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COMPETITIVE ENTERPRISE INSTITUTE
Advancing Liberty from the Economy to Ecology

December 12, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NW
Washington, D.C. 20549

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies
File No. S7-24-15, Release No. IC-31933

Dear Mr. Secretary:

We write on behalf of the Competitive Enterprise Institute (CEI) regarding the Commission's proposal to regulate the use of derivatives by registered investment companies and business development companies.[1] Last March, CEI submitted comments to the SEC that raised several concerns about the legal basis and policy merits of the proposed rule.[2] In light of the recent memorandum issued by the agency's Division of Economic and Risk Analysis (DERA) regarding "risk adjustment and haircut schedules,"[3] we write to reiterate our objections and ask the Commission to reconsider the proposed rule.

Of more immediate concern, however, is the SEC's request for additional comments concerning the DERA Memorandum. The SEC press release announcing the DERA Memorandum stated that "[i]nterested parties may provide comments."[4] This constituted a reopening of the comment period, which had previously closed on March 28, 2016. However, this reopening was procedurally improper. For this reason, we request that the Commission publish a notice in the Federal Register announcing both the DERA Memorandum and its reopening of the comment period for the proposed rule. This is necessary to ensure that the public has a meaningful opportunity to participate in this rulemaking process, as the Administrative Procedure Act requires.

The SEC should have sought comment on the DERA Memorandum in the Federal Register

As a procedural matter, the Commission erred in announcing the DERA Memorandum via press release—and inviting public comment on it—without publishing an accompanying notice in the

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

2. Comments of CEI, Use of Derivatives by Registered Investment Companies and Business Development Companies (Mar. 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-176.pdf.

3. Securities and Exchange Commission, Division of Economic and Risk Analysis, *Memorandum re: Risk Adjustment and Haircut Schedules* (Nov. 1, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-260.pdf.

4. Press Release, *SEC Staff Provides Additional Economic Analysis on Proposed Derivatives Rule* (Nov. 1, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-232.html.

Federal Register inviting such comment. Given that the haircut schedules and margin requirements laid out in the Memorandum may well impose binding obligations on regulated investment companies, the document should have been announced in the Federal Register pursuant to the agency's obligations under the Administrative Procedure Act and the Investment Company Act of 1940.[5] Issuing a press release on the Commission's website regarding the Memorandum does not substitute for the agency notifying the public of the document in the Federal Register.[6] Therefore, it is paramount that the Commission promptly issue a Federal Register notice that it has reopened the period during which interested parties may submit written comments regarding the proposed rule.[7] Otherwise, parties that do not carefully monitor SEC press releases but do follow the Federal Register may lose out on an opportunity to fully participate in the rulemaking—potentially undermining their ability to obtain judicial review of the rule.[8] The Commission has received just a single written filing regarding the Memorandum,[9] despite having received over 100 filings regarding the original proposal—underscoring the importance of Federal Register notice.[10]

The proposed rule's cost-benefit analysis and legal basis remain flawed

We also remain concerned with several other aspects of the proposed rule as originally published in December 2015. As our March 2016 filing explained, the cost-benefit analysis underlying the proposed rule is deficient. The analysis dwells on the supposed benefits of limiting exposure to derivatives for investors in funds and business development companies, but it ignores the attendant costs of such limits. As federal courts have emphasized, the SEC has a "statutory obligation to determine as best it can the economic implications" of any rule the agency proposes.[11] However, instead of attempting to perform such an analysis for the proposed rule, the Commission summarily declared that it was "unable to quantify the economic effects because" it "lack[ed] the information necessary to provide a reasonable estimate."[12] Although the proposal briefly mentioned the rule's potentially significant economic costs, such as the loss of investor choice and reduced capital formation, the agency sought to quantify only basic compliance expenses.

The proposed rule would also effectively deprive retail investors of access to certain types of mutual and exchange-traded funds, leaving these individuals exposed to greater risk of market volatility and economic shocks. By arbitrarily limiting the leverage a fund can deploy using the "gross notional"

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5. *See* 5 U.S.C. § 553(b); *see also* 15 U.S.C. § 80a-38 (requiring SEC to abide by processes laid out in 44 U.S.C. §§ 1501–1511 when publishing regulations pursuant to the Investment Company Act).

6. *See, e.g.*, Utility Solid Waste Activities Group v. EPA, 236 F.3d 749, 754 (D.C. Cir. 2001) (an agency's announcement of a binding rule via Internet notice is not an acceptable substitute for publication in the Federal Register).

7. *See* CropLife America v. EPA, 329 F.3d 876, 878 (D.C. Cir. 2003) (vacating EPA rule announced as a "directive" without an opportunity for public participation).

8. *Cf.* 15 U.S.C. § 80a-42 (courts may not hear any "objection to the order of the Commission … unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure so to do.").

9. Blackrock, *Supplemental Letter on Use of Derivatives by Registered Investment Companies and Business Development Companies* (Dec. 5, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-266.pdf.

10. *See generally* SEC.gov, *Comments on Proposed Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies Offerings*, https://www.sec.gov/comments/s7-24-15/s72415.shtml (last visited Dec. 12, 2016).

11. Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005); *see also* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011) (invalidating SEC Proxy Access Rules because the agency had "inconsistently and opportunistically framed the costs and the benefits" of the rule).

12. 80 Fed. Reg. at 80957.

method, the rule would ensnare many funds that do not take on excessive risk, but instead provide retail investors with relatively low-risk strategies that offer returns with a very low correlation to more traditional investments. These funds have enabled non-accredited investors to employ strategies previously available only to the wealthy. Discouraging funds from making low-risk, low-volatility "liquid alternative" investments would be especially harmful to non-accredited investors.

Most importantly, the rule appears to exceed the limits imposed on the Commission's authority to regulate derivatives by the Commodity Futures Modernization Act of 2000 (CFMA).[13] This law clarified the respective roles of the SEC and the Commodity Futures Trading Commission to regulate derivatives, an area that had previously been clouded with considerable regulatory uncertainty. Under the CFMA, non-security based derivatives fall outside the scope of the SEC's authority, while many other forms of derivatives—including over-the-counter swaps—fall outside the scope of *both* the SEC's and the CFTC's authority.[14] The CFMA also exempts from either agency's jurisdiction so-called "hybrid instruments" involving futures contracts that are partially connected to bank transactions.[15] Yet the proposed rule appears to ignore these exemptions, offering no explanation for why the SEC is authorized to regulate the issuance of these instruments. Instead, the agency simply asserts that derivatives and financial commitment transactions resemble traditional types of senior securities, without parsing the pertinent statutory definitions.

Therefore, we urge the SEC to refrain from further action in this proceeding until it has sought comment regarding the DERA Memorandum in the Federal Register through a formal reopening of the comment period, and until the agency has fully considered the new comments that it receives.

Sincerely,

/s/ Sam Kazman

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13. Pub. L. No. 106-554, app. E, 114 Stat. 2763, 2763A-365 (2000).

14. *See* CFMA § 209; *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. VII, 124 Stat. 1376 (2010).

15. CFMA tit. IV (codified as amended at 7 U.S.C. §§ 27–27f).