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March 17th 2016

Via e-mail to rule-comments@sec.gov

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; Release No. IC-31933; File No.S7-24-15

Dear Mr. Fields,

Highland Consulting Associates, Inc. ("Highland") appreciates this opportunity to comment on proposed rule 18f-4 File Number S7-24-15¹, about which the Securities and Exchange Commission solicited comment on the use of derivatives by investment companies registered under the Investment Company Act of 1940 ("40 Act"). Although the proposal solicits comments in a number of areas, we are confining our comments to a few limited areas of particular interest to Highland and our clients.

Highland Consulting Associates, Inc. was founded in 1993 and provides conflict-free, fee-only consulting services to institutional investors and their fiduciaries. Our firm operates on the philosophy of "investor advocacy." As our clients' Investor Advocates®, we work to improve our clients' prospects for success. Our approach dictates that our ownership, operational, and compensation structures be aligned with clients, adhering to the philosophy that "our only alliance is with our clients." Highland serves a wide array of clients. Fiduciary clients include defined benefit and defined contribution plans, foundations, endowments, and other institutional investors. Clients also include family offices and similar private investors. We advise over 100 clients with total assets of approximately \$12 billion.

¹ Use of Derivatives by Registered Investment Companies and Business Development Companies; Release No. IC-31933; File No.S7-24-15 available at <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>

Merriam Webster defines an advocate as “one that pleads the cause of another.” The Investor Advocate® pleads the cause of client investors to assist them in meeting their investment needs and goals. Informed and experienced Investor Advocates® can overcome the time, cost and knowledge constraints of client situations to improve the probability of achieving investment success and of successfully meeting fiduciary responsibilities. It is in this spirit of advocacy that we comment on the proposed rule.

Impact of Derivatives Exposure Limitations

Question: “Are certain types of funds likely to use the 150% exposure limit exclusively for leveraging purposes? If so, do commenters believe that such a level of exposure would be inappropriate? Should any concerns about a fund using derivatives transactions exclusively for leveraging purposes be addressed through a reduced exposure limitation? Is 150% an appropriate exposure limit? If not, should it be higher or lower, for example 200% or 100%? Does the 150% exposure limit, together with the rule’s other limitations, achieve an appropriate balance between providing flexibility and limiting the amount of leverage a fund could obtain (and thus the potential risks associated with leverage)? Does the 150% exposure limit effectively address the varying ways in which funds use derivatives, including for hedging purposes?”

We believe one of the fundamental risk management challenges investors face is due to the relative volatility of assets. The most common high-return, high-risk assets available in mutual fund form are equity funds. The vast majority of those funds are unlevered. Yet those assets are high volatility and in a market downturn like 2008 had large losses. We present some summary data on page 3. Various stock indexes included in rows 1-3 lost between 37% and 53% in 2008. Those assets have high volatility, and importantly also have high correlations (closer to 1.0) to global equities. Most investors who make return-seeking portfolios have portfolios that are overwhelmingly concentrated in one type of risk, namely equity risk. The funds in those portfolios tend to be highly correlated and lose value at similar times. Historically, investors have had portfolios like these in part because leverage restrictions have limited access to otherwise suitable alternatives.

A variety of conventional and alternative assets exist which are both less correlated and less volatile. Less correlated assets provide more meaningful diversification. We illustrate some examples in rows 4-7 of the following page. Even if some of the assets in rows 4-7 were leveraged, the volatility and losses following a period like 2008 *would still be less* than that realized by most conventional, unleveraged equity funds.

Table 1: Volatility and Correlation Comparison of Different Investment Types

Name (Proxy Market Description)	Annualized Volatility (5 Years Ended Dec 2015 in %)	Correlation to Global Equities (Proxied by MSCI World Index)	2008 Return in %
1: S&P 500 Index (US Stocks)	12	0.95	-37
2: MSCI EAFE Index (Developed, Non-US Stocks)	15	0.97	-43
3: MSCI Emerging Markets Index (Emerging Market Stocks)	18	0.86	-53
4: Barclays US Aggregate Index (US Investment Grade bonds)	3	-0.08	5
5: Credit Suisse Merger Arb Liquid Index (A Merger Arbitrage Index)	4	0.50	-8
6: S&P Diversified Trends Indicator Index (A Managed Futures Index)	6	-0.11	8
7: Deutsche Bank USD Currency Harvest (A Currency Strategy Index)	9	0.81	-29

In recent years, more strategies have been offered in the 40 Act form allowing investors to construct more diversified and risk-managed portfolios. Many investors benefit from the availability of these strategies in the 40 Act form. Investors in their company 401K or 403B plans benefit. Pension plans, endowments, foundations, and other investors also commonly use the 40 Act vehicle. In contrast to other more private vehicles, the 40 Act ensures minimum levels of transparency, liquidity and governance. The increasing availability of these types of 40 Act funds also has generated indirect benefits for investors who may use private vehicles. In response to increased competition from 40 Act funds, private fund managers have increased transparency, decreased fees and have improved governance.

The meaningful diversification benefits provided by many alternative mutual funds must allow for a certain amount of leverage. Certainly not every investment strategy is suitable for a 40 Act fund, particularly an open ended version permitting daily redemptions. Some strategies are likely too illiquid, or too volatile to be effectively implemented in the form. We agree that safeguards should be implemented to protect investors. However, we believe there are likely more effective means to accomplish this than via strict limits on notional exposure that the proposed rule contemplates.

Defining Derivative Exposure

Question: “Is the proposed rule’s use of notional amounts as the basis for calculating a fund’s exposure under a derivatives transaction appropriate? Does the notional amount of a derivatives transaction generally serve as an appropriate means of measuring a fund’s exposure to the applicable reference asset or metric? Are there particular types of derivatives transactions or reference assets for which the notional amount would or would not be effective in this regard? For such derivatives, what alternative measures might be used and why would they be more appropriate? Would such alternative measures be easier for funds and compliance staff to administer?”

Should we consider permitting or requiring that the notional amounts for interest rate futures and swaps be adjusted so that they are calculated in terms of 10-year bond equivalents or make other duration adjustments to reflect the average duration of a fund that invests primarily in debt securities? Would this result in a better assessment of a fund’s exposure to interest rate risk? Why or why not?

The usage of notional exposure amounts is problematic for a number of reasons. One of the most important is that notional exposure can be weakly related and potentially misleading as to the true risk of a strategy. A straightforward example can be seen with fixed income derivatives. An exposure to a 2-year duration bond has less interest rate risk than an exposure to a 30-year duration bond. A 2-year duration bond could be leveraged multiple times and still have less interest rate risk than a 30-year bond.

The issue also manifests in most other markets. An exposure to US large cap stocks has been less volatile than an exposure to emerging market stocks. An exposure to Japanese Yen has been less volatile historically than an exposure to Russian Rubles. An exposure to coffee historically has been less volatile than an exposure to gasoline.

As we alluded to earlier, portfolio diversification benefits mathematically are maximized when low volatility, low correlation assets are permitted to be leveraged to a level of risk more consistent with other assets. In our preliminary conversations with managers who operate funds that would be impacted by the proposed rule, many have articulated that the volatility of their funds would have to be reduced substantially. Virtually all of those impacted funds that our clients use already have less volatility than mainstream equity funds. Decreasing the volatility of this set of funds would negatively impact a number of our clients. Their diversification benefits would decrease. To maintain target returns they would be required to implement less diversified and higher volatility portfolios. An alternative for our clients to increasing risk would be to provide less generous retirement benefits to employees, or to decrease charitable spending and donations.

An alternative risk limitation regime may emphasize volatility or VaR. While VaR is an imperfect framework, it does address this issue of the relative volatility of different assets. In addition to emphasizing volatility or VaR, an emphasis on liquidity may be useful.

Feasibility of Certain Strategies to Operate Under the 40 Act and Impact to Investors

Question: “The 150% exposure limit (and the 300% exposure limit in the risk-based portfolio limit) would apply to all funds without regard to the type of fund or the fund’s strategy. Are there certain types of funds for which a higher or lower exposure limit would be appropriate? Do commenters agree that it may be feasible, for the reasons discussed above, for funds that do not wish to rely on the proposed rule to deregister under the Investment Company Act and for the fund’s sponsor to offer the fund’s strategy as a private fund (which can be offered solely to a limited range of investors) or as a public or private commodity pool? Are these alternatives, which do not have statutory limitations on the use of leverage, feasible vehicles for these types of strategies?”

Yes, funds can deregister and offer the fund’s strategy as a private fund. These types of private funds can be and are offered to endowments, pensions, or inside 401K/403B plans. However, the impact to investors would be meaningful. Many institutional investors face frictions investing in these types of private vehicles. Administration and audit processes are more cumbersome and expensive. The process of contributions and redemptions from these funds can also be more difficult. 40 Act funds have an advantage in terms of standardization and tradability. 40 Act funds are far more widely available to even institutional investors.

Alternatives to Proposed Derivatives Notional Exposure Restrictions

Question: “Do commenters agree that the proposed rule should include, in addition to the exposure-based portfolio limit, an alternative portfolio limitation that focuses primarily on a risk assessment of a fund’s use of derivatives? Do commenters agree that, where a fund’s derivatives transactions, in the aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, it would be appropriate to permit the fund to engage in derivatives transactions to a greater extent than would be permitted under any exposure-based portfolio limit?”

As a general principle we do believe that a risk-based framework would be helpful. Rather than an emphasis on hedging as proposed, a framework that emphasizes volatility or VaR and liquidity of underlying assets would be more effective.

Question: “Do commenters agree that the proposed 300% outer limit on exposure is appropriate? Do commenters agree that a 300% exposure limit would address the concerns we discuss above while also preserving the utility of the risk-based portfolio limit for funds that use derivatives, in aggregate, to result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives? Should we make it higher or lower, for example 250% or 350%, and how would a different limit address the concerns we discuss above?”

There are a number of 40 Act funds that operate with exposures greater than 300%. The Commission's observations of some funds' operating exposures of 900% or more are consistent with our observations as well. In our experience with these funds, the funds' volatility is usually still well below that of markets like traditional equities. A limit of 300% would sharply reduce the diversification benefit that these funds can provide as part of a broader portfolio. On a standalone basis most of these funds are lower volatility than what investors can find on an unleveraged basis. And these funds can provide meaningful diversification benefits when incorporated into portfolios. This goes to confirm the challenges with associating notional exposure with risk in a strategy.

Question: "Rather than determining the risk-based coverage amount in accordance with policies and procedures approved by the board, should we prescribe risk-based coverage amounts in the proposed rule? Should we, for example, provide that the risk-based coverage amount must be determined based on a specific financial model (i.e., VaR at a particular confidence level)? Should we specify a percentage of the derivative's notional value? If so, what percentage should we choose? Should it vary for different types of derivatives? For example, should the proposed rule include a standardized schedule that specifies the risk-based coverage amount for particular derivatives transactions? If so, should the schedule be similar to, or different from, the standardized schedules under rules that have been proposed or adopted for swap entities that are required to collect initial margin and elect to use a standardized schedule approach instead of an internal model approach? If so, should the standardized schedule approach be in addition to, or in place of, the approach currently described in the proposed rule? Why or why not?"

In many cases, an existing framework regarding coverage for various derivatives contracts already exists. Futures and options exchanges have already established margin requirements that will vary by instrument. Centrally cleared swaps also have margin requirements set by an exchange in accordance with the exchanges' long term historical experience and knowledge of the specific instruments. It may be a duplication to create another coverage framework specific to 40 Act funds. Some over-the-counter derivatives are used, but in those cases the fund is typically counterparty to a dealer. That dealer itself is enforcing coverage. It's likely that the exchanges and private dealers would be able to respond more quickly in the event of changing market conditions which might require changes in coverage.

Question: "The proposed rule would require a fund to calculate VaR using a time horizon of at least 10 trading days, but not more than 20 trading days. Do commenters agree that it is appropriate to provide a range of trading days, to give funds some flexibility in selecting a time horizon based on the fund's own particular characteristics? Do commenters agree that a range of 10 to 20 trading days would be appropriate? Should the number of trading days be lower than 10, or higher than 20? Should the number of trading days be a specific number, instead of a range? Why or why not? If so, which specific number would be appropriate? Should we, for example, specify 10 or 20 trading days?"

Giving a window of days may incite gaming behavior by funds. For example, the choice of 10-day instead of 20-day VaR may decrease reported VaR by up to 30%. The usage of VaR itself may be a communication challenge with 40 Act investors. While practitioners understand the limitations of VaR, a VaR number still may be misinterpreted by investors as a maximum investors can lose. Most investors are accustomed to seeing volatility or standard deviation. While the metric is imperfect, volatility does allow comparability of riskiness with less potential for misinterpretation. Volatility on an annualized basis tends to be the most commonly reported volatility measure, and likely can be provided by a variety of risk measurement software packages.

If the objectives of regulation are to provide protections from funds taking excessive levels of risk, then a maximum volatility framework may be more useful to regulate funds that make extensive use of derivatives. A logical maximum level may be around or near the highest volatility commonly available through unlevered funds, such as the volatility level of emerging markets or small cap funds. For example, a maximum expected volatility of 20% would be similar to many types of mainstream equity funds. Equity funds constitute a large portion of the total number of 40 Act mutual funds. Investors are accustomed to seeing similar levels of volatility in these types of funds. Importantly, a framework like this would make improved differentiations between low or modest volatility strategies and extremely high volatility strategies that use similar amounts of leverage.

Volatility itself is an incomplete measure of risk. Another important and relevant measure of risk for 40 Act funds is liquidity risk. Funds that permit daily investor redemptions should be and are regulated on their exposure to illiquid assets. Many of the leveraged funds we see typically operate with large amounts of cash equivalents or short-duration high-quality assets. We've seen many funds operate with 50-80%+ of these types of assets backing exposure. These assets can be used to meet investor redemptions, meet margin calls, or settle trades. A minimum portfolio liquidity requirement for funds that use a certain level of leverage may make sense. For example, a minimum 25% or more of assets held in certain types of short-duration high-quality assets. This requirement could increase for funds that have higher levels of leverage or volatility.

Transparency to Investors

Question: "As discussed above, proposed rule 18f-4 would require funds that engage in derivatives transactions to comply with one of two alternative portfolio limitations: the exposure-based portfolio limit or the risk-based portfolio limit. While we are proposing to require that funds maintain certain records relating to their compliance with the applicable portfolio limitation, we are not proposing that they report to the public or the Commission the funds' aggregate exposure or, for funds that operate under the risk-based portfolio limit, the results of the funds' VaR tests. Would there be a benefit to publicly reporting this information? Should we require funds to report on proposed Form N-CEN or Form N-PORT either or both of the funds' aggregate exposures or their securities' VaRs and full portfolio VaRs (if applicable)?"

We believe investors benefit from transparency. The risk to managers of gaming or front running is likely limited if they are reporting aggregate risk measures. 40 Act funds report positions on an ongoing basis. Managers that operate leveraged funds should provide higher levels of transparency to investors. Those funds should have and likely do have risk measurement systems which can easily provide this type of information on an ongoing basis. Funds should report measures like their expected volatility or aggregate VaR publicly on an ongoing basis. While the Commission doesn't propose additional measures such as equity beta, sensitivity to interest rate shifts or shifts in credit spreads, these measures would all be useful tools for investors to better understand fund risk which will allow more informed judgement regarding their investments. More than likely, these types of metrics are feasible for funds to report, especially if they have already made the requisite investments into risk management systems and technology. We would encourage the reporting of these types of measures publicly on an ongoing basis.

We appreciate the efforts of the Commission and its staff to better protect investors and increase transparency regarding derivatives activity in investment funds. We hope our comments are helpful, and we would be pleased to discuss any aspect of this letter in greater detail.

Sincerely,

A handwritten signature in black ink that reads "Al Hemmingsen". The signature is written in a cursive, flowing style.

Highland Consulting Associates, Inc.

By: Al Hemmingsen, CFA

Title: Director of Research