BETTER
MARKETS

March 28, 2016

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

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

Dear Secretary Fields:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposed rule ("Proposal") issued by the Securities and Exchange Commission ("SEC" or "Commission").[2]

The Proposal would impose new restrictions on the use of derivatives by registered investment companies and business development companies (collectively, "funds"). The Proposal contains a number of important protections that will require funds to manage the considerable risks associated with derivatives transactions more prudently. Furthermore, it represents a laudable example of retrospective rule (or "guidance") review resulting in significantly stronger measures that will better protect investors and financial market stability.

The principal shortcoming of the Proposal is that it fails to adequately confront the more essential question of whether funds should be allowed to engage in **any** derivatives transactions at all, in light of the stringent limits set forth in the Investment Company Act of 1940 (ICA). In addition, as explained more fully below, some of the specific safeguards in the Proposal should be strengthened. Finally, the Commission

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 *See* Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015).

should resist calls to dilute the important disclosure requirements in the Proposal, and it should not be swayed by overstated, baseless, and routine confidentiality and competition concerns.

BACKGROUND AND SUMMARY

The Investment Company Act of 1940 (the "ICA") prohibits registered investment companies from issuing "senior securities," subject to narrow exceptions. Section 18(a)(1), for example, explicitly bars closed-end funds from issuing any class of senior security unless immediately after such issuance or sale the investment company will have asset coverage of at least 300%. Section 18(f)(1) prohibits an open-end fund from issuing any class of senior security except that it may borrow from a bank if immediately after any such borrowing there is asset coverage of at least 300% for all of its borrowings. These restrictions were designed to protect fund investors from the risks associated with excessive leverage. When the ICA was enacted, such risks typically arose when a fund obtained loans or issued debt securities.

In 1979, the SEC issued Investment Company Act Release No. 10666 ("Release 10666"), effectively creating additional exemptions from the ban on the issuance of senior securities by investment companies. It provided that funds engaging in three types of transactions that result in increased leverage—reverse repurchase agreements, firm commitment agreements, and standby commitment agreements—would not be deemed to violate the ICA if the funds retained sufficient liquid assets to cover any potential losses. This asset coverage requirement was intended to serve as a "practical limit on the amount of leverage which an investment company can undertake."[3] Subsequently, through a succession of SEC releases and no-action letters, this exemption was expanded to allow trading in derivatives.

However, the 2008 financial crisis highlighted the need for change, as the 18 trillion dollar mutual fund industry suffered enormous losses due to their reliance on swaps and other derivative instruments.[4] Investors remain exposed to the type of rapidly-amplifying losses that can occur when funds lean heavily on exotic, leverage-producing investment strategies. Compounding the problem, current regulations only require funds to disclose a limited amount of information about their derivatives risk profile. This leaves retail investors and even financial advisers in the dark regarding the risk levels in their portfolios. And it hampers the ability of regulators and policymakers to monitor the markets for accumulations of risk that could affect financial stability. The issue has remained salient even to the present day, as leveraged

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3 *See* 80 Fed. Reg. 80900 (quoting Release 10666, at discussion of "Segregated Accounts").

4 Dave Michaels, *Mutual Funds Face Leverage Caps Under SEC Rule on Derivatives,* Bloomberg Business (Dec. 11, 2015) http://www.bloomberg.com/news/articles/2015-12-11/mutual-funds-using-derivatives-face-new-limits-under-sec-plan.

exchanged-traded funds were roundly criticized in recent months for exacerbating and amplifying the severe volatility in the equity markets.[5]

In 2010, recognizing that the derivatives market has continued to grow in volume and in complexity in recent years, the SEC initiated a review of the adequacy of the regulatory framework governing the use of derivatives by funds. As a result of that review, Chair Mary Jo White declared that existing SEC guidance no longer adequately protects investors from the dangers of excessive leverage.[6]

On December 11, 2015, the Commission, by a vote of three to one, proposed rule 18f-4 under the ICA. The Proposal would continue to allow registered investment companies and business development companies to engage in derivatives transactions (and financial commitment transactions) notwithstanding the ICA's prohibitions on the issuance of senior securities.[7] However, to better protect investors, the Proposal imposes a series of new limits and requirements. It is the latest in a progression of SEC rulemakings aimed at mitigating the risks to investors stemming from increasing complexity in the operations of the asset management industry.

The Proposal notes that the Financial Stability Oversight Council ("FSOC") recently requested comment on certain aspects of the investment management industry, including leverage-related risks. The SEC considered the comments that the FSOC collected while developing the Proposal. The FSOC's interest in the area is yet another affirmation of the importance of regulating funds' leverage-related risk not only to protect investors but also to ensure the stability of our financial markets.

OVERVIEW OF THE PROPOSAL

The Proposal has four essential features. It imposes (1) limits on the amount of permitted leverage; (2) an obligation to segregate assets to cover those liabilities; (3) a duty to establish a derivatives risk management program under certain circumstances; and (4) a variety of related governance and recordkeeping requirements.

Exposure limits

A registered fund seeking to rely on the Proposal would need to comply with one of two **alternative portfolio limitations**:

[5] Joe Renison, *Vix ETFs Contributed to August Turmoil*, Financial Times (Sep. 17, 2015, 10:18 A.M.) http://www.ft.com/intl/cms/s/0/94b064cc-5cf5-11e5-9846-de406ccb37f2.html#axzz3tq011jfs.

[6] *See* Public Statement of Mary Jo White (December 11, 2015), *available at* http://www.sec.gov/news/statement/chair-white-statement-at-open-meeting.html ("The current regulatory framework no longer effectively achieves the statutory objectives of the Investment Company Act, which seeks to protect investors from the risks of excessive leverage.").

[7] The Commission relies on its authority under Section 6(c) of the ICA to create a conditional exemption from the ICA's bar against the issuance of senior securities.

- **Exposure-based limit:** The fund's exposure would be limited to 150% of the registered fund's net assets, where "exposure" is (generally) calculated as the aggregate notional amount of the fund's derivatives transactions, plus its obligations under financial commitment transactions and aggregated indebtedness under other senior securities transactions.

- **Risk based-limit:** The fund's exposure (calculated as above) would be limited to 300% of the fund's net assets, but only if its derivatives transactions, in the aggregate, reduce the total value-at-risk (VaR) of the fund's portfolio. (That is to say, the VaR with derivatives must be less than the VaR without derivatives.)

Segregation of coverage assets

The Proposal also would require a fund to **segregate assets** in connection with derivative transactions in an amount equal to (or greater than) the sum of:

- **Mark-to-market coverage amount:** The amount the fund would need to pay to close out its derivatives at the time of the determination; and

- **Risk-based coverage amount:** A reasonable estimate of the potential amount the fund would pay if the fund exited the derivatives under a stress scenario.

Risk management programs

The Proposal would also require funds that engage in derivatives transactions with a combined notional value of at least 50% of a fund's net assets, and funds that transact in any amount of complex derivatives, to establish a formalized **derivatives risk management program.** The risk management program would be required in addition to certain requirements related to risk management that would be applicable to every fund that transacts in derivatives in reliance on the Proposal.

Governance and reporting requirements

Finally, the Proposal would require various board approvals and periodic board reviews of the fund's compliance with the Proposal, as well as new recordkeeping, disclosure, and reporting requirements relating to a fund's use of derivatives.

COMMENTS

I. The Proposal fails to justify the SEC's continued willingness to exempt funds from the clear prohibitions in the ICA.

The Proposal raises, yet fails to resolve, a fundamental threshold issue. As noted in the Release, many derivatives can be regarded as senior securities and, absent exemptive relief, trading in them violates Section 18 of the ICA. For decades, the SEC has chosen to relax this statutory prohibition. The SEC has imposed certain conditions on funds' use of senior securities, including derivatives, but it has nevertheless circumvented the plain language of the ICA.

While the SEC does have a general exemptive authority in Section 6(c) of the ICA, it does not constitute an unbounded right to ignore the statute's explicit requirements and prohibitions or its underlying purposes. Indeed, the Commission's use of that exemptive authority is expressly conditioned on several factors, including findings 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 subchapter."[8]

With respect to derivatives trading by registered investment companies, it is not at all clear that such activity is or could be consistent with those three findings. The rationale underlying the original statutory limits on senior securities seems more relevant today than ever before in terms of protecting the public interest, protecting investors, and fulfilling the policies underlying the ICA. Derivatives are not only powerful risk amplifiers that can pose threats to investors and financial stability, they also can create other collateral harms that undermine the public interest. Critics have frequently noted that the use of derivatives in mutual funds is diverting investment dollars away from stocks and bonds and toward commodities; increasing speculation in the commodity markets; and contributing to commodity price distortions, price volatility, and a more fragile economic recovery. And derivatives investments frequently amount to little more than a wager on the performance of referenced assets without contributing to capital formation.

The Commission has not adequately explained how the Proposal even colorably meets the criteria for exemptive relief. The Release does not question the Commission's essential approach or provide a compelling justification for the continued and expanded exercise of that authority. While the Release notes that funds may actually use derivatives to hedge or limit risk in their portfolios, it contains insufficient analysis of the degree to which this occurs. Nor does the Release adequately address the danger that derivatives trading will be justified as hedging

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8 *See* 15 U.S.C. § 80a-6(c) (emphasis added).

when in fact it is really the pursuit of yield.[9] The SEC should confront these issues more directly and comprehensively before allowing funds to continue trading in derivatives, even with the important safeguards that are contained in the Proposal.

In short, the approach taken by the Commission in the Proposal may well be vulnerable to legal challenge and it warrants further scrutiny. In light of all of these considerations, and with the growing use of derivatives by funds and the increasing complexity of the derivatives market, now is the time to re-evaluate the SEC's fundamental approach. The wisdom of continuing to exempt any amount of derivatives trading by funds should be further analyzed and, if possible, justified. Otherwise, it must not be permitted and the Proposal must not be finalized in its current form.

II. If funds are permitted to continue transacting in derivatives notwithstanding the ICA, then the Proposal represents a critically important new layer of protections, following a laudable retrospective review of an outdated regulatory framework.

The Proposal represents a much-needed effort to institute prudent safeguards to ensure that funds appropriately manage the tremendous risks associated with transacting in derivatives. It further represents a recognition that highly leveraged investment strategies are fundamentally at odds with the role of ICA-registered funds, and with the interests of the retail investors that own such funds.

As a general proposition, the four elements of the rule are appropriate, necessary, and well-crafted. The Proposal will also better equip the SEC to oversee the use of derivatives. Currently, making a comprehensive assessment of the risks that attend highly leveraged investment strategies is problematic due to insufficient data, and a lack of oversight by regulators compounds these risks for retail investors and for financial stability more broadly. In fact, Better Markets is hopeful that the Proposal represents the beginning of a process of implementing detailed and globally consistent reporting standards across the asset management industry. Such standards would give

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[9] Making sure that hedging is actually used for risk management purposes rather than speculative trading purposes is a crucial challenge for the SEC and one that must be fully addressed before any rule is finalized. This challenge is illustrated in the effort to ensure that the hedging exemption in the Volcker rule is not used to defeat the intended ban on proprietary trading by banks. History also illustrates the risks posed by trading activity that is labeled as "hedging" but which is in fact speculative and potentially very destructive. The London Whale debacle at JP Morgan is just one compelling example. Katy Burne, Aaron Lucchetti, and Gregory Zuckerman, *Hedge or Bet? Parsing the J.P. Morgan Trade*, Wall St. J. (May 16, 2012, 11:59 A.M.), *available at* http://www.wsj.com/articles/SB10001424052702303505504577406633898981786.
The Proposal reflects some effort to address this challenge by applying a comparative VaR analysis to ensure that derivatives positions actually mitigate rather than increase risk under the risk-based exposure limit. However, that approach does not answer the fundamental threshold question of whether it really is prudent—or consistent with the law—to permit derivatives trading by registered investment companies at all. Moreover, as discussed in text below, the basic weaknesses in the VaR methodology cast doubt on the effectiveness of that approach.

regulators the data necessary to more precisely locate and measure the extent of leverage risks—laying a foundation for more robust oversight protocols in the future.

Finally, we also note that the Proposal represents a positive example of an agency undertaking, on its own initiative, an assessment of the adequacy of an existing regulatory framework in an important financial market. While, as noted above, the SEC should have gone further in examining and justifying the appropriateness of allowing funds to continue transacting in derivatives in the first instance, it nevertheless deserves credit for proactively designing a proposal that will effect an improvement on the status quo. This is especially true given the frequent calls from opponents of regulation for "retrospective rule review," requests that are too often intended to undermine or dilute important regulatory protections, not strengthen them.

III. Though the proposal is largely technically sound, a number of the specific technical components should be strengthened or otherwise modified.

A. Alternative portfolio limitation rules

As explained above, funds seeking to utilize the Rule 18f-4 exemption and transact in derivatives would be required to comply with one of two alternative portfolio limitation rules: an exposure-based portfolio limit, or a risk-based portfolio limit. Both portfolio limitation rules are designed to reduce leverage and undue speculation by limiting the amount of exposure to underlying reference assets that a fund would be able to achieve through derivatives transactions.

i. Exposure-based portfolio limit

If a fund elects to operate under the exposure-based portfolio limit, it would be required to operate such that its exposure to derivatives transactions (and other senior securities) does not exceed 150% of its net assets. This upper limit is too high. From the standpoint of legislative intent, we question whether a rule that exempts funds from a statutory bar against transacting in derivatives should permit a fund to operate with derivatives exposure equal to even 100% of its net assets, let alone 150%. Such an approach violates not only the letter of the law but its spirit as well. Indeed, in a stress scenario, such derivatives exposure could produce devastating results for the health of the fund.

The Release attempts to justify this approach on two grounds. First, it notes that 99% of mutual funds sampled in a study by the SEC's Division of Economic and Risk Analysis have exposure to derivatives transactions below the proposed 150% threshold.[10] Second, it observes that the 150% limit will be effective at reining in the

[10] *See* 80 Fed. Reg. 80918.

practices of alternative strategy funds that employ high-leverage investment strategies.[11] Such funds may find it impractical to reduce their reference asset exposure below 150%, and the Proposal indicates that those funds may choose to de-register under the ICA.[12]

Both of these points may be quite correct. Indeed, there is no way to reconcile high-leverage investment strategies with the letter or spirit of the ICA, and funds that employ them should not be permitted to register under the ICA. But neither of these observations justifies the 150% limit in the Proposal. It is simply wrong to set the 150% threshold to screen out only those funds with the most egregious derivative exposure risk profiles. Best intentions notwithstanding, funds may well interpret the Proposal's 150% threshold as a tacit endorsement of operating with exposure well in excess of 100%—enough to wipe out the fund in a severe stress event. In addition, much of the analysis in the Release shows that the SEC is actually uncertain about the degree to which funds operating under the 150% limit would be using derivatives for bona fide hedging purposed to reduce risk, or using them to increase leverage and yield.[13] The 150% limit is especially inappropriate in light of this acknowledged uncertainty.

The Commission should set the exposure threshold at a lower level. For example, a presumptively more appropriate threshold would be 50% as suggested in the Release. That level would be more consistent with the original statutory limit on a fund's ability to borrow from a bank.[14] At most, the Commission should adopt 100% as the top exposure limit. As noted in the Release, this would "more closely track" the approach taken in Release 10666.[15] Given the **increased** complexities in the derivatives market, any new limit on derivatives exposure should **decrease** the potential risk.

ii. Risk-Based Portfolio Limit

The risk-based portfolio limit permits a fund to obtain exposure of up to 300% of its net assets as long as it satisfies a VaR test designed to measure whether the fund's derivatives transactions, in the aggregate, **reduce** the fund's exposure to market risk. This option is designed to accommodate funds that engage in extensive derivatives transactions to limit their exposure to market risk.

The proposed model-based method of determining the amount of risk-based portfolio limit relies on a VaR calculation. To satisfy the VaR test, the VaR of the fund's

11 *See id.*
12 *See id.* at 80918-19.
13 *See id.* at 80909.
14 *See id.*
15 *See id.*

entire portfolio must be less than the fund's "securities VaR," which is defined as the VaR of all holdings other than derivatives transactions.

This raises a serious concern, as VaR-based models have been widely criticized as fundamentally flawed.[16] Before the financial crisis, many banks underestimated the market risk associated with the assets in their trading book while using VaR. When the crisis hit, the consequences were devastating: the implosion of prominent financial institutions, the collapse of the credit markets, and widespread damage cascading through the real economy. Critics have since noted that the very design of VaR "hides potentially catastrophic losses" and concluded that VaR is simply an inadequate risk management tool.[17] Even the use of VaR as a measure of comparative risk is a concern, as VaR models can be manipulated or gamed by market participants to allow them to assume greater levels of risk than is prudent or permitted.

If applied in the Proposal, then any such models should be subject to rigorous scrutiny by the Commission as part of an approval process, and made available for public scrutiny as soon as commercially practicable. Allowing the application of potentially flawed models, even for a limited time, poses unacceptable risks.

In any case, permitting a fund to retain derivatives exposure with a notional value equal to 300% of its net assets, under a statutory regime that was originally written to bar derivative transactions constituting senior securities, is an especially expansive assertion of the SEC's authority—an authority that, as discussed above, has not been persuasively invoked as the basis for allowing **any** derivatives trading by funds.

B. Disclosure

Under the current disclosure regime, investors, including financial advisers, often cannot easily determine the extent to which mutual funds employ futures, options, swaps, and other derivative instruments—not to mention the risk that such instruments add to a portfolio.[18] For example, it can be very confusing, especially for retail investors, to see a fund with 50% cash that is keeping pace with the market. Many times, investors may not fully grasp that the cash is merely collateral for derivatives that carry significant additional risk factors.

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[16] *See, e.g.,* Andrew L. McElroy, *Drastic Times Call For Drastic Risk Measures: Why Value-at-risk Is (Still) a Flawed Preventative of Financial Crises and What Regulators Can Do About It,* 6 J. Bus. Entrepreneurship & L. Iss. 2 (2013), *available at:* http://digitalcommons.pepperdine.edu/jbel/vol6/iss2/2.

[17] *See id; also* Kevin Dowd, *Alchemists of Loss: How modern finance and government intervention crashed the financial system,* 361 (2010) "As an aside, if we wish to use probabilistic risk measures . . .then the Value-at-Risk methodology should be avoided: risk managers, please write out a hundred times, "The VaR is a discredited risk measure. I promise not to use it again.".

[18] *See* 80 Fed. Reg. 80932.

Further, funds often invest in very complex securities, some of which are even customized for particular funds, but not listed in their portfolio documents in any consistent manner. Even when listed, the disclosures are often impenetrable and impossible to decipher.

Accordingly, the Proposal requires funds to divulge more and clearer information in a standardized format about their derivatives exposure and the risk it entails. Proposed forms N-PORT and N-CEN require an array of disclosures related to options and warrants, specific risk metrics, and detailed information about which of the two alternative portfolio limitations the fund has elected to adopt. The Commission is to be lauded for designing reporting standards that include adequate leverage information (level of cash, assets, and derivatives) that will show mutual funds' sensitivity to large market moves and will facilitate meaningful analyses of risks across the financial sector.

The Commission should not dilute these disclosure requirements. As is all too typical, if not routine, funds have raised concerns that their competitive market positions will be adversely affected if they must disclose more information, but the quarterly and annual position transparency contemplated under the Proposal is appropriate and necessary, notwithstanding these concerns. The Proposal strikes an appropriate balance between (a) providing investors with an understanding about how a fund's investment strategy works, its risks, and its benefits, and (b) respecting funds' competitive concerns.

C. Transition Period

The Proposal states that if the Commission adopts proposed Rule 18f-4, then the SEC will rescind Release 10666 and staff no-action letters addressing the treatment of derivatives and financial commitment transactions under the ICA. The Proposal does not indicate when such rescission would go into effect, and the Commission seems particularly solicitous of comment on the appropriateness of a transition period and the appropriate amount of time before rescinding Release 10666 and staff no-action letters.

In making its determination, the Commission should not be swayed by unfounded industry arguments for any transition period that lasts longer than the time actually necessary for funds to adjust their portfolio holdings and adapt their disclosure systems in an orderly manner. Given the importance of the proposed reforms to investors, financial market stability, and more comprehensive disclosure and oversight, the transition should be as short as possible.

CONCLUSION

We hope that these comments are helpful as the Commission finalizes its Proposal.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Legal Director & Securities Specialist

Allen Dreschel
Attorney

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
[redacted]

[redacted]

www.bettermarkets.com