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December 5, 2016

Submitted via electronic filing: www.sec.gov/rules/proposed.shtml

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

Re: Supplemental Letter on Use of Derivatives by Registered Investment Companies and Business Development Companies, File Number S7-24-15

Dear Mr. Fields:

We are submitting this letter as a supplement to our March 28, 2016 letter regarding the Securities and Exchange Commission ("Commission" or "SEC") proposal on "Use of Derivatives by Registered Investment Companies and Business Development Companies" ("Proposal").[1] More specifically, this letter comments on the Division of Economic and Risk Analysis ("DERA") November 1, 2016 memorandum, "Risk Adjustment and Haircut Schedules" ("DERA Analysis").[2] We commend the Commission for carefully considering the recommendations that have been put forth by commenters and for taking a data-driven approach to evaluating various suggestions. Should the Commission move forward with the rule as currently proposed, we are very supportive of the application of risk-based adjustments with respect to the proposed portfolio limits as well as expanding the definition of Qualifying Coverage Assets ("QCA") in line with the approach taken in global standards for margin for uncleared swaps. The purpose of this letter is to provide additional recommendations and clarifications with respect to the proposed definition of QCA as it relates to the DERA Analysis of haircuts included in the prudential regulators and Commodity Futures Trading Commission ("CFTC") schedules for Eligible Noncash Margin Collateral ("PR/CFTC Schedules").

As we highlighted in our March 28 letter, should the Commission move forward with the rule as currently proposed, we strongly encourage the Commission to expand the proposed definition of QCA to avoid several unintended negative consequences for registered fund shareholders, in addition to potentially counteracting the objectives of the recently finalized rules for liquidity risk management.[3] More specifically, the proposed definition of QCA will likely result in registered funds holding unnecessary amounts of cash, which will reduce returns for long-term savers and potentially impede the ability of funds to manage redemptions through pro rata or risk constant selling of fund assets. In particular, we believe the proposed definition of QCA

[1] SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf ("Proposal").

[2] SEC Division of Economic and Risk Analysis, Memorandum: Use of Derivatives by Registered Investment Companies and Business Development Companies, File S7-24-15 (Nov. 1, 2016), available at https://www.sec.gov/comments/s7-24-15/s72415-260.pdf ("DERA Analysis").

[3] SEC, Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82142 (Nov. 18, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-11-18/pdf/2016-25348.pdf.

would disadvantage individual retail investors, whose only means of accessing professional investment management services is generally through registered investment funds. We believe that this would be an undesirable policy outcome. We, therefore, recommend careful consideration of alternative approaches suggested by commenters. In particular, the DERA Analysis considers commenter suggestions to align the definition of QCA with assets permitted as margin for uncleared swaps and applying haircuts to account for volatility of asset values. Existing standards related to margin for uncleared swaps generally permit the following types of assets, among others, to satisfy both initial margin and variation margin requirements, so long as requisite haircuts are applied: (i) high-quality government and central bank securities; (ii) high-quality corporate bonds; and (iii) equities included in major stock market indices.[4] We believe that the DERA Analysis provides a sound analytical basis for making this important change to the proposal. That said, a comprehensive solution for the asset segregation requirements necessitates the consideration of additional changes to the proposal, as described in detail in this letter. We believe it is important that these suggestions are considered alongside the DERA Analysis.

I. Fund-of-Funds

Fund-of-funds should be granted a carve-out from the asset segregation requirements that would permit fund-of-funds, in which derivatives are utilized to mitigate a particular exposure (e.g., currency exposure), to segregate underlying fund shares to satisfy asset segregation requirements.

As we highlighted in our March 28 letter, the proposed changes to the asset segregation requirements pose challenges for registered funds that are structured as fund-of-funds, particularly if such funds are designed to explicitly mitigate a particular risk to which certain investors may not wish to be exposed. One example of this type of fund is a fund that tracks an international equity index by investing in shares of an international equity fund while using foreign currency forwards, futures, or swaps to hedge the currency risk associated with the international equity investments. There are a growing number of funds that offer currency hedging as an option to investors in order to mitigate the currency risk that US investors would otherwise be exposed to when investing in non-US securities. Such funds permit investors who wish to diversify their holdings beyond US markets but are concerned about currency risk, to mitigate their exposure to foreign currency while still accessing the needed diversification associated with investing outside the US.

Many funds designed to offer foreign equity exposure on a currency-hedged basis operate as funds-of-funds, as obtaining the desired foreign equity exposure through existing unhedged funds provides a known investment process as well as scale benefits to investors. Given that such funds-of-funds typically obtain equity exposure solely through holding shares of

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[4] Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74910 (Nov. 30, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-11 -30/pdf/2015-28671.pdf ; Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-01 -06/pdf/2015-32320.pdf ("CFTC Margin Rule"). *See also* Margin requirements for non-centrally cleared derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Mar. 2015), available at http://www.bis.org/bcbs/publ/d317.pdf. As part of the G20 commitments to provide greater oversight and transparency of the derivatives markets, the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO") undertook significant efforts to establish an international framework of minimum margin requirements for uncleared derivatives. The prudential regulators Margin Rules, the CFTC Margin Rules and the BCBS/IOSCO Final Margin Policy Framework each permit equities and other assets to be posted as margin for uncleared derivatives.

other funds and not through investing in securities directly, there are likely no other holdings in fund-of-fund structures that could be used to satisfy the proposed changes to the asset segregation requirements. As such, the proposed approach to asset segregation would force funds-of-funds to hold unnecessary levels of cash or restructure their investment methodology to invest in securities directly, introducing complexity and potentially increasing costs to shareholders. As such, the Proposal stands to be disruptive to fund-of-fund investors and potentially limit access to and reduce the returns of investors in products designed to help them diversify their holdings while mitigating unwanted currency risks associated with their investments. We believe this outcome would be particularly detrimental to individual retail investors who have no other access to professional asset management services, and will, therefore, be disadvantaged by being forced to choose between lower returns or accepting unwanted risks. As such, we believe that it is important to reiterate this concern in the context of the DERA Analysis because even were the Commission to adopt an expanded definition of QCA based on the PR/CFTC Schedules, this action would not be sufficient to address the challenges posed by the proposed asset segregation requirements for fund-of funds.

In order to prevent these unintended consequences, we recommend the Commission consider a carve-out from the segregation requirement that would permit fund-of-funds, in which derivatives are utilized to mitigate a particular exposure (e.g., currency exposure), to segregate underlying fund shares to satisfy asset segregation requirements. This is because (a) fund-of-funds that operate pursuant to Section 12(d)(1)(G) of the Investment Company Act of 1940 ("1940 Act") often have no holdings other than underlying funds, and derivatives are utilized to mitigate a risk inherent in the underlying funds, and (b) absent an ability to pledge underlying fund securities, in order to fulfill their investment objectives, such funds would have to alter their investment methodology to invest in greater amounts of cash and any other securities the Commission permits as QCA directly, which would lead to greater complexity and potentially higher costs for shareholders and reduced returns.[5]

If the Commission is not inclined to grant this carve-out to address the issues that will be faced by fund-of-funds under the asset segregation proposal, we recommend the Commission permit fund-of-funds to utilize holdings of the funds in which they invest for asset segregation purposes so long as the definition of QCA is expanded in line with the PR/CFTC Schedules, including non-US equities (as described in Section III of this letter). If the Commission were to adopt a definition of QCA in line with the PR/CFTC approach, permitting fund-of-funds to utilize holdings of the funds in which they invest for asset segregation purposes would address the fact that fund-of-funds do not typically have any holdings other than shares of other funds. However, it would also be necessary to ensure that non-US equities are included in the definition of QCA, with an appropriate haircut, to avoid disadvantaging currency-hedged equity products. In addition, if the Commission decides not to change the proposed definition of QCA, this approach would not be sufficient to address the challenges for fund-of-funds and many other types of funds. <u>Though, we underscore that we believe the simplest, and therefore preferable, way to address this issue is to grant the carve-out described above</u>.

[5] 15 U.S.C. §80a-12(d)(1)(G).

II. Exchange-Traded Funds ("ETFs")

The Commission should permit ETF shares to be used as QCA so long as a haircut commensurate with the ETF's underlying holdings is applied.

While the DERA Analysis reviewed only the PR/CFTC Margin Values for Eligible Noncash Margin Collateral, we note that ETF shares are permitted in other haircut schedules, such as those used by the CME Group,[6] and are a significant source of collateral for fund-of-fund structures. We believe that assets approved as margin by US prudential regulators and other global authorities as well as those approved by clearinghouses are appropriate and have already been acknowledged by other regulators to be sufficiently risk mitigating. As such, we encourage the Commission to consider permitting ETF shares to be used as QCA so long as a haircut that is commensurate with the ETF's underlying holdings is applied.

III. Non-US Equities

Non-US equities should be treated consistently with the treatment of US equities, and should be considered QCA so long as an appropriate haircut is applied.

The DERA Analysis examines a sample of asset types that are considered eligible noncash margin collateral by the PR/CFTC and reviews the discount factors applied to those assets in the context of historical data. The DERA Analysis observes that the "existing haircut schedule generally is consistent with the underlying risk levels of the reference assets."[7] We appreciate the Commission's thorough review of the haircut schedule.

We recognize that the DERA Analysis "of Table 6 does not seek to analyze the entire PR/CFTC schedule,"[8] but instead examines common categories of assets (e.g., equity). In this regard, we note that the analysis for equity securities in Tables 6 and 7 only included S&P 500 equities (with S&P 1500 equities considered but not analyzed due to data limitations). We would like to highlight that while the Standardized Haircut Schedule included in the CFTC "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" only references domestic equities, the discussion of the rule indicates that it permits "An index that a covered swap entity's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction."[9] Likewise, the commensurate international standards, including those recognized by the Basel Committee on Banking Supervisions and Board of the International Organization of Securities Commissions "Margin Requirements for Non-Centrally Cleared Derivatives" permit all equities included in major stock indices.[10]

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6 CME Group, Collateral Acceptance Criteria for Exchange Traded Funds and Stocks, available at http://www.cmegroup.com/clearing/files/etf-and-stock-as-collateral.pdf ("CME ETF Criteria"); CME Group, Acceptable Performance Bond Collateral for Base Guaranty Fund Products, available at https://www.cmegroup.com/clearing/files/acceptable-collateral-futures-options-select-forwards.pdf ("CME Haircut Table").

7 DERA Analysis at 10.

8 DERA Analysis at 9.

9 CFTC, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 701 (Jan. 6, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf.

10 BCBS and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Mar. 2015) at 27, available at http://www.bis.org/bcbs/publ/d317.pdf.

Given the breadth of investments made by US registered funds, we assume that the DERA Analysis' focus on domestic equities was for illustrative purposes only. Should the Commission move forward with an approach similar to that of the standards for uncleared swap margin, the Commission should permit all equities that are included in major equity indices as QCA, with applicable haircuts. In particular, we recommend that the haircuts applied be the same for US equities and non-US equities. We would be concerned if the approach that the Commission ultimately pursues only permitted domestic equities as QCA, because this would result in unequal treatment for a large segment of US registered funds. As of September 30, 2016, we estimate that US registered funds that pursue investment strategies dedicated to non-US equities or global equities total $2.76 trillion.[11] Many of these funds use derivatives to manage currency risk.

For comparison purposes, we computed standard deviation and 99% 1-month VaR for a recognized international equity index, the MSCI EAFE Index. Based on this analysis, we believe that applying the same haircut for US equities as non-US developed market equities would be appropriate.

Exhibit 1: Risk Levels for Major International Equity Indices

	Standard Deviation		99% 1-Month VaR[b]
	1997-2016	**2004-2016**	
S&P 500 Index[a]	4.7%	4.6%	11.5%
MSCI EAFE Index	4.7%	4.7%	12.7%

a: Note that we have provided our own calculations for the S&P 500 Index based on our data for calibration purposes. May not tie exactly to DERA Analysis. Standard deviation based on standard deviation of 4 week returns from December 1996 through December of 2015 and December 2004 through December of 2015.

b: VaR is the 99% worst 4 week period from December 1996 through December 2015. Source of returns is % price change from FactSet.

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We thank the Commission for providing BlackRock the opportunity to express our support for your efforts and to provide our comments and suggestions on the Proposal and DERA Analysis. Please contact the undersigned if you have any questions or comments regarding BlackRock's views.

Sincerely,

Barbara Novick
Vice Chairman

[11] Source: Strategic Insight (SimFund). As of Sep. 30, 2016. Includes US-domiciled ETFs, open-end funds, closed-end funds, and fund of funds classified as International Equity funds, per Lipper.

cc:

The Honorable Mary Jo White
Chairman
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The Honorable Michael Piwowar
Commissioner
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The Honorable Kara M. Stein
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