GUGGENHEIM INVESTMENTS

March 28, 2016

VIA ELECTRONIC DELIVERY

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Mr. Fields:

Guggenheim Investments[1] ("Guggenheim" or "we") appreciates the opportunity to respond to the request by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for comments regarding the above-referenced release (the "Proposing Release").[2]

We appreciate the Commission's concerns regarding the use of derivatives by mutual funds and other registered investment companies and business development companies (each a "fund" and collectively, "funds"). Further, we support the Commission's efforts to provide additional certainty with respect to funds' use of derivatives through rulemaking under Section 18 of the Investment Company Act of 1940, as amended ("1940 Act"), including defined board of director/trustee ("Board") involvement and the addition of a derivatives risk manager.

However, we would like to reiterate our stance in our comment letter on the Concept Release in 2011 that the use of derivatives in the hands of responsible portfolio managers can be a highly effective investment tool.[3] Namely, derivatives can increase shareholder investment options,

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1 Guggenheim Investments represents the investment management business of Guggenheim Partners, LLC, which includes Guggenheim Partners Investment Management, LLC ("GPIM"), Security Investors, LLC ("SI") and Guggenheim Funds Investment Advisors, LLC, ("GFIA"). We refer to the funds under Guggenheim's management as "Guggenheim Funds" or "Funds."

2 Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,884 (Dec. 28, 2015).

3 Letter from Amy J. Lee, Senior Vice President, Security Investors, LLC, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated November 7, 2011 ("2011 Guggenheim Comment Letter") (responding to the SEC's 2011 Concept Release soliciting comments on a variety of matters related to mutual funds' use of derivatives).

reduce trading costs and provide for effective risk management. We are disappointed that the Proposing Release only in passing mentions certain benefits of derivative use.[4]

We believe that certain elements of proposed Rule 18f-4 present serious concerns. We particularly oppose the element that would impose notional limitations on funds, which would have the effect of dramatically changing numerous funds' investment strategies and making them less efficient, resulting in increased costs (i.e., lower net returns) for shareholders. As currently proposed, limitations on derivatives usage may also result in a decrease in investment opportunities for funds and shareholders. If the Commission proceeds with adopting new derivatives regulation, this comment letter provides some suggestions which may lead to a better balance between permitting funds to use derivatives for hedging, risk mitigation and investment purposes and imposing reasonable, practical restrictions that address the risks derivatives may present to funds and their shareholders.

As the initial provider of leveraged and inverse mutual funds, we have more than 20 years of experience utilizing a wide array of derivatives products that provide targeted exposure to shareholders. We offer a variety of funds that invest in various asset classes that provide tools for shareholders to gain leveraged exposure (long and short) to various benchmarks ("trading tools") or to hedge risks in their investment portfolios in daily liquid funds. We have also been an innovator of funds that employ alternative investment strategies such as managed futures, which may provide a means of diversification for shareholders' portfolios. In developing these comments, we have drawn on our extensive experience in managing such funds and our resulting appreciation for both the benefits and risks of derivatives.

I. Background – Guggenheim Funds' Beneficial Use of Derivatives

As the Commission acknowledges in the Proposing Release, funds employ derivatives for a variety of beneficial purposes, including to: seek higher returns through increased investment exposures; hedge interest rate, credit, and other risks in their investment portfolios; gain access to certain markets; and achieve greater transaction efficiency.[5] The use of derivatives is important to many Guggenheim Funds to obtain the investment exposure required by their strategies and selected by fund shareholders. We are concerned that the Commission may not fully appreciate the benefits funds obtain through the use of derivatives or the benefits to shareholders of access to various funds that use managed futures, leveraged and inverse, and other strategies as investment options that provide risk management and other investment tools.

As low transaction cost investment options, derivatives are important to many Guggenheim Funds to help reduce costs borne by shareholders. Certain Guggenheim Funds utilize derivatives to gain exposure to underlying benchmarks and indices or asset classes in a more cost effective manner than trading directly. Derivatives transaction costs are frequently a fraction of those incurred in equity and fixed income transactions. As an example, the cost of trading an S&P 500 equity basket of securities is approximately 2 to 3 basis points, whereas the same exposure obtained through swaps is 1 to 1.5 basis points and through futures is less than 0.2 basis points. Similarly, the cost of

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4 Unfortunately, the Proposing Release does not expand upon these benefits and mainly focuses on the Commission's views on the potential misuse of derivatives.

5 Proposing Release at 80,885.

trading a small-cap Russell 2000 equity basket of securities is approximately 5 to 8 basis points versus 1 to 1.5 bps for swaps to gain the same exposure and less than 0.2 basis points for futures.[6] Certain Guggenheim Funds allow for unlimited exchange privileges, which can result in substantial shareholder turnover and magnify the impact of transaction costs. Increased transaction costs could therefore have an adverse effect on performance and therefore on shareholders.

The Rule 18f-4 portfolio limitations would seriously impact the operations of each of the following categories of Guggenheim Funds.

Leveraged and Inverse Funds. The difference in transaction costs between trading in derivatives and trading the underlying "cash market" (i.e., trading directly in the underlying asset linked to the derivatives) can be very meaningful for certain of Guggenheim's mutual funds, particularly those that use derivatives as core instruments to gain levered long or inverse exposure to the Funds' underlying benchmarks ("Leveraged Funds" and "Inverse Funds," respectively). Leveraged and Inverse Funds provide shareholders with liquid investment options to use as trading tools to obtain desired leveraged investment exposures and to manage risks in their investments portfolios. Leveraged and Inverse Funds enable shareholders to make tactical decisions about their specific level of exposure to markets. Additionally, Inverse Funds provide shareholders with the ability to hedge market risks in their portfolios by providing shareholders with access to an efficient and cost effective hedging tool. As disclosed to shareholders and prospective shareholders, Leveraged Funds and Inverse Funds are not intended for all shareholders.

Derivatives such as swaps and futures provide these Funds liquidity and efficiency. The Leveraged and Inverse Funds invest in derivatives that are highly liquid and cost effective for shareholders. This allows the Funds to open and close investment positions with great efficiency and at a low cost to Fund shareholders, which directly impacts and improves fund performance. The Leveraged and Inverse Funds are designed for high levels of shareholder turnover ("Tradeable Funds"), are not meant to be long term holdings, and are instead meant to be short term tactical investments. The short term nature of positions in Leveraged and Inverse Funds, along with unlimited exchange privileges, makes it necessary for Leveraged and Inverse Funds to use extremely liquid and cost effective instruments. The purchase and sale of assets directly would not provide the same liquidity and would increase costs.

Several Inverse Funds currently exceed the 150% derivatives limit (as discussed below) in order to achieve an exposure consistent with their stated investment objective (e.g. 200% inverse exposure) and would not pass the VaR test (as discussed below).

High Yield Fixed Income Funds. Certain fixed income Funds use derivatives for duration and credit risk management, primarily interest rate swaps and credit default swaps ("CDS"). Interest rate swaps permit these Funds to manage duration risk and target specific interest rates without transacting in many individual securities. The interest rate swaps used by the Funds are highly liquid and generally cleared instruments. CDS allow the Funds to hedge credit risk.

Certain Tradeable Funds also use derivatives to provide synthetic high yield fixed income exposure through the use of index-based CDS and U.S. Treasury futures. Index-based CDS and treasury

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6 Guggenheim calculations, assuming 1 to 1.5 cents per share commission for equity trades.

futures are highly liquid and cleared such that, when used in tandem, provide a return profile that correlates to the high yield cash bond market. Limitations on derivatives usage would require high yield Tradeable Funds to purchase cash fixed income securities rather than obtaining investment exposure synthetically. Cash high yield bonds typically have wider spreads and less liquidity than index-based CDS. In the event of large redemptions, a Tradeable Fund holding cash bond positions would be forced to try to liquidate these bonds and incur the related costs, negatively affecting such Fund through the impact of increased costs on performance. In contrast, the high yield Tradeable Funds have had no issues meeting redemptions while using liquid derivatives to achieve their desired investment exposure.

International Equity Funds. Derivatives also allow Guggenheim to offer international equity Funds that provide exposure to foreign equity markets. Certain Guggenheim Funds invest in both equity futures and currency futures to provide the desired international exposure. Such a Fund that uses derivatives to employ a non-levered strategy to track the returns of a foreign equity index may obtain 100% notional equity futures exposure to achieve long exposure to the securities included in the index in a cost efficient manner, plus 100% notional currency futures exposure to gain the currency exposure and thereby replicate foreign index returns in US dollars (this approach would result in 200% notional exposure). An equity fund that gains exposure to an international equity benchmark (e.g., Nikkei 225 index) buying each stock in the index would have a similar risk and return profile to a fund that uses 200% futures exposure, as described above. The fund using derivatives, however, would have notional exposure exceeding the 150% limit and would also not satisfy the VaR Test.

Alternative Investment Strategy Funds. Guggenheim also provides Funds that employ alternative investment strategies, such as managed futures. Through the use of derivatives, these Funds provide shareholders with unique tools to diversify their overall investment portfolios. These Funds are viewed as key components of a well-balanced investment portfolio.

It is commonplace that managed futures funds have notional derivatives exposure in excess of 150% and even in excess 300%. However, it is important to note that, due to the funds' diversification across multiple markets and asset classes, the overall risk of managed futures funds in terms of realized volatility is typically less than an investment in an unleveraged equity fund. Our analysis of managed futures funds confirms this, as less than 10 % of managed futures funds have experienced volatility greater than that of the S&P 500 since their respective inception dates. In fact, we found that the median volatility of the roughly 50 managed futures funds was only two-thirds the volatility of the S&P 500.[7]

The ability of managed futures funds to take long and short positions in a variety of asset classes, such as equities, fixed income, currencies and commodities, has historically provided a return profile that is uncorrelated to traditional stock and bond investing. Because of this lack of correlation, managed futures funds have provided shareholders with a tool to weather volatile markets. The benefits of managed futures funds were highly evident in the most recent financial crisis, when they were among the only category of investment products with positive returns.[8]

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[7] Guggenheim calculations.

[8] In 2008, large cap stocks were down 37%, small cap stocks were down 34%, international stocks were down 43%, high yield bonds were down 26%, and commodities were down 46%. As a

Limiting the notional derivative exposure of managed futures funds would compromise the ability of these funds to diversify across asset classes and may limit the benefits of managed futures funds to their shareholders in the next financial crisis.

Liquidity of Derivatives Held by Guggenheim Funds. The Commission states that "derivatives can raise risks for a fund relating to…illiquidity."[9] Many derivatives, however, are equally as or more liquid than other instruments. This liquidity can take the form of increased market depth and tighter bid/ask spreads. For example, the total notional amount of S&P 500 e-mini futures contracts traded in February 2016 was approximately $4 trillion (representing approximately 42 million contracts traded).[10] In comparison, the New York Stock Exchange dollar volume for the same period was approximately $1.5 trillion, representing over 43 billion shares.[11]

The Guggenheim Funds also have measures in place to address the risks of derivatives. For example, many of our swap agreements have "knockout" provisions that limit a Fund's liability to a certain percentage of notional swap exposure during market dislocations. This, in effect, results in a potential liability that is far less than the total notional exposure of the swap. Furthermore, swap agreements have provisions that allow for early termination.

Additionally, we conduct a thorough analysis of the liquidity of derivatives in which our Funds transact and have successfully managed our derivatives portfolios through many large increases and decreases in various Funds' assets. For example, it is not uncommon for our Tradeable Funds to incur large redemptions or ten-fold increases in assets in a given day. As a result of our due diligence on derivatives liquidity, we are well equipped to handle this significant subscription and redemption activity.

II. Comments on the Proposed Portfolio Limitation Requirement

A. The Commission Does Not Demonstrate that the Portfolio Limitations Are Necessary or Appropriate

Proposed Rule 18f-4 would require funds engaging in derivatives transactions to comply with one of two portfolio limitations immediately after entering into each derivatives or other senior securities transaction.[12]

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comparison, the Guggenheim Managed Futures Strategy Fund (H-Class shares) were up 8.5% in 2008.

9 Proposing Release at 80,885.

10 *See CMEG Exchange Volume Report – Monthly*, CME Group (Feb. 2016), http://www.cmegroup.com/daily_bulletin/monthly_volume/Web_Volume_Report_CMEG.pdf. *See also* Guggenheim calculations.

11 *NYSE Group Volume in All Stocks Traded, 2010 – current*, NYSE Market Data (2016), http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=3311 &category=3.

12 Under the so-called "Exposure-Based Portfolio Limit", the aggregate exposure of a fund would not be permitted to exceed 150% of the value of its net assets. Under the "Risk-Based Portfolio Limit",

Recognizing the benefits of derivatives usage for funds, the Commission and its Staff for over three decades have maintained a long-standing policy that a fund can avoid "senior security" concerns under Section 18 when engaging in derivatives and financial commitment transactions that involve leverage if the fund daily segregates/earmarks liquid assets equal to, or otherwise covers, its obligations arising from these transactions.[13] Since Release 10666, various Staff no-action letters have permitted funds to invest in derivatives subject to certain conditions. These long-standing positions have shaped industry segregation and cover practices.

The Commission requests comment on whether the use of notional amounts as the basis for calculating a fund's exposure under a derivatives transaction is appropriate. We oppose the imposition of notional limits on a fund's derivatives activity and strongly believe that imposing these notional limits is not necessary or appropriate to address the statutory purpose underlying Section 18. The proposed new notional portfolio limits would represent a significant departure from the Commission's and Staff's long-standing policy setting forth a framework for funds' use of derivatives and financial commitment transactions. Furthermore, there are a variety of other mechanisms in place by funds, and requirements of other regulators and clearinghouses that also address the risks of derivatives. We believe that the Commission has not adequately justified such a significant departure from its long-standing policy.

Instead, we believe that the new asset segregation requirement, including the proposed "Mark-to-Market Coverage Amount" and the additional "Risk-Based Coverage Amount" (with the modifications we propose below), together with principles-based Board requirements, should be sufficient to address shareholder protection concerns underlying Section 18 of the 1940 Act.

First, the Commission has not demonstrated that the new limits are necessary to meet the statutory purpose underlying Section 18.

Congressional concerns underlying Section 18 include mitigating or eliminating the adverse effect on the interests of shareholders and the national public from: (i) the unduly increased speculative

a fund could maintain up to 300% notional exposure if the fund's "full portfolio" value-at-risk ("VaR") was less than the fund's "securities VaR" (excluding derivatives).

Exposure would include (i) the aggregate notional amounts of the fund's derivatives transactions; (ii) the aggregate obligations under the fund's financial commitment transactions; and (iii) the fund's aggregate indebtedness with respect to any other senior securities transaction. The notional amount would mean the market value of an equivalent position in the underlying reference asset, or the principal amount on which payment obligations under a derivatives transaction are calculated (with certain adjustments). As proposed Rule 18f-4 states, a fund's VaR is an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level, subject to certain minimum requirements for the VaR analysis. Both the Exposure-Based Portfolio Limit and the Risk-Based Portfolio Limit would permit netting of certain economically offsetting transactions for purposes of calculating exposure. *See* Proposing Release at 80,995.

[13] Securities Trading Practices of Registered Investment Companies, *Investment Company Act Release No. 10666* (Apr. 18, 1979) ("Release 10666"); Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) ("Dreyfus") (noting that the staff states that if the investment company "covers" the applicable position, then a senior security is not present).

nature of funds created by excessive borrowing and the issuance of excessive amounts of senior securities; and (ii) funds operating without adequate assets and reserves.[14] The Commission stated in Release 10666, and the Staff has reiterated in no-action letters, that the asset coverage requirement will satisfy the shareholder protection purposes and concerns underlying Section 18 because it: (i) "will function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock;" and (ii) will "assure the availability of adequate funds to meet the obligations arising from such activities."[15]

In the Proposing Release, the Commission identifies scenarios involving two affiliated mutual funds and two closed-end funds that suffered losses in part from derivatives in the wake of the financial crisis of 2008-2009 to demonstrate the significance of losses that a fund may bear on derivatives investments.[16] However, we believe that these situations merely demonstrate the inherent risk of investments in certain derivatives and financial commitment transactions—they do not highlight a fundamental problem with funds' use of derivatives consistent with Release 10666 and the related no-action letters. Provided that the risks of derivatives investments by the registered funds were fully disclosed to shareholders, we do not agree that the losses suffered by these funds' shareholders in the midst of a global financial crisis justify the reversal of more than three decades of established SEC policy. In addition, the SEC has not demonstrated how proposed Rule 18f-4 would have helped in the situations it identifies as problematic. The fact that the Commission has not identified other instances in which investors were harmed in this way when funds have been able to use a broader category of liquid assets for asset segregation demonstrates the strength of the current regime.

Accordingly, the Proposing Release does not establish why the current cover-based regime would not be able to provide sufficient regulation with certain modifications designed to address the Commission's concerns.

Second, we believe that the Commission has not established why the portfolio limitations are necessary in light of protections under regulations that are already in place or that are being adopted by the Commission and other regulators. Derivatives are highly regulated financial instruments. Many categories of derivatives are now traded on designated contract markets or swap execution facilities and cleared through a clearinghouse. Trading on these facilities increases transparency and liquidity, and clearing significantly reduces counterparty risk with respect to a transaction. As discussed further below, the Comptroller of the Currency, the Federal Reserve Board and certain other prudential regulators (collectively, the "Prudential Regulators"), the Commodity Futures Trading Commission ("CFTC") and clearinghouses have implemented margin requirements and other rules under or consistent with the Dodd-Frank Wall Street Reform and Consumer Protection

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14 Section 1(b)(7) and (8) of the 1940 Act. *See also* Proposing Release at 80,887 nn.30 and 31 (citing Section 1(b)(7) and (8) and Release 10666 n.8).

15 Release 10666 at 25,132. In Release 10666, the SEC identified the amount that must be covered under other types of transactions but did not define the "exposure" that must be covered for futures contracts.

16 We believe the losses suffered as a result of the derivatives use of the private fund cited by the Commission do not provide a relevant example, as this fund was not subject to Section 18.

Act ("Dodd-Frank") to address the risks of all forms of derivatives products (with limited exceptions), and the SEC will implement similar rules with respect to security-based swaps in the near future. The Commission has not explained how this extensive set of statutory and regulatory prohibitions and restrictions on the use of derivatives by funds will impact the Commission's perceived need to impose additional regulations on the use of derivatives to address the shareholder protection purposes and concerns underlying Section 18 of the 1940 Act.

Third, the use of derivatives in excess of 150% is necessary for many funds to obtain the levels of investment exposure required by their investment objectives and strategies and selected by fund shareholders. We submit that any risks that may be associated with a fund's use of different and potentially high levels of derivatives could continue to be addressed through the current cover-based regime (with certain modifications) rather than through new and inflexible limitations. While the Commission's mission is principally to protect shareholders, maintain the integrity of the capital markets and to promote capital formation,[17] the securities laws were not intended to eliminate all investment risk from the market.[18] Rather, the Commission aims to ensure that funds disclose the risks of investing in the funds to shareholders so that shareholders may make informed decisions regarding their fund investments.[19] We believe that the 1940 Act and the rules thereunder have historically not been, and should not now be construed as, the basis for establishing shareholder suitability standards for funds that use certain levels of derivatives.

Different shareholders have different risk appetites and should be permitted a wide range of options considering their different investment needs and risk profiles and the varying tools in the market for the modern shareholder to utilize. Furthermore, we urge the Commission to recognize the benefits to shareholders of having diversified options and allow shareholders to take reasonably calculated risk as discussed above.

B. Use of a Notional-Based Portfolio Limitation Approach is Flawed

The portfolio limitation requirement could seriously impact the operations and/or viability of certain funds that, as discussed in Section I above, are beneficial investment options for

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17 *See* Securities Industry and Financial Markets Association, SEC No-Action Letter (March 14, 2008) ("The mission of the Commission is to protect investors, maintain fair and orderly securities markets, and facilitate capital formation.")

18 The Commissioners have stated that the Commission's objective is not to eliminate risk. *See* Speech, Chair Mary Joe White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Dec. 11, 2014. ("Our objective, however, is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors. Just as our regulatory program evolves, so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of "reward for risk" that is at the center of our capital markets.")

19 *See* Speech, Commissioner Daniel M. Gallagher, Remarks before the SEC/Academy of Finance Shadowing Program (April 3, 2014) ("In fact, although the SEC is often thought of as an enforcement agency, it was originally established as a disclosure agency. What this means is that the SEC seeks to ensure first and foremost that investors have access to certain basic information about their current and potential investments, including, among other things, the risks associated with those investments, so that they can make their own informed investment decisions.")

shareholders. Under the proposed regime, certain funds would not be able to continue operations as they exist today and other funds would need to reduce derivatives usage to the detriment of the funds and shareholders. Among other things, the portfolio limitation requirement could increase costs, decrease returns and reduce shareholder choice. Further, the portfolio limitation requirement may not reduce risk and may in fact result in funds choosing less liquid instruments.

First, the level of a fund's notional derivatives exposure is not necessarily correlated with risk exposure created by the fund's derivatives. For example, an international equity fund could achieve similar exposure through either a Yen-denominated Nikkei futures contract, or a combination of a USD-denominated Nikkei futures contract and a Yen currency futures contract. Therefore, a fund constructed with USD-based equity futures and currency futures would have a similar risk profile to one that is composed solely of local-currency equity futures but with twice the notional derivatives exposure.

Similarly, the notional derivatives exposure of a managed futures fund is not an accurate measure of the fund's level of risk. Although 10 times gross notional exposure may seem high, managed futures funds invest both long and short positions in multiple markets and asset classes, which produces a balanced portfolio. As noted above, our analysis of managed futures funds confirms that less than 10% of managed futures funds have experienced volatility above that of the S&P 500 since their respective inception dates and that the median volatility of the managed futures fund category was roughly two-thirds the volatility of the S&P 500.[20] The growth of alternative funds in recent years, including managed futures funds, is evidence of shareholders' interest in obtaining alternative sources of exposure, beyond traditional stock and bond investing.

Another example of notional exposure misstating risk can be demonstrated by looking at natural gas futures and five-year treasury futures. Over the past 10-year period, the annualized volatility of a Natural Gas futures contract is over 40% while that of a 5-Year U.S. Treasury Note futures contract is under 4%.[21] Based on this comparison, a 10 times leveraged position in 5-Year U.S. Treasury Note futures has experienced less volatility than an unleveraged position in Natural Gas futures.

Additionally, our own Funds have demonstrated that notional exposure is not indicative of a fund's ability to meet redemptions or risk profile. We agree that funds should have assets available to meet obligations arising from derivative transactions and meet shareholder requests for redemptions. However, we submit that certain Guggenheim Funds that exceeded 150% notional derivatives exposure have weathered volatile and unusual market circumstances, including experiencing large redemptions in a single day, without having difficulty satisfying redemption requests or meeting payment obligations under derivatives while satisfying the applicable Fund's investment objectives and strategies.

The liquidity of the derivatives that these Funds utilize along with over 20 years of experience with these instruments has enabled us to properly invest these Funds regardless of market conditions and shareholder flows. We have successfully met fund redemptions through several market

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20 Guggenheim calculations.

21 *Id*.

disruptions and unusual events, such as the tech bubble of the early 2000s, the attacks of September 11th and the 2008-2009 financial crisis. The ability to utilize derivatives was a key factor in successfully managing our Funds through these turbulent times.

As the preceding paragraphs demonstrate, we believe that one must look beyond notional exposure to fully appreciate the benefits and risks associated with derivatives usage.

Second, portfolio limitations on derivatives usage would not necessarily reduce a fund's investment risk profile and may result in unintended consequences. Reduction of risk is one of the potential benefits of the portfolio limitations that the Commission identifies.[22] However, if the portfolio limitations are adopted, certain funds may choose alternative investment options that do not create exposure as defined under proposed Rule 18f-4, such as structured notes and purchased options, to continue to obtain equivalent investment exposure to that currently achieved through derivatives. These instruments tend to be less liquid and costlier than derivatives and may introduce new risks that may be difficult to hedge.

For example, structured notes typically settle on a t+5 basis, whereas swaps and futures typically are settled t+1. In addition, orders for structured notes must be placed early in the trading day for same-day execution. A fund using structured notes may need to draw on a credit line to fund redemptions more often than a fund using futures or swaps. The borrowing costs would adversely impact fund performance, harming remaining shareholders, who did not cause the redemption. Also, structured notes typically have financing spreads that are 5 basis points higher than a comparable swap.[23]

As another example, the use of purchased call and put options may introduce risks not raised by swaps and futures. Although exchange-traded, options markets are not as liquid, typically have higher bid/ask spreads, and are not as deep as futures markets. Options also introduce additional risks such as volatility (vega) risk. Limiting a fund's use of derivatives would then restrict a fund's ability to hedge the additional volatility risk introduced by purchased call or put options. Furthermore, funds would suffer additional costs through time decay, or theta, as the value of the option decays over time.

Increased cost and reduced liquidity could ultimately harm shareholders through reduced investment performance.

Finally, funds would likely face extensive operational burdens in implementing the portfolio limitations. For example, implementing "time-of-transaction" testing would require real-time calculations of notional exposure, which could require significant changes to funds' current compliance monitoring systems, further increasing costs. Current compliance monitoring systems may not be able to conduct the automated real-time calculations that would be required under the proposal's "time-of-transaction" testing. For example, it may be difficult for funds to capture notional exposures consistently at the time of transaction, particularly with respect to swaps.

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22 Proposing Release at 80,965.

23 Per discussions with various brokers.

C. We Propose Replacing the Notional Limit with a Margin-Based Limitation

If the Commission ultimately determines that new limitations beyond the current asset segregation requirements are necessary, we urge the Commission to replace proposed inflexible portfolio limitations with a margin-based approach. As discussed previously, we believe that an approach based on notional exposure is a flawed means to limit the risk exposures of funds arising from the use of derivatives. As discussed in more detail below, a margin-based approach would better quantify and address the specific risks created by a fund's derivatives transactions.

Overview of Proposed Margin-Based Approach. Our proposed margin-based approach contains two elements:

(i) Initial Margin Cap: a limit on the percent of a fund's total assets that can be used as initial margin to 37.5% of total assets; and

(ii) Heightened Asset Segregation: a requirement that a fund segregate/earmark on its books an amount of assets that are not deemed illiquid under current Commission guidance ("liquid assets")[24] equal to the initial margin requirements used by clearinghouses and the CFTC, Prudential Regulators and SEC initial margin requirements for OTC contracts (once adopted).

If a fund uses derivatives transactions not subject to initial margin requirements, we propose that the highest initial margin requirements applicable to a derivatives transaction in the same asset class be included in the Initial Margin Cap and used for Heightened Asset Segregation purposes.[25]

Benefits of the Margin-Based Approach. The margin system adopted by clearinghouses uses a market simulation-based VaR algorithm. Similarly, the CFTC and Prudential Margin Requirements (and SEC Proposed Margin Requirements) permit swap dealers to calculate the minimum amounts of initial margin to be posted and collected by using either: (i) a risk-based proprietary model, or (ii) a standardized schedule provided in the final rulemaking where the initial margin amount will equal a percentage of the notional exposure of the transaction.[26]

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[24] The Commission currently defines an illiquid security as one that cannot be disposed of within seven days at approximately the same value at which the fund valued the instrument.

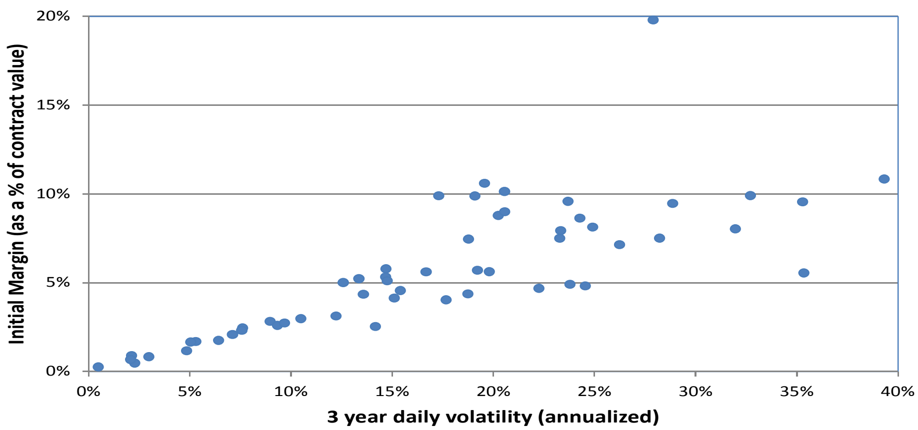
[25] Given the Commission's recognition of the sufficiency of the current approach to asset segregation for financial commitment transactions, as discussed in more detail below, we would request that the Commission allow funds to exclude financial commitment transactions when calculating compliance with the Initial Margin Cap.

[26] The margin percentages under the CFTC and Prudential Margin Requirements and proposed by the SEC correspond with those jointly prepared by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") and included in their final policy framework established minimum standards for margin requirements for non-centrally cleared derivatives. *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 78 Fed. Reg. 4365 (Jan. 22, 2013) ("SEC Proposed Margin Requirements"); *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016) ("CFTC Margin Requirements"); Basel

The proposed margin-based approach would build on the important risk-reducing regulations of the CFTC, Prudential Regulators and (when adopted) SEC and provide an even greater degree of protection to shareholders in the funds through the Initial Margin Cap and Heightened Asset Segregation requirements. A margin-based approach would be more responsive to evolving market conditions than a fixed portfolio limitation or a VaR approach (which is based on a look-back period and may not capture spikes in volatility). We believe that this approach effectively sets an overall leverage limit for funds without unduly limiting the ability of funds to invest in derivatives transactions. Additionally, a margin-based approach would be objective and relatively simple to implement, and funds already have most of the necessary infrastructure to comply with the requirements.

By adopting the margin-based approach, the SEC would be taking advantage of and harmonizing methods honed by the CFTC over the past four decades in its regulation of derivatives.

We further note that clearinghouses have successfully used this methodology for decades, throughout various market and financial crises. The chart below shows current initial margin across a variety of futures contracts and highlights the strong positive relationship between contract volatility and initial margin requirement.



<u>Additional Benefits of the Heightened Asset Segregation Requirement</u>. We believe that the Heightened Asset Segregation requirement would serve as a complement to the proposed Initial Margin Cap and serve as an additional practical limitation on a fund's ability to use derivatives to obtain leveraged investment exposure. This would also ensure that, in the event a fund faced significant margin calls requiring the fund to exceed its Initial Margin Cap, the fund would have sufficient assets to utilize to cover the insufficiency and reduce its positions in order to comply with the Initial Margin Cap.

Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Margin Requirements for Non-Centrally Cleared Derivatives (Mar. 2015), *available at* http://www.bis.org/bcbs/publ/d317.pdf ("BCBS/IOSCO Framework"); and *See* Prudential Regulators, Margin and Capital Requirements for Covered Swap Entities, Final Rule, 80 Fed. Reg. 74840 (November 30, 2015) ("Prudential Margin Requirements").

Basis for Proposed Percentage Limitation. We believe that the 37.5% Initial Margin Cap would serve as a useful means of limiting risk but would also provide sufficient flexibility to allow funds to remain fully invested during periods of market stress and the resulting increases of initial margin requirements as a percentage of futures contract value. We note that the proposed increased 37.5% Initial Margin Cap for funds would provide a practical limitation on the use of leverage by funds while still recognizing such funds' needs to obtain investment exposure through derivatives transactions in excess of the standard limit as explained below.

The proposed 37.5% Initial Margin Cap would allow most leveraged and inverse funds, that serve as valuable trading tools for shareholders, to continue to operate while also imposing practical limitations on derivatives usage. For example, for a fund that utilizes equity swaps that require 15% initial margin, the Initial Margin Cap would limit equity swap exposure to 250% of fund assets (37.5% divided by 15% equals 250%).

As another example, for an equity fund that uses futures and swaps, consider a fund that targets 200% exposure to an equity benchmark using an equal split of equity swaps and S&P 500 e-mini futures. The fund would be required to post 15% initial margin for equity swaps under the CFTC standard margin schedule for OTC swaps and 5% initial margin for the S&P 500 e-mini futures based on current exchange margin requirements. Therefore, the fund would have a total of 20% of assets as initial margin (below the 37.5% limit). Note that under our Heightened Asset Segregation requirement, the fund would also be required to earmark on its books liquid assets equal to an additional 20% of assets.

For funds using multiple futures contracts, the exchange calculated SPAN margin would be included in the Initial Margin Cap. As discussed previously, this is a risk-based margin system that has been adopted by clearinghouses.

Conceivably, a fund using only futures could obtain roughly much higher exposure to the S&P 500. However, a fund would not consistently be able to provide exposure near the theoretical maximum level of exposure in the long run because futures margin requirements increase during periods of market volatility. For example, in March of 2009, initial margin on S&P 500 e-mini futures was approximately 15%. In such an environment a fund would reach the proposed Initial Margin Cap at 250% (37.5% divided by 15% equals 250%).

Initial margin requirements for some commodity futures were even higher. For example, in early 2009, the initial margin on WTI Crude Oil futures was roughly 25%. This means a fund investing solely in WTI Crude futures would be limited to approximately 150% exposure using the Initial Margin Cap in early 2009.

Under the Heightened Asset Segregation requirement a fund would be required to segregate/earmark additional assets equal to the total initial margin requirements of all of its derivatives. Assets that are segregated/earmarked are required to be liquid assets. As examples, a fund with 37.5% initial margin would be required to segregate/earmark an additional 37.5% in liquid assets, while a fund with 5% initial margin would be required to segregate/earmark an additional 5% in liquid assets.

This 37.5% Initial Margin Cap and Heightened Asset Segregation requirement would allow most funds to continue to operate while providing a reasonable and practical limit on their derivatives use.

D. We Propose Risk-Adjusted Calculation of Exposure

If the Commission proceeds with implementing notional-based exposure limits, we urge the Commission to subject these limits to certain adjustments based on the type of the derivatives transactions. We believe that, if notional limits are adopted, the calculation of notional exposure for a wide variety of derivatives transactions, and particularly fixed-income derivatives, should be subject to certain haircuts to more appropriately address the specific risks arising from each underlying asset class through a "risk-adjusted exposure" calculation.

To develop a standard risk-adjusted exposure approach, we recommend that the Commission consider the risk-adjustment approach it has taken in other contexts and taken by other regulators. For example, we recommend that the Commission develop a standard risk-adjusted exposure chart based on asset classes consulting the initial margin percentages for derivatives that have been studied and adopted by the Prudential Regulators, the CFTC, and in its related proposed rule, the Commission. These percentages are based on asset-specific risk analyses and also correspond with the standards jointly prepared by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") and included in their final policy framework that established minimum standards for margin requirements for non-centrally cleared derivatives.[27]

E. Other Adjustments to Exposure

If the Commission proceeds with implementing notional-based exposure limits, we propose that the Commission adjust certain of the components of the exposure measure.

First, we believe that swaps that contain knockout clauses should not be measured by the notional amount of the swap but rather should be measured by the potential losses under the knockout provision. For example, a $100 million swap with a 40% knockout clause should be measured as $40 million of derivatives exposure, as $40 million is the maximum market-based loss that the fund could suffer.

Second, we also recommend that duration adjustments be made to the measure of exposure created by fixed income derivatives. The Commission requests comments on whether the 10-year U.S. Treasury bond would provide an appropriate reference asset as the basis for such duration adjustments.[28] We recommend that, instead of the 10-year bond, the longest issued U.S. Treasury bond be used as the reference asset. This is currently the 30-year bond. We believe this is appropriate because the 30-year Treasury bond has over time experienced volatility approximately equivalent to that of the S&P 500. The following table highlights durations across the treasury curve and corresponding adjustments.

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[27] *See* BCBS/IOSCO Framework.

[28] Proposing Release at 80,908.

U.S. Treasury maturity	Duration	Duration as % of 30 year U.S. Treasury
2 year	1.9	9%
3 year	3.0	14%
5 year	4.8	23%
7 year	6.6	32%
10 year	9.2	44%
30 year	21.0	100%

For example, the duration of the 30-year bond is currently 21 years. If a $100 million fixed income derivative has a duration of 10 years, the appropriate notional exposure would be 10/21 which equals approximated 48%. Therefore, only $48 million of the $100 million fixed income derivative would count towards notional derivatives exposure. We believe this appropriately reflects the risk (volatility) of this asset class.

Third, we believe that the SEC should allow a broader ability to net offsetting transactions that effectively eliminate all or some of a fund's exposure with fewer limitations as long as notional exposure is actually reduced. Specifically, the SEC should allow funds to offset transactions that create offsetting exposure with different maturities and different instrument types, which funds commonly enter into for risk management purposes as a cost effective way to eliminate market exposure. For example, the exposure under a long S&P 500 e-mini futures contract with June expiration should be offset by a hedge position created by exposure under a long S&P 500 index put option with an April or May expiration. In this example, the effective exposure is the difference between the strike price and the current market price. Alternatively, the Commission should clarify what material terms must be the same.

Furthermore, the Commission should allow funds to disregard the notional exposure of hedging transactions, or provide significant reductions for purposes of the exposure calculation for these transactions. Hedging transactions are not entered into to create investment exposure, and we believe funds are capable of establishing internal guidelines to determine what transactions constitute an appropriate hedge (particularly if the Commission were to adopt general standards for what constitutes a hedge).

Finally, we would be supportive if the Commission considered a higher derivatives limit for Leveraged and Inverse Funds and managed futures funds. In this regard, we urge the Commission to note that the Proposing Release has not identified any misuse of derivatives by these types of funds and the points raised herein on these funds' investment needs and benefits provided to shareholders.

F. Carve-Out for Financial Commitment Transactions

The Commission does not propose to exclude financial commitment transactions from a fund's exposure for purposes of the portfolio limitation requirements. However, we believe that the asset segregation requirement for financial commitment transactions should adequately address concerns about leverage and adequacy of assets in connection with a fund's use of financial commitment transactions.

Based on the characteristics of financial commitment transactions, the Commission proposes to require funds to apply an asset segregation approach similar to that taken in Release 10666 for those transactions (i.e., segregating an amount equal to the fund's full potential obligation). The Commission acknowledges in the Proposing Release that the asset segregation requirement for financial commitment transactions "may be an effective way both to impose a limit on the amount of leverage a fund could obtain through those transactions, and require the fund to have adequate assets to meet its obligations."[29] The Commission states that it is including Financial Commitment Obligations in the calculation of exposure based on a concern that a fund otherwise "could obtain aggregate exposure in excess" of the limits.[30] However, the Commission does not explain the reason this would be a problem. Given the Commission's recognition of the sufficiency of the current approach to asset segregation for financial commitment transactions, we would request that the SEC allow funds to exclude financial commitment transactions when calculating exposure for purposes of the portfolio limitation requirement.

G. Additional Necessary Clarifications

If the Commission proceeds with implementing notional-based exposure limits, we propose that the Commission should provide clarification regarding certain aspects of the portfolio limitations.

We request that the Commission provide additional guidance surrounding the VaR testing. As discussed above, VaR using risk factors like "equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk"[31] is not very clear. All of these "risks" are reflected in historical prices, so we question whether simply looking at the historical risk and variance-covariance table is sufficient. Additionally under proposed Rule 18f-4, a fund would only be permitted to use a historical VaR methodology if at least three years of historical data is available. We request that the Commission provide additional guidance on how funds would treat newly-listed derivatives contracts that do not have three years of historical data.

We also request clarification from the Commission that fully funded total return swaps, which do not create any future payment obligation, would not be considered derivatives transactions for purposes of the limitations under proposed Rule 18f-4.

We also request that the Commission provide guidance regarding the consequences for exceeding a portfolio limitation or any other limitation that is adopted. We urge the Commission to include an exception or cure period for a limited time period to allow a fund to remedy an inadvertent excess of a portfolio limitation. For example, a fund may exceed a limitation because of cash flow issues that are beyond the control of the fund's manager (e.g., where a fund invests in derivatives based on expected subscriptions and redemptions that ultimately are not made). We would

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29 *Id.* at 80,995.

30 *Id.* at 80,906-07.

31 Proposing Release at 80,920.

recommend at least a five business day cure period, which should provide enough time for derivatives to be traded back to compliance.

Additionally, we request clarification regarding the prohibition of buying derivatives when a fund is beyond the derivatives limitation. For example, in the case of short exposure, a fund typically reduces its exposure by purchasing derivatives. The Proposed Rule should provide generally that trades that reduce derivative exposure should be permitted if a fund has exceeded the limitations, even if a specific trade does not bring the fund below the applicable limitation.

We also request guidance on issues relating to forecasted subscriptions and redemptions. Questions arise relating to the timing of calculations for compliance with the portfolio limitations in light of forecasted subscriptions and redemptions. Fund managers often must make investment decisions and place trade orders based on expected subscriptions and redemptions. We therefore suggest that funds be permitted to base the time-of-transaction compliance calculations on the forecasted assets of the fund (the current fund assets combined with any forecasted subscriptions and redemptions and forecasted market impact on fund assets). For example, a fund that expects to experience subscriptions that triple the fund's size based on preliminary indications from an intermediary must place orders to invest those forecasted subscriptions on the same day, even though the exact dollar value of the subscriptions is not known until the following morning. At the exact time of purchase, the fund needs to transact and gain investment exposure based on the estimated subscriptions, not the current assets. In addition, a fund may unintentionally breach derivatives limits if forecasted shareholder activity and/or forecasted assets are materially different from expectations. Again, we believe that a cure period would be appropriate in such a circumstance.

Limits on the use of derivatives may also cause a fund to not be able to achieve its investment objective on a temporary basis. As an extreme example, there have been several cases of the stock market closing for several minutes (or even hours) during the trading day over the past several years. In these cases, the derivatives market remained open. While in each case, stock exchanges have re-opened before the close of business, if stock exchanges shut down prior to and through the close of business, a fund with subscriptions may only be able to use derivatives to gain exposure. This would put fund managers in a difficult position of having a fund temporarily not fully invested in line with its investment objective. We request that the Commission create a temporary exception for such circumstances that would allow funds to exceed notional limits on a temporary basis.

H. Leveraged and Inverse Fund Exemption

We believe that leveraged and inverse funds should be exempted from this rule. The way in which such a fund uses derivatives and the specific level of derivatives exposure obtained through investment in the fund are clearly stated in the funds' investment objective and the related risks are clearly disclosed in the funds' prospectus and statement of additional information. As noted above, many leveraged and inverse funds are used as trading tools, and serve as important elements of certain shareholders' portfolios. As daily trading tools, these funds have no incentive or motivation to take on additional risk in excess of their stated investment objective.

The Proposing Release mentions the possibility of grandfathering leveraged and inverse exchange traded funds. We recommend leveraged and inverse mutual funds be included if grandfathering is allowed. However, we are generally wary of grandfathering as it may cause confusion and may limit future growth of leveraged and inverse products, and would limit future choice for shareholders. Specifically to have "pre Rule 18f-4" funds which are able to exceed the Rule 18f-4 limits and "post Rule 18f-4" funds which need to abide by the Rule 18f-4 limits may be confusing. Also, to allow only existing funds to exceed limits would limit shareholder choice in the future as new funds would not be allowed.

I. Securities Lending

The Commission requests comments regarding whether a fund's obligation to return securities lending collateral should be regulated as a financial commitment transaction.[32] We note that the Commission and its Staff have already put in place extensive guidance regarding securities lending by funds. This guidance, promulgated through no-action letters, has formed the basis of funds' securities lending practices. The Commission has not indicated any reason why this guidance is no longer sufficient. Given this regulatory landscape, we do not believe securities lending collateral should be considered a financial commitment transaction.

III. Comments on the Asset Segregation Requirements

Proposed Rule 18f-4 would require a fund to segregate on its books "Qualifying Coverage Assets" equal to the sum of a "Mark-to-Market Coverage Amount" plus a "Risk-Based Coverage Amount" (each as defined below) on a daily basis. We generally support the use of enhanced asset segregation requirements to regulate funds' use of derivatives but would encourage the Commission to consider certain modifications as proposed in this letter.

A. We Generally Support the Use of Mark-to-Market Coverage Amount But Encourage The Commission to Allow Broader Netting and Offsetting Transactions

Proposed Rule 18f-4 would define the Mark-to-Market Coverage Amount as the amount currently payable by the fund if the fund exits the derivatives transaction. The Mark-to-Market Coverage Amount would be reduced by the value of any variation margin but not initial margin.

We support the use of a mark-to-market approach to asset segregation and believe the daily segregation requirement is a reasonable and appropriate restriction on a fund's ability to use derivatives transactions. We also support the Commission's proposal that variation margin posted by a fund in connection with a derivatives transaction should reduce the Mark-to-Market Coverage Amount for such transaction.

Proposed Rule 18f-4 would permit a fund to calculate Mark-to-Market and Risk-Based Coverage Amounts on a net basis for derivatives transactions for which the fund has entered into "a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions" (*i.e.*, with the same counterparty).[33] We support this beneficial use of netting arrangements.

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32 *Id.* at 80,900.

33 Proposing Release at 80,927.

However, we urge the Commission to allow a fund to expand the permissible netting arrangements to permit netting of offsetting exposures across different counterparties (as permitted under Staff guidance since the Dreyfus letter) for purposes of calculating either coverage amount. We also request that, when netting across counterparties, netting be permitted for instruments of different maturities, as mentioned above. In support of these requests, we note that any transaction that actually reduces a fund's risk under another transaction reduces a fund's investment and risk exposure.

We acknowledge that the Commission may have counterparty credit risk concerns with respect to netting across different counterparties.[34] We also note that the Commission has not articulated a clear reason why netting of offsetting economic exposure should not be permitted in this context.

Initially, we note that many funds enter into exchange-traded and cleared derivatives that are subject to daily margining and collateralization. Clearing transactions through clearinghouses significantly decreases counterparty credit risk and the required margin offsets market risk. Therefore, we request that the Commission confirm that margin provided under a standard clearing arrangement be allowed to reduce both the Mark-to-Market Coverage Amount and Risk-Based Coverage Amount.

Further, with respect to OTC derivatives, funds typically and soon will generally be required to enter into credit support documents requiring daily, mark-to-market bilateral initial margin (subject to thresholds). Additionally, fund advisers typically have counterparty credit review procedures for the implementation and on-going monitoring (often including daily counterparty credit risk analysis) of these counterparty relationships.[35]

Given these protections, we strongly believe that funds should be permitted to net exposures across counterparties for purposes of calculating both the Risk-Based Coverage Amount and Mark-to-Market Coverage Amount.

We would also support the Commission considering allowing netting of financial commitment transactions subject to master netting agreements under the rule and of economically offsetting transactions across counterparties. We do not see a reason for a distinction between the netting permitted for such financial commitment transactions and derivatives transactions.

The Commission requests comments on whether funds should be required to determine Mark-to-Market Coverage Amounts at the same time they determine their NAV. We request clarification as the NAV per share is determined by 8 p.m. However, subscriptions and redemptions, trades, and margin movements are generally not processed until the following morning. We recommend that coverage amounts be determined after all trades, subscriptions and redemptions, and margin movement have been processed the following day.

34 Proposing Release at 80,928 and 80,931.

35 For example, we have long maintained a credit review committee which meets regularly to discuss the creditworthiness of our derivative counterparties. The committee provides quarterly reports to the Funds' Board of Directors.

B. Risk-Based Coverage Amount

In addition to the Mark-to-Market Coverage Amount, proposed Rule 18f-4 would require funds to segregate a Risk-Based Coverage Amount, which is defined as a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. This amount must be determined using Board-approved policies and procedures that take into account the structure, terms, and characteristics of the derivatives transaction and the underlying reference asset. A fund could use one or more financial models that take these factors into account to determine the Risk-Based Coverage Amount. The Risk-Based Coverage Amount would be reduced by the value of initial margin. Our comments relating to the Mark-to-Market Coverage Amount apply equally to the Risk-Based Coverage Amount.

The Commission indicates in the Proposing Release that the Risk-Based Coverage Amount was intended to address the concern that the Mark-to-Market Coverage Amount would only represent the amount of a fund's obligation if it were to exit the position at a particular time and that there may be a significant gap between the Mark-to Market Coverage Amount and the fund's future payment obligations under the derivatives transaction. We submit that using initial margin requirements under exchange margin rules and the CFTC Margin Requirements, Prudential Margin Requirements and, once adopted, the SEC Margin Requirements as a measure of the Risk-Based Coverage Amount (whether or not a fund is subject to an initial margin requirement) will generally adequately address the Commission's concerns. These rules calculate initial margin amounts at a level meant to address stressed conditions.[36] Accordingly, requiring funds to make separate Risk-Based Coverage Amount determinations for these transactions should not be necessary. We believe that it would be beneficial to allow funds to substitute the initial margin amounts, as applicable, and avoid making a tailored and separate Risk-Based Coverage Amount determination for these trades, so long as the fund determines that the initial margin amount would be a reasonably appropriate amount.

We support the SEC's proposal that initial margin posted by a fund in connection with a derivatives transaction should further reduce the Risk-Based Coverage Amount for such transaction. Consistent with our suggestions above with respect to Mark-to-Market Coverage Amount, we would also urge the Commission to expand the scope of the netting that could be used to reduce the amount of Risk-Based Coverage Amount and permit the use of offsetting transactions.

Additionally, the Commission has not provided sufficient guidance regarding the definition of "stressed conditions." We would urge the Commission to allow funds to interpret stressed conditions in accordance with the standards used by clearinghouses for calculating initial margin and that other regulators have used in their Margin Requirements.

C. Qualifying Coverage Assets

Under proposed Rule 18f-4, Qualifying Coverage Assets for derivatives transactions would mean cash and cash equivalents. Cash equivalents would mean "short-term, highly liquid investments

[36] The Commission notes that all margin rules have not yet been adopted and that not all funds may be required to post initial margin, but does not raise any additional objections to the use of initial margin as a substitute for another calculation. Proposing Release at 80,930-1.

that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates."[37] Qualifying Coverage Assets for Financial Commitment Obligations would also include "assets that are convertible to cash or that will generate cash" prior to the date on which the fund can be expected to need to pay such obligation or that "have been pledged with respect to" the obligations and "can be expected to satisfy such obligation."

The Commission requested comment on whether a fund should be permitted to segregate other types of assets. We strongly urge the Commission to broaden the definition of Qualifying Coverage Assets to include all liquid assets, subject to standardized haircuts on assets other than cash or cash equivalents consistent with the approach taken by the CFTC and Prudential Regulators.[38]

The use of any liquid assets, and not just cash/cash equivalents, has been Commission policy over the past two decades, since the Merrill Lynch letter. Limiting qualifying coverage assets to cash and cash equivalents would up-end 20 years of consistent Commission and Staff policy and industry practice without any reasonable justification.

We recognize the Commission's concern that cover assets could decrease in value at the same time as the fund experiences losses on its derivatives transactions.[39] However, the Commission has not identified instances in which shareholders were harmed over the past two decades when funds have been able to use a broader category of liquid assets for asset segregation, including through the recent financial crises, other than the single example of two funds that experienced losses on portfolio securities at the same time that they needed to make large payments on their derivatives transactions.[40]

This new policy is also at odds with the Commission's own proposed rules with respect to eligible assets available to collateralize non-cleared security-based swaps and the analogous collateral requirements of the Prudential Regulators, the CFTC and the BCBS/IOSCO Framework. Each of these regulatory bodies permits a reasonably broader category of qualifying assets with standardized haircuts to reflect the specific risks of the relevant asset. These other regulators have actually broadened the scope of eligible assets for margin in recognition that severely restricting those assets is not necessary.[41] We would also support the Commission permitting shares of registered ETFs to be considered as Qualifying Coverage Assets. Accordingly, we suggest that, instead of limiting the categories of Qualifying Coverage Assets to address the Commission's

[37] *Id.*at 80,932.

[38] See e.g., the standardized haircut schedule for the CFTC Margin Requirements in 17 CFR 23.156.

[39] Proposing Release at 80,932.

[40] Proposing Release at 80,896.

[41] Under the CFTC's rules, eligible collateral includes cash, sovereign debt, government-sponsored debt, instrument grade debt (including corporate and municipal bonds), equities, gold, and shares of certain funds. *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016).

concern, the Commission apply standardized haircuts to assets other than cash or cash equivalents consistent with the approaches taken in these other contexts.[42]

The Commission has also underestimated the negative impact holding large amounts of cash and cash equivalents may have on funds. In particular, such a limited definition of Qualifying Coverage Assets may conflict with funds' abilities to pursue their investment objectives and strategies and would unnecessarily impede the funds' ability to remain fully invested rather than holding large quantities of cash.

As noted above, we support the proposed approach under which initial margin posted by a fund in connection with a transaction reduces the Risk-Based Coverage Amount for such transaction. We note, however, that some funds are not subject to initial margin requirements due to the limited nature of their derivatives trading activity (e.g., if their swap trading does not reach the initial margin thresholds). If the Commission does not generally broaden the Qualifying Coverage Assets definition as suggested above, funds that are not required to post initial margin should be able to segregate on their books the same types of assets those funds would otherwise be required to post as initial margin (subject to applicable haircuts) as Qualifying Coverage Assets. If these funds are not permitted to segregate the wider range of assets, they would be unnecessarily submitted to a cash drag that would not be imposed on funds that engage in larger volumes of derivatives transaction and are permitted to reduce the amount of coverage amount by the amount of margin they post.

We support the proposal to put in place an expanded definition of Qualifying Coverage Assets for financial commitment transactions. However, our comments requesting a broader or modified definition that includes all liquid assets apply equally to the definition of Qualifying Coverage Assets for financial commitment transactions.

IV. We Support the Requirement that Advisers and Funds Adopt Policies and Procedures to Manage the Risks Associated With Derivatives But Are Concerned That Proposed Rule 18f-4 Would Put an Inappropriate Amount of Responsibility for Derivatives Monitoring on the Board

A. We Agree that Funds Should Have in Place a Derivatives Management Program

Proposed Rule 18f-4 would require a fund to adopt a Derivatives Risk Management ("DRM") Program unless the fund complies, and monitors compliance, with a portfolio limitation under which: (i) immediately after entering into any derivatives transaction, the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets (the "50% Limitation"); and (ii) the fund does not enter into any complex derivatives transactions ("Complex Derivatives Limitation"). A fund's DRM Program would consist of written policies and procedures reasonably designed to, among other things, assess and manage risks associated with its derivatives transactions, including leverage, market, counterparty, liquidity,

42 *See* CFTC Margin Rules; Prudential Margin Rules.

operational and other relevant risks. The Commission believes that this requirement would serve to establish a standardized level of risk management for applicable funds.[43]

We agree with the Commission that, to the extent DRM Programs result in more robust monitoring of the risks related to derivatives, the DRM Programs may reduce the risk of a fund suffering unexpected losses and reduce adverse repercussions for others in the market, such as fund counterparties. We support the requirement that all funds be required to establish policies and procedures to assess and manage risks associated with derivatives transactions.

B. Proposed Rule 18f-4 Would Require a Fund's Board to Engage too Closely in Management Functions

Proposed Rule 18f-4 would impose certain requirements on a fund's Board. The Board would be required to approve: (i) the particular portfolio limitations under which the fund will operate, *i.e.*, (a) the 150% limit, (b) the 300% limit, or (c) the 50% plus no complex derivatives transactions limit; and (ii) "policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets."[44] Additionally, proposed Rule 18f-4 would further require that the fund's Board, including a majority of its independent directors: approve the DRM Program initially and approve any material changes; "review, no less frequently than quarterly, a written report" prepared by the derivatives risk manager describing the DRM Program's adequacy and effectiveness; and approve the fund's designation of the derivatives risk manager.[45]

A fund's Board plays a very important role in the fund industry and serves as an "independent check" on the fund's investment adviser. However, we are concerned with the level of involvement assigned to a fund's Board in proposed Rule 18f-4. At its core, the DRM Program is an investment management function that falls properly within the purview of a fund's investment adviser. While a Board should continue to be responsible for the general oversight of the adviser's investment program (as it currently is with respect to any investment strategies a fund engages in), it should not be required to engage in micromanagement of a fund's investment program with respect to one particular class of investments. Similarly, the Board should not be responsible for designating a fund's derivatives risk manager. Requiring the Board to designate specific personnel requires it to participate too closely in a management function. The same effect could be accomplished by describing the responsibilities and qualifications of the derivatives risk manager in the proposed Board-approved policies and procedures without causing the Board to depart from its traditional oversight function.

The Commission has previously stated that operational matters that do not present a conflict between the interests of investment advisers and the funds they advise should be handled primarily or exclusively by the investment adviser. By imposing new requirements on independent directors that are unrelated to potential conflicts of interest, the Commission risks diluting the independent

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43 Proposing Release at 80,934.

44 Proposing Release at 80,945.

45 *Id.* at 80,994.

directors' ability to focus attention on those matters that do give rise to potential conflicts and are therefore consistent with the independent directors' traditional "watchdog" function.

Further, we would recommend that the Commission acknowledge, given the potentially complex and often highly technical nature of derivatives investments, that directors are not required to have expertise with respect to such instruments and should clarify that their role is limited to that of oversight and that their responsibilities relating to the derivatives risk management program should not translate into an obligation to become involved in the day-to-day management of the fund.

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If it would be helpful to discuss our specific or general views on the Proposing Release, please contact Amy J. Lee at [redacted]. We appreciate your consideration and look forward to working with you on this important matter.

Sincerely yours,

Donald C. Cacciapaglia
Vice Chairman
Guggenheim Investments

With a copy to:

The Honorable Mary Jo White, Chair

The Honorable Kara M. Stein

The Honorable Michael S. Piwowar

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