposed Rule sets. We are not aware of any other rule under the Investment Company Act which mandates regulatory limits on a fund's investments based on the perceived risks of those investments, outside of Rule 2a-7 for money market funds. The limits of Rule 2a-7 are entirely appropriate based on the objectives of money funds to limit volatility of their net asset value. Apart from that instance, however, we do not believe that the SEC should set exposure limits for any asset class, including derivatives, particularly when there are other ways to protect investors as provided by the Proposed Rule. We analyzed the Price Funds' compliance with the proposed exposure limits under present market conditions and, while the exposure limits would not cause our funds to reduce their current allocation to derivatives, future market conditions or investment strategies may necessitate exposures above the proposed limits.[20] We believe that imposing such exposure limits constrains suitable investments and may curb future innovations in the fund industry that could offer desirable investment opportunities to mutual fund investors, such as asset allocation and retirement income solutions.

Moreover, we believe that exposure limits are unnecessary because of the combined impact of enhanced asset segregation requirements and the oversight provided by the new formalized derivatives risk management program, which effectively protect investors by minimizing a fund's risks from the use of derivatives. As expressed in our comment letter to the SEC's Concept Release,[21] Section 18 of the Investment Company Act is intended to limit indebtedness leverage and asset coverage serves this purpose in two ways. First, asset segregation requirements minimize the amount of indebtedness leverage undertaken by a mutual fund. Second, asset segregation helps to ensure the availability of adequate funds to meet potential future obligations stemming from indebtedness. We continue to believe that asset segregation minimizes a fund's ability to take on leverage.[22]

The SEC based its decision to implement exposure limits on a finding that "in some cases [asset segregation alone did] not provide a sufficient limit on the amount of leverage a fund [could] obtain through derivatives".[23] We agree that mark-to-market asset coverage may not be

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notional threshold. Further, once implemented, we believe a fund complex would continue to maintain its derivatives risk program even if its funds had crossed the 50% threshold at one time, but subsequently fell below it.

[20] Based on testing under the guidelines of the Proposed Rule, at present, one Price Fund (a global bond fund) exceeded the 150% exposure limit but fell within the 300% relative VaR limit. The remainder of the Price Funds, with current derivatives exposures, had notional exposures less than the 150% exposure limit.

[21] *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)] ("**Concept Release**") Comment Letter of T. Rowe Price Associates, Inc. on Concept Release (Nov. 7, 2011) (File No. S7-33-11).

[22] *Proposed Rule* at 80899. ("The proposed rule's portfolio limitations are designed primarily to address concerns about a fund's ability to obtain leverage through derivatives transactions, whereas the proposed rule's requirements to maintain qualifying coverage assets are designed primarily to address concerns about a fund's ability to meet its obligations.")

[23] *Id.* at 80899.

sufficient to cover a fund's potential future obligations. However, we believe that the additional requirement to segregate a risk-based coverage amount, which may be based on policies and procedures monitored under the derivatives risk management program, will minimize a fund's ability to leverage its portfolio and provide sufficient assets to meet future obligations.[24] In fact, the risk-based coverage amount would be based on board-approved policies and procedures designed by a derivatives risk manager (independent of portfolio management), to address: a fund's specific derivatives transactions and the underlying reference assets, a fund's investment strategies and risks, and a determination of the sufficiency of assets under stressed conditions. In addition, the risk management program can serve as an effective guard rail to a fund's derivative usage, ensuring that the fund does not take on leverage that is inconsistent with the fund's guidelines or investment strategy.

Therefore, we believe that the SEC should not impose exposure limits on derivatives at this time – and any future consideration of such limits should be informed by further study of the effectiveness of funds' derivatives risk management programs coupled with the risk-based and mark-to-market coverage amounts provided under the improved asset segregation requirements.

A. Modifications to Exposure Limits:

If, however, the SEC retains derivatives exposure limits in the final rule, we support the views expressed in the SIFMA and ICI comment letters on the Proposed Rule, proposing to: (i) risk-adjust notional amounts; (ii) increase the 150% exposure limit to 200%, and (iii) redefine the VaR limit.

Under the proposed exposure limits, funds would be required to calculate the 150% and 300% exposure limits using full notional amounts for all derivatives positions with limited use of netting positions.[25] In addition, to utilize the 300% exposure limit, funds would be required to measure the VaR of two components: (i) the fund's entire portfolio, including securities, other investments, and derivatives transactions ("**Full Portfolio VaR**"); and (ii) the fund's portfolio of securities and other investments, excluding any derivatives transactions ("**Securities VaR**").

The SEC recognizes that using the full notional amount to calculate the exposure limitation for derivatives "could be viewed as a relatively blunt measurement" but when weighed against the difficulty of administering another method "a notional amount limitation would be more administrable, and thus more effective, as a means of limiting potential leverage from derivatives…."[26] We believe that the exposure limits should be refined to take into consideration the inherent risk (volatility) associated with different types of derivatives. Therefore, TRPA supports the use of risk-adjusted notional amounts in the derivatives exposure

[24] *Supra* at 7 n. 19.

[25] *Proposed Rule* at 80933. ("for purposes of the exposure limits under the proposed rule, a fund may net directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms, even if those transactions are entered into with different counterparties and without regard to whether those transactions are subject to a netting agreement.")

[26] *Id.* at 80909.

limits rather than full notional value, consistent with the approaches outlined in the SIFMA and ICI comment letters. These approaches seek to provide a consistent, universal, and administrable approach to risk adjusting notional amounts based on schedules or factors.[27] We believe risk adjusting the notional amounts for purposes of the exposure limits will alleviate unintended consequences, such as limiting the ability of portfolio managers to use derivatives in order to mitigate risk – particularly in the context of fixed income funds.

We also support SIFMA's proposal to increase the 150% exposure limit to 200%. Based on the testing we performed for the Price Funds, we believe that the proposed 150% exposure limit may constrain the portfolio management of some funds under certain market conditions. This is particularly true in the case of a conservatively managed global fixed income fund (see Annex A for an illustration of how such a fund could be adversely impacted by the 150% exposure limit).

In addition, TRPA supports SIFMA's recommendation to substitute an absolute VaR test for the relative VaR test in the Proposed Rule. The relative VaR test does not appropriately measure the overall risk of a fund; it only measures the additional risk to a fund from investing in derivatives. The absolute VaR test is a more precise and realistic measure of risk because it accounts for how the derivatives interact both with each other and with the other investments in the portfolio. Therefore, we believe that an absolute VaR test with an upper exposure limit of 300% provides portfolio managers with an appropriate risk-based framework to guide effective and efficient investment decisions.

B. Intraday testing requirement:

Under the Proposed Rule, funds would be required to compute the exposure limit tests and VaR tests prior to entering into each transaction. In order to facilitate these computations, a fund would need to track the VaR of all fund holdings (including securities, derivatives, financial commitments, and other senior securities) on a real-time basis. We believe real time tracking of the risk measures of such securities is beyond the scope of most fund compliance systems. For example, funds that are relying on the risk-reducing, exposure limit test would be required to undertake a complicated VaR test on a real-time basis throughout the trading day. VaR calculations are normally performed in risk management systems that are not integrated within the trading or compliance processes. Integration of risk, compliance, and trading systems to allow for real-time VaR calculations would be a costly and time consuming endeavor. Therefore, we recommend that the Proposed Rule permit funds to test compliance with the exposure limits and VaR once each business day as determined by the derivatives risk manager, which will allow funds to gather and accurately test the data.[28]

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[27] For example, one such schedule proposed by SIFMA is the standard initial margin schedule published by the Bank for International Settlements ("**BIS**"), which Prudential Regulators globally rely on as a framework to risk weight different assets. TRPA agrees with SIFMA that the BIS schedule could be effectively used by mutual funds to determine the relative riskiness of the referenced derivative.

[28] We believe there are other examples where the SEC is comfortable with a fund using end-of-day information to measure compliance. For example, in the context of calculations of daily and weekly liquidity, a money market fund may choose any reasonable time to calculate its total assets and daily and weekly liquidity, as long as the liquidity is computed at the same time at least once every business day. However, if a money market fund falls

C. Compliance Period:

In addition to eliminating the real time requirement to calculate exposure and VaR limits, we believe that funds breaching those limits should be allowed a reasonable period of time to cure the violation. We believe the SEC should revise the timing of the Proposed Rule's calculation period to allow for a seven (7) calendar day compliance period that would enable a fund to get back into compliance with any breached exposure or VaR limit in a manner that minimizes the potential harm to investors. This compliance period provides an opportunity for the portfolio manager to bring the fund back into compliance in an orderly manner either by reducing the exposure created by the fund's derivatives positions or selling other assets, as may be necessary. During this compliance period, the fund would be prevented from entering into derivatives or financial commitment transactions that increase risk, other than tapping a credit facility used for the sole purpose of satisfying redemptions, but would be allowed to continue entering into transactions that either off-set or close-out derivative transactions.

D. Safe Harbor for Funds Electing to Segregate Full Notional:

We recommend that the Proposed Rule include a safe-harbor that would allow funds to elect to utilize full notional coverage for all derivatives and senior security transactions to be exempt from all requirements of the Proposed Rule. Fund managers electing the safe harbor would be required to segregate full notional for all senior security transactions, regardless of settlement type, with the expanded list of eligible assets under the Swaps Margin Rules. While TRPA would likely not avail itself of the safe harbor, we think other smaller fund groups should have the option of using a more conservative asset segregation framework in order to avoid the costs or other aspects of the Proposed Rule.

We believe that full notional segregation addresses the SEC's concerns outlined in the Proposed Rule:

- Limiting Leverage - Funds relying on the safe harbor would not be allowed to segregate mark-to-market for cash settled derivatives, which we believe fully addresses a fund's ability to speculate through leverage because funds would not be able to enter into an aggregate notional amount of senior securities transactions that exceeds the fund's net assets;
- Ensuring Asset Sufficiency - As we stated above, expanding the qualifying coverage assets to include instruments eligible for collateral in the Swaps Margin Rules with applicable haircuts ensures that a fund will have sufficient assets to cover future contingent obligations, even during stressed markets; and
- Monitoring of Derivatives Risk - Full notional segregation should eliminate the need for a derivatives risk management program since the risk of incurring excessive leverage and asset sufficiency are addressed by full notional asset coverage.

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below the appropriate threshold for daily or weekly liquid assets, the fund would be required to purchase assets that improve the fund's compliance with the liquidity thresholds. We are proposing a similar framework for monitoring a portfolio's exposure limits.

III. **Board Requirements:**

When a fund exceeds a 50% threshold of notional derivatives exposure or enters into a complex derivative transaction, the Proposed Rule would require a fund to maintain a derivatives risk management program with general board oversight. The board would be required to initially approve each fund's derivatives risk management program, including any material changes, to approve the appointment of the derivatives risk manager, and to review a quarterly assessment report from the risk manager. We believe that the appropriate role for the board with respect to the derivatives risk management program is one of oversight and that fund directors should not be responsible for decisions and choices in managing or monitoring a fund's investments that are more appropriately made by the fund's investment adviser as part of its investment management responsibilities, or the derivatives risk manager, as applicable. We believe the fund compliance rule, Rule 38a-1, which has been considered a success by the industry, is the model to use in crafting the board's role over derivatives risk management. While elements of the Proposed Rule are similar to Rule 38a-1, certain aspects of the Proposed Rule go beyond the requirements of Rule 38a-1 and take the board into operational and investment decision making more appropriately left to fund management. For example, we do not believe it is appropriate for the board to approve specific limits on a fund's derivatives exposures, risk-based coverage calculations, or the measurement tools that are used as part of the derivatives risk management program.

In this regard, the Proposed Rule would require boards to approve one of two derivatives exposure limits (150% notional or 300% risk-based) that would apply to a fund, and the SEC compares this determination in the Proposed Rule to other types of approvals required under SEC exemptive rules for cross transactions, multi-class structures and use of affiliated brokers and underwriters. We do not view the board approvals under these exemptive rules as comparable to what the board must determine in approving a fund's derivatives exposure limits. First, the typical fund director may not have the technical expertise to apply VAR, leverage factors and other risk-based methodologies to assess the reasonableness of the limit with respect to a fund's investment program. Second, we fail to see conflicts of interest if the fund manager were to make this determination – which generally should be an important factor for requiring board approval of any action determined by the manager. The Proposed Rule indicates that by approving the exposure limits, it 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."[29] We think there are other ways to accomplish this result, such as periodic reporting to the board by the fund's portfolio manager and derivatives risk manager as to the fund's derivatives positions; whether the derivatives are being used to reduce or increase exposures; and the contribution of such derivatives to the fund's performance and risk profile. In addition, the reporting required under the derivatives risk management program can highlight any new types of derivatives investments or particular exposures identified by the risk manager for review by the fund board.

[29] *Proposed Rule* at 80924.

Finally, we are confused by the requirement for the board to review written reports from the derivatives risk manager, at least quarterly, "that review the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation."[30] This quarterly review requirement goes further than Rule 38a-1 and seems duplicative of the overall role of the board with respect to its traditional function to oversee management. Further, we are not sure how this requirement would be implemented in practice – for example, whether SEC examiners expect to see a fund board make these explicit findings quarterly as part of a board's records. Instead, we would suggest that the SEC use Rule 38a-1 as a guide, requiring an annual review of the adequacy of the derivatives risk management program, and that the derivatives risk manager, similar to the fund's compliance office under Rule 38a-1, be given discretion with respect to the material elements, activities and results of the program that would be reported quarterly to the fund board under the Proposed Rule.

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We appreciate your consideration of our views on this significant topic. If you have any questions or would like to discuss our letter, please do not hesitate to contact Christopher Edge, Head of Equity Risk Management, at [redacted], Eric Bolisay, Head of Derivatives Strategic Operations, at [redacted], Fran Pollack-Matz, Senior Legal Counsel, at [redacted], Predrag Rogic, Senior Legal Counsel, at [redacted], or Jeremy Mitzel, Legal Counsel, at [redacted].

Sincerely,

/s/David Oestreicher

David Oestreicher
T. Rowe Price Associates, Inc.
Vice President and Chief Legal Counsel

[30] *Id.* at 80935.

Annex A: Hypothetical

A conservatively managed global credit fund may seek to change its current exposure to domestic credit ("**US**"), emerging markets ("**EM**"), and international developed markets ("**ID**") equal to a target allocation of 50% US, 40% EM and 10% ID (the "**Target Allocation**"). By utilizing derivatives, the fund could quickly deploy its strategy through the following action:

Assume current cash securities holdings equal to 0% in EM, 50 % in US, and 50% ID ("**Cash Portfolio")**
Adjusting the fund to the Target Allocation would require a 160% notional exposure to derivatives:

- 40% notional bought protection on index based credit default swap ("**CDX**") (ex. CDX EUR ITRAXX) to reduce ID credit exposure to 10%;
- 40% notional pay fixed Euro interest rate swaps to reduce ID interest rate exposure to 10%;
- 40% notional sold protection emerging market CDX (ex. CDX EM) to increase EM credit exposure to 40%; and
- 40% notional receiver fixed Brazilian interest rate swaps to increase EM rate exposure to 40%.

If the exposure limits are imposed as currently drafted, this fund may not be able to fully and effectively utilize derivatives to provide investors with the liquidity advantage of derivatives compared to holding physical emerging market securities. Derivatives may also minimize potential tax burdens and market access issues that may result from holding physical securities.