

March 25, 2019

VIA EMAIL DELIVERY

Sarah G. ten Siethoff, Associate Director  
Brian M. Johnson, Assistant Director  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Upcoming Re-Proposal of the Rule to Regulate the Use of Derivatives by  
Registered Investment Companies and Business Development Companies

Dear Brian and Sarah,

It was a pleasure meeting with you and your colleagues on October 4, 2018 to provide input into the upcoming re-proposal of the Rule to Regulate the Use of Derivatives by Registered Investment Companies. I am sending this letter as follow-up to put my thoughts in writing, respond to questions that were raised during the meeting, and propose an approach that I think has merit.

The firm I work for, Welton Investment Partners, is registered as Commodity Trading Advisor (CTA) and offers managed futures products, which are increasingly being sought by investors to diversify their portfolios. Managed futures products typically invest in exchange traded derivatives using a quantitative approach.

I understand that under Sec. 18 of the Investment Company Act of 1940 your goal with the upcoming re-proposal is to protect investors from 'undue speculation'. Specifically, you would like to address the potential for excessive risk-taking that the leverage associated with derivatives can provide, and are seeking to find a way to quantify and limit leverage and risk without unnecessarily hindering the offering of alternative investment products like managed futures.

Since managed futures products are likely to have more derivatives exposure than a typical Fund, a regulatory approach that works for managed futures, while it may not be 'one size fits all', could have wider application in meeting your goals. My preference is for a quantitative approach, with metrics that are easy to understand, implement and enforce, as opposed to a more subjective approach that could lead to ambiguous situations, cause delay in reducing exposure when appropriate, and be more difficult for managers to implement.

Accordingly, I would propose that the Commission consider the following approach as an effective way to regulate derivatives in 40 Act Funds:

1. Mark-to-Market Coverage Amount - Quantify the Leverage of Derivatives Using Margin. For exchange traded derivatives use margin as set by the exchanges, for SWAPS and uncleared OTC derivatives use the Standard Initial Margin Model (SIMM) developed under the auspices of the International Swap Dealers Association (ISDA), and as a final fallback use the Prudential Regulators Final Margin Rule.
2. Risk-Based Coverage Amount - Set a Limit on Absolute Derivatives Exposure Based on a Multiple of Margin. Require that a Fund set aside two times margin (including what is already posted) as a cap on the absolute amount of derivatives leverage that can be used.
3. Portfolio Level Risk Amount - Set a Portfolio Limit on Derivatives Exposure Using a Risk Based Measure. While an overall margin-based cap will afford significant investor protection, there could still remain the possibility of a concentration of derivatives leverage in one or a small number of positions, the risk of which can be quantified and addressed through a cap on Value at Risk (VaR).
4. Qualifying Coverage Assets - Limit and Segregate the Assets that Can be Used to Satisfy the Risk-Based Coverage Amount. To make sure that there are sufficient funds available to meet margin calls, require that the assets used to satisfy the additional margin-based requirement are segregated, and be either cash or highly liquid low-risk cash equivalents.

Combining a margin based leverage cap with a portfolio risk based cap is an effective way to regulate derivatives in 40 Act Funds. A more detailed discussion follows below.

#### 1. Quantify Overall Derivatives Exposure Using Margin.

You may recall at the outset of the meeting my initial concern was to persuade you to reject any notional-based measure as an ineffective and inherently flawed way to measure leverage or risk. You indicated that a large number of the comment letters received on the prior proposal shared these concerns, and that you were receptive to rejecting any notional based measures. To reiterate, notional is 'bad' and margin 'good' for the following reasons:

- Notional contract value in many cases (in particular for large notional low volatility fixed income contracts), bears no relationship to risk/volatility, and depending on the particular instruments traded, could force managers to construct portfolios that are less diversified, more risky, and of less use to investors looking for uncorrelated returns.

- Margin set by exchanges has been in use for decades, is independently set and monitored, and is dynamic and adjusted daily in response to market conditions.
- An increase in margin by the exchanges in response to market conditions could automatically require liquidation or reduction of a position when a fund's Mark-to-Market Coverage Amount for derivatives exceeds the Qualifying Coverage Assets.
- The use of margin as a metric would involve no discretion on the part of a Fund, would not require board action to oversee, and should be relatively straightforward to implement.

Margin comes in a number of forms across a variety of instruments, and the question becomes which measures to use and how to combine them.

For exchange traded and cleared derivatives the answer is straightforward – use the initial margin set by the exchange

For OTC and Swaps, the Dodd-Frank reforms and increased Swaps regulation by the CFTC and NFA have brought about the use of SIMM for a significant and increasing number of transactions.

Under the jurisdiction of the NFA and CFTC, SIMM is being implemented for Swaps dealers in tranches based on their size, with the largest dealers already in compliance. Phases 1-3 are already completed, Phase 4 is to be implemented by September 1, 2019, and Phase 5 is due to be completed by September 1, 2020. See: Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74849 (November 30, 2015)

While SIMM provides a mostly parallel approach to exchange set margin, there are some differences that would potentially need to be reconciled. In particular, SIMM margin may be higher because in most circumstances it will not change during the life of a trade versus exchange margins which can be reset daily. As a result, a fund taking an equivalent position in futures contracts versus a Swap could possibly have different margins, raising the question of whether an adjustment should be considered.

More information on SIMM, what it covers, and updates on its implementation can be found on the ISDA website: <https://www.isda.org/category/margin/>

As a final fallback for the dwindling number of derivatives not covered by exchange margins or SIMM, the Prudential Regulators' Final Margin Rule could be applied, using the percentages set forth in Table A below.

TABLE A—STANDARDIZED MINIMUM GROSS INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS<sup>1</sup>

Asset Class	Gross initial margin (% of notional exposure)
Credit: 0–2 year duration .....	2
Credit: 2–5 year duration .....	5
Credit: 5+ year duration .....	10
Commodity .....	15
Equity .....	15
Foreign Exchange/Currency .....	6
Cross Currency Swaps: 0–2 year duration .....	1
Cross-Currency Swaps: 2–5 year duration .....	2
Cross-Currency Swaps: 5+ year duration .....	4
Interest Rate: 0–2 year duration .....	1
Interest Rate: 2–5 year duration .....	2
Interest Rate: 5+ year duration .....	4
Other .....	15

Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74909 (November 30, 2015); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 700-701 (January 6, 2016).

Depending on the variance among the different types of margin, it may make sense to consider adjustment factors to bring the Final Margin Rule percentages, SIMM and exchange margins in line.

2. Set an Overall Margin-Based Cap on Derivatives Exposure.

To provide effective absolute protection against over exposure to derivatives, require Funds to segregate cash, cash equivalents or other liquid assets in an amount equal to double the appropriate margin requirement for their positions. Note that the double margin requirement would include assets already on deposit with a Futures Commission Merchant (FCM) or other applicable counterparties.

3. Set an Absolute Portfolio Level Risk Cap Based on VaR.

There are significant benefits to combining a VaR cap with a margin cap. Margin alone may fail to capture the concentration of leverage in one or a small number of positions, and VaR in isolation has been criticized for not capturing ‘tail risks’ and understating risk in ‘stressed conditions’. VaR quantifies the maximum potential loss due to market risk as opposed to leverage. By combining the two, both risk and leverage will effectively be capped, using dynamic measures that may require automatic reduction of existing positions when conditions dictate.

VaR can be applied as both an absolute metric or relative to a benchmark or reference portfolio. A number of approaches exist for calculating VaR, including the parametric (Variance-Covariance) model, the Historical Simulation Model, and the Monte Carlo Simulation Model. While a particular model may be more appropriate for a given portfolio, results are expressed as the maximum potential loss at a given confidence level (probability) over a specific time period.

For Absolute VaR, while there are a range of values that would effectively protect investors, I would propose that Funds be required to meet the standard of a 99% probability that they not lose more than 35% over a 30 day holding period. If using the Historical Approach this should be based on a three-year lookback on actual performance, and where actual is not available, on simulated returns.

For Relative VaR, as a starting point I would suggest two and a half times the risk of loss of a relevant benchmark or reference portfolio, with the same 99% confidence over a 30 day holding period based on a three-year lookback.

A Fund could choose between Absolute VaR and Relative VaR as appropriate, and would need to retain for audit the exact methods and data used to calculate the relevant VaR.

I would note that VaR is part of the regulatory approach taken in Europe with regard to UCITS, which includes a VaR component along the lines of what is proposed above.

#### 4. Limit and Require Segregation of the Assets That Can Be Used to Meet the Multiple of Margin Requirement.

Assets that are used to meet the additional margin requirement should be cash, or highly liquid cash equivalents, that will be readily available if needed to satisfy margin calls.

In 1979, in Investment Company Act Release No 10666, the Commission set forth an approach requiring the segregation of liquid assets to meet potential obligations arising from risky investments. The approach has been refined through a series of no-action letters addressing how and when Funds must segregate assets against a variety of derivatives transactions. See: Use of Derivatives by Investment Companies under the Investment Act of 1940 Act Release No. 29776 (August 31, 2011) at Pg. 23. This established approach has worked well and we think is the best way to handle the segregation of funds to meet an enhanced margin requirement for investment in derivatives.

As an additional reference, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 700-703 (January 6, 2016) sets forth a list of assets that can be used as collateral for Swaps margin, which include a major currency, a US Treasury or other US Government security, a variety of securities issued by other entities as well as publicly traded debt and stocks, provide they meet specific requirements, with a haircut schedule depending on the asset.

5. Conclusion.

As further support for the proposed use of margin and VaR, [The 2017 US Treasury Department Report: A Financial System That Creates Economic Opportunities: Asset Management and Insurance](#) expressed concerns about the portfolio limits in the original proposed rule and the use of notional exposure as a metric (see pg. 37):

“First, portfolio limits could unnecessarily restrict funds from using derivatives...and would result in less efficient asset management, higher transaction costs, and lower returns. The result could be the closure of certain funds, or forced changes to investment strategies that would disrupt current business practices and reduce investor choice.”

“Second, the proposed rule’s use of gross notional amount as a measure for derivatives exposure is problematic. ...a high gross notional exposure of a fund’s portfolio is not necessarily correlated with leverage or risk levels.”

I appreciated the opportunity to meet with you and would be happy to return for further discussions or respond to any questions.

Respectfully submitted,

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