

PIMCO

Via Electronic Submission

March 28, 2016

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

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

Dear Secretary Fields:

Pacific Investment Management Company LLC ("PIMCO") appreciates the opportunity to respond to the U.S. Securities and Exchange Commission's ("SEC" or "Commission") proposed Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), regarding the use of derivatives by registered investment companies and business development companies ("funds").¹ Although PIMCO supports the Commission in its efforts to protect investors and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives, we believe that the proposal goes beyond what is necessary to protect investors, and imposes new restrictions on funds without any demonstrated benefit to investors.

PIMCO is registered as an investment adviser with the SEC and as a commodity trading advisor and a commodity pool operator with the U.S. Commodity Futures Trading Commission ("CFTC"). As of December 31, 2015, PIMCO managed approximately \$1.43 trillion in assets on behalf of millions of individuals and thousands of institutions in the United States and globally, including state retirement plans, unions, university endowments, corporate defined contribution and defined benefit plans, and pension plans for teachers, firefighters and other government employees. As of December 31, 2015, PIMCO managed 182 funds that were registered under the 1940 Act, with total assets of approximately \$364 billion. PIMCO manages both separately managed accounts in accordance with specific investment guidelines and objectives specified by our clients, and both private and public funds that are offered to institutional and individual investors. In the case of all of these management services, PIMCO is engaged in long-term investment management of our clients' assets as a fiduciary.

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¹ Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31,933, 80 Fed. Reg. 80,883 (proposed Dec. 28, 2015) (to be codified at 17 C.F.R. pts. 270, 274) [hereinafter Proposing Release].

PIMCO is a leading provider of investment management services to fixed income funds, and employs a broad range of portfolio management tools in seeking to control risk, reduce risk exposures, and seek returns consistent with a fund's investment objective. Derivatives are an important tool in the management of fixed income portfolios, and are used for various purposes, including: (i) as a higher returning substitute for comparable physical securities (in combination with segregated assets on the position); (ii) for reducing portfolio risk (*e.g.* decreasing portfolio duration, buying credit protection, and reducing currency exposure); (iii) to manage duration and curve exposure more precisely; (iv) to gain exposures that may not be possible through physical instruments; and (v) to put cash to work and to maintain exposures during periods of redemptions. PIMCO also offers a line of "enhanced index" funds, which seek benchmark returns through the use of derivatives (such as S&P 500 futures contracts), and seek alpha in an unrelated asset class (*i.e.* fixed income).

If the Proposed Rule is adopted in its current form, PIMCO's use of derivatives in many funds it manages would be limited, resulting in less liquidity, less efficient management of the funds, potential increased transaction costs, and potentially lower returns for investors in the funds. Many derivatives are among the most liquid instruments available in the market. Given the Commission's focus on liquidity in funds², it seems counterintuitive to propose a rule that could limit funds' use of instruments that have proven useful in managing liquidity. Indeed, PIMCO believes that the Commission should carefully consider how these two proposals may have unintended consequences relative to the Commission's policy objectives.

I. Executive Summary

PIMCO generally supports the Commission's efforts to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and agrees with many of the provisions of the Proposed Rule. However, we wish to offer several recommendations that would reduce the negative impact to fund investors, while still addressing the Commission's goal of protecting investors. Each of these recommendations is summarized below, and addressed in greater detail further in this letter.

- *The Commission should not adopt the proposed portfolio limitations at this time.* The Commission should not include the portfolio limitations in the final rule, but rather should finalize and implement the other provisions of the Proposed Rule, as well as the Investment Company Reporting Modernization Proposal³ and the Liquidity Proposal. The Commission could then assess the need for further limitations on funds' use of derivatives based upon empirical data and, if the Commission determines that there is a need for further limitations, they could be narrowly tailored to address the regulatory objective.
- *If the Commission determines to adopt the proposed portfolio limitations, it should modify the proposal in certain respects, including:*
 - *The notional amount of certain types of derivatives should be risk-adjusted for*

² See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization, Investment Company Act Release No. 31,835, 80 Fed. Reg. 62,274 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. pts. 210, 270, 274) [hereinafter Liquidity Proposal].

³ See Investment Company Reporting Modernization, Investment Company Act Release No. 31,610, 80 Fed. Reg. 33,590 (June 12, 2015) [hereinafter Investment Company Reporting Modernization Proposal].

purposes of these limitations. Notional amount is not a risk measure. This is particularly the case for fixed income derivatives and for bespoke derivatives. The Proposed Rule incorrectly treats derivatives with very different risk characteristics equally. With regard to fixed income derivatives, the Commission should adopt a risk-adjustment methodology that measures the true risk impact, such as a duration-weighted adjustment to the notional amount, so that the risk-adjusted notional amount is reflective of the risk of a particular derivatives transaction.

- *The notional amount of currency derivatives that reduce the currency exposure of a portfolio security should be excluded.* Funds should be permitted to exclude from the portfolio limitations any currency derivatives that reduce the currency exposure resulting from a non-US dollar-denominated security held by the fund, on a currency by currency basis. Only derivatives resulting in “excess currency” (*i.e.* currency exposure that does not reduce the currency exposures from a security held by the fund) should be included in the portfolio limitation.
- *Funds should be permitted to switch between reliance on the “exposure-based portfolio limit” and the “risk-based portfolio limit” without prior approval of the fund’s board.* Rapidly changing market conditions could make it difficult to obtain board approval in advance if it is necessary to change from reliance on the exposure-based portfolio limit to the risk-based portfolio limit (or vice versa). This information will be reported to the fund’s board in any event, and will be reported in the fund’s public filings.
- *The proposed value-at-risk (“VaR”) test for reliance on the risk-based portfolio limit should be revised.* For funds with stated benchmarks, the benchmark risk exposures should be deemed market neutral. Hence, the VaR test that is required in order for a fund to rely upon the higher risk-based portfolio limit should be modified to measure VaR relative to the fund’s benchmark. This would limit funds from leveraging relative to their benchmark, while allowing greater flexibility to use derivatives.
- *The assets available as “qualifying coverage assets” for purposes of the segregated assets test should be broadened.* The assets available for cover should be broader than cash and cash equivalents to prevent funds from having a “cash drag” on performance. The Commission can achieve its goals of ensuring that funds have adequate assets to meet their liabilities without limiting the assets available for cover in such a way. In addition, assets that are acceptable as margin should be acceptable as cover assets, subject to appropriate haircuts.

II. The Commission Should Not Adopt the Proposed Portfolio Limitations

The Commission should not adopt the proposed portfolio limitations at this time because there is no indication that these limitations are necessary, the Commission does not have reliable data to assess the impact of these limitations, and the existing regulatory framework is adequate. Although PIMCO appreciates the Commission’s concerns that a fund’s investors could be harmed if the fund’s issuance of senior securities “increase[s] unduly the speculative character”⁴

⁴ See Proposing Release, 80 Fed. Reg. at 80,890.

of securities issued to common shareholders, we believe that the Commission's existing regulatory framework, has worked well over an extended period of time, and the other proposed modifications included in the Proposed Rule⁵ will enhance this regulatory framework and provide the Commission with additional information regarding funds' use of derivatives. Therefore, there is no need to include the proposed portfolio limitations in the final rule.

The Proposed Rule will require funds that engage in more than a limited amount of derivatives transactions, or that use complex derivatives transactions, to develop a formal derivatives risk management program, subject to the oversight of the fund's board and administered by a designated derivatives risk manager, which would need to be reasonably designed to assess and manage the particular risks presented by the fund's use of derivatives.⁶ In addition, the Proposed Rule enhances the current asset segregation requirements by increasing the amount required to be segregated and by placing further limitations on the types of assets that may be available as cover.⁷ These two provisions of the Proposed Rule will increase the amount of coverage required, and limit the assets available to satisfy the coverage requirement, which will have the effect of constraining a fund's ability to leverage. Finally, the Proposed Rule requires funds to comply with additional recordkeeping and reporting requirements with respect to their use of derivatives, which will provide the Commission with additional data to monitor the use of derivatives by funds, and to better understand the impact of such use on the fund's volatility.⁸

We also believe that the Commission's estimate of the impact of the portfolio limitations, which is based upon a white paper prepared by the Commission's Division of Economic and Risk Analysis ("DERA"), significantly underestimates the number of funds that would be impacted, and fails to correctly recognize the types of funds that would be impacted.⁹ For example, the white paper acknowledges that "Taxable Bond funds" represent only approximately 17% of the industry's assets under management.¹⁰ The white paper also noted difficulties in collecting reliable data for the analysis, and, as a result, the white paper concluded that fewer than 1% of "Traditional Mutual Funds," and no "Closed-End Funds," the two main categories in which taxable bond funds would be classified, exceeded the 150% exposure based portfolio limit.¹¹ We believe that the white paper significantly understates the use of derivatives by mainstream fixed income funds, and that many of these funds would be required to reduce their use of derivatives, and potentially increase volatility and liquidity risk, if the Proposed Rule

⁵ Although we generally agree with the many of the provisions of the Proposed Rule, we do recommend expanding the types of assets that would be available as "qualifying coverage assets." See Proposing Release, 80 Fed. Reg. at 80,932-33.

⁶ *Id.* at 80,935.

⁷ Although we recommend a change to the Proposed Rule with respect to the assets available as "qualifying coverage assets," we are supportive of a narrowing of the assets available for coverage from the current standard of all liquid assets.

⁸ See Proposing Rule, 80 Fed. Reg. at 80,950, 80,952. These proposed reporting requirements are in addition to those proposed in a prior Commission proposal, which has yet to be adopted. See Investment Company Reporting Modernization Proposal. Commissioner Piwowar noted in his dissenting statement at the open meeting at which the Proposed Rule was approved, that he believes that the Commission should first adopt the Investment Company Modernization Proposal, analyze the data received, and determine whether there is a need for further limits on a fund's use of derivatives. We concur with Commissioner Piwowar's view. See Michael S. Piwowar, Commissioner, SEC, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015), <https://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html>.

⁹ See Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (Dec. 2015) [hereinafter DERA White Paper], <http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf>.

¹⁰ DERA White Paper, *supra* note 9, at 6.

¹¹ DERA White Paper, *supra* note 9, at 15.

is adopted as proposed.

We believe that the Commission should not include the portfolio limitations in the final rule, but rather should finalize and implement the other provisions of the Proposed Rule, as well as the Investment Company Reporting Modernization Proposal and the Liquidity Proposal. The Commission could then assess the need for further limitations on funds' use of derivatives based upon empirical data and, if the Commission determines that there is a need for further limitations, they could be narrowly tailored to address the regulatory objective.

III. If the Commission Includes the Portfolio Limitations in the Final Rule, It Should Modify Certain Requirements of the Tests

A. The Notional Amount of Derivatives Should Be Risk-Adjusted for Purposes of the Portfolio Limitations

The portfolio limitations should be modified to adjust the notional amount of derivatives transactions based upon the risk of the underlying reference asset. Notional amount is not a measure of the underlying risk of the derivatives contract, but rather the basis for determining the amounts payable under a derivatives contract.¹² The risk of the derivatives contract is primarily dependent upon the risk of the underlying asset. As a result, two different derivatives with the same notional amount can have very different risk profiles. For example, a Eurodollar future contract has minimal price volatility since it represents minimal interest rate risk due to its short maturity (*e.g.* 3 months), while a 30 year swap contract has much greater price volatility because it represents interest rate exposure for a longer time period. Under the proposed portfolio limitations, these two derivatives would have equal weighting if they had the same notional amount.

We believe that the use of notional amount as a limitation on the use of derivatives will have a negative impact on the management of a fixed income portfolio, and will limit the ability of the portfolio manager to mitigate risk and achieve target risk levels in an efficient manner. For example, if a portfolio manager wishes to target a specific duration target, it may be very difficult to achieve by simply purchasing fixed income securities of various durations because the securities needed, and in the needed weighting to achieve the duration target, may not be available. However, the portfolio manager could achieve the specific duration target by entering into interest rate derivatives contracts, such as Eurodollar futures or interest rate swaps, to achieve the precise duration target, without significantly increasing the riskiness of the fund. However, this strategy could result in significant use of derivatives, if measured by notional amount. In this example, including the notional amount of interest rate swaps and Eurodollar futures in the 150% gross notional exposure test vastly overstates the risk exposure of these instruments in the portfolio.

The DERA White Paper acknowledges that notional amount is a sub-optimal risk measure.¹³ If notional amount is used as an indicator of risk for purposes of the portfolio limitations, it is important that the notional amount be adjusted so that risk is consistently

¹² The Commission acknowledges this fact in the Proposing Release. Proposing Release, 80 Fed. Reg. at 80,903 (“we recognize that a derivative’s notional amount does not reflect the way in which the fund uses the derivative and that the notional amount is not a risk measure.”).

¹³ DERA White Paper, *supra* note 9, at 10 (“because of differences in expected volatilities of the underlying assets, notional amounts of derivatives across different underlying asset [sic] generally do not represent the same unit of risk.”).

measured in the same units. For this reason, we recommend that the Commission risk adjust the notional amount for purposes of the portfolio limitations based upon the relative risk of the underlying asset. This would have the effect of limiting the use of derivatives that expose the fund to greater risk of loss, while not unduly limiting the use of derivatives that do not have a significant impact on the fund's volatility. This would be consistent with the Commission's goal of limiting the use of derivatives that may "increase unduly the speculative nature"¹⁴ of the fund. We recommend two possible alternatives to make this risk adjustment.

We believe that the most precise manner in which a risk adjustment could be made would be to adopt a duration-weighted adjustment based upon an appropriate reference security. Using this methodology, the notional amount of a particular derivative would be multiplied by the ratio of the derivative's duration and the duration of the reference security. This would effectively risk adjust all interest-rate sensitive securities, reflecting the reduced volatility of shorter duration securities relative to longer duration securities. We would suggest that the reference security should be a 30-year bond, which has volatility approximating the S&P 500. Asset classes that are not interest rate sensitive would be counted at their full notional amount. This approach is simple and easy to administer.

To illustrate the effect of this adjustment, Appendix A contains two examples of instruments that could be used to achieve a total duration target of 20 years. The first chart shows the notional amount of each instrument without a duration adjustment, while the second chart shows the calculation of the duration adjustment, and the duration adjusted notional amount for each instrument. As the first chart illustrates, although each of the instruments has the same interest rate risk (as measured by duration), the notional amount of the instruments varies greatly, from \$1 million for the 30 year treasury bond future to \$80 million for the Eurodollar future contract. The second chart uses a duration adjustment, using the duration of a 30 year bond equivalent (*i.e.* the 30 year treasury future) to risk adjust the notional amount of each instrument. As a result, each of the instruments has a duration-adjusted notional amount of \$1 million, which reflects the fact that each instrument has the same interest rate risk.

We believe that the correct reference security in the duration adjustment calculation is the 30 year bond equivalent because the volatility approximates the volatility of stocks and commodities, which would be included at their full notional amount in our proposal. This is illustrated in Appendix B. Appendix B shows the annualized volatility of Eurodollar futures, interest rate swaps of various terms, stocks, and commodities. As the chart illustrates, historically, a 30 year interest rate swap is slightly more volatile than commodities, but slightly less volatile than stocks. Therefore, derivatives on equities, commodities, and the 30 year bond would be included in the portfolio limitations at their full notional amount, while interest rate derivatives of shorter durations would be adjusted as described above (and as illustrated in Appendix A).

Another possible approach being proposed by industry groups, and which we support, would be to adopt a standardized schedule of risk adjustments that would be applied to various derivatives to risk adjust the notional value of derivatives held by the fund. As the Commission acknowledges, an exposure-based test based on notional amounts is a "blunt" measurement of investment risks.¹⁵ The adoption of a schedule of risk adjustments based upon various

¹⁴ See Proposing Release, 80 Fed. Reg. at 80,963.

¹⁵ *Id.* at 80,903.

underlying asset classes would appropriately weight riskier assets, while not unduly restricting the use of derivatives that may have a high notional amount while adding little risk to the portfolio. We suggest that the Commission use the standardized schedule for initial margin requirements for non-cleared swaps and non-cleared security-based swaps adopted by the Prudential Regulators¹⁶ as the basis for developing multipliers for risk-adjusting the notional amount of various derivatives. This schedule includes derivatives with various underlying asset classes, including credit, interest rates, commodities, equities, and foreign currencies. In order to develop the multipliers for the various asset classes, the asset classes with the highest percentage initial margin requirements (i.e. equities and commodities – 15%) would be included in the test at their full notional amount. All other derivatives would be adjusted, based upon the underlying asset and its initial margin requirement relative to equities and commodities, to derive a multiplier that would be applied to the notional amount of the derivative. For example, an interest rate derivative with a 0-2 year duration (which has a 1% initial margin requirement), would be adjusted so that only 6.7% (1% divided by 15%) of its notional amount would be included in the portfolio limitation calculation.

Although we support the use of a risk-adjustment schedule over no risk adjustment at all, we believe that the duration adjustment is a better method because it adjusts risk on a continuum rather than bucketing instruments with different risk characteristics together. For example, using the Prudential Regulators' initial margin schedule for uncleared swaps as the basis for a risk adjusted notional amount schedule would result in the same notional amount adjustment for all interest rate swaps with a term of 5 years or more. Using a duration-weighted adjustment would account for the particular interest rate risk of each term, and would adjust notional amount accordingly. Also, using a duration adjustment eliminates the requirement to maintain a risk-adjustment schedule.¹⁷

B. Other Recommended Changes to the Portfolio Limitations

We also recommend additional changes to the weighting of certain derivatives in the portfolio limitations, changes in the treatment of certain financial commitment transactions, and a change to the provision of the Proposed Rule relating to changing reliance on the exposure-based and risk-based portfolio limitations.

Excess Currency. We recommend that foreign currency derivatives only be included in the portfolio limitations to the extent that such derivatives result in “excess currency” exposure.¹⁸ Excess currency refers to currency derivatives that exceed the notional amount

¹⁶ The Prudential Regulators are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

¹⁷ We note that although the DERA White Paper states that it is market convention to divide the notional amount of Eurodollar futures by four, and makes this adjustment to the notional amount in conducting its analysis, DERA White Paper, *supra* note 9, at 11, the Proposed Rule does not include this adjustment (although the Commission seeks comment on this issue). Therefore, the Commission's reliance on the DERA White Paper to assess the impact of the Proposed Rule is flawed. We note, however, that if the Commission adopts a duration-weighted adjustment, there is no need to divide the notional amount of Eurodollar futures by four because the duration-adjustment itself takes into account the .25 year duration of these contracts. In the event that the Commission does not adopt a duration-weighted notional adjustment, we recommend that the notional amount of Eurodollar futures contracts be divided by four (prior to the application of any risk-based adjustment to the notional amount of such contracts) in order to reflect the three-month term of these contracts.

¹⁸ Guides to relevant registration statement forms provide that such “excess currency” exposure are considered “senior securities” as defined in section 18 of the 1940 Act. *See, e.g.*, Guide 22 to Form N-3 (May 2015); Guide 23 to Form N-1A, *enacted by* Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Release No. 13,436, 48 Fed. Reg. 37,928 (Aug. 22, 1983), *rescinded by* Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23,064, 63 Fed. Reg. 13,916 (Mar. 23, 1998). Although the guides to Form N-1A were rescinded in 1998 in connection with amendments to Form N-1A, analogous guides

necessary to reduce currency exposure from a non-US dollar-denominated security held by the fund (measured on a currency by currency basis). As an example, in a fund that may invest in non-US dollar-denominated securities, the fund is exposed to currency risk on any non-US dollar-denominated securities held by the fund. This risk may be substantial in the case of a fund that invests primarily in these types of securities (e.g. a foreign bond fund). This risk may be mitigated by entering into short positions in the non-US dollar currency using forward contracts or other currency derivatives. However, if the fund enters into a substantial amount of these derivatives, its ability to utilize derivatives for other purposes (such as achieving duration targets) would be very limited under the Commission's proposal. Therefore, we suggest that only short currency positions in excess of the amount of non-US dollar currency exposure be included in the portfolio limitations test, applied on a currency by currency basis. This would effectively exclude currency derivatives that reduce risk, while including currency derivatives that add risk to the portfolio.¹⁹

Mortgage TBAs and Bond Forwards. It is unclear whether a bond forward contract or a mortgage-related security purchased on a "to be announced" basis ("mortgage TBA"), should be treated as a derivatives transaction or as a financial commitment transaction.²⁰ The definition of "derivatives transaction" under the Proposed Rule includes "forward contract."²¹ However, the definition of "financial commitment transaction" includes a "firm commitment agreement."²² We believe that mortgage TBAs and bond forwards are financial commitment transactions under the Proposed Rule because the fund is obligated to pay the purchase price on a future date, and thus they are firm commitment agreements.

Although we believe that mortgage TBAs and bond forwards are financial commitment transactions and not "derivatives transactions," we believe nevertheless that their notional amount should be risk-adjusted in a similar manner as we have proposed above for derivatives transactions. In addition, the Proposed Rule does not provide for netting of offsetting financial commitment transactions as it does for derivatives transactions.²³ These types of transactions are economically similar to bond futures transactions, so we believe that they should be treated the same for purposes of the portfolio limitations.

Selection of Portfolio Limits. We recommend that a fund be permitted to switch between the exposure-based limit and the risk-based limit without seeking prior approval of the board of the fund. Due to the possibility of rapidly changing market conditions, it is simply not practical to seek board approval every time it becomes necessary to change these portfolio limits. The Proposed Rule requires reporting of the portfolio limitation relied upon by the fund, and any changes to the applicable limitation would seem to be a matter for the derivatives risk manager

continue in effect for other funds that do not file registration statements under Form N-1A, and funds continue to rely upon the positions set forth in the guides.

¹⁹ We note that a more sophisticated approach would involve measuring currency exposure relative to the fund's benchmark index. For example, for a fund with a benchmark that includes currencies, currency positions that would reduce tracking error relative to the fund's benchmark would be excluded from the portfolio limitations, while those that increase tracking error relative to the fund's benchmark would be included in the portfolio limitations.

²⁰ We also note that the table setting forth the methodologies for calculating notional amounts includes "FX forward[s]" and "Forward rate agreement[s]," but does not address mortgage TBAs or bond forwards. Proposing Release, 80 Fed. Reg. at 80,902, Table 1.

²¹ *Id.* at 80,899.

²² *See id.* at 80,937.

²³ The Proposed Rule permits netting of offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. *Id.* at 80,906 n.192.

to report to the board in the quarterly updates. As a result, there does not seem to be a need to obtain board approval, in advance, each time the investment adviser determines that it is advisable to switch the applicable portfolio limitation. Moreover, changes in proposed Form N-CEN that are included along with the Proposed Rule would require a fund to identify the portfolio limitation (or limitations) that the fund relied upon during the reporting period.²⁴

C. The Value at Risk Test For Reliance on the Risk-Based Portfolio Limit Should be Modified to Measure Relative Risk

The Proposed Rule would permit a fund that cannot comply with the exposure-based portfolio limit to comply with a risk-based portfolio limit of 300%, provided that the fund can comply with a VaR test. The relevant VaR test would be satisfied if the fund's "full portfolio VaR" (the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions) is less than the fund's "securities VaR" (the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions). The purpose of this test is to permit a higher portfolio limitation for funds that use derivatives in a manner that reduces rather than magnifies the potential for loss from market movements.²⁵

Although we are supportive of an approach that utilizes a relative VaR test, we believe that comparing the "securities VaR" to the "full portfolio VaR" should not be the test to determine whether a fund should be permitted to utilize the risk-based portfolio limitation. The problem with the proposed test is that it measures risk on an absolute basis, rather than on a relative basis. For example, an investor investing in a high yield bond fund has much different expectations of the expected volatility of the fund than an investor investing in a short-term bond fund. Each investor's expectations are based upon the volatility of the asset class in which the fund invests, as represented by the fund's benchmark. Therefore, if the fund's benchmark is volatile, the investor expects that the fund will exhibit similar volatility. It is not important to an investor whether volatility was caused by securities held by the fund or derivatives transactions entered into by the fund. The volatility of the fund relative to its benchmark is what is important to an investor.

The Commission's proposed VaR test could also lead a portfolio manager to purchase riskier securities in order to have a higher "securities VaR," increasing the likelihood that the "full portfolio VaR" would be lower, and permitting reliance on the higher, risk-based portfolio limit. A VaR test that compares volatility relative to the fund's benchmark would remove this incentive, and is a more meaningful and appropriate test for reliance on the risk-based portfolio limit.

We believe that the VaR test should incorporate the extent to which the use of derivatives causes the fund to have tracking error relative to its benchmark index. We suggest that the VaR test be modified so that a fund may rely upon the risk-based portfolio limit if the "full portfolio VaR" relative to the fund's benchmark index is less than the fund's "securities VaR" relative to the fund's benchmark index. This test takes into account the expectations of an investor in the fund: that the fund's volatility will approximate the volatility of its benchmark. It also prevents a fund from leveraging relative to its benchmark through the use of derivatives, since derivatives that increase leverage (and therefore volatility relative to the benchmark),

²⁴ Proposing Release, 80 Fed. Reg. at 80,952 n.505 and accompanying text.

²⁵ *Id.* at 80,916.

would tend to cause the fund to fail the VaR test (unless there are offsetting derivatives positions that lower the “full portfolio VaR” relative to the benchmark).²⁶

The VaR test we are proposing retains the Commission’s concept of comparing the fund’s “securities VaR” to its “full portfolio VaR” rather than imposing a restriction on the fund’s ability to invest in risky or volatile securities investments (as would be the case with an absolute VaR test). Moreover, it limits the risk of undue speculation, since a fund exceeding the exposure-based portfolio limit would be required to use derivatives to reduce tracking error relative to its benchmark. Finally, although non-money market funds are already required to select an “appropriate broad-based securities market index,”²⁷ any concern the Commission may have regarding the appropriateness of the benchmark index used in the VaR test we are proposing could be addressed by requiring the fund’s board to initially approve the benchmark index, as well as any changes of the index that the fund uses as its benchmark.

IV. The Segregated Assets Proposal Should Permit a Broader Class of Assets to be Used as Qualifying Coverage Assets

The Proposed Rule would require a fund to maintain an amount of “qualifying coverage assets” for each derivatives transaction that it enters into, designed to enable the fund to meet its obligations arising from that transaction. The amount required to be covered includes both a “mark-to-market coverage amount”²⁸ that represents the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of measurement, and a “risk-based coverage amount” that represents “a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.”²⁹ Certain reductions in the mark-to-market and risk-based coverage amounts are permitted to take into account netting arrangements³⁰ and margin or collateral that has been posted in connection with a derivatives transaction.³¹ “Qualifying coverage assets” for derivatives transactions generally must be maintained in cash and cash equivalents.³²

Although we generally support the asset segregation provisions of the Proposed Rule, we believe that a broader class of assets should be permitted to be used as “qualifying coverage assets.” Investors invest in a fund expecting that the fund will fully invest its assets in accordance with its investment objectives and strategies disclosed in the prospectus. Restricting qualifying coverage assets as proposed may harm investors because their funds may be required to maintain overly large cash balances, which would result in a “cash drag” on performance, and increase

²⁶ Any concerns that the Commission may have that the benchmark itself could be levered could be addressed by adopting a provision in the rule that the benchmark must be unlevered.

²⁷ See Form N-1A, Item 27(b)(7) (Mar. 2016).

²⁸ We note that for cleared derivatives, the mark-to-market coverage amount would be zero since variation margin in the amount necessary to exit the position would be required to be posted.

²⁹ Proposing Release, 80 Fed. Reg. at 80,926.

³⁰ For reasons similar to our view stated previously that, for purposes of the portfolio limitations, the same offsets should be permitted for financial commitment transactions, such as mortgage TBAs and bond forwards, as for derivatives transactions, we also suggest that the Proposed Rule should permit netting of obligations arising under financial commitment transactions that are subject to the provisions of a netting agreement to the same extent as for derivatives transactions.

³¹ Proposing Release, 80 Fed. Reg. at 80,927, 80,930.

³² For derivatives transactions in which a fund’s obligation may be satisfied by delivering a particular asset, that asset is also included in “qualifying coverage assets.” *Id.* at 80,932; see also *id.* at 80,982 n.739.

coverage assets as proposed may harm investors because their funds may be required to maintain overly large cash balances, which would result in a “cash drag” on performance, and increase tracking error relative to the fund’s benchmark.

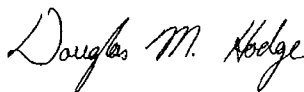
We appreciate the Commission’s concern that there could be a correlation between the underlying obligation being covered and the assets being used to cover the obligation, which could result in the obligation increasing in amount at the same time as the coverage assets decrease in value.³³ However, we believe that this concern can be addressed in two ways. First, a buffer could be built into the amount of the segregation amount, which the Commission effectively has included in the Proposed Rule by including the “risk-based coverage amount.” Second, assets other than cash and cash equivalents that are used as cover could be subject to a “haircut,” which would provide an additional buffer against the price depreciation of those assets. We believe that it is more appropriate, and it is consistent with the Commission’s stated goal of ensuring that the fund has sufficient assets necessary to meet its obligations, to permit the same types of assets that are permitted to be posted as margin, to be considered “qualifying coverage assets,” subject to applicable haircuts.

We suggest that the Commission permit use of the same assets as “qualifying coverage assets” as is permitted by the CFTC and the Prudential Regulators’ rules regarding margin requirements for swaps and securities-based swaps, subject to the same haircuts.³⁴ If these assets were posted as margin by the fund, the amount posted would be available to reduce the fund’s mark-to-market or risk-based coverage amounts, depending upon whether the assets were posted as variation margin or initial margin. In either case, the fund should be permitted to include as qualifying coverage assets the same types of assets that would effectively cover its obligations if they had been posted to a counterparty. This would provide additional flexibility for funds to fully invest their assets, while addressing the Commission’s concerns about the fund having sufficient assets to meet its obligations.

* * * * *

We thank the Commission for the opportunity for us to comment on the Proposed Rule and appreciate in advance the Commission's diligent consideration of our comments. Please feel free to contact us if we can provide any assistance to you in the further evaluation of these very important issues.

Sincerely,



Douglas M. Hodge
Chief Executive Officer

³³ Proposing Release, 80 Fed. Reg. at 80,932.

³⁴ Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Dep’t of Treasury, Federal Reserve System, FDIC, FCA, FHFA Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (CFTC Jan. 6, 2016) (to be codified at 17 C.F.R. pts. 23, 140).

Appendix A

**Same risk profile but
different notional values**

Illustrative example without duration adjustment to notional

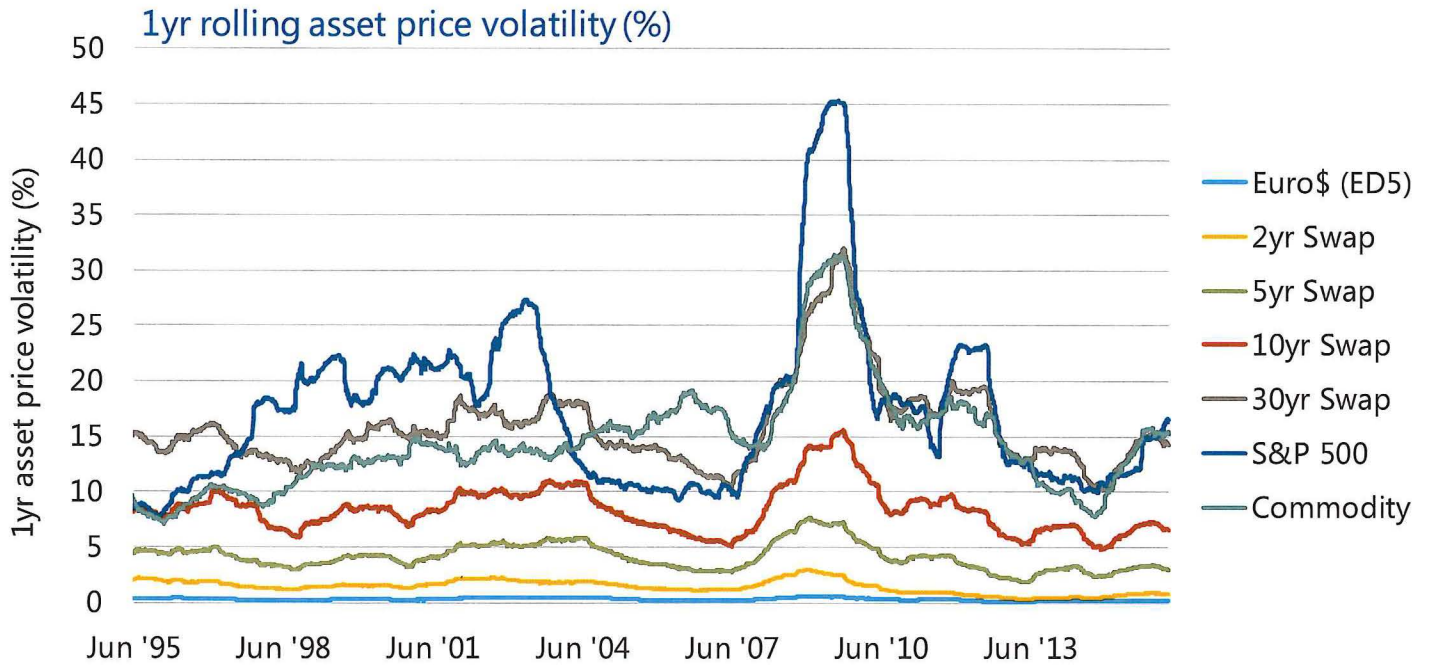
Instrument	Contract size	Price	Duration	# of contracts	Total notional	Total duration
Eurodollar Future	\$ 1,000,000	\$100	0.25 yr	80	\$ 80,000,000	20 yr
2 Year Interest Rate Swap	\$ 1,000,000	\$100	2 yr	10	\$ 10,000,000	20 yr
5 Year Treasury Bond Future	\$ 100,000	\$100	4 yr	50	\$ 5,000,000	20 yr
10 Year Interest Rate Swap	\$ 1,000,000	\$100	9.3 yr	2.15	\$ 2,150,000	20 yr
30 Year Treasury Bond Future	\$ 100,000	\$100	20 yr	10	\$ 1,000,000	20 yr

**Same risk profile and
Same adjusted notional values**

Illustrative example with duration adjustment to notional

Instrument	Contract size	Price	Duration	# of contracts	Total notional	Duration adjustment	Total notional with adjustment*	Total duration
Eurodollar Future	\$ 1,000,000	\$100	0.25 yr	80	\$ 80,000,000	0.25/20	\$ 1,000,000	20 yr
2 Year Interest Rate Swap	\$ 1,000,000	\$100	2 yr	10	\$ 10,000,000	2/20	\$ 1,000,000	20 yr
5 Year Treasury Bond Future	\$ 100,000	\$100	4 yr	50	\$ 5,000,000	4/20	\$ 1,000,000	20 yr
10 Year Interest Rate Swap	\$ 1,000,000	\$100	9.3 yr	2.15	\$ 2,150,000	9.3/20	\$ 1,000,000	20 yr
30 Year Treasury Bond Future	\$ 100,000	\$100	20 yr	10	\$ 1,000,000	20/20	\$ 1,000,000	20 yr

Appendix B



Annualized Volatility (%)	1995-Present	Past 10yr	Past 1 yr
Euro\$ (ED5)	0.3	0.3	0.2
2yr Swap	1.5	1.3	0.8
5yr Swap	4.3	4.1	2.9
10yr Swap	8.6	8.6	6.6
30yr Swap	16.4	17.7	14.3
S&P 500	19.0	20.5	16.5
Commodity	15.5	17.7	15.4