August 18, 2016

Via Electronic Mail (rule-comments@sec.gov)

Mr. 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, SEC Rel. IC-31933; File No. S-7-24-15

Dear Mr. Fields:

The Investment Adviser Association[1] appreciates the opportunity to provide supplemental comments on the Securities and Exchange Commission's proposal to adopt new rule 18f-4 under the Investment Company Act of 1940 ("ICA") governing the use of derivatives by registered funds.[2] We are writing with respect to the ICI's recent recommendation that, if the Commission proceeds with portfolio limits based on a fund's notional exposure to derivatives, it should allow funds to risk-adjust those notional amounts according to a specific schedule.[3]

In March, the IAA submitted a comment letter opposing the rule's two proposed portfolio limitations.[4] We did not—and still do not—believe that such an approach is necessary to achieve the Commission's stated goals. We continue to believe that the gross notional exposure of derivatives in a portfolio is not an accurate representation of leverage or systemic risk, and that

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA's membership consists of approximately 600 firms that collectively manage nearly $20 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. More than 40 percent of IAA members manage at least one registered investment company or business development company ("BDC"). For more information, please visit www.investmentadviser.org.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Rel. IC-31933 (Dec. 11, 2015) ("Proposal"), available at http://www.sec.gov/rules/proposed/2015/ic-31933.pdf. The rule applies to mutual funds, exchange-traded funds, closed-end funds, and companies that have elected to be treated as a BDC under the ICA, collectively referred to in the Proposal and this letter as "funds."

[3] *See* Supplemental Letter from David Blass, General Counsel, Investment Company Institute (July 28, 2016) ("ICI Supplemental Letter"), available at https://www.sec.gov/comments/s7-24-15/s72415-244.pdf. We do not comment here with respect to the Commission's proposed risk-based portfolio limit that the Commission should significantly amend from the Proposal in order to make the test usable for registered funds.

[4] *See* Letter from Robert C. Grohowski, General Counsel, Investment Adviser Association to the SEC on the Proposal (Mar. 28, 2016) ("March Letter"), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/160328cmnt.pdf ("conditioning the use of derivatives on compliance with either the 150 percent or 300 percent [of the value of the fund's net assets] tests is unnecessary to protect investors").

the proposed portfolio limits based on gross notional exposure are unnecessary and unwarranted given the other components of the proposed rule.[5]

Nevertheless, we understand that the Commission is giving serious consideration to moving forward with its proposed portfolio limits. If the Commission determines that some sort of portfolio limits based on the fund's exposure of aggregate notional amounts of derivatives should be required under Section 18, then we continue to recommend the Commission consider a risk adjustment to the proposed measurement. In our March Letter, we noted that the Commission could consider "risk weighting" the measurement of fund exposure to underlying derivatives transactions by, for example, providing a haircut to the value of derivatives when calculating the aggregate notional value.

This concept has been further developed in the ICI Supplemental Letter. The ICI recommends that if the Commission proceeds with portfolio limits, it should include risk-adjusting notional limits according to a specific schedule based on the "Initial Margin Schedule" for uncleared swaps adopted by the prudential regulators and the CFTC.[6] The rationale for the proposed risk-adjustment schedule is that derivatives that are less risky will receive a larger adjustment to notional than derivatives that are more risky, thus better reflecting the fund's true risk of loss under the transaction.

The ICI's proposed risk-adjustment schedule seems to be a reasonable approach for risk-adjusting notional amounts. It is relatively simple and straightforward, based on a currently

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[5] In particular, the Proposal's other components contain significant new asset segregation requirements that require funds to earmark an amount beyond the amount that would be necessary to exit the derivatives transaction. This additional "risk-based coverage amount" would provide a cushion that both addresses potential future losses and naturally constrains a fund's ability to take on leverage. In our March Letter, we recommended the Commission adopt an alternative approach that would rely instead on this proposed risk-based coverage amount of cash and other assets that the fund would likely be required to pay or deliver under a derivatives transaction, even in "stressed" conditions, especially given that segregated assets could only be earmarked for a single transaction.

We also note that FSOC has highlighted the deficiencies with a gross notional exposure measurement, noting that "summing the long and short notional positions [in gross notional exposure] ignores favorable effects of hedging or offsetting positions, which may reduce risk." FSOC, Update on Review of Asset Management Products and Activities (Apr. 18, 2016) at 16, available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf. FSOC also noted that "aggregating notional derivative amounts to measure synthetic leverage [via derivatives] is likely to overstate leverage" and that evaluating risks from the use of leverage "requires an analysis of other factors," such as investment positions, trading and hedging strategies, financing arrangements, counterparties, margin requirements, and the effects of central clearing.

[6] *See Margin and Capital Requirements for Cleared Swap Entities,* 80 Fed. Reg. 74839 (Nov. 30, 2015) (final rule), available at https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf; *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016) (final rule) at Section 23.154(c), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf. *See also,* ICI Supplemental Letter at 5, n. 12 ("[t]he Initial Margin Schedule specifies the minimum amount of initial margin that will need to be posted and received for uncleared swaps, if the parties to the swap do not elect to determine the initial margin under a model approved by the relevant regulator.")

existing haircut schedule, and should result in a more appropriately tailored metric for determining compliance with the portfolio limits. And, as we and other commenters pointed out in our earlier letters, the idea of risk-adjustments is consistent with the approach taken in other jurisdictions.

Our support for the ICI's proposed schedule is coupled with support for ICI's other recommendation—that in addition to adopting the risk-adjustment schedule, the Commission should also increase the exposure-based portfolio limit (from 150 percent to 200 percent) and the risk-based portfolio limit (from 300 percent to 350 percent). While we remain opposed to the limits in general, if adopted, the thresholds should be raised.

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We appreciate the opportunity to provide supplemental comments on the Proposal and would be pleased to meet with the Commission and its staff regarding our comments and to provide any additional information. Please contact me or Monique S. Botkin, IAA Associate General Counsel, at (with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

David Grim, Director, Division of Investment Management
Diane Blizzard, Associate Director, Division of Investment Management