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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

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

Dear Mr. Fields,

We appreciate the opportunity to respond to the request by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for comments regarding the above-referenced release ("Proposing Release").[1] The Proposing Release contemplates a new approach to the regulation of funds' use of derivatives and other transactions that raise "senior securities" issues under Section 18 of the Investment Company Act of 1940 ("1940 Act") as set forth in proposed new rule 18f-4 under the 1940 Act ("Rule 18f-4").

We appreciate the Commission's attention to the use of derivatives by mutual funds, other registered investment companies and business development companies ("BDCs") (each a "fund" and collectively, "funds"). Further, we generally support the Commission's efforts through rulemaking to provide additional certainty with respect to funds' use of derivatives and other transactions that may create leverage under Section 18 with certain modifications discussed herein.

However, we believe that certain elements of proposed Rule 18f-4 present serious concerns. We particularly oppose the element that would impose new and inflexible portfolio limitations, which would have the effect of putting a number of funds out of business, reducing the efficiency and investment returns of certain funds, reducing investor choice, increasing costs for shareholders and serving as a barrier to entry for certain new funds or strategies. In this regard, we note that the Commission and its Staff have properly maintained a long-standing policy for over three decades that a fund can "avoid the creation of a senior security" and the issue of compliance with Section

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015).

18 when engaging in transactions that involve leverage if the fund daily segregates assets equal to, or otherwise covers, its obligations arising from these transactions. As discussed herein, we believe that the current cover-based approach with certain changes would be a far more appropriate means to address the Commission's concerns. If the Commission does proceed with adopting portfolio limitations, however, we believe that the Commission should establish 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.

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. In the United States, we represent a substantial number of U.S. mutual fund complexes, closed-end funds, exchange-traded funds ("ETFs"), BDCs, fund boards, fund independent directors, fund advisers and fund service providers. In developing these comments, we have drawn on our extensive experience in the financial services industry generally. Although we have discussed certain matters addressed in the Proposing Release with some of our clients, the comments that follow reflect only the views of a group of attorneys in our financial services practice, and do not necessarily reflect the views of our clients, other members of our financial services group or the firm generally.

I. BACKGROUND: SECTION 18 AND CURRENT COMMISSION AND STAFF GUIDANCE

Section 18(f)(1) and Section 18(a)(1) of the 1940 Act restrict the ability of open-end funds and closed-end funds to issue senior securities.[2] BDCs, with certain exceptions, are also subject to the limitations of Section 18(a) to the same extent as closed-end funds.[3] Section 18(g) defines a "senior security" as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends."

[2] Section 18(f)(1) prohibits an open-end fund from issuing or selling any senior security, except that the fund may borrow from a bank provided that immediately after any such borrowing there is asset coverage of at least 300% for all of the fund's borrowings. Section 18(a)(1) prohibits a closed-end fund from issuing or selling any "senior security that represents an indebtedness" unless it has at least 300% asset coverage for all borrowings (or 200% if the senior security is a stock).

[3] *See* Section 61(a). In contrast to closed-end funds, the asset coverage requirement applicable to senior securities issued by BDCs is 200% rather than 300% regardless of whether the senior security is represented by indebtedness or preferred stock.

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Congressional concerns underlying Section 18 include mitigating or eliminating the adverse effect on the interests of investors and the national public from: (i) excessive borrowing and the issuance of excessive amounts of senior securities; and (ii) funds operating without adequate assets and reserves.[4] The Commission and its Staff have historically taken positions that investments in certain types of derivatives and other transactions that have a leveraging impact fall within the definition of "evidence of indebtedness" and are potentially senior securities when they create leverage.[5]

However, for over three decades, the Commission has maintained a long-standing policy that allows a fund to avoid "issuing a senior security" and related concerns, as well as the issue of compliance with Section 18(f), when the fund engages in transactions that create leverage if the fund daily segregates or earmarks liquid assets equal to or otherwise "covers" its obligations arising under the transactions. This policy was initially stated by the Commission in 1979 in Release 10666 and has been interpreted under no-action letters issued by the Staff of the Commission's Division of Investment Management ("Staff").[6] The Commission stated in Release 10666, and the Staff has reiterated in no-action letters, that the asset coverage requirement will satisfy the investor protection purposes and concerns underlying Section 18 because it will: (i) "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) "assure the availability of adequate funds to meet the obligations arising from such activities."[7] Accordingly, the

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4 Section 1(b)(7) and (8) of the 1940 Act. *See also* Proposing Release at 80887 nn.30 and 31.

5 *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 at text accompanying n.14 (Apr. 18, 1979) ("Release 10666"); Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) ("Dreyfus"). "Leverage" means for these purposes "an obligation, or indebtedness, to someone other than the fund's shareholders [that enables] the fund to participate in gains and losses on an amount that exceeds its initial investment."

6 *See* Release 10666; Dreyfus; Merrill Lynch Asset Management L.P., SEC No-Action Letter (July 2, 1996) ("Merrill Lynch"); Robertson Stephens Investment Trust, SEC No-Action Letter (Aug. 24, 1995); "Dear Chief Financial Officer" Letter, from Lawrence A. Friend, Chief Accountant of Div. of Investment Management (Nov. 7, 1997); Emerald Mgt. Co., SEC No-Action Letter (Jan. 21, 1978); Sanford C. Bernstein, SEC No-Action Letter (June 25, 1990) ("Bernstein"); Hutton Options Trading L.P., SEC No-Action Letter (Feb. 2, 1989) ("Hutton Options"). The Commission recently acknowledged its cover regime in its 2011 concept release requesting comment on funds' use of derivatives. *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Co. Act Rel. No. 29776 (Aug. 31, 2011) ("Concept Release").

7 Release 10666 at 25132. 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 or swaps.

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Commission's current policy under Section 18 allows funds to avoid treating derivatives and financial commitment transactions as senior securities provided they comply with the asset coverage requirement.

Since 1979, the Staff provided guidance through no-action relief that allowed funds to "cover" derivatives transactions with any liquid assets and through the use of a variety of types of offsetting transactions.[8] Currently, many funds apply a mark-to-market cover approach to certain derivatives, and some funds do so exclusively.[9] These funds have taken this position with the assent of the Staff, which as a matter of practice reviews funds' disclosures regarding their segregation practices during the registration statement review process and comments on practices that it considers inappropriate, and accelerates the effectiveness of registration statements when its comments have been addressed. The Commission has also approved exemptive orders authorizing certain funds to operate without raising concerns regarding these practices.

The Commission states in the Proposing Release that it is concerned that the current asset segregation regime may not "impose an effective limit on leverage" or may fail to require a fund to have adequate assets to meet its obligations.[10]

II. COMMENTS ON THE ASSET SEGREGATION REQUIREMENTS

Proposed Rule 18f-4 would require a fund daily 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" for derivatives or equal to the fund's "Financial Commitment Obligations" for a newly defined category of instruments, "financial commitment transactions" (each as defined below). We generally support the use of enhanced asset segregation requirements to regulate funds' use of derivatives and financial commitment transactions but would encourage the Commission to consider certain modifications to the asset segregation requirements as discussed herein.

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8 *See* Dreyfus (permitting the use of offsetting positions); Merrill Lynch (permitting the use of "any asset, including equity securities and non-investment grade debt . . . so long as the asset is liquid and marked to market daily").

9 The Proposing Release notes that industry practices with respect to the appropriate cover amount – whether the notional amount or the mark-to-market amount currently due – and type of cover assets for various transactions have developed over time based "at least in part" on no-action letters and Staff guidance. Proposing Release at 80888-89.

10 *Id.* at 80893, 80895. However, the Commission acknowledged that the asset segregation requirement would also help address the undue speculation concern if funds limit derivatives use to comply with that condition. *Id.* at 80925.

A. Mark-to-Market Coverage Amount

Proposed Rule 18f-4 would define the Mark-to-Market Coverage Amount as the amount payable by the fund if the fund were to exit the derivatives transaction at the time of measurement. 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. This approach is also largely consistent with the Commission's current guidance in Release 10666, which requires a fund to segregate certain liquid assets equal to the fund's obligations arising under reverse repurchase agreements, firm commitment agreements and standby commitment agreements and all "comparable trading practices." We also support the proposal to allow a fund to identify any coverage amounts on the books and records of the fund, consistent with current guidance.

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.

B. Risk-Based Coverage Amount

Proposed Rule 18f-4 would define the Risk-Based Coverage Amount 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. The Commission states in the Proposing Release that 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 or other collateral but not variation margin.

We agree with the Commission's statement that segregation of a transaction's notional value could require a fund "to hold more liquid assets than may be necessary to address the investor protection purposes and concerns underlying section 18."[11] As discussed further in Section IV, we believe that segregation of the Risk-Based Coverage Amount would provide a more effective limitation on undue speculation than the notional portfolio limitations because it would be more tailored to the

[11] *Id.* at 80929.

realities of the risk created by a particular derivatives transaction and would more accurately reflect the risk profile of the different investments in the fund's portfolio.

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.

However, we believe that a fund should be permitted, for one or more categories of derivatives transactions, to determine that the required initial margin amount, or, for a fund not subject to an initial margin requirement, the amount of initial margin that would be required if the fund was subject to an initial margin requirement, is an appropriate measure of 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 there may be a significant gap between the Mark-to-Market Coverage Amount and the fund's future payment obligations under the derivatives transaction.[12]

We submit that using initial margin requirements under exchange / clearinghouse margin rules, the CFTC Margin Rules, the Prudential Margin Rules and, once adopted, the SEC Proposed Margin Rules as a measure of the Risk-Based Coverage Amount (whether or not a fund is subject to an initial margin requirement) will adequately address the Commission's concerns.[13] These rules calculate initial margin amounts at a level meant to address stressed conditions.[14] As a result, requiring funds to make separate Risk-Based Coverage Amount determinations for these transactions should not be necessary. Accordingly, we request that the Commission acknowledge that funds may determine that required margin amounts under applicable margin rules are an

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[12] *Id.* at 80929.

[13] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) ("CFTC Margin Rules" adopted by the Commodity Futures Trading Commission ("CFTC")); Margin and Capital Requirements for Covered Swap Entities, Final Rule, 80 Fed. Reg. 74840 (Nov. 30, 2015) ("Prudential Margin Rules" adopted by the Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Financial Agency ("Prudential Regulators")); 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 Rules"); CFTC Rule 39.13(g) (setting the standards for the derivatives clearing organization initial margin requirements).

[14] 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 80930-31.

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appropriate measure for the Risk-Based Coverage Amount for certain transactions or categories of transactions.

We also request that the Commission provide additional clarity on how the Risk-Based Coverage Amount may be determined. For example, the proposed concept of "stressed conditions" is not defined, and we request that the Commission provide additional guidance regarding the meaning of this term.

We expect the Commission will receive numerous proposed approaches for the Risk-Based Coverage Amount calculation, and recommend that the Commission consider such proposals carefully in adopting any final rule.

C. Netting for Derivatives Transactions

Proposed Rule 18f-4 would permit a fund to calculate Mark-to-Market and Risk-Based Coverage Amounts on a net basis for derivative 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). We support this use of netting arrangements without limitation on the specific types of contracts being netted but urge the Commission to expand the permissible netting arrangements and clarify certain points.

We believe that netting of economically offsetting exposures across different counterparties should be available to funds calculating either coverage amount. We believe that any transactions that could reasonably be expected to create offsetting exposure to market risk will and do neutralize leverage and asset sufficiency concerns: they eliminate a fund's risk of market loss under each transaction. We note that the Commission stated that Rule 18f-4 would limit netting to the context of a netting agreement because the fund "could potentially be required to tender the full amount" under each transaction.[15]

However, the Commission has not demonstrated any real reason why netting of economically offsetting exposure should not be permitted in this context. We acknowledge that the Commission may have included this limitation in proposed Rule 18f-4 due to concerns regarding counterparty credit risk.[16] However, we submit that, for over-the-counter ("OTC") derivatives, funds typically enter into credit support documents requiring daily, mark-to-market bilateral margining. Also,

15 *Id.* at 80931. The Commission Staff has issued numerous no-action letters regarding netting of offsetting transactions without requiring the two transactions to be entered with the same counterparty. *See* Dreyfus; Hutton Options; and Bernstein.

16 Proposing Release at 80928 and 80931.

funds' advisers typically have counterparty credit review procedures applicable to the implementation and on-going monitoring of fund counterparty relationships, often including daily counterparty credit risk analysis. In addition, where not already required by the terms of individual contracts, mandatory posting of initial and variation margin by funds' counterparties will soon be standard for certain OTC derivatives transactions. Given these protections afforded to funds, 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.

Further, we do not believe that counterparty credit concerns should apply to futures and other cleared derivatives.[17] We request that the Commission clarify that transactions guaranteed by a clearinghouse would satisfy the netting agreement requirement, including where a fund faces a clearinghouse through multiple futures commission merchants and/or derivatives dealers.

We also note that some funds use a "portfolio margin" arrangement with certain counterparties under which the initial margin amounts are not tied to specific transactions. We request that the Commission confirm these arrangements would fall within the permitted netting under Rule 18f-4, and allow calculation of Mark-to-Market and Risk-Based Coverage Amounts on a portfolio basis in such a case.

We also request that the Commission permit netting of financial commitment transactions where (i) there are netting agreements in place and (ii) across counterparties. We do not see any reason that netting should be permitted for derivatives and not for financial commitment transactions.

D. Financial Commitment Obligations

Proposed Rule 18f-4 would also require a fund to segregate an amount equal to the fund's Financial Commitment Obligations, defined as the amount of cash or other assets the fund is required to pay or deliver under a financial commitment transaction. A financial commitment transaction would mean any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement, whether conditional or unconditional.

As discussed in Section IV below, we agree with the Commission's conclusion that these requirements "may be an effective way both to impose a limit on the amount of leverage a fund could obtain through those transactions, and to require the fund to have adequate assets to meet its

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[17] The CFTC has acknowledged in adopting its clearing requirements that central clearing can "substantially reduce counterparty risk. . ." *See* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions; Final Rule, 77 Fed. Reg. 6336 at n.10 (Feb. 7, 2012) (quoting S. Rep. No. 111-176, at 33 (2010)).

obligations."[18] Holding the full required payment or delivery amount mirrors the approach under Release 10666. Accordingly, we believe that the asset segregation requirements should adequately address concerns about leverage and adequacy of assets in connection with a fund's use of financial commitment transactions. We therefore request that the SEC remove financial commitment transactions from the portfolio limitation requirements.

We do not agree, however, that "unfunded commitments" to lend money to a portfolio company or to invest capital in a private fund should be treated as financial commitment transactions subject to the asset segregation requirements. The nature of a fund's obligation under an unfunded commitment is materially different from that of a fund's obligation under a firm or standby commitment currently subject to Release 10666's requirements. Not only is the likelihood that an unfunded commitment will be called much less than in the case of a firm or standby commitment, but a fund's potential liability, if any, for failure to satisfy its commitment often will, depending upon the specific terms and conditions of the commitment, be much less than that arising from failure to satisfy a firm or standby commitment. Moreover, unfunded commitments do not have a leveraging effect and are generally not required to be recorded as liabilities of the fund under U.S. generally accepted accounting principles, and therefore should be excluded from the asset segregation requirements. As the Commission noted in Release 10666, commitments that "neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage" were not intended to be subject to Release 10666's general statement of policy.[19] We believe a similar result should apply to unfunded commitments and, accordingly, recommend that the Commission revisit the treatment of unfunded commitments as financial commitment transactions, with a view to eliminating or at a minimum better tailoring the proposed rule's applicability to unfunded commitments.

E. Qualifying Coverage Assets Should Include all Liquid Assets

Under proposed Rule 18f-4, Qualifying Coverage Assets for derivatives transactions would mean only cash and cash equivalents. The Proposing Release states that cash equivalents would be defined by reference to U.S. generally accepted accounting principles and would mean "short-term, highly liquid investments 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."[20] 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

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18 Proposing Release at 80945.

19 Release 10666 at n.12.

20 Proposing Release at 80932.

can be expected to need to pay such obligations or "that have been pledged with respect to" the obligation and "can be expected to satisfy such obligation." The Commission requests comment on whether a fund should be permitted to segregate other types of assets.

Generally Expanded Definition of Qualifying Coverage Assets. We strongly urge the Commission to expand the definition of Qualifying Coverage Assets to include all liquid assets. We understand that, for many funds, holding large amounts of cash and cash equivalents is not consistent with the funds' investment objectives and strategies. The proposed definition of Qualifying Coverage Assets may harm investors in such funds by reducing levels of invested assets and limiting the potential for positive performance results, creating what is called "cash drag" on the portfolio.

The use of a broader range of liquid assets, and not just cash and cash equivalents, has been Commission and Staff policy since the Commission issued Release 10666. The types of permitted segregable assets were expanded to include all liquid assets when the Staff issued the Merrill Lynch letter in 1996.[21] This long-standing coverage regime that permits the use of any liquid assets has served funds and investors well, including during the 2008-2009 financial crisis and other times of market disruption.

We recognize the Commission's stated concern that coverage assets could decrease in value at the same time that the fund experiences losses on its derivatives transactions, particularly in times of stressed conditions.[22] We note that the Commission suggests that other types of assets "may be more likely to experience volatility in price or the decline in value in times of stress, even if subject to a haircut."[23] However, the only evidence of a need to limit Qualifying Coverage Assets to cash and cash equivalents that the Commission presents is the single example of two funds that suffered losses on their portfolio securities while also being required to make additional payments under their derivatives transactions, requiring the funds to sell portfolio securities to meet their obligations under the derivatives transactions at an inopportune time.[24] The fact that the Commission has not identified other instances in which investors were harmed in this way over the past two decades in which funds have been able to use any liquid assets for asset segregation purposes demonstrates the strength of the current regime.

21 *See* Merrill Lynch.

22 Proposing Release at 80932.

23 *Id.*

24 *Id.* at 80896.

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Moreover, this new policy is at odds with the CFTC and Prudential Margin Rules and the BCBS/IOSCO Framework, and the Commission's own Proposed Margin Rules.[25] Each of these regulatory frameworks would permit parties to a transaction that are subject to initial margin requirements to post a broad range of categories of assets as margin, subject to standardized percentage reductions to the value of such assets that can be counted toward the margin requirement (or "haircuts") to reflect the specific risks of the posted asset.[26] This new policy is also at odds with the proposed approach under which initial margin could reduce the Risk-Based Coverage Amount and variation margin could reduce the Mark-to-Market Coverage Amount: these approaches allow the use of all of the types of assets permitted to be posted as margin to reduce coverage amounts. The Commission has not explained why it is necessary or appropriate to apply a different standard for required coverage amounts that are not reduced by the initial and variation margin amounts. Accordingly, we suggest that, instead of limiting the categories of Qualifying Coverage Assets to address the Commission's concern, the Commission apply standardized haircuts to coverage assets other than cash or cash equivalents consistent with the approaches taken in these other contexts.

Expanded Definition of Qualifying Coverage Assets for Funds Not Required to Post Initial Margin. 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 that those funds would otherwise be required to post as initial margin (subject to applicable haircuts) as Qualifying Coverage Assets. 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. However, 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 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 transactions and are permitted to reduce the amount of coverage amount by the amount of initial margin they post.

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25 Basel 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").

26 These other regulators have actually broadened the scope of eligible assets for margin in recognition that severely restricting those assets is not necessary. For example, in the adopting release for the CFTC Margin Rules, the CFTC stated that it had expanded the list of eligible collateral in response to commenters. Under the CFTC's rules, eligible collateral includes cash, sovereign debt, government-sponsored debt, investment grade debt (including corporate and municipal bonds), equities, gold, and shares of certain funds. *See* CFTC Margin Rules.

Expanded Definition of Qualifying Coverage Assets for Currency-Hedged ETFs. In addition to the foregoing concerns, we note that the Commission's proposed definition of Qualifying Coverage Assets would particularly affect currency-hedged index ETFs, which have attracted significant assets in recent years.

Currency movements can significantly affect the total returns of international investments across asset classes. The higher the currency volatility, the larger the potential impact on portfolio returns when measured in the base currency. For investors wishing to reduce this volatility, currency-hedged ETFs provide a solution by allowing them to hedge the currency of their investment returns into that of their target base currency. The impact of currency movements is thus reduced by implementing a currency hedge.

Currency-hedged indices typically assume 100% investment in non-U.S. securities and currency hedging instruments (typically one month forward currency contracts). In turn, currency-hedged ETFs invest as close as possible to 100% of their assets in non-U.S. securities and currency hedging instruments in order to track their respective benchmark indices. Typically, such ETFs only maintain minimal amounts of cash or cash equivalents; the ETFs use the securities in their portfolios for asset coverage purposes.

The requirement to maintain cash or cash equivalents as Qualifying Coverage Assets would limit currency-hedged ETFs' ability to achieve their investment objectives and strategies. Requiring such ETFs to hold cash or cash equivalents would not just add a cash drag on the absolute performance of a fund that otherwise would be fully invested, but would also prevent a currency-hedged index ETF from accurately tracking its index. As noted above, the indices tracked by currency-hedged ETFs would not include the cash or cash equivalents required to be held by the ETF as Qualifying Coverage Assets, and an ETF that is required to hold such assets therefore would experience structural "tracking error" (the difference between the performance of the ETF and that of its underlying benchmark) that could be substantial. The proposal to limit the scope of assets that may be used as Qualifying Coverage Assets for derivative transactions thus would have disproportionate impact on currency-hedged ETFs.

Currency-hedged ETFs do not give rise to the leveraging concerns underlying the proposed Rule 18f-4. Moreover, there is no indication in the Proposing Release that the Commission intended for the proposed Rule 18f-4 to affect the operations of currency-hedged ETFs, in marked contrast to the Proposing Release's discussions of certain other categories of funds, or that the Commission views currency-hedging activities as particularly speculative.

Accordingly, in light of the potential material adverse effect on a class of ETFs that has garnered over $56 billion in assets[27] without any compelling regulatory interest, we reiterate that the Commission should expand the definition of Qualifying Coverage Assets to include all liquid assets and thus enable currency-hedged ETFs to continue to operate in a manner which enables them to achieve their investment objectives.

Expanded Definition of Qualifying Coverage Assets for Financial Commitment Transactions. Our comments requesting a broader definition of Qualified Coverage Assets including all liquid assets noted above apply equally to the definition of Qualifying Coverage Assets for financial commitment transactions.

In addition, we support the proposed expanded definition of Qualifying Coverage Assets for financial commitment transactions that would allow Qualifying Coverage Assets to include assets convertible to cash or that will generate cash prior to the payment date under financial commitment transactions.

We also note that it is not clear what it means for an asset to be convertible to cash. We request that the Commission clarify that this would include assets the fund reasonably determines it could liquidate on the market prior to the fund's payment or delivery date under its financial commitment transactions.

We also support the proposal that assets that are pledged with respect to a Financial Commitment Obligation and that can be expected to satisfy the Financial Commitment Obligation be included in the expanded definition of Qualifying Coverage Assets. We also agree with the Commission's stated interpretation allowing a fund to treat assets it has transferred to its counterparty in connection with a reverse repurchase agreement as having been pledged.[28] We note that the text of proposed Rule 18f-4 appears to indicate that the use of pledged assets to reduce Financial Commitment Obligations is permitted only if such assets can be expected to satisfy such obligation. We note that some funds do not use the exact assets pledged to actually close out the transaction and request that the Commission clarify that those assets could nevertheless be used to reduce Financial Commitment Obligations.

Expanded Definition of Qualifying Coverage Assets for Business Development Companies. The concerns expressed above are equally applicable to BDCs, if not more so. Due to the highly illiquid nature of their assets (which by statute are required to be comprised largely of unregistered debt and equity securities of private U.S. operating companies), BDCs have substantially fewer liquid

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27 Based on information available from Morningstar as of February 29, 2016.

28 Proposing Release at 80949.

assets with which to cover financial commitment transactions than most registered investment companies. As a result, even with our recommended expansion of the definition of Qualifying Coverage Assets to include all liquid assets, BDCs may suffer a significant cash drag on performance in order to satisfy the asset segregation requirements. To mitigate this disproportionately negative impact on BDCs, we recommend that the Commission consider further expansion of the Qualifying Coverage Assets to include the amount of undrawn credit available to a BDC under outstanding credit facilities.

III. COMMENTS ON THE DERIVATIVES RISK MANAGEMENT PROGRAM AND BOARD RESPONSIBILITIES

A. Scope of the Derivatives Risk Management Program

Rule 18f-4 would require any fund that invests in (i) more than a limited amount of derivatives transactions or (ii) any amount of complex derivatives transactions to establish a formalized derivatives risk management program and to designate a derivatives risk manager who may not be a portfolio manager of the fund.

While we agree in principle that funds that invest in derivatives should adopt policies and procedures to assess and manage the risks associated with those investments, we believe the Commission should clarify and refine the apportionment of certain roles between, on the one hand, the derivatives risk management program and the derivatives risk manager and, on the other hand, the Rule 38a-1 compliance program and the chief compliance officer (“CCO”).

Rule 18f-4 would impose a number of new responsibilities on a fund’s board of trustees or directors (“Board”) and, in particular, on those Board members who are not interested persons, as defined in the 1940 Act (“Independent Trustees”). Specifically, Rule 18f-4 would require a Board, including a majority of the Independent Trustees, to: (i) approve the derivatives risk management program and any material changes to the program; (ii) review, at least quarterly, a report prepared by the derivatives risk manager describing the program’s adequacy and effectiveness; and (iii) approve the fund’s designation of a derivatives risk manager. In addition, the Board, including a majority of the independent trustees, would be required to approve (i) the portfolio limitation option under which the fund will operate and (ii) “policies and procedures reasonably designed to provide for the fund’s maintenance of qualifying coverage assets.”

We are concerned that these new responsibilities would (i) require Boards to engage more directly in portfolio management functions rather than oversee portfolio management functions; (ii) inappropriately assign special responsibilities to Independent Trustees that have historically been reserved for circumstances in which potential conflicts of interest between funds and their investment advisers exist; and (iii) imply a certain degree of required expertise on the part of

Independent Trustees with respect to derivatives that could deter qualified individuals from serving on Boards.

We are also concerned that Rule 18f-4 would require any fund that exceeds the 50% threshold to establish a derivatives risk management program even in cases in which a fund exceeds the threshold inadvertently and/or for a short period of time. For a fund that generally operates below the 50% threshold, such a requirement would be both unnecessary and unduly burdensome. We would urge the Commission to consider adopting a cure period during which a fund that has inadvertently exceeded the threshold could reduce its exposure and avoid the expense of adopting a derivatives risk management program.

We note that, while Rule 18f-4 would permit a fund to invest in a de minimis amount of derivatives transactions without being required to adopt a derivatives risk management program, there is no similar de minimis threshold for complex derivatives transactions. We would request that the Commission permit a fund to engage in a limited amount of complex derivatives transactions without being required to establish a derivatives risk management program.

B. Rule 18f-4 Would Require a Board to Engage More Directly in Management Functions

At its core, we believe that the derivatives risk management program is an investment management function that falls properly within the purview of a fund's investment adviser. Given that a Board is already responsible for the general oversight of the adviser's investment and risk management programs, the Board and the Independent Trustees should not be required to micromanage such programs relating to one particular class of investments. Instead, consistent with historical practice, a Board's responsibilities under Rule 18f-4 should be limited to providing oversight and should not intrude into management of the fund. As the Division of Investment Management has observed:

> Rules that impose specific duties and responsibilities on the independent directors should not require them to "micro-manage" operational matters. To the extent possible, operational matters that do not present a conflict of interest between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.[29]

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[29] Division of Investment Management, Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulations at 266 (May 1992). As discussed more fully below, we do not believe there exist conflicts of interest between investment advisers and the funds they manage with respect to investments in derivatives.

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Requiring a Board and the Independent Trustees not only to approve the derivatives risk program but also to approve the particular portfolio limitation under which the fund will operate and the policies and procedures relating to a fund's maintenance of Qualifying Coverage Assets would inappropriately expand the Board's role beyond its traditional "watchdog" function and require it to become involved in the day-to-day portfolio management functions that funds and their shareholders have historically left to the expertise of the fund's investment adviser. The Commission should clarify in the adopting release for Rule 18f-4 that the Board's role is oversight and not day-to-day portfolio management.

Similarly, a Board should not be responsible for designating a fund's derivatives risk manager. Requiring the Board to designate specific personnel for a function tied so closely to the adviser's investment management program for a fund also requires the Board to participate more directly in a management function.[30] The same effect could be accomplished by requiring that the responsibilities and qualifications of the derivatives risk manager be clearly described in the proposed Board-approved policies and procedures without causing the Board to depart from its traditional oversight function.

C. There Is No Potential Conflict of Interest between Investment Advisers and Funds with Respect to Investments in Derivatives

We do not believe that investments in derivatives present the type of potential conflict of interest between an investment adviser and a fund that would typically require the Independent Trustees' separate evaluation (*e.g.*, approval of the fund's management contract, approval of distribution plans that use fund assets or approval of permitted transactions between the adviser or its affiliates and the fund). Given this, we believe that it is not necessary that Rule 18f-4 single out the Independent Trustees for special oversight and approval responsibilities. Although the Proposing Release states that "there may potentially be conflicts of interest between the investment adviser

[30] We acknowledge that, in some instances, such as designation and compensation of a fund's CCO, approval by a fund's Independent Trustees may be appropriate to address potential conflicts of interest between investments advisers and the funds they manage. *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74714 (Dec. 24, 2003) ("2003 Compliance Programs Release"). We do not believe, however, that any such conflicts exist with respect to the derivatives risk manager. Indeed the only potential conflict of interest the Commission identifies in the Proposing Release—that the interests of personnel of an investment fund/adviser who receive performance-based compensation may not be aligned with those of the funds they advise—is addressed in Rule 18f-4's prohibition of a fund's portfolio manager serving as the fund's derivatives risk manager.

and the fund with respect to the use of derivatives by the fund," the Commission provides no real indication of what form such conflicts of interest might take.[31]

In contrast with other contexts that require oversight and approval by Independent Trustees, a fund's investments in derivatives do not give rise to concerns of potential self-dealing by the fund's adviser. To the contrary, with respect to investments in derivatives, the interests of investment advisers and the funds they advise are aligned. An adviser has every incentive to achieve positive long-term fund performance and to avoid the reputational harm that would be associated with its ineffective use of derivatives. In addition, an investment adviser's use of derivatives is already limited to investments that are consistent with a fund's established investment strategy and policies and, if the substantive limitations in Rule 18f-4 are adopted, would be further constrained.

As noted above, the Division of Investment Management has 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 Trustees that are unrelated to potential conflicts of interest (both in Rule 18f-4 and in the recently proposed rule 22e-4[32]), the Commission risks interfering with the Independent Trustees' ability to focus on those matters that do give rise to actual conflicts.

D. Rule 18f-4 Implies that Independent Trustees Are Expected to Have Specialized Expertise with Respect to Derivatives

As an initial matter, we reiterate that we believe that the Commission should reconsider whether it is appropriate to single out a specific type of investment for special scrutiny by Boards and Independent Trustees. We note that funds routinely seek to achieve their investment objectives using a wide array of instruments and assets, some of which may present more risk than others. In singling out derivatives transactions for special scrutiny and heightened oversight by Boards and Independent Trustees, there is a risk that Boards may be required to focus more narrowly on derivatives transactions rather than being able to use a more holistic approach to risk oversight that

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31 As noted above, the Proposing Release does identify a potential conflict of interest relating to portfolio managers who receive performance-based compensation in discussing why Rule 18f-4 would prohibit a fund's portfolio manager from serving as the derivatives risk manager of the derivatives risk management program. Such a conflict (if it exists) is unrelated to the Independent Trustee responsibilities under Rule 18f-4.

32 *See* Proposing Release; Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, 80 Fed. Reg. 62273 (Oct. 15, 2015).

would apply heightened scrutiny to a fund's riskiest assets rather than focusing specifically on derivatives transactions.

The level of responsibility that would be placed on Boards and specifically Independent Trustees under Rule 18f-4 may lead to the conclusion that Independent Trustees should have a degree of expertise with respect to derivatives that is not contemplated with respect to other types of investments.

We are also concerned that Rule 18f-4 could impose additional liability on Independent Trustees with respect to the approvals they are required to make under Rule 18f-4, or, at a minimum, could lead to the perception that Independent Trustees will be exposed to increased liability under Rule 18f-4. In either case, a consequence could be to deter otherwise qualified individuals from seeking or accepting appointments to fund Boards. Such a trend could have the effect of reducing the diversity of experience and viewpoints on a Board.

The Commission should acknowledge, given the complex and often highly technical nature of derivatives investments, that Boards and Independent Trustees are not required to have specific expertise with respect to such investments and should clarify that their role is limited to that of governance and oversight and that their responsibilities relating to the derivatives risk management program should not translate into an obligation to become experts with respect to these investments.

E. The Commission Should Clarify the Roles of the Derivatives Risk Management Program/Derivatives Risk Manager and the Rule 38a-1 Compliance Program/CCO

As noted above, Rule 18f-4 would require funds that invests in more than a limited amount of derivatives transactions or that use complex derivatives transactions to establish a derivatives risk management program and to designate a derivatives risk manager. We believe that most mutual fund complexes or advisers with significant investments in derivatives currently have policies and procedures in place to monitor, assess and manage the risks associated with funds' investments in derivatives, and we generally support the Commission's proposal to require funds to formalize and, where necessary, establish or expand, their risk management programs relating to derivatives.

However, we believe the Commission should limit the scope of the derivatives risk management program to risk management and not cause the program to encroach on funds' existing Rule 38a-1 compliance programs. While the Commission has described the purpose of the derivatives risk management program as enhancing derivatives risk management, certain of the responsibilities of the program identified in the Rule 18f-4, such as "monitoring whether the fund's use of derivatives transactions is consistent with any investment guidelines established by the fund or the fund's investment adviser, the relevant portfolio limitation applicable to the fund under [the proposed rule], and relevant disclosure to investors," may overlap with Rule 38a-1's requirement that funds establish policies and procedures reasonably designed to prevent violation of the federal securities laws. Since compliance with the requirements of the proposed rule, if adopted, would need to be incorporated into a fund's existing compliance program overseen by the fund's CCO, it is unclear what purpose is served by creating a parallel compliance responsibility for the derivatives risk manager, as such an approach could cause uncertainty with respect to the distribution of responsibilities between these individuals and could result in Boards receiving redundant reports. We note that the Commission's statement in the 2003 Compliance Programs Release that a single individual be appointed as CCO of a fund is intended to avoid "balkaniz[ing] responsibility for fund compliance and isolat[ing] fund boards from compliance personnel, thus impeding boards' abilities to exercise their oversight responsibilities effectively."[33] Indeed, the adopting release to Rule 38a-1 emphasized the importance of channeling compliance oversight and compliance-related communication with the Board to a "single person with overall compliance responsibility for the fund who answers directly to the board."[34] As proposed, certain of the responsibilities imposed on the derivatives risk management program and the derivatives risk manager could interfere with that aim.

In this regard, we believe the Commission should more closely consider the interaction between the proposed derivatives risk management program and funds' existing Rule 38a-1 programs and better delineate the roles of these two programs to eliminate the redundancies and uncertainty caused by overlapping functions. Specifically, the Commission should restrict the role of the derivatives risk management program and the derivatives risk manager to assessing and managing derivatives-related risks and communicating material issues relating to those risks to fund management or the Board when appropriate. In contrast, any compliance-oriented functions implicated by the proposed rule should be integrated into a fund's existing Rule 38a-1 procedural framework, rather than creating a separate and parallel compliance program.

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[33] 2003 Compliance Programs Release at 74721. The Commission acknowledges the Rule 38a-1 requirements in the Proposing Release stating that "[i]f a fund were to breach the portfolio limitation established by the board, this would likely be a material compliance matter that would be required to be disclosed in writing to the fund's board in the CCO's annual report to the board. We expect that this may serve to further enhance funds' risk management practices. In addition, a fund's exceeding its portfolio limit also could be a serious compliance issue that should be brought to the board's attention promptly." Proposing Release at 80937.

[34] 2003 Compliance Programs Release at 74722.

IV. COMMENTS ON THE PROPOSED PORTFOLIO LIMITATIONS

A. Introduction and Overview of Proposed Limitations

Proposed Rule 18f-4 would permit a fund to enter into derivatives transactions provided that, immediately after entering into each derivative or other senior securities transaction:

- The aggregate exposure of the fund does not exceed 150% of the value of the fund's net assets ("Exposure-Based Portfolio Limit"); or

- If the fund's derivatives use reduces its market risk (called "value-at-risk" ("VaR")), the aggregate exposure of the fund does not exceed 300% of the value of the fund's net assets ("Risk-Based Portfolio Limit").

"Exposure" would mean the sum of (i) the aggregate derivatives notional amounts (with a special definition for "complex derivatives"); (ii) the aggregate Financial Commitment Obligations; and (iii) the aggregate indebtedness with respect to any other senior securities transaction. VaR would mean an estimate of potential losses on an instrument or portfolio over a 10-20 trading day horizon and at a 99% confidence level, subject to certain other minimum requirements for the VaR analysis. For purposes of the exposure calculation, a fund could net economically offsetting derivatives that are the same instrument type and have the same reference asset, maturity and other material terms.

We generally oppose the new and inflexible notional-based portfolio limitations under proposed Rule 18f-4 on both legal and policy grounds and strongly believe that imposing these limitations is not necessary or appropriate to address the statutory purpose underlying Section 18. The Commission's long-standing coverage regime has served funds and investors well, and the Commission has not presented convincing evidence that would justify imposing additional leverage limits beyond those in the coverage regime. As discussed herein, we believe that the existing coverage regime, with certain suggested changes, should be sufficient to address the investor protection concerns underlying Section 18.

If the Commission proceeds with implementing new portfolio limitations, however, we would recommend that the Commission modify various aspects of the portfolio limitations, as discussed in more detail below.

B. The Proposed Rule Raises Significant Issues Under Administrative Law

As noted above, the Commission has maintained a long-standing policy that allows funds to avoid issuing "senior securities" if the fund "covers" a derivative or financial commitment transaction by segregating or earmarking liquid assets or enters into an offsetting transaction. The Commission now takes the view that any derivative or financial commitment transaction that creates a "future payment obligation—a conditional or unconditional contractual obligation to pay in the future"—involves the issuance of a senior security whether or not it is covered.[35] Accordingly, the proposed rule would create a new definition of what it means to "issue a senior security." The proposed rule ignores the plain language of the definition of the term "senior security" in Section 18 of the 1940 Act and would reverse the Commission's long-standing interpretation of the definition of "issuing a senior security" as applied to derivatives and financial commitment transactions.

The Administrative Procedure Act provides that a rule may be held unlawful and set aside if, among other reasons, it is not in accordance with law or excess of statutory authority.[36] Under *Chevron* v. *Natural Res. Def. Council, Inc.*, the validity of an agency rulemaking is evaluated under a two-step test.[37] The court must first determine whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter and the court must give effect to the unambiguously expressed intent of Congress. If the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. This principle is also known as the plain language test.

It is difficult to see how the proposed portfolio limitations follow from the plain language of the 1940 Act's prohibition of the issuance of senior securities. Section 18 is clearly intended to regulate the capital structure of investment companies, as reflected in its language relating to "issuance" – which implies an offer, sale and distribution of securities (*e.g.*, debt securities) – and to "classes" of securities – which implies priority in payment obligations, which is echoed throughout the section.

The current coverage regime follows the language of Section 18 because it focuses on payment priority and on the leveraging aspects of derivatives that are most analogous to issuing debt securities. A fund that covers its obligations under a derivative or financial commitment transaction avoids creating seniority in the capital structure of the fund for at least two reasons.

First, coverage assures that there are enough assets to meet the fund's obligations under the derivative or financial commitment transaction without having to rely on the value of other holdings.

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35 Proposing Release at 80889-90 (emphasis added).

36 5 U.S.C. § 706.

37 *Chevron U.S.A., Inc*. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

Second, coverage functions as a practical limitation on the liabilities arising from the leverage produced by a fund's derivatives and financial commitment transactions. Similar to the manner in which the maximum loss on an investment in a company is limited to the amount of the investment, regardless of how levered the company and the returns on its securities might be, coverage provides practical limits on a fund's potential liabilities to third parties from losses on a derivative or financial commitment transaction. By contrast, a fund that issues debt or borrows from a bank and suffers losses on its levered portfolio potentially could end up owing debtholders amounts that far exceed the value of any particular investment or even the net asset value of the fund. Section 18 is intended to limit the debtholders' prior claims on fund assets arising from this type of leverage (*i.e.*, leverage created when a fund issues debt or borrows from a bank) rather than the potential for loss arising from the leverage inherent in traditional investments. The coverage regime is consistent with the structure and purpose of Section 18 because it assures that the potential liabilities created by a derivative or financial commitment transaction are functionally similar to the potential for loss from leverage inherent in traditional investments.

However, one cannot make similar arguments regarding the proposed portfolio limitations. The central features of these limitations are arbitrary limits on notional exposure that have no relationship to the capital structure of a fund, priority of derivatives payments over shareholders' redemption rights, or the issuance of debt. A fund that has notional exposure of 151% has created almost exactly the same issues with respect to priority of payment and limitation of leverage as a fund with notional exposure of 150%, and the seniority of the obligation created by the first fund is virtually identical to that created by the second. Yet the proposed rule would treat the first fund as having issued a violative senior security and the second one as not.

Further, courts have found it problematic when a regulatory agency, such as the Commission, has changed a long-standing definition, without adequate support in the plain language of the statute. For example, the D.C. Circuit Court stated in *Goldstein v. SEC* that, when considering the Commission's justification for a new rule requiring registration of private fund advisers based on a change in the definition of what it means to be a client of an investment adviser, "without any evidence that the role of fund advisers with respect to investors has undergone a *transformation*, there is a disconnect between the factors the Commission cited and the rule it promulgated."[38] The court held that the "Commission's rule creates a situation in which funds with one hundred or fewer investors are exempt from the [1940 Act], but those with fifteen or more investors trigger registration under the Advisers Act. This is an arbitrary rule."[39]

38 *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (emphasis added).

39 *Id.*

Analogously to the rule at issue in *Goldstein*, the proposed new definition and related portfolio limitations would create a situation in which funds with leverage at the notional leverage limits or above have issued violative senior securities, but funds with marginally lower leverage have not. Based on *Goldstein* and other cases, a departure from the long-standing interpretation permitting the use of derivatives and financial commitment transactions under the asset coverage regime would need to be supported by an identified fundamental change in the nature of the relationship between "senior securities" and funds' use of derivatives or financial commitment transactions. We believe that the nature of the definition of "senior securities" under Section 18 and any relation that definition might have to derivatives or financial commitment transactions have not changed since the Commission stated its policy with respect to leverage in 1979. The proposal does not identify a transformation in the relationship between "issuing senior securities" and funds' use of derivatives or financial commitment transactions that justifies the replacement of the long-standing coverage regime with the new portfolio limitations.

The Proposing Release identifies a number of policy reasons for the Commission's proposed change in definition, including that the Commission is concerned that the current approach "in some cases may not adequately address" the fundamental concerns underlying Section 18.[40] Based on these statements, we believe that the change in definition represents the product of the Commission's recent increased focus on policy issues raised by funds' use of derivatives. However, under the principles articulated in *Goldstein*, the Commission would need more than policy concerns to adequately support a departure from a definition of issuing senior securities that has been in place for over three decades and based on which many funds have constructed investment programs.

While we take the policy issues raised by the Commission seriously, we believe that <u>they can and should be addressed through the coverage regime</u> (as we discuss in more detail in Section 5.C below) to avoid these statutory issues. We believe that it is highly problematic for the Commission to disrupt long-standing industry practices and the investment programs of hundreds or thousands of funds by adopting an entirely new definition of what it means to "issue a senior security" that has no textual foundation in the 1940 Act and that would address statutory purposes that we believe the coverage regime can fully address. If the Commission adopts the new portfolio limitation element as proposed, we believe that it would set a troubling precedent that would allow the Commission to change long-standing definitions without appropriate statutory justification and that would create significant uncertainty in all aspects of the 1940 Act regulatory regime.

We believe that new definition is not justified under the plain language of Section 18 or by any fundamental change in the nature of "issuing senior securities," and is inconsistent with the

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[40] Proposing Release at 80893.

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reasonable and appropriate way that the Commission has historically interpreted and applied Section 18. For these reasons, we believe the Commission should not adopt the new definition and accompanying portfolio limitation requirements and instead should focus on addressing its identified concerns through uniform and protective asset segregation standards and risk management requirements.

C. The Portfolio Limitations Are Not Necessary to Meet the Statutory Purposes Underlying Section 18

The long-standing coverage-based regime has served funds and investors well, including during the 2008-2009 financial crisis and other times of market disruption, and should be able to provide sufficient regulation for funds' use of derivatives with certain modifications designed to address the Commission's concerns.

In addition, the Commission has identified no specific change or problem that supports adding the new portfolio limitations. As discussed in more detail in Section V.A.3 hereof, the only hard evidence of a need for a new regime the Commission can offer consists of several examples of funds that suffered losses in part from derivatives.[41] Provided that the risks of derivatives investments by the registered funds were fully disclosed to investors, losses suffered by these funds' shareholders in the midst of a global financial crisis do not justify the reversal of long-standing Commission policy. They do not demonstrate a reason why the proposed new and inflexible limitations on exposure are necessary or appropriate to protect investors. Moreover, the Commission has not demonstrated how proposed Rule 18f-4 would have prevented the losses in these examples that it identifies as problematic. Instead, these examples merely illustrate the risks of investments in certain transactions.

The fact that there are no other no examples or evidence that the existing coverage-based regime was or will be insufficient to address concerns about funds' investment in instruments that create leverage demonstrates the strength of this regime. Accordingly, the Proposing Release does not establish that the new portfolio limitations are necessary to meet the investor protection purpose underlying Section 18.

We recognize that the Proposing Release does specify a number of policy rationales for the Commission's action, including that: (i) the derivatives markets have grown in volume and complexity since the issuance of Release 10666 and the Staff no-action letters; (ii) certain funds

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41 We note that, while the Commission identifies losses suffered by a private fund from derivatives use, this fund was not subject to Section 18 and therefore we believe this fund's losses cannot be used to justify new regulation of registered funds.

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have increased their use of derivatives over the past two decades; (iii) many funds segregate an amount equal to the funds' daily mark-to-market liability for certain net cash-settled derivatives based on guidance provided by the Staff in the disclosure review context, which is an amount that is substantially less than under the initial approach under Release 10666 and the Commission believes enables funds to obtain a greater extent of leverage than contemplated in Release 10666; (iv) many funds segregate various types of liquid assets rather than limited categories of high quality assets described in Release 10666, which the Commission notes could decline in value at the time the fund experiences losses on its derivatives and may enable a fund to obtain a greater extent of leverage than contemplated in Release 10666; and (v) the Commission is concerned the current approach "in some cases may not adequately address" the fundamental investor protection policy concerns underlying Section 18.[42]

These rationales express a desire of the Commission to limit risks to investors arising out of funds' leverage obtained through the use of derivatives and financial commitment transactions. However, we believe that these risks would more appropriately be addressed by a continuation of the current coverage-based regime (with certain modifications) rather than by new and inflexible limitations on funds' exposure. In this regard, while the Commission's mission is principally to protect investors, maintain the integrity of the capital markets and to promote capital formation,[43] the securities laws were not intended to regulate the investment risks that are inherent in markets.[44] Rather, the Commission has historically aimed to ensure that funds disclose the risks of investing in funds to investors so that investors may make informed decisions regarding their investments.[45]

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42 Proposing Release at 80892-94.

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

44 The Commissioners have stated that the Commission's objective is not to eliminate risk. *See* Speech, Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Dec. 11, 2014 ("2014 Mary Jo White Speech") ("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.").

45 *See* Speech, Commissioner Daniel M. Gallagher, Remarks before the SEC/Academy of Finance Shadowing Program (Apr. 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

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 investor suitability standards for funds that use derivatives beyond certain levels.

We also note that the use of varying levels of exposure under derivatives and financial commitment transactions is necessary for many funds to obtain the levels of investment exposure required by their strategies and selected by fund investors. In this regard, as discussed in more detail in Section V.A.3 herein, 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 market. The Commission should recognize the benefits of investors having diversified investment options through a range of different funds in which to invest, including funds that make use of varying levels of derivative and financial commitment transactions exposures, and allow investors to take reasonably calculated risks in making their investment decisions.

In addition, as discussed in more detail in Section V.A.3 herein, the Commission has not addressed how the Commission's perceived need to impose portfolio limitations will be otherwise addressed by the SEC's, CFTC's and Prudential Regulators' risk mitigating requirements that directly apply to derivatives. These requirements include new regulations that have been and are currently being implemented under the Dodd-Frank Act requiring clearing and exchange trading and two-way margin for many swaps, and should mitigate certain risks funds may otherwise face through the use of derivatives. To the extent that the Commission does not believe a fund's in-the-money derivatives or derivatives not subject to initial margin would be appropriately limited under the new asset segregation requirements, notwithstanding additional risk-based coverage, the Commission could adopt specific asset segregation requirements applicable to that situation rather than adopting an entirely new element under Section 18.

Further, we also note that the Commission does not take into account that its proposed portfolio-level risk metric reporting requirements applicable to funds, if adopted, will generate a wealth of information regarding funds' use of derivatives and financial commitment transactions that take into account nuanced factors such as delta in assessing a fund's exposure.[46] We believe the Commission, consistent with principles of evidence-based rulemaking, should start collecting and assessing this information prior to adopting the entirely new portfolio limitation requirements. If the Commission ultimately determines to move forward with adopting a portfolio limitation

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and potential investments, including, among other things, the risks associated with those investments, so that they can make their own informed investment decisions.").

46 Investment Company Reporting Modernization Release, Investment Company Act Release No. 31610 (May 20, 2015) [80 Fed. Reg. 33590] (June 12, 2015) ("Investment Company Reporting Modernization Release").

requirement, we propose that the Commission proceed using a two-step approach: first adopt changes to the asset segregation and board requirements and, only after taking time to consider the information submitted on new Form N-PORT, continue considering adopting a portfolio limitation requirement.

D. The Portfolio Limitations Would Have Serious Unforeseen Consequences on Funds and Do Not Reflect the Reality of Risks Posed by Funds' Uses of Derivatives and Financial Commitment Transactions

First, under the proposed rule, certain funds would not be able to continue operations as they exist today or would need to substantially change the way they operate. As acknowledged by the Commission, these funds may need to liquidate or deregister as investment companies and operate as public or private commodity pools. Investors in such funds would no longer benefit from the ability to obtain the desired investment exposure through a registered investment vehicle that is subject to the robust regulatory oversight of the Commission, and may not be able to replace such exposure.

The practical impact of the portfolio limitations would be far greater than the expected consequences of the proposed rule as described in the Proposing Release, which suggests that the proposed rule would mainly impact alternative strategy funds and leveraged ETFs. We submit that many other funds would need to reduce their usage of derivatives and financial commitment transactions that create leverage to comply with the portfolio limitations. These funds would be forced to seek to obtain the same investment exposures through investments in derivatives that do not create leverage (*e.g.*, options, which pose different, and potentially less favorable, risks) or through the use of less efficient investment techniques. For example, certain fixed income funds would need to purchase cash fixed income securities rather than continue to obtain investment exposure to fixed income securities through derivatives.

As discussed in more detail in Section V.B.3 below, such funds would likely need to pay spreads on substitute investments that are much larger than on the related derivatives and that certain substitute investments such as fixed income instruments are often less liquid than the related derivatives. This would negatively affect funds, for example, if they were forced to liquidate cash fixed income securities at inopportune times. Accordingly, the portfolio limitations may significantly increase costs and potentially reduce liquidity which will ultimately hurt shareholders through reduced investment performance, while not necessarily reducing a fund's investment risk profile. We understand that the Commission will receive numerous data points supporting this point from the industry. We request that the Commission take into consideration the numerous apparently unintended consequences that would result from the proposed rule.

Second, the new and inflexible limitations on exposure also ignore the different reasons funds have to use different types of derivatives. For example, an international equity fund may use derivatives to obtain exposure to equity securities in relatively difficult-to-access markets and, separately, to provide a currency hedge component. As described in more detail below, these two uses of derivatives can create significantly different levels of risk for the fund. A notional-based exposure limit fails to capture these two different uses for derivatives and the related differences in risks posed to the fund.

As a related point, the portfolio limitation requirement does not recognize that different categories of derivatives and financial commitment transactions create exposures to different levels of risk. For example, shorter duration fixed income derivatives present less risk than longer-duration fixed income derivatives because they are less sensitive to movements in the underlying instruments. Notwithstanding the different levels of risk, all users of fixed income derivatives would be subject to the same limitation on exposure. In addition, the Commission treats futures and cleared and uncleared swaps the same for purposes of the new portfolio limits whereas futures and cleared swaps are generally more liquid than uncleared swaps.

Third, the Proposing Release does not sufficiently address the variety of issues with implementing the VaR test under the Risk-Based Portfolio Limit due to the lack of standards for VaR calculations. There is no one unique estimate of VaR as it is based on a formula requiring a history of data. We submit that the different methods of calculating VaR may result in fund complexes having vastly different risk profiles in practice. The issues associated with the implementation of VaR are further compounded by the additional cost to funds that will need to engage third-party consultants to assist in the development and operation of the VaR testing system.

Finally, there would also be extensive operational burdens in implementing the portfolio limitations. For example, implementing “time-of-transaction” testing would require real-time calculations of notional exposure, which may require significant changes to funds’ current compliance monitoring systems.

E. If the Commission Proceeds with Implementing Portfolio Limitations, the Commission Should Consider Implementing Risk-Weighted Adjustments to the Measure of Exposure

If the Commission does proceed with implementing notional-based exposure limits, we urge the Commission to adjust these limits based on the specific type of the derivatives transactions. We believe that the calculation of notional exposure for various 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 (*i.e.*, a “Risk-Adjusted Exposure”).

Alternatively, the Commission could consider implementing duration adjustments to the measure of exposure created by fixed income derivatives. We agree with the Proposing Release that calculating notional amounts for certain short-term derivatives transactions without adjusting for duration could overstate "the magnitude of the fund's investment exposure."[47]

The Commission could consider the approach taken by other regulators and used in the Commission's own Proposed Margin Rules. For example, these rules permit swap dealers to calculate the minimum amounts of initial margin to be posted and collected 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.[48] Similarly, the Commission could permit funds to determine the appropriate risk-weighting on a contract-by-contract basis at its election using either: (i) a risk-based proprietary model developed by the fund and its board, or (ii) a standardized schedule provided either in the final rulemaking or through reference to commonly accepted industry models.

To develop a set of percentages for the Risk-Adjusted Exposure approach, we recommend that the Commission consult the percentages proscribed by other regulators for derivatives that are based on asset-specific risk analyses that have been studied and adopted by the Prudential Regulators, the CFTC, and in its related Proposed Margin Rule, the Commission. These percentages also correspond with those included in the final BCBS/IOSCO Framework, which established an international framework for minimum standards for margin requirements for non-centrally cleared derivatives. The Commission could develop a notional adjustment schedule that measures exposure created by the riskiest assets at 100% and reducing the other asset classes proportionally by reference to the margin schedule.

We expect the Commission will receive numerous proposed Risk-Adjusted Exposure approaches, and recommend the Commission consider such proposals carefully in adopting any final rule.

F. If the Commission Proceeds with Implementing Portfolio Limitations, the Commission Should Consider Certain Modifications to the Risk-Based Portfolio Limit

As proposed, in order for a fund to be able to maintain a notional exposure of 300%, the fund's "full portfolio" VaR would need to be less than the fund's "securities VaR" (excluding derivatives).[49] We understand that the Risk-Based Portfolio Limit VaR comparison, as currently

[47] Proposing Release at 80908.

[48] *See* CFTC Margin Rules; Prudential Margin Rules; and SEC Proposed Margin Rules.

[49] Proposing Release at 80994.

proposed, provides limited practical use if the full portfolio VaR is compared against a portfolio composed only of the securities held by the fund. We expect the Commission will receive numerous proposed adjustments to the Risk-Based Portfolio Limit, and recommend the Commission consider such proposals carefully in adopting any final rule.[50]

Changing this methodology would render the 300% test useful from a practical perspective while also preserving the notion that, in order to qualify for the higher 300% limit, certain exposure must be risk reducing.

G. If the Commission Proceeds with Implementing Portfolio Limitations, We Propose that the Commission Adjust Certain of the Components of the Proposal and Provide Clarification Regarding Certain Aspects of the Portfolio Limitations

Netting and Hedging. While not exactly offsetting, there are many kinds of transactions that can effectively eliminate a fund's investment and risk in derivatives. As noted above, the proposed rule limits netting of derivatives contracts to those that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. This limitation on netting ignores the fact that offsetting transactions with different maturities and different instrument types are commonly entered into for risk management and exposure reduction purposes. For example, funds may enter into offsetting contracts with varied maturity dates as a more cost effective method of eliminating or reducing market exposure in lieu of terminating a contract altogether. We believe that the Commission needs to allow funds a broader ability to net offsetting transactions that effectively eliminate all or some exposure under a transaction with fewer limitations as long as the offsetting transactions truly reduce notional exposure.

Furthermore, the Commission should also allow funds to disregard the notional exposure under hedging transactions for purposes of the portfolio limitation, or provide a substantial reduction in the calculation of notional amount. As noted above, hedging transactions are entered into for different purposes than those that are intended to create investment exposure. We recognize the Commission's concern related to the difficulties in developing "a suitably objective standard" for

[50] For example, the Commission could consider developing a more flexible test that is predicated on an understanding that, in proposing the 150% limit, the SEC appears to have acknowledged its belief that a fund with exposure of up to 150% is not engaged in "undue speculation" and, as such, the SEC appears to suggest that 150% creates a reasonable and acceptable level of leverage. *See id.* at 80906 ("[The Commission] proposed to set this limit at 150% of net assets (and at 300% of net assets for a fund operating under the risk-based portfolio limit) because [the Commission believes] that is an appropriate limit on a fund's exposure from derivatives, financial commitment transactions, and other senior securities transactions.").

an exception for hedging transactions.[51] However, if the SEC adopts general standards for what would constitute an appropriate offsetting or hedging transaction, we believe that a fund is capable of establishing internal guidelines and procedures to determine what transactions adequately satisfy such standards.

We urge the Commission to consider that when a fund enters into such offsetting contracts, as described herein, the fund is actively attempting to reduce its risk and/or overall market exposure. By broadening the scope of permissible offsetting and hedging transactions, the Commission would be providing a fund with additional tools through which to accomplish this risk mitigation.

VaR Testing. As noted above, the VaR tests present a number of practical problems. We request that the Commission provide additional guidance surrounding the VaR testing. Using VaR risk factors like "equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk"[52] is not very clear. All of these "risks" are reflected in historical prices, so we question whether simply looking at the historical risk and covariance table is sufficient. Additionally, we request that the Commission provide additional guidance on how funds would treat newly-listed or newly available derivatives contracts.

Cure Periods. We would also request that the Commission provide guidance regarding the consequences for exceeding the portfolio limitation or any other limitation that is adopted. We urge the Commission to include an exception for a limited time period to allow a fund to remedy an inadvertent excess over 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 investments that ultimately are not made). The Commission should also provide guidance that a fund that exceeds a limitation could trade in derivatives that reduce its exposure, even if the specific trade does not bring the fund into compliance with the limitation.

Time of Calculations. We also request that the Commission provide guidance regarding the timing of calculations regarding compliance with the portfolio limitations. Fund managers often must make investments based on expected subscriptions and redemptions. We would therefore suggest that funds be permitted to base the time-of-transaction calculations on the forecasted assets of the fund (the initial fund assets combined with any forecasted subscriptions and redemptions). The Commission should also provide guidance on the timing of the derivatives price calculations (*e.g.*, in cases where there are dramatic price moves in futures after the stock market close). We

51 Proposing Release at 80914.

52 Proposing Release at 80996.

understand that many funds have concluded that there are numerous technical challenges in this area. We urge the Commission to consider industry comments carefully.

H. Carve-Out for Financial Commitment Transactions

The asset segregation requirement for financial commitment transactions should adequately address concerns about both leverage and adequacy of assets in connection with a fund's use of financial commitment transactions. We therefore request that the Commission remove financial commitment transactions from the exposure calculation for the portfolio limitation requirements. 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). As noted above, 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."[53] The Commission states that it is including Financial Commitment Obligations in its calculation of exposure based on a concern that a fund otherwise "could obtain aggregate exposure in excess" of the limits.[54] 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.

I. If the Commission Proceeds with Implementing Portfolio Limitations, We Propose that the Commission Adjust the Limitations to Restore the Greater Leverage Flexibility Congress Intended BDCs To Have

As noted earlier, Congress expressly intended that BDCs have the ability to incur greater leverage than registered investment companies, establishing a minimum asset coverage ratio of 200% instead of the minimum 300% asset coverage ratio required generally for registered investment companies. This difference effectively permits BDCs to incur twice as much leverage as most registered investment companies. Because the proposed rule's portfolio limitations do not distinguish among types of investment companies, BDCs will be subject to the same overall limitations on leverage as registered investment companies. In order to avoid undermining the clear Congressional intent that BDCs be permitted greater leverage than registered investment

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53 *Id.* at 80995.

54 *Id.* at 80906-07.

companies, we recommend that the Commission revise the portfolio limitations to restore the distinctions and balance intended by Congress.[55]

V. COMMENTS ON THE COMMISSION'S COST-BENEFIT ANALYSIS AND THE COMMISSION'S RULEMAKING AUTHORITY

Section IV of the Proposing Release provides an economic analysis of the proposed rule. It includes a discussion of the economic impacts of the proposed rule, including effects on efficiency, competition and capital formation (a cost-benefit analysis ("CBA")).[56] The CBA seeks comments on, among other things, whether the analysis has: (1) identified all benefits and costs including all effects on efficiency, competition, and capital formation; (2) given due consideration to each benefit and cost, including each effect on efficiency, competition and capital formation; and (3) identified and considered reasonable alternatives to the proposed rule.[57]

Our comments are directed at the portions of the CBA that address the Exposure-Based Portfolio Limit, the Risk-Based Portfolio Limit and asset segregation requirements (collectively, "Derivatives Restrictions").

As discussed below, we do not believe that the CBA supports the adoption of the Derivatives Restrictions from the perspective of their impact on efficiency, competition and capital formation. We also do not believe that the benefits that the CBA purports to rely on adequately support the adoption of the proposed rule. Furthermore, we believe that the costs to investors, including the anticipated reduction in investment options available to investors, far outweigh the purported benefits the Commission cites.

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[55] We recommend that comparable flexibility be provided to closed-end funds to acknowledge the greater flexibility under the 1940 Act afforded those funds as well.

[56] We acknowledge that Section 6(c) of the 1940 Act allows the Commission to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest, and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." However, Section 2(c) of the 1940 Act requires that, whenever the Commission is engaged in rulemaking under the 1940 Act and is required to consider or determine whether an action is in the public interest, the "Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

[57] Proposing Release at 80980.

A. The CBA Relies on Purported Benefits Supporting Investor Protection That Are Not Properly Characterized As Such Nor Established or Empirically Validated in the Proposing Release

The primary benefit that the CBA asserts is that the Derivatives Restrictions under the proposed rule are likely to strengthen investor protection. It makes two claims in that regard:

- To the extent that the proposed rule strengthens investor protection, it should also sustain and promote investors' willingness to participate in the market; and

- The proposed rule is likely to reduce the risk that investors will experience losses associated with leveraged investment exposures.[58]

We do not believe that either of the Commission's claims can be considered to validly support the adoption of the Derivatives Restrictions under the proposed rule.

1. Claim Regarding Promotion of Investors' Willingness to Participate in the Market

The CBA contains the following statement regarding a purported benefit that the proposed rule would provide:

> We expect, that to the extent the proposed rule strengthens investor protection, the proposed rule should also both sustain and promote investors' willingness to participate in the market. This could lead to increased investment in funds, which in turn could lead to increased demand for securities which could, in turn, promote capital formation.[59]

In essence, the Commission is suggesting that its current treatment of funds' investments in derivatives transactions acts as a meaningful deterrent to investment in funds by the public and that this deterrent would be removed if the proposed rule is adopted. The CBA provides absolutely no evidence to support this claim. To treat such a claim as a primary ground to support a far reaching change in Commission policy, it would be expected that the Commission would support the claim with credible survey data or other relevant empirical evidence. No such evidence in support of the proposed rule is offered in the CBA.

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58 *Id*. at 80957.

59 *Id*.

To the contrary, the CBA provides stark, compelling evidence refuting this claim. The CBA acknowledges that the fund industry has grown "significantly" since 2010.[60] The phrase "significantly" dramatically understates the reality.

According to the Division of Economic and Risk Analysis's White Paper on Derivatives, at the end of 2010 open-end funds, closed-end funds and ETFs had a total of $10.9 trillion of assets under management.[61] The CBA, citing Morningstar, states that assets under management at these three categories of funds had grown to $17.9 trillion as of the end of June 2015.[62] This increase of $7 trillion represents approximately a 60% increase in assets under management in just four and a half years.

The CBA further comments that alternative strategy funds (excluding commodity funds), which "tend to be greater users of derivatives," had recently experienced particularly notable growth with an annual net inflow of 28% during the four year period between the end of 2010 and the end of 2014.[63]

Thus, the empirical data presented by the Commission simply does not support a claim that the Commission's current approach to derivatives is deterring investors' willingness to invest in funds. Even more strikingly, investors are showing an increased relative propensity to invest in funds that are significant users of derivatives compared to other funds.

Thus, the Commission has failed to provide a rational basis to contend that its current policies regarding the use of derivatives by funds have meaningfully deterred the growth of funds in general or derivative-oriented funds in particular. As a corollary, there is no rational basis to assert that the proposed rule if adopted would have the impact of spurring such investment.

2. Claim Regarding Reduction of Risk to Investors

The second claim the Commission makes in support of its asserted investor protection benefit is that the proposed rule will protect fund investors from derivatives-related losses. The Commission

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60 *Id*. at 80955.

61 Daniel Deli, Paul Hanouna, Christof W. Stahle, Yue Tang and William Yost, *Use of Derivatives by Registered Investment Companies*, Division of Economic and Risk Analysis (2015) at 21 ("DERA Report").

62 Proposing Release at 80955.

63 *Id.*

states that leverage magnifies losses that may result from adverse market movements. It sets forth the following scenario:

> [A] fund that obtains leverage through derivatives . . . may suffer those magnified losses and, because losses on a fund's derivatives transactions can create payment obligations for the fund, the losses can force a fund's adviser to sell the fund's investments to generate liquid assets in order for the fund to meet its obligations. This could force the fund to enter into forced sales in stressed market conditions, resulting in large losses or even liquidation. The proposed rule, by effectively imposing a limit on the amount of leverage a fund may obtain through derivatives, should reduce the possibility of fund losses attributable to leverage. This can have investor protection benefits as well as reduce the risk of adverse effects on fund counterparties. . . . For these reasons, we believe that the proposed rule should encourage capital formation by promoting investors' willingness to invest in funds (or to remain invested in them even in a falling market) and market stability.[64]

In making this claim the Commission appears to take the position that its "investor protection" mandate under the 1940 Act extends to protecting investors from experiencing losses, or perhaps experiencing too large an amount of losses, on their investments in a fund.

As discussed in Section IV.C above, we do not believe that the Commission is authorized under the 1940 Act to engage in regulation designed to seek to limit or mitigate potential losses to investors. Instead, the Commission's role is to ensure that investors and prospective investors in funds are fully informed about the risks associated with their investment through disclosure. This is a fundamental distinction.

Also as discussed in Section IV.C, Congress did not authorize the Commission to decide that a fund is too risky to be offered to investors. Congress rather charged the Commission with seeking to ensure that investors are provided with information about a fund and the potential risks and rewards that it presents that allow the investor to determine whether the risk profile presented by that fund is appropriate for their personal investment objectives.

In this regard, Commission Chair White has recognized that it is neither necessary nor appropriate to seek to remove all risk from investment in funds.[65] Under the 1940 Act a fund may pursue an investment strategy that may be expected to result in small gains or small losses over time or it may pursue an investment strategy that may be expected to result in large gains or large losses over time.

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64 *Id*. at 80598 (footnote omitted).

65 *See* 2014 Mary Jo White Speech.

Risk in a fund can arise from the nature of the fund's holdings of equity and debt security. It can also arise from the fund's use of derivatives. Either type of risk can contribute to losses to investors in the fund. It simply is not the job, nor within the authority, of the Commission to seek to prevent or mitigate either type of losses, provided that investors are properly informed of existence of these risks. For the reasons discussed above, we believe that the Commission's key identified benefit under the proposed rule is not a benefit that is within the scope of the authorized exercise of the Commission's investor protection mission under the 1940 Act.

It is also important to note that, while a fund's investments and its use of derivatives expose it to the potential for losses to its investors, the very same factors also may result in gains for its investors. Risk and reward are fundamental to investment in funds. Fund investors understand that they are not placing their money in an FDIC-insured bank account in which they are not exposed to any loss on their insured funds. Rather, they are placing their investment at risk with the understanding that these assets are subject to potential for gain and/or loss over time.

To the extent that the Commission's unauthorized Derivatives Restrictions are described by the Commission as creating a benefit by reducing investors' exposure to loss, it is just as much creating a detriment to investors as it correspondingly limits their opportunity for gain.[66] Thus, we do not believe that this prong of the CBA can properly be described as a benefit.

Apart from the Commission's lack of authority to pursue the objectives of the Derivatives Restrictions under the rubric of investor protection, we also believe as discussed below that the CBA and the Proposing Release fail to demonstrate that the speculative threat that the CBA hypothesizes, in fact, constitutes a material risk.

3. The Proposing Release Fails to Provide Empirical Evidence of a Material Threat that Must be Addressed by the Derivatives Restrictions

The Proposing Release seeks to justify the Derivatives Restrictions by citing three recent enforcement settlements involving registered funds.[67] As noted in Section IV.C, these settlements fall far short of justifying a wholesale restructuring of the ability of funds to use derivatives to pursue their investment objectives and strategies established for the funds and the reversal of over three decades of Commission policy. In the cited proceedings, the Commission only alleged

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66 Furthermore, the Commission recognizes that funds have uses for derivatives that address efficiency rather than seeking investment gains. For example, funds may use index futures to equitize cash rather than purchasing the underlying asset where using the derivative is more efficient and less costly to the fund than investment in the underlying. Proposing Release at 80960.

67 Proposing Release at 80896.

violations of various disclosure-related provisions of the federal securities laws.[68] The Commission claims that these three cases "demonstrate the substantial and rapid losses that can result from a fund's investment in derivatives" and thus inform the Commission's reconsideration of registered investment company derivatives trading restrictions. The Commission did not, however, allege violations of Section 18 of the 1940 Act in any of these actions. Significantly, there is no indication in the respective settlement orders or the Proposing Release that the Commission's proposed new limits would have prevented the losses the respective funds experienced and do not demonstrate why the new limits are necessary or appropriate to protect investors.[69]

The Commission also identifies the losses of the private fund Amaranth Advisors LLC ("Amaranth Advisors") as a demonstration of the risks associated with derivatives investing, and the challenges associated with hedging and covering derivatives positions. The Commission admits that, as a private fund excluded from regulation under the 1940 Act, Amaranth Advisors was not subject to any capital structure or leverage limitations,[70] and there is no indication from the information available that, had Amaranth Advisors been subject to Section 18 of the 1940 Act, the Commission's proposed new limits on fund derivatives trading would have limited the fund's derivatives trading and/or prevented the losses the fund experienced. Accordingly, we believe this fund's losses cannot be used to justify regulation of registered funds.

Furthermore, the Commission's discussion of Amaranth Advisors fails to put the event and its own proposed rulemaking in context of the broader regulatory framework and reforms applicable to derivatives trading. In the wake of the fund's collapse, the CFTC charged Amaranth Advisors with

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68 *In the Matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc.*, Investment Co. Act Rel. No. 30099 (June 6, 2012) (settled action); *In the Matter of Claymore Advisors, LLC*, Investment Co. Act Rel. No. 30308 (Dec. 19, 2012); *In the Matter of Fiduciary Asset Management, LLC*, Investment Co. Act Rel. No. 30309 (Dec. 19, 2012) (settled action); *In the Matter of UBS Willow Management L.L.C. and UBS Fund Advisor L.L.C.*, Investment Co. Act Rel. No. 31869 (Oct. 16, 2015) (settled action).

69 The OppenheimerFunds settlement order reports that one fund had net assets of approximately $2 billion and additional market exposure through total return swaps on CMBS of $1 billion while the other fund had net assets of approximately $2.2 billion and additional market exposure through TRS of $800 million. Per the snapshot of exposure the settlement order in the Claymore settlement provides as of August 2008, the fund in question had written options total notional exposure of 136% of the fund's net asset value. The UBS Willow settlement order reports that as of the first quarter of 2009, the CDS portfolio of the fund was 25% of the net assets of the fund. Each of these ratios equals or is less than the Commission's proposed 150% leveraged-based portfolio limitation.

70 Proposing Release at 80896 n.127.

attempted manipulation of the natural gas markets, for which the adviser settled with the CFTC.[71] The Amaranth case has been specifically cited to justify changes to the CFTC position limit regulations.[72] The Commission is silent on whether it has considered that these proposed changes might go some way to preventing a future Amaranth Advisors-type collapse, preferring instead to consider registered investment company derivative investing and 1940 Act regulation in a vacuum.

The Commission does not cite any Section 18 violation cases in its Proposing Release, and a review of all available Commission administrative proceedings finds no cases brought against open-end funds, closed-end funds or BDCs for Section 18 violations related to derivatives trading. Based on the above, we believe the Commission has not demonstrated through these examples that the proposed rule is necessary or appropriate.

4. The CBA Fails to Acknowledge Regulatory Changes That Undermine Its Claim of Benefits from the Derivatives Restrictions

The CBA does not appropriately recognize the enhanced risk mitigation arising from Dodd-Frank Act mandated regulation that is already in place or forthcoming. In this regard, the Commission's failure to adequately consider its proposal in the broader context of Dodd-Frank Act and other recent regulation in the derivatives trading space—some of which the Commission has itself proposed and adopted—is inconsistent with one of the central tenants of Executive Order 13563 ("Executive Order"), which directs agencies to "tailor [their] regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the *costs of cumulative regulations*."[73] Furthermore, the Executive

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71 *See* Press Release: U.S. Commodity Futures Trading Commission Charges Hedge Fund Amaranth and its Former Head Energy Trader, Brian Hunter, with Attempted Manipulation of the Price of Natural Gas Futures, July 25, 2007.

72 *See* Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013) (proposed rule).

73 Improving Regulation and Regulatory Review, Exec. Order 13563, Section 1, 76 Fed. Reg. 3821 (Jan. 21, 2011) (emphasis added) ("Executive Order"). Because the SEC is an independent agency under 44 U.S.C. § 3502(b)(5), the Executive Order does not expressly apply to it. Executive Order 13579, however, provides that independent regulatory agencies such as the Commission should comply with the provisions of the Executive Order to the extent permitted by law. 76 Fed. Reg. 41587 (Jul. 14, 2011). In this regard, then Commission Chairman Mary L. Schapiro testified that the Commission's staff guidance in regard to cost benefit analysis draws on, among other things, the Executive Order. Chairman Mary L. Schapiro, Testimony concerning economic analysis in SEC rulemaking, before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee, U.S. House of Representatives, April. 17, 2012.

Order recognizes that "[s]ome sectors and industries face a significant number of regulatory requirements, some of which may be redundant, inconsistent, or overlapping."[74]

Early in the Proposing Release as a central justification for the Commission's new approach to the regulatory framework applicable to funds' use of derivatives, the Commission describes a hypothetical scenario involving a fund's use of derivatives that—as a result of the Dodd-Frank Act reforms—will become the narrow exception to the rule. The scenario the Commission contemplates is one in which a fund does not segregate any assets for a derivatives trade. The Commission states that this situation may arise "because the derivative is in a gain position, or because the derivative has a market value of zero (as will generally be the case at the inception of the transaction."[75] The Commission concludes that there is no limitation on the fund's derivatives trading in this mark-to-market segregation approach scenario because no assets are segregated.[76] However, a scenario where a fund is not limited *at all* in its derivatives trades even where those trades have a value of zero or are in-the-money is largely a relic of the past because of initial margin requirements.

Exchange-traded derivatives have always been subject to initial margin requirements, and Dodd-Frank Act reforms are in the process of pushing most swaps trading onto exchanges were the swaps will be centrally-cleared and subject to initial margin requirements. As the Commission notes in the Proposing Release, if Commission rules are implemented as proposed, all Commission-regulated uncleared security-based swaps will eventually be subject to minimum margin requirements, and other uncleared swaps above certain trading thresholds will also be subject to minimum margin requirements.[77] So, even where no assets must be segregated or variation margin posted for a trade, these initial margin rules will generally limit a fund's ability to obtain exposures through derivatives trading. These other Dodd-Frank Act reforms potentially already limit or will limit risk taking in registered funds as well as with regard to other market participants, undercutting some of the Commission's justification for its rulemaking and potentially making the proposed Derivatives Restrictions duplicative in parts.

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74 Executive Order, Section 3.

75 Proposing Release at 80894 (internal citations omitted).

76 *Id*.

77 *Id.* at 80931 n.363. In early 2016, the International Swaps and Derivatives Association estimated that $86 trillion of the $700 trillion gross notional value of the total swaps market will not be able to be cleared. *See* Philip Stafford, *Risky Derivatives Trades Face Higher Costs*, FIN. TIMES, Feb. 4, 2016. That means that only approximately 12% of the worldwide swaps market will remain uncleared, and of this section of the market, only a further sub-set of trades will not be subject to any initial margin requirements.

In addition, in February 2012, the CFTC adopted rule changes that subject advisers to registered funds that exceed certain commodity interest trading thresholds to registration as commodity pool operators ("CPOs") and operation of relevant registered funds under CFTC jurisdiction.[78] Given the level where the thresholds were set,[79] many registered funds that would be subject to the need to make portfolio and other operational changes to their business in response to the proposed rule are already dually-regulated by the CFTC and the Commission.[80]

The Commission proposal does not acknowledge the additional dual regulation already in place with regard to the funds it anticipates will be affected by the proposal, and any potential efficiencies that can be achieved. The following is an example. Where funds trade commodity interests above a certain threshold and thus must be operated by a registered CPO, that registered CPO must report extensive information regarding the operation and portfolio of that fund to the CFTC and NFA[81] on CFTC Form CPO-PQR and/or NFA Form PQR on an effectively quarterly basis. We understand based on discussions with registered CPOs that NFA staff members regularly follow-up with questions regarding their CFTC Form CPO-PQR and NFA Form PQR filings. This activity indicates that the NFA is using data it collects in these filings such as pool monthly rates of return

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[78] Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations. 77 Fed. Reg. 11252 (Feb. 24, 2012) (final rule).

[79] Under CFTC Rule 4.5(c)(iii), in order for a fund adviser to claim an exclusion from CFTC regulation for a registered investment company, the adviser must operate such registered investment company so as to limit use of commodity futures or commodity options contracts, or swaps ("commodity interests") such that trading meets one of the two following alternative tests: (1) the aggregate initial margins and premiums required to establish such positions, determined at the time the most recent position was established, will not exceed five percent of the liquidation value of the Fund's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into (excluding in-the-money amounts of an option that is in-the-money at the time of purchase); <u>or</u> (2) the aggregate net notional value of the commodity interest positions determined at the time the most recent position was established, will not exceed 100 percent of the liquidation value of the Fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. The "commodity interest" trading that may subject a CPO to CFTC registration encompasses much, but not all, possible trading that the Commission would consider to be derivatives that potentially create a senior security.

[80] In its 2015 annual report, the National Futures Association ("NFA") reported that as a result of recent regulatory changes, CPO membership has increased by approximately 600 firms, and the number of regulated pools rose from 1900 to more than 5000. Some of these were private funds, but many were registered investment companies. NFA 2015 Annual Review (Nov. 19, 2015) at page 4.

[81] The NFA is the self-regulatory organization of the U.S. derivatives trading industry. The CFTC has delegated to the NFA many of its registration and compliance functions. CPOs register through a process that the NFA administers, and registered CPOs are subject to NFA onsite audits.

and the schedule of pool investments to oversee in a substantive manner pools for which CPOs must be registered.[82] This information is very similar to the information private funds provide the Commission on Form PF. In addition, the CFTC has always gathered data from large futures traders on CFTC Form 40, and recently began collecting information about swaps trading on CFTC Form 40S.[83] The Commission proposal fails to recognize these tools for reviewing a significant number of heavy commodity interest-user registered investment company portfolios that are already in place, the cost of compliance, and any efficiencies the Commission may be able to leverage from the regulation and reporting already in place.

Furthermore, the Commission proposal does not acknowledge the existence of the CFTC-SEC Joint Advisory Committee. In establishing the CFTC-SEC Joint Advisory Committee,[84] the CFTC and the Commission have already put in place the infrastructure to coordinate on addressing matters of joint interest such as addressing the May 6, 2010 "flash crash."[85] The CFTC and Commission have

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82 CFTC Rule 4.27; Appendix A to the CFTC Part 4 rules; NFA Compliance Rule 2-46. Note that certain questions that the DERA Report was unable to answer regarding registered funds' use of derivatives because of the limitations of the information collected in, for example, Form N-CSR and N-SAR are directly addressed in information reported on Form CPO-PQR. For example, the DERA states that 77% of mutual funds disclose that they can invest in options; however the DERA Report was not necessarily able to determine what sub-set of those funds are writing options—which potentially involves a future payment obligation—and which funds only purchase options—which only entails the possible loss of premium. The DERA Report notes that the shortcoming in the data is because Form N-SAR "does not distinguish between written and purchased options." DERA Report at 2 n.8. *Cf*. Form CPO-PQR Schedule B, Question 6 that asks for separate reporting of both the long and short value of options positions a reporting pool held on the reporting date.

83 CFTC Rule 18.04; Appendix A to the CFTC Part 18 rules.

84 "The committee's objectives and scope of activities shall be to conduct public meetings, to submit reports and recommendations to the CFTC and the SEC and otherwise to serve as a vehicle for discussion and communication on regulatory issues of mutual concern and their effect on the CFTC's and SEC's statutory responsibilities. Subjects to be addressed by the committee shall include…the agencies' efforts on regulatory harmonization. The committee shall work…to recommend processes and procedures for achieving and reporting on those goals." Charter of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, Objectives and Scope of Activities, *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/cftc-sec-joint_charter.pdf.

85 Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, Findings Regarding the Market Events of May 6, 2010 (Sept. 30, 2010), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

reported cooperating on issuing joint rulemakings in the past.[86] With regard to this rulemaking, the CFTC could share information it has obtained through various reports such as CFTC Form CPO-PQR. However, to date we are not aware that the CFTC and the Commission are consulting formally on this proposed rulemaking, and the release does not mention any coordination. The issues should be explored with a joint study given that the CFTC and Commission regulate most, if not all, of the universe of derivatives funds may trade, and as noted above, both regulate many registered funds that will be most affected by the rulemaking. This study could be spearheaded by the CFTC-SEC Joint Advisory Committee.

5. The CBA Relies on Unsupported Claims of Potential Derivatives-Triggered Harm to Financial Stability

The CBA speculates that the hypothetical distress or liquidation of a fund related to "extreme fund losses" from derivatives transactions could result in forced asset sales in stressed market conditions.[87] This appears to be an effort to suggest that derivative activities of funds pose some type of systemic threat to financial stability due to the potential for a spillover effect to a range of capital market participants.

Here, again, to rely on a benefit derived from the mitigation of this purported risk, we would expect that the Commission would provide strong empirical evidence backing such a claim. Yet, the CBA does not provide any type of empirical analysis of the circumstances that would actually result in a fire sale scenario that would threaten financial stability. The hypothesis appears to rely on the possibility that sales of assets by a single fund in response to derivatives-related pressures could be so significant that they would cause a destabilization of one or more categories of assets and certain market participants. This raises a range of issues regarding hypothetical volume and timing of such sales, the types of assets that would be involved, the types of markets in which the assets trade and the likely posture and reactions of other market participants.

Market participants buy and sell assets for a range of reasons on an ongoing basis. At any given time when a fund might hypothetically be engaged in derivatives related asset sales there could be innumerable factors that may result in an increase or decrease in the value of a particular asset or category of assets. The CBA does not provide any basis to show that of all the various independent purchase and sale transactions there should be an assumption that derivatives related sales by a fund would have a disruptive effect on particular assets, markets or market participants.

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[86] Under the Dodd-Frank Act, the two agencies are directed to engage in a number of joint rulemakings.

[87] Proposing Release at 80963.

The CBA acknowledges that absence of a foundation for its speculation regarding potential financial stability effects. It states:

> While we *lack empirical evidence* that [a] registered fund's liquidation under stressed market conditions, including the potential forced sale of assets, could have adverse effects on market participants, we believe that the avoidance of potential negative externalities from a fund's liquidation into a stressed market broadly promotes market resiliency and stability.[88]

This type of unsupported speculation does not establish benefits that can be validly used to underpin a CBA justifying the Derivatives Restrictions. It simply fails to meet the Commission's own rigorous standards for empirical evaluation and weighing of costs and benefits associated with a Commission rulemaking under the 1940 Act set forth in guidance provided by the Commission's Office of General Counsel and Division of Risk, Strategy, and Financial Innovation ("RSFI") in a memorandum regarding economic analysis in Commission rulemaking ("Cost-Benefit Memorandum").[89]

6. The CBA Fails to Provide Any Empirical Analysis of the Purported Benefits of the Proposed Rule

A critical purpose of the CBA requirement under the 1940 Act is to ensure that the Commission conducts a careful evaluation of the benefits and costs, including an adverse impact on capital formation arising from reduced access to the capital markets of its regulatory actions. Given the overall size of the mutual fund sector, regulatory action that could make it harder for emerging and mid-sized businesses to access funding that they need to compete and grow should be a matter of great consequence to the Commission. The CBA states that the Commission has attempted to quantify the costs, benefits and effects of the proposed rule where possible.[90] It goes on to state that, in many cases, the Commission is unable to quantify the economic effects because it lacks the information necessary to provide a reasonable estimate.

The CBA does not provide any empirical evaluation analysis of the purported benefits of the Derivatives Restrictions. Nor does it explain why it does not do so.

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88 *Id*. n.563 (emphasis added).

89 *See* Memorandum to Staff of the Rulemaking Divisions and Offices from the Office of General Counsel and the Division of Risk, Strategy, and Financial Innovation regarding Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012).

90 Proposing Release at 80957.

This approach is not in accordance with nor is it an adequate discharge of the Commission's obligations under the 1940 Act to consider whether a rulemaking promotes efficiency, competition and capital formation.[91] Moreover, it is not consistent with the guidance provided in the Cost-Benefit Memorandum.

The Cost-Benefit Memorandum directs that the Commission's rulemaking staff should work with economists to, among other things, quantify expected benefits and costs to the extent possible.[92] The Cost-Benefit Memorandum explains that even without hard data, quantification may be possible by making and explaining certain assumptions.[93]

The Memorandum further notes that:

> Court decisions addressing the economic analysis in Commission rules have likewise stressed the need to attempt to quantify anticipated costs and benefits, *even where the available data is imperfect and where doing so may require using estimates (including ranges of potential impact) and extrapolating from analogous situations*.[94]

The CBA makes no effort to undertake such quantification with respect to the two purported benefits it relies on to justify the Derivatives Restrictions. This leaves open a number of questions: Would a rigorous empirical analysis have supported an argument that the impact of imposing the Derivatives Restrictions would been to have a material positive impact on promoting capital formation? Would a rigorous empirical analysis have supported the CBA's risk reduction argument? How would such an analysis have addressed the fact that mandating the reduced use of derivatives by funds would likely have both the impact of reducing losses in some cases and reducing gains in other cases?

The CBA does not explain why it eschews these or any other forms of empirical analysis that could support its two claims of benefits purportedly arising from the Derivatives Restrictions.

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91 15 U.S.C. § 80a-2(c).

92 Cost-Benefit Memorandum at 9.

93 *Id*. at 12.

94 *Id*. at 13 (emphasis added).

B. There Are Significant Deficiencies in CBA's Discussion of Costs Related to the Derivatives Restrictions

1. The CBA Fails to Provide an Empirical Analysis of the Costs to Investors That Would Be Imposed by the Derivatives Restrictions

In its discussion of potential costs of the Derivatives Restrictions, the CBA states that:

> Because we do not know to what extent the current regulatory framework for derivatives may been influencing funds' use of derivatives . . . we do not know to what extent funds would change existing positions. Accordingly, we cannot quantify this potential effect.[95]

The CBA goes on to discuss a range of potential actions funds with varying degrees of exposure to the proposed Derivatives Restrictions might take if the restrictions are adopted and how these actions could impact fund performance and operations. While the Commission appears to be well equipped to discuss these potential scenarios, it makes no effort to quantify the likely impact they would have on funds and their investors.

This approach plainly ignores the direction given by the Memorandum. The Memorandum recognizes the imperative for the Commission to make good faith assumptions and model the likely impact of such assumptions. Simply declining to do so does not satisfy the Commission's obligations under the 1940 Act.

The practical impact of the Derivative Restrictions, if adopted, is likely to go far beyond funds that are large users of derivatives to a much broader range of funds, as the Commission has acknowledged:

> There is also substantial variability in how any given fund may react to the proposed rule, if adopted, and how the market may react in turn. A fund that uses a moderate amount of derivatives may increase or decrease its derivatives usage, or shift within types of derivatives . . . A fund may alter its investment strategy in order to comply with one of the proposed rule's portfolio exposure limitations by reducing use of derivatives and not substituting other instruments to achieve

95 Proposing Release at 80959.

> equivalent exposures. To the extent that a fund alters its investment strategy, this change may represent an opportunity cost to investors.[96]

However, most striking is the CBA's treatment of the costs associated with the impact of the Derivatives Restrictions on funds that use derivatives extensively. The Commission acknowledges that some of these funds may be put out of business by the Derivatives Restrictions as they will have to deregister and liquidate, or the adviser may merge the fund into another fund or offer the fund's strategy as a private fund or a commodity pool.[97] As to such funds the Commission does provide empirical estimates of the costs associated with each of these options.

In this context, a key implication of the Derivatives Restrictions for efficiency, competition and capital formation are the fact that investors and potential investors will be deprived of currently available fund option. Declaring a legal fund option to be prohibited is a serious action. As discussed above, we do not believe that this is within the authority of the Commission.

To the extent that the Commission nevertheless decides to pursue such a course of action, it is essential that it undertake empirical evaluation of the costs to efficiency, competition and capital formation that would be associated with the implementation of the Derivatives Restrictions.

This would call for empirical analysis of, among other things, (i) the potential adverse impact on efficiency in fund operations of the reduction in the availability of derivatives as a means of executing fund strategies, (ii) the potential adverse impact on competition as the Derivatives Restriction reduces the range of investment strategies available to investors, and (iii) the potential adverse impact on capital formation as funds are required or motivated to reduce their use of derivatives.

2. Adverse Effect on Investor Choice

Investors are commonly advised to have exposure to commodity interests in their portfolio for diversification purposes. The benefits of diversifying stock and bond portfolios with physical commodity investments have been widely recognized.[98] Financial research has shown that the risk/return performance of a portfolio can be improved by acquiring uncorrelated or negatively correlated assets, and physical commodity exposure can generally perform that role in a portfolio

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96 *Id*. at 80957.

97 *Id*. at 80961.

98 *See, e.g.*, Risk Management Exemption from Federal Speculative Position Limits, 72 Fed. Reg. 66097-98 (proposed Nov. 27, 2007).

of other financial assets.[99] Many funds that use derivatives are designed to provide positive returns when the rest of an investor's equity and bond fund portfolio is declining in value.

For example, for many retail investors, mutual funds that offer physical commodity exposure are the most efficient, cost-effective, and risk-limited and may be the only accessible means of diversifying their portfolio with physical commodity exposure. In response to the demand from retail customers for physical commodity exposure, the mutual fund industry has provided investors with access to the asset class by offering funds that invest heavily in derivatives and specifically physical commodity-focused mutual funds. For retail investors, the method to achieve the closest investment exposure to commodity interests is by investment in mutual funds that invest in derivatives (*e.g.*, futures on agricultural, energy and metals futures). Exposure to movements in prices in the cash, spot markets for physical commodities is only achievable in registered funds through derivatives trading. The Commission's proposed limitations —which it acknowledges could force some registered funds to liquidate or be operated as private funds or public commodity pools[100] — could deny investors access to those markets, thus limiting investor choice and appropriate diversification opportunities. Retail investors could be denied access to products for which they have already demonstrated their demand as acknowledged in the CBA.[101]

3. Costs Borne by Shareholders

The cost of compliance with applicable law and rules for mutual funds, America's favorite collective investment vehicle, is already very high. The costs of compliance with the Commission's proposal — even with modifications — has the potential to increase costs significantly per sponsor, per fund and industry-wide. In taking any additional regulatory action, the Commission should carefully consider and account for additional costs and benefits to the U.S. investing public and the derivative trading markets. As the Commission Staff is aware from its role as the primary regulator of registered funds, mutual funds typically consider compliance costs, board costs, liquidation costs and fund-specific reporting to regulators to be fund expenses because they are undertaken to comply with requirements directly applicable to the fund. In addition, trading transaction costs such as brokerage are borne by the fund. As a result, the costs the Commission contemplates will arise with regard to compliance with its proposals or liquidation or deregistration of funds (*e.g.*, no matter how a fund reacts to the conditions the Commission is imposing) will be borne by shareholders

99 *See, e.g.*, *id*.

100 Proposing Release at 80957.

101 Although the Commission's proposal seems focused on alternative funds, we note that the Investment Company Institute's ("ICI") comment letter to the Commission on this rulemaking identifies other categories of funds that will be potentially severely adversely affected. We urge the Commission to study the ICI data.

rather than being covered by the sponsor or adviser. Investors will disproportionally and inappropriately bear the costs of the Commission's new "protections" to the mutual fund regulatory regime, enhancements for which there is no evidence investors need. The Commission needs to balance the impact of additional expenses—which tend to compound themselves over time—on shareholder returns—less returns for retirement, college or other savings goals—against any added benefit to be derived from any new regulatory requirements.

Where the Commission has discussed costs and benefits for the industry, some of those benefits do not necessarily result in capital formation, but simply entail an income redistribution among market participants and service providers. For example, the Commission notes that where funds might need to use third-party information providers to help the funds comply with the proposed portfolio limitations, that that demand for third-party services "could potentially affect those third-party providers as well" suggesting that the new portfolio limitation requirement could underwrite the businesses of certain market participants.[102] Stepping back from the Commission's catalog of costs and benefits of the proposal, it is worth considering whether the entities the Commission has concluded will benefit from the rulemaking are really the entities the industry and its primary regulator ought to be favoring with regulation. It bears keeping in mind that retail investors saving for retirement, college and other savings goals will be financing such Commission-identified benefits to any third-party consultants.

C. The Proposed Rule Is Subject to Challenge as Not Being Necessary or Appropriate as Required Under Sections 6(c) and 38(a) of the 1940 Act

In order for a regulation issued by the Commission to be authorized under the 1940 Act, it must be necessary or appropriate to the exercise of the Commission's powers granted therein.[103] In addition, any rulemaking pursuant to the Commission's exemptive authority under Section 6(c) of the 1940 Act must be necessary or appropriate in the public interest.[104] As discussed in more detail above, the discussion of the proposed rule's quantifiable benefits and costs in the proposing release fails to support a contention that the proposed rule would provide meaningful benefits to investors, while imposing a range of financial costs and lost opportunities on investors. Funds, along with the Commission, have been operating under a less restrictive approach for an extended period of time with no material adverse effects.

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[102] Proposing Release at 80965.

[103] 15 U.S.C. § 80a-38(a).

[104] 15 U.S.C. § 80a-6(c).

The Supreme Court has recently ruled that the balance of costs and benefits must be considered in whether an agency's authority to issue a regulation is subject to an appropriate and necessary standard. In that regard, the Supreme Court stated that no regulation is "appropriate" if it does significantly more harm than good.[105] As discussed above, we do not believe that the CBA supports the purported benefits on which the Derivatives Restrictions rely. At the same time a consequence of the Derivatives Restrictions, should they be finalized in their current form, would be the significant limitation of investment opportunities for funds and their investors, with the strong possibility of forcing certain funds to liquidate. Accordingly, the imposition of a new comprehensive and restrictive regime, as is contemplated under the proposed rule, would be viewed as being neither necessary nor appropriate.

VI. COMMENTS ON AMENDMENTS TO FORM N-CEN

A. Funds Should Identify the Applicable Portfolio Limitation on Form N-CEN and Funds Should Not Be Required to Include Such Information in Any Other Medium

The Proposing Release proposes to amend Item 31 of Part C of the proposed Form N-CEN[106] to require funds to identify on Form N-CEN the portfolio limitation under Rule 18f-4 on which the fund relied during the reporting period. If the Commission adopts the portfolio limitations, we support this requirement as we believe such disclosure would aid the Commission in understanding funds' use of derivatives, and assist the Commission in monitoring compliance with Rule 18f-4, while imposing minimal additional costs on the funds that make such filings.

However, we do not believe that such information should be included in a fund's statement of additional information or other primarily investor-facing disclosure. Such information would be of little to no practical use or interest to an investor and therefore may only serve to confuse an investor's understanding of a fund and its holdings. We believe that the primary beneficiary of such data collection would be the Commission, which is best positioned to make use of the additional disclosure.

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105 *Michigan* v. *E.P.A.*, 135 S.Ct. 2699 (2015).

106 *See* Investment Company Reporting Modernization Release.

VII. TRANSITION AND COMPLIANCE PERIOD COMMENTS

A. An Additional Compliance Period Should Be Provided for the Proposed Amendments to Forms N-PORT and N-CEN

As discussed in Section IV.C. above, we believe, first and foremost, that the Commission should postpone any adoption of a portfolio limitation requirement until after first adopting changes to the asset segregation and board requirements and then, only after taking time to consider the information gathered from submissions of new Form N-PORT, continue considering adopting a portfolio limitation requirement. Therefore, we believe that Form N-PORT must be adopted prior to the reexamination of the necessity of a portfolio limitation requirement. However, should the Commission choose to adopt the portfolio limitation substantially as proposed, we believe that an additional compliance period should be provided for implementation of the proposed amendments to Forms N-PORT and N-CEN.

The Proposing Release for Forms N-PORT and N-CEN proposed two sets of compliance deadlines: for Form N-PORT, a "tiered" set of compliance dates based on the asset size of the filer, ranging from 18–30 months following the effective date, and for Form N-CEN, 18 months from the effective date, regardless of filer size.[107] We believe that, given the scope of obligations proposed under both the new Forms N-PORT and N-CEN and those under Rule 18f-4, the periods of time allotted by the Proposing Release for Forms N-PORT and N-CEN would be insufficient.

We believe, based on the compounded burden of compliance with both Rule 18f-4 and Forms N-PORT and N-CEN, the Commission must grant additional time for compliance. Especially in instances where a fund must adopt a derivatives risk management program or is forced to change its strategies or procedures under Rule 18f-4, the compounded burdens of compliance may be particularly acute. Accordingly, we believe that any additional compliance period for the Forms N-PORT and N-CEN should be granted according to the timeline adopted with respect to the transition period for compliance with Rule 18f-4 generally. In addition, unless the Commission takes the two-step approach suggested in Section IV.C, we believe that any such compliance period adopted should be subsequent to the transition period for compliance with Rule 18f-4, as discussed in Section VII.B. below.

We would recommend the adoption of additional compliance time to afford funds time to adapt their compliance frameworks to the updated proposed requirements of Forms N-PORT and N-CEN.

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107 *Id.* at 33653-54.

We believe such additional time is necessary to ensure filings will be done accurately and in compliance with all newly-proposed regulations.

B. A Transition Period for Compliance with New Rule 18f-4 Is Both Appropriate and Necessary, Should Not Be Tiered By Size of Fund, and Should Extend for the Maximum Proposed Time of 30 Months

We are strongly in favor of the adoption of a transition period for compliance with Rule 18f-4. Further, given the size, intricacies, and technicality of the proposed Rule 18f-4, we recommend the Commission permit all funds, regardless of size, to have at least the 30 month compliance time period proposed for smaller funds.

We note that many funds may be required to make significant changes to their investment policies, portfolio makeup, investing or risk management strategies, and operational and compliance systems to conform with the requirements of proposed Rule 18f-4. Such changes may require: (i) designing entirely new investing or risk management strategies; (ii) in some cases obtaining board or shareholder approval of these strategies; (iii) creating new operational or compliance systems to implement any new policies or strategies; and (iv) revising a fund's disclosure documents in accordance with all such changes. In particular, we believe the challenges of implementing necessary operational programs will be significant, and that, when coupled with the possible requirement of significant Board consideration and action, compliance with the proposed Rule 18f-4 will require a substantial period of time.

Equally important, the costs and complexity of compliance with Rule 18f-4 for a given fund may be uncorrelated with that fund's size or other simple or readily discernable metrics. Therefore, we believe that, given the sum total burden of compliance, the 30-month compliance time period proposed for smaller funds should be extended to all funds, regardless of size.

C. The Only Appropriate Timing for the Rescission of Release 10666 and the Staff's No-Action Letters is Simultaneous with the Close of the Transition Period

The Proposing Release proposes to allow a fund to rely on Rule 18f-4 after its effective date as soon as the fund is able to comply with the Rule's conditions. In addition, the Proposing Release proposes to rescind Release 10666 and the Staff's no-action letters addressing derivatives and financial commitment transactions. However, it would also allow funds to continue to rely on Release 10666 and related Staff guidance during the transition period or until a fund is able to rely on Rule 18f-4. We agree with each of these components of the Proposing Release. We also believe it is important that funds be able to rely on 10666 and related SEC Staff no-action letters and guidance until the end of the transition period or until they are able to comply with Rule 18f-4.

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We appreciate the opportunity to comment on the Proposing Release. Please feel free to contact Julien Bourgeois at [redacted], Brendan C. Fox at [redacted], David J. Harris at [redacted], Philip T. Hinkle at [redacted], Megan C. Johnson at [redacted], Matthew K. Kerfoot at [redacted], Robert H. Ledig at [redacted], Mark D. Perlow at [redacted] or Audrey Wagner at ([redacted] with any questions about this submission.

Very truly yours,

/s/ Dechert LLP

Dechert LLP