MEMORANDUM

To: Liquidity Risk Management Programs Proposal File

Use of Derivatives by Registered Investment Companies and Business Development Companies Proposal File

From: James Maclean
Attorney-Adviser, Division of Investment Management ("IM")

Date: May 6, 2016

Re: Meeting with Representatives of Federated Investors

On April 27, 2016, Diane Blizzard (Associate Director, IM), Brian McLaughlin Johnson (Senior Special Counsel, IM), Sarah ten Siethoff (Assistant Director, IM), Thoreau Bartmann (Branch Chief, IM), Christof Stahel (Assistant Director, Division of Economic and Risk Analysis ("DERA")) and Yue Tang (Economist, DERA) met with the following representatives of Federated Investors:

- Michael R. Granito (Chief Risk Officer);
- Peter Germain (General Counsel); and
- Stephen Van Meter (Chief Compliance Officer).

Among other things, the participants discussed the Commission's proposals relating to (i) liquidity risk management programs and swing pricing; and (ii) the use of derivatives by registered investment companies and business development companies. Information provided by Federated Investors in connection with this meeting is set forth in Annex A.

Annex A

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Securities and Exchange Commission

April 27, 2016

Presented by:

Michael R. Granito
Chief Risk Officer

Peter Germain
General Counsel

Stephen Van Meter
Chief Compliance Officer

Agenda

- Liquidity Rule Proposal
  - Liquidity Bucket Reporting and Disclosure
  - Systemic Risk Considerations
  - Swing Pricing
- Derivatives Rule Proposal
  - Risk Management
  - Asset Segregation
  - Portfolio Limits

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Liquidity Rule Proposal – Federated Comment Letter Highlights

- While useful in concept, we disagree with key elements of the proposal for individual security reporting and disclosure.
- We recommend portfolio level reporting and disclosure using a reduced number of categories.
- We do not oppose the "days-to-liquidate" framework for defining categories.
- We do not oppose *partially* basing liquidity on the concept of a material sale price difference from the time T price.
- We do not oppose the 1 – 3 Day Liquid Bucket concept, but propose this be treated as a target that must be met consistent with implementing the fund investment strategy.

Industry Opposition to the Liquidity Proposal

- Reporting and disclosing individual security liquidity bucketing in the manner proposed implies a false degree of accuracy and would be costly.
- The definition of liquidity risk is problematic for the purpose of estimating time to liquidate: "normal or reasonably foreseeable stress market conditions".
- The time horizon for assessing a material difference from the time T price is unduly long.
- The 1 – 3 Day Liquid Bucket requirement as proposed would interfere with the implementation of investment strategy.

A Practical Way Forward

- If individual security liquidity measures are retained, consider requiring days-to-liquidate estimates based solely on historical data (including data for comparable securities) with no specific relationship to time T price. Specify execution at "non-fire sale" prices. Require reporting but not disclosure.
- For portfolio level reporting and disclosure, interpret "normal or reasonably foreseeable stress market conditions" as the "the market conditions most likely to be experienced".
  - Direct advisers to assume redemptions in only the applicable fund and not the complex and not the market overall.
  - Note: Currently liquidity determination is made for a round lot in a normal market. The new requirement should be more explicit in how it changes either assumption.
  - Solicit additional stressed market liquidity measures in the forthcoming Stress Test Rule when other stress parameters can be identified.
- For portfolio liquidity buckets, require time T price comparison for 1, 2-3 and 4-7 day buckets, but not beyond 7 days.
  - Comparison of sale prices on day 8 and beyond to the time T price is a theoretical question.
- Suggest directing (or at least recommending that) the industry move to T+2 (or T+3) settlement and working to standardize data.

Systemic Risk Considerations

- For liquidity or other concerns, in order to have useful stress test results and valid comparisons across funds, advisers must be given common market stress parameters to employ.
- The forthcoming Stress Test Rule can examine complex wide or industry-wide redemption scenarios (among other things) and require that funds adopt policies and procedures to defend against more extreme events.
- For systemic risk oversight, the SEC should perform its own analysis of fund holdings and not attempt to aggregate reported data.
  - Receive daily or weekly data directly from fund data aggregators (i.e. custodians or other record keepers).
  - Could perform rapid industry assessments (e.g. the sweep performed post the Third Avenue event).
  - Employ its own experts (building on existing "big data" programs?) to develop a center of excellence for systemic market oversight.

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Swing Pricing

- We agree that Swing Pricing may be a useful tool.
- However, we cite numerous challenges to implementation:
  - Operational issues.
  - Investor confusion and need for education.
  - Gaming and material nonpublic information.
  - Industry would need a lengthy implementation period.
- There are also alternatives that should be carefully studied:
  - Redemption fees – the proposed rule is silent on this.
  - T+1 pricing for large redemptions.
  - Dual Pricing.
- The new rule will have far-reaching effect and set fund-pricing ground rules for years to come.

Derivatives Rule – Risk Management Program

- Complex derivatives should not automatically necessitate a formal risk management program.
- Funds should not be exempt from a formal program if derivatives contribute a material degree of risk or represent a principle investment strategy.
- Funds that are systematically or dynamically leveraged to a material extent should require a risk management program and additional risk disclosure, but should not necessarily be ruled out because of portfolio derivatives limits.

Asset Segregation

- We agree with the proposed requirements based on the "mark-to-market" and "risk-based" coverage amounts.
- However, we disagree with the requirement that all such amounts be kept in cash and equivalents.
  - Cash and equivalent requirements are also an additional means of controlling economic leverage. This limitation is redundant once risk-based limits on derivatives are implemented (via portfolio limits or VaR-based principles).
  - Mark-to-market coverage amounts should be cash and equivalents.
  - Risk-based coverage should be in the 1-3 Day Liquid Bucket (or equivalent concept).
    - Risk-based amounts are "precautionary" and will rarely be used. Forcing these into cash and equivalents does not meet a cost/benefit standard.

Portfolio Limits

- We disagree with the proposed gross limit framework that does not permit economic hedging.
  - This could have unknown and unintended consequences as market practices change and new instrument types are developed.
  - It could prevent a fund from hedging in a crisis.
- We recommend a principles-based rule that will stand the test of time.
  - For funds that elect the Relative VaR test, instead of the proposed requirement that:

$$(\text{VaR of portfolio with derivatives}) - (\text{VaR of portfolio without derivatives}) < 0 \qquad (1)$$

    the Commission could adopt the requirement that:

$$\{(\text{VaR of portfolio with derivatives}) \,/\, (\text{VaR of portfolio without derivatives})\} < X \qquad (2)$$

  - For funds that elect the Absolute VaR test, instead of the proposed requirement that:

$$(\text{VaR of portfolio with derivatives}) - (\text{VaR of portfolio without derivatives}) < 0 \qquad (3)$$

    the Commission could adopt the requirement that:

$$\{(\text{VaR of portfolio with derivatives}) - (\text{VaR of portfolio without derivatives})\} \,/\, (\text{Net Assets}) < Y \qquad (4)$$

- Federated has historical provided quarterly fund board reports showing relative portfolio risks (tracking errors) with and without derivative exposures.