Invesco

VIA ELECTRONIC SUBMISSION

March 24, 2020

Ms. Vanessa Countryman
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; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, File No. S7-24-15

Dear Ms. Countryman:

Invesco Ltd. ("**Invesco**") appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "**SEC**" or "**Commission**") on the re-proposal of Rule 18f-4 (the "**Proposed Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), and the proposed amendments to Forms N-PORT, Form N-LIQUID (to be re-titled "Form N-RN") and Form N-CEN.[1] Invesco is pleased that the Commission is re-proposing Rule 18f-4 to provide an updated and more comprehensive approach to the regulation of registered funds' use of derivatives transactions and other leveraging transactions. Invesco is also pleased that the Proposed Rule is responsive to feedback provided by Invesco and others on the version of Rule 18f-4 originally proposed by the Commission in 2015.[2]

Invesco is a leading independent global investment manager with approximately $1,159.4 billion in assets under management as of February 29, 2020. Invesco is a global company focused on investment management, and our services are provided through a wide range of strategies and vehicles, including open-end mutual funds, closed-end funds, exchange-traded funds, collective trust funds, separately managed accounts, real estate investment trusts, unit investment trusts and

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[1] See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (January 24, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf (the "**Proposing Release**"). Terms defined in the Proposing Release or the Proposed Rule have the same meaning when used in this letter unless otherwise defined herein.

[2] See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80884 (December 28, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-12-28/pdf/2015-31704.pdf (the "**2015 Proposal**"). Invesco provided comments to the Commission on the 2015 Proposal. See Comment Letter of Invesco Advisers, Inc. (March 28, 2016), available at https://www.sec.gov/comments/s7-24-15/s72415-166.pdf (the "**2015 Invesco Comment Letter**").

other pooled vehicles. Invesco's indirect wholly-owned U.S. registered investment adviser subsidiaries, including Invesco Advisers, Inc. and Invesco Capital Management LLC, advise or sponsor mutual funds, ETFs, closed-end funds and unit investment trusts for a broad client base.

I. **Executive Summary**

Invesco remains supportive of the Commission's efforts to develop an updated and more comprehensive approach to the regulation of registered funds' use of derivatives and other leveraging transactions. Invesco agrees with the Commission that registered funds using derivatives transactions should be subject to a regulatory framework that requires them and their advisers to manage attendant risks, including the risk of leverage that implicates the "undue speculation" and "asset sufficiency" concerns expressed in Sections 1(b)(7) and 1(b)(8), respectively, of the Investment Company Act. Invesco also agrees with the Commission that a modernized, comprehensive approach to regulating registered funds' use of derivatives would address potential adverse results from funds' current, disparate asset segregation practices, which have evolved in the forty years since Release 10666 and do not require funds to holistically assess and manage the several risks associated with derivatives transactions, including market and counterparty risks. We believe the Proposed Rule will aptly address the investor protection purposes and concerns that underlie Section 18 of the Investment Company Act through its principles-based derivatives risk management program and rigorous stress testing requirements and its VaR-based limit on fund leverage risk.[3]

Invesco is pleased that the Commission has considered and responded to feedback provided by commenters on the 2015 Proposal. In particular, Invesco supports the elimination of any requirement that registered funds comply with a derivatives notional amount limitation to control leverage risk or, for funds using relatively larger notional amounts of derivatives, a requirement that the derivatives be in aggregate risk reducing. As discussed in the 2015 Invesco Comment Letter, we believed that the 2015 Proposal's approach to limiting derivatives exposure and leverage through notional amount limits was overbroad and based upon a flawed assumption that all types of derivatives give rise to equivalent risk, and failed to reflect funds' nuanced use of derivatives for both speculative and risk-mitigation purposes.[4]

While we are generally supportive of Rule 18f-4's adoption, we recommend certain modifications, supplements and clarifications to the Proposed Rule in the remainder of this letter,

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[3] In the 2015 Invesco Comment Letter, we urged the Commission to adopt VaR as a sophisticated risk management tool for limiting fund leverage, complemented by a requirement that funds stress test their portfolios to mitigate the Commission's stated concerns about "tail risk" and VaR's limitations. See 2015 Invesco Comment Letter at 9-13. We also expressed support for a principles-based requirement for registered funds that are more significant derivatives users to establish and implement derivatives risk management programs that focus on a fund's particular derivatives use, its broader investment portfolio and the investment process followed by its portfolio managers. See *id* at 19-20.

[4] See *id* at 5-9.

along with our rationale and basis for each recommendation. These recommendations are summarized below. We believe that the recommended modifications, supplements and clarifications will (i) benefit the implementation and effectiveness of registered funds' derivative risk management programs and the VaR-based limit on fund leverage risk, (ii) reflect the statutory distinction between open-end fund and closed-end fund capital structures in the application of the relative VaR test, (iii) improve the scope of the Proposed Rule to ensure that funds that are limited derivatives users are appropriately excepted from compliance costs and burdens that are disproportionate to the derivatives risks incurred, (iv) prevent unintended consequences to money market funds, (v) ensure that fund investors receive information regarding funds' use of derivative instruments that is understandable and useful, (vi) provide funds and their advisers sufficient time to design and implement effective derivative risk management programs that comply with Rule 18f-4 and (vii) generally facilitate funds' continued use of derivatives transactions as critically important instruments for achieving investment objectives and managing investment risks.

- *Recommendations Regarding VaR-Based Limit on Fund Leverage Risk*
    - Permit a fund that is subject to the relative VaR test to elect to compute its VaR ratio using either (x) a designated reference index or (y) its actual portfolio of securities and other investments, but excluding derivatives transactions;
    - For a closed-end fund that is subject to the relative VaR test, provide for a higher VaR ratio percentage limit to reflect the permissible issuance by the fund of senior securities that are stock;
    - When a fund is not in compliance with its applicable VaR test, permit more time for the fund to rectify the non-compliance. Additionally, once a fund has regained compliance with its VaR test, permit the fund to resume using derivatives transactions (including risk additive derivatives) without the three consecutive business day requirement and regardless of whether the fund's derivatives risk manager has completed the required board reporting;
    - Explicitly permit a fund to scale its VaR calculation results from a 95% confidence level to a 99% confidence level; and
    - Provide additional clarification and guidance with respect to designated reference index determinations and the applicability of the absolute VaR test.
- *Recommendations Regarding the Limited Derivatives User Exceptions*
    - Combine the two alternative exceptions into a single exception. To qualify as a limited derivatives user under the single exception, a fund's derivatives exposure must be 10% or less of its net assets, but the notional amount of derivatives transactions that constitute qualifying hedges of currency risk would be omitted in computing the fund's derivatives exposure; and

- Provide certain technical changes and guidance, including permitting a fund to calculate its aggregate notional amount after giving effect to notional amount netting in limited circumstances.

- *Recommendation Regarding Board Oversight and Reporting*

  - Eliminate the requirement that a fund's derivatives risk manager provide to the fund board a written representation regarding the reasonableness of the design of the fund's derivatives risk management program and replace it with a requirement that the derivatives risk manager provide the board a written report, at least annually, that addresses the operation of the program, assesses its adequacy and effectiveness of implementation and discloses any material changes.

- *Recommendation Regarding Scope of Derivatives Transactions*

  - Clarify that "when issued" transactions and other similar delayed delivery transactions are not derivatives transactions to avoid unintended consequences for money market funds.

- *Recommendation Regarding Fund Reporting Requirements*

  - Revise the Form N-PORT amendments to provide that none of the information reported by a fund in response to Items B.9 and B.10 is made publicly available.

- *Recommended Transition Period*

  - Provide a 24-month transition period for funds to prepare to come into compliance with Rule 18f-4.

II. **Summary of the Proposed Rule and Amendments to Fund Reporting Requirements**

The Proposed Rule would operate as an exemptive rule under the Investment Company Act and permit a "fund" (which term includes registered open-end companies (including exchange-traded funds), closed-end companies and companies that have elected to be treated as business development companies under the Investment Company Act but excludes money market funds and unit investment trusts) to enter into derivatives transactions (which include short sale borrowings) notwithstanding the prohibitions and restrictions on funds' issuance of senior securities under Sections 18 and 61 of the Investment Company Act, subject to the fund's compliance with the following conditions:

- Adoption and implementation of a written derivatives risk management program tailored to the fund's use of derivatives and its other investments. The program requires a fund to: (i) identify and assess its derivatives risks, (ii) establish and enforce investment or risk guidelines that provide for quantitative metrics or thresholds of the fund's derivatives risks that the fund

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does not normally expect to exceed and measures to be taken if they are exceeded, (iii) periodically stress test its portfolio to evaluate potential losses in response to extreme but plausible market changes or changes in market risk factors, (iv) backtest each business day the results of the fund's VaR calculation model, (v) internally report on the program's operation to fund portfolio managers and escalate to those portfolio managers and the fund board material risks arising from the fund's derivative transactions and (vi) periodically review the program to evaluate its effectiveness and reflect changes in risk over time.

- Designation and board approval of a derivatives risk manager, constituted by an officer or a group of officers of the fund's investment adviser, that is responsible for administering the fund's derivatives risk management program, has relevant experience regarding the management of derivatives risk, has a direct reporting line to the fund board and is appropriately independent of the fund portfolio managers.

- Adherence to an outer limit on leverage risk based on VaR. This limit is measured using a relative VaR test that compares the fund's VaR to the VaR of a designated reference index. If the derivatives risk manager is unable to identify an appropriate designated reference index, the fund would alternatively be required to comply with an absolute VaR test. Compliance with the relevant VaR test would be tested at least once each business day.

- Periodic, regular reporting by the fund's derivatives risk manager to the fund board on the adequacy and the effectiveness of implementation of the fund's derivatives risk management program, and analyzing the results of stress testing and backtesting required under the program and any exceedances of risk guidelines.

- Certain recordkeeping requirements designed to facilitate the ability of the Commission's staff, the fund board and the fund's and its adviser's compliance personnel to evaluate compliance with the rule.

The Proposed Rule would except funds that are limited derivatives users from the derivatives risk management program requirement and the VaR-based limit on leverage risk. To qualify, a fund must either (i) limit its derivatives exposure (the aggregate notional amount of its derivatives instruments and the value of assets sold short, after duration adjustment for interest rate derivatives and delta adjustments for options) to 10% or less of its net assets or (ii) use derivatives transactions solely to hedge foreign currency risk. A fund that is a limited derivatives user would still need to adopt and implement policies and procedures that are reasonably designed to manage the fund's derivatives risks.

The Proposed Rule would also allow funds to enter into reverse repurchase agreements and similar financing transactions and unfunded commitment agreements to make loans to or investments in another entity in the future, notwithstanding Sections 18 and 61 of the Investment Company Act, subject to conditions tailored to these transactions. With respect to reverse repurchase agreements and similar financing transactions, a fund would be required to aggregate the amount of indebtedness incurred under such transactions with the amount of any other senior

securities representing indebtedness when calculating its asset coverage ratio requirements under Section 18.

Finally, in connection with Rule 18f-4 the Commission proposes to amend certain fund reporting requirements. These include amendments to (i) Form N-CEN requiring a fund subject to Form N-CEN reporting to disclose whether it is a limited derivatives user and whether it has entered into reverse repurchase agreements or similar financing transactions, (ii) Form N-PORT requiring a fund subject to Form N-PORT reporting to disclose its derivatives exposure from both derivative instruments and short sales, as well as VaR information for the reporting period, its designated reference index and backtesting results (as applicable) and (iii) Form N-RN requiring a fund to report the occurrence of non-compliance with its VaR test that is not rectified within three business days. The Commission proposes to make publicly available the new information reported on Form N-PORT for the third month of each fiscal quarter of a fund (60 days after the end of the fiscal quarter).

III. Recommendations Regarding VaR-Based Limit on Fund Leverage Risk

A. Relative VaR Test: Permit Funds to Compute VaR Ratio Using Securities Portfolio

Invesco believes that derivatives risk managers for a substantial majority of funds subject to the VaR-based limit on leverage risk should be able to identify designated reference indexes and, consequently, that many funds will be subject to the relative VaR test. Invesco further believes that these funds can be challenged in complying with the relative VaR test when one or more of the following is the case: (i) a fund's designated reference index is a low volatility index with a relatively low VaR, (ii) an actively managed fund holds investments (not including derivatives transactions) that deviate materially from the constituents of its designated reference index (i.e., the fund has a high "active share") or (iii) a fund holds investments outside of the markets or asset classes in which it typically invests because of a special situation (for example, where a fixed-income fund receives listed equity securities in connection with a restructuring of a company's debt securities).

As an example, a fund that predominantly and normally invests in senior secured bank loans will likely select one of the leading, broad based indexes of leveraged loans as its designated reference index. Because these loans have senior positions in borrowing companies' capital structures and floating rates of interest that give rise to little interest rate risk, the VaR of the index will be low on an absolute basis. Should the fund receive equity securities in connection with the work-out of an insolvent borrower or make a small allocation to high yield bonds to express a view on relative value in the corporate credit market, the fund might be unable to also use a modest amount of credit derivatives to increase its exposure to corporate credit (assuming it would not qualify for the limited derivatives user exception). Because the VaR of the fund's designated reference index is low on an absolute basis, the fund's allocation to high yield bonds and equity can themselves cause the fund's VaR ratio to approach or exceed 150%. As another example, a fixed-income fund that normally invests in an intermediate term portfolio of U.S. government-

related securities might select as a designated reference index a market weighted index of the U.S. government market with an intermediate-term weighted average maturity. Because the absolute VaR of this index is low, the fund might be prohibited from simultaneously taking an overweight position in U.S. treasury securities with longer remaining maturities and a long position in U.S. treasury futures contracts to extend its duration and express an active view on the direction of U.S. interest rates.

These examples demonstrate that the relative VaR test can prevent a fund from appropriately using derivatives transactions to pursue its investment objectives while taking active positions (expressed through either derivatives or other investments) that deviate from its designated reference index. In the examples, the desired derivatives use would neither cause the relevant fund to diverge from investor expectations regarding the fund's investment objectives and desired levels of investment risk nor cause fund to incur an amount of indebtedness leverage that is inconsistent with the investor protection purposes and concerns underlying Section 18. As the Commission notes in the Proposing Release, Section 18 limits the extent to which a fund can potentially increase its market exposure through leveraging by issuing senior securities, but it does not limit a fund's level of risk or volatility.[5] Yet these examples demonstrate that the relative VaR test can operate to limit appropriate investment risk taking and require a fund to conform more closely to its designated reference index. Invesco disagrees with this outcome and believes that the relative VaR test should function only to limit the risk of leverage incurred by a fund. When a fund's derivatives transactions raise neither "undue speculation" nor "asset sufficiency" concerns, Rule 18f-4 should not operate to constrain active management. We note that the Investment Company Act and fund disclosure and reporting requirements provide other protections that are designed to ensure that a fund sufficiently describes its investment strategy, objectives and restrictions and pursues an investment program that is consistent with those strategies, objectives and restrictions. For example, funds must describe in detail their investment strategies, objectives, policies and restrictions in registration statements on Form N-1A or N-2, produce semi-annual and annual reports that include financial statements and financial performance information and discussion and make filings on Form N-PORT.[6]

We believe that this shortcoming of the relative VaR test can be avoided if Rule 18f-4 is revised to permit a fund subject to the relative VaR test to elect to compute its VaR ratio using either (x) the VaR of a designated reference index selected in accordance with the rule or (y) the VaR of its actual portfolio of securities and other investments, but excluding derivatives transactions (its "**securities portfolio**" and "**securities VaR**"). A fund that anticipates challenges in consistently complying with a relative VaR test measured using an index VaR in the denominator of the VaR ratio could elect under Rule 18f-4 to instead comply with a relative VaR test measured using the VaR of its actual portfolio of non-derivative investments in the denominator. Indeed, one could argue that using a fund's securities VaR in the denominator of

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[5] See Proposing Release at 4471.

[6] See also Section 35 of the Investment Company Act and Rule 35d-1 thereunder.

the VaR ratio is more closely aligned with the statutory goal of Section 18 because the ratio would measure the actual incremental risk of loss that derivatives transactions add to the fund's investment portfolio through increased market exposure.

In the Proposing Release, the Commission explains that the 2015 Proposal included a risk-based portfolio limit that compared a fund's full portfolio VaR to its securities VaR, but that the Commission rejected this approach in the Proposed Rule because some funds that use derivatives extensively hold primarily cash and cash equivalents, which would have a very low securities VaR inappropriate as a reference level of risk.[7] Invesco agrees that the securities VaR approach would be inappropriate for these funds. However, we expect that these funds would alternatively select a designated reference index (including a blended index or an "additional index" as defined in the instructions to Item 27 of Form N-1A) for purposes of the relative VaR test, or operate subject to the absolute VaR test if an appropriate index cannot be identified.[8] Additionally, while we do not anticipate that calculating securities VaR will be operationally challenging or burdensome, funds that are challenged would retain flexibility to use a designated reference index.

If a fund uses other types of senior securities constituting indebtedness as part of its investment strategy (in addition to derivatives transactions), we propose that the securities VaR test use the VaR of a "scaled down" version of the fund's securities portfolio in the denominator of the VaR ratio to prevent the fund from incurring an aggregate amount of indebtedness leverage that is inconsistent with the rule. For example, if an open-end fund with $100 of net assets borrows $20 from a bank, invests its $120 of total assets in securities and also uses derivatives transactions, we propose that the fund compute the securities VaR of its actual $120 securities portfolio and then adjust that VaR downward to reflect an asset base of only $100. This adjustment can be made straightforwardly: the fund would (i) calculate the VaR of its $120 securities portfolio as a U.S. dollar amount, (ii) multiply that U.S. dollar amount by a factor of .833 (representing the quotient of (x) its total assets ($120) less the amount of other senior securities constituting indebtedness ($20) and (y) its total assets ($120)) and (iii) divide the resulting U.S. dollar amount by the fund's net assets ($100). The resulting VaR percentage would be used in the denominator of the fund's VaR ratio.

We propose that the derivatives risk manager of a fund subject to the relative VaR test would elect upon the implementation of the fund's derivatives risk management program whether to compute the test using a designated reference index or the fund's securities portfolio and that the derivatives risk manager be permitted to change its election only as part of a formal, periodic review of the fund's derivatives risk management program. Funds computing the relative VaR

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[7] See Proposing Release at 4473.

[8] Should the Commission adopt our recommendation with respect to the relative VaR test and allow a fund subject to the relative VaR test to elect to compute its VaR ratio using its securities VaR, the existence of these funds supports maintaining the absolute VaR test in final Rule 18f-4.

test using their securities VaR would disclose this in their annual reports in lieu of disclosing a designated reference index.

Finally, we believe that the issues with the Proposed Rule's relative VaR test discussed above can also be addressed and rectified by the Commission's adoption of a higher VaR ratio percentage limit. Other commenters supporting such an increase have requested the Commission adopt a 200% relative VaR limit and a corresponding 20% absolute VaR limit (before any adjustments for closed-end funds), explaining that the higher relative VaR percentage limit will address natural VaR differences between a fund and its designated reference index (including differences arising from non-leverage variables). These commenters also note the benefits of harmonizing Rule 18f-4's VaR-based leverage limit with the well-tested VaR-based limits imposed in Europe for UCITS. We concur that increased percentage limits will enable more funds to continue with their current investment strategies while still imposing a hard outer boundary on leverage risk incurred through derivatives transactions, and request that the Commission consider higher percentage limits in conjunction with the securities VaR approach discussed above.

B. Closed-End Funds and the Relative VaR Test: Provide for a Higher VaR Ratio Percentage Limit to Reflect Issuance of Senior Securities that are Stock

Section 18 of the Investment Company Act permits closed-end funds to have more complicated capital structures than open-end funds by authorizing such funds to issue senior securities representing indebtedness and senior securities that are stock. The Commission acknowledges this statutory distinction in the Proposing Release but declines to modify the relative VaR test as applied to closed-end funds, explaining that the Proposed Rule is focused on indebtedness leverage created by derivatives transactions and that a closed-end fund's ability to issue preferred stock does not suggest that it should be able to obtain additional indebtedness leverage (as compared to open-end funds) through derivatives transactions.[9] We agree that a closed-end fund should not be able to obtain greater indebtedness leverage through derivatives transactions than an open-end fund, but believe that the Commission has failed to appropriately recognize the leveraging effect of a closed-end fund's permissible issuance of preferred shares in the relative VaR test. A closed-end fund that issues preferred shares and invests the proceeds of such issuance will provide leveraged returns on its investment portfolio to common shareholders and can be expected to have a VaR greater than an appropriately selected designated reference index (which must be an unleveraged index). A closed-end fund is permitted to add another layer of senior securities to its capital structure through the issuance or incurrence of indebtedness, within which the Proposed Rule includes (and seeks to constrain) indebtedness leverage incurred through derivatives transactions. It follows that the proposed 150% VaR ratio limit applied to an open-end fund must be proportionately increased when applied to a closed-end fund to reflect any issuance of senior securities that are stock.

[9] See Proposing Release at 4474.

An open-end fund with $100 of net assets and no senior securities can incur up to $50 of indebtedness leverage and maintain the 300% asset coverage required under Section 18(f)(1) of the Investment Company Act. The fund would have $150 of total assets invested based upon $100 of net assets (representing a leverage ratio of 150%). The Commission notes, as a rationale for the 150% relative VaR test limit, that the fund's VaR should be approximately 150% of the VaR of its designated reference index. An closed-end fund pursuing the identical investment strategy with $100 of net assets and no senior securities can incur $50 of indebtedness leverage through the issuance of debt and, with $150 of total assets after the debt issuance, have 300% asset coverage for the indebtedness as required by Section 18(a)(1)(A) of the Investment Company Act. The fund could next issue preferred stock with a liquidation preference of $50 and, with total assets after the issuance of $200, have 200% asset coverage for its senior securities as required by Section 18(a)(2)(A) of the Investment Company Act. The fund would have $200 of total assets invested based upon $100 of net assets (representing a 200% leverage ratio). Using the Commission's analysis, this closed-end fund's VaR should be approximately 200% of the VaR of its designated reference index. This incremental "riskiness" as compared to the open-end fund is directly attributable to the fund's use of preferred share financing in its capital structure. Consequently, Invesco believes that the VaR ratio percentage limit on this fund's relative VaR test should be 200% to reflect the leveraging effect of the fund's permissible issuance of senior securities in the form of preferred stock. This percentage is arrived at by adding the percentage of the fund's net assets represented by the liquidation preference of the preferred shares (50%) to the baseline 150% percentage. Although the increased percentage limit permits the closed-end fund to maintain a higher VaR ratio than the open-end fund to account for the leveraging effect of its outstanding preferred shares, the relative VaR test equivalently constrains each fund's ability to increase its VaR through indebtedness leverage (including derivatives transactions).

Because Sections 18(a)(2)(A) and (B) of the Investment Company Act in effect limit the leverage ratio of a closed-end fund to 200%, we believe that the proposed upward adjustment to the relative VaR percentage limit to reflect senior securities in the form of stock should be capped so that the limit, after such adjustment, does not exceed 200%. This restriction would prevent a closed-end fund that makes relatively greater use of preferred shares in its capital structure from also incurring indebtedness leverage through borrowings and derivatives transactions that frustrates the statutory intention of Sections 18(a)(2)(A) and (B). For example, if a closed-end fund with $100 of net assets and no senior securities issues preferred stock with a liquidation preference of $60 (representing 60% of the fund's net assets), the percentage limit on the fund's relative VaR test after adjustment test would be 200% (and not 210%). This is reflective of the fact that this fund, unlike the closed-end fund described in the immediately preceding paragraph, could not incur $50 of indebtedness leverage and satisfy the asset coverage requirements of Section 18(a)(2)(B).[10]

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[10] We acknowledge that, while the Section 18(f)(1) asset coverage requirement functions as a "maintenance covenant" on open-end funds and requires that asset coverage violations be remedied in three days, the Section 18(a) asset coverage requirements function as "incurrence covenants" on closed-end funds and require compliance only if a fund desires to take certain action (i.e., incur debt, issue preferred stock, purchase common

Accordingly, we recommend that the Proposed Rule be modified to allow a closed-end fund subject to the relative VaR test to adjust the 150% baseline percentage limit upward by an amount equal to the lesser of (i) the percentage of the fund's net assets represented by the liquidation preference of any issued and outstanding preferred shares (i.e., the quotient of such liquidation preference and the fund's net assets) as of the relevant determination date and (ii) 50%.

Should the Commission adopt our recommendation with respect to the relative VaR test and allow a fund to elect to compute its VaR ratio using its securities VaR, we believe that a closed-end fund electing as such should similarly be permitted to increase the relative VaR percentage limit above 150% to reflect the portion of its capital structure represented by senior securities that are stock (with the "scaling down" of its securities VaR discussed above to account for any use by the fund of bank borrowings, notes, bonds or other senior securities representing indebtedness leverage).

C. Impact of VaR Test Breaches: Permit More Time for Funds to Rectify Non-Compliance and Eliminate the Three Consecutive Business Day Requirement

If a fund determines that it is not in compliance with its applicable VaR test, the Proposed Rule would require that the fund rectify the non-compliance promptly and within no more than three business days after such determination, failing which (i) the fund's derivatives risk manager would be required to make specified reporting to the fund board, (ii) the derivatives risk manager must analyze the circumstances giving rise to the non-compliance and make appropriate updates to the fund's derivatives risk management program and (iii) the fund would be prohibited from entering into derivatives transactions that are not risk reducing until compliance is achieved for a three consecutive business day period and the requirements in (i) and (ii) are satisfied. The fund would also be required to report its non-compliance to the Commission using Form N-RN. In the Proposing Release, the Commission explains that this three-day rectification approach is similar to Section 18(f)(1) of the Investment Company Act, which also provides for a three-day rectification period in the event of insufficient asset coverage of open-end fund bank borrowings.[11]

Invesco is supportive that the Proposed Rule would not explicitly require a fund that does not regain compliance with its VaR test within the rectification period to exit its derivatives transactions or make other portfolio adjustments, and believes that the consequences to a fund for failing to regain compliance within the rectification period, including board and SEC reporting, are sufficiently serious that funds and their advisers will act expeditiously to rectify VaR test breaches. However, we expect that the process of rectifying non-compliance with the VaR test will be more investigative and complex as compared to curing asset coverage ratio violations such

stock or declare dividends on common stock or preferred stock). We do not think this is an important distinction for these purposes and, because the Section 18(a) asset coverage requirements can prevent a closed-end fund from making periodic distributions to shareholders, we believe that closed-end funds generally treat these requirements as "maintenance covenants".

[11] See Proposing Release at 4479.

that a period longer than three business days is justified. We recommend a rectification period of seven calendar days.

When an open-end fund determines that the outstanding principal amount of its bank borrowings are insufficiently covered under Section 18(f)(1), it need only alert its bank lenders of its desire to make a loan paydown, sell and settle portfolio holdings as necessary to raise cash for the paydown and wire the paydown to its lenders. When a fund determines it is non-compliant with its VaR test, understanding the reasons and taking rectifying action will most certainly be more complicated. When alerted to a fund's VaR test breach, the derivatives risk manager will need to research the reasons for the breach, including assessing whether it is attributable to changes in the fund's portfolio, the VaR model's treatment of market risk factors, volatility, historical data used in the model, or any combination of these factors. Once determined, the derivatives risk manager would then be expected to communicate the breach and its causes to portfolio managers pursuant to the program's escalation protocols, who would need a period to liaise with the derivatives risk manager to formulate a rectification plan and then implement it. We believe this process can reasonably be expected to take a full week.

We note that in recently promulgated Rule 22e-4 under the Investment Company Act, which sets forth requirements for certain registered funds to adopt liquidity risk management programs, an in-scope fund is given seven calendar days to respond to a shortfall of its highly liquid investments below its highly liquid investment minimum (an "**HLIM breach**") before the fund's program administrator must report the HLIM breach to the fund board and the fund must report the HLIM breach to the Commission on Form N-LIQUID.[12] We think the process followed by a derivatives risk manager in response to a VaR test breach would be similar to that followed by a Rule 22e-4 program administrator in response to an HLIM breach in terms of investigation, internal communication, rectification plan formulation and implementation and the time required for each. Accordingly, we think Rule 22e-4 and its timing requirements in respect of HLIM breaches provides a basis for lengthening the VaR test breach rectification period to seven calendar days.

Additionally, if a fund regains compliance with its VaR test after a period of non-compliance that lasts longer than the permitted rectification period, we believe that the fund should be able to resume using derivatives transactions (not only derivatives transactions that are risk reducing) so long as the fund's derivatives risk manager has analyzed the circumstances that caused the non-compliance and made appropriate changes to the fund's derivatives risk management program to address those circumstances. We think conditioning the fund's resumption of desired derivatives transaction use upon whether the fund maintains compliance with its VaR test for three consecutive business days is arbitrary and potentially detrimental to fund investors, as this condition would likely impede the implementation of investment decisions made by the fund's portfolio managers during the period. As noted above, the circumstances giving rise to a fund's non-compliance with its VaR test can be nuanced and non-indicative of

[12] See Investment Company Act Rule 22e-4(b)(1)(iii)(A). See also Form N-LIQUID, Part D.

excessive leveraging of a fund. For the same reasons, we disagree that the fund's resumption of desired derivatives transaction use should be conditioned upon the fund's derivatives risk manager having made the required report to the fund board. While board reporting in this instance is appropriate, conditioning the resumption of the fund's normal investment program on the report having been formally made to the board is inconsistent with the oversight (and not management) role played by the board. Additionally, if a fund quickly regains compliance with its VaR test after the permitted rectification period has elapsed, a board report regarding how and by when the fund is expected to regain compliance with its VaR test is extraneous.

If the goal of these two conditions is to prevent funds from becoming serial violators of their VaR tests (for periods longer or shorter than the permitted rectification period), we believe that another element of the Proposed Rule already better addresses this issue. Specifically, we expect that a derivatives risk manager of such a fund would need to conduct a deeper assessment of the fund's derivatives risk management program and its effectiveness and of the fund's investment program as part of a formal, periodic review of the program (which would include a review of the VaR calculation model and any designated reference index).

D. Explicitly Permit VaR Confidence Level Scaling

The Proposed Rule's definition of "VaR" would require a fund's VaR model to use a 99% confidence level and a time horizon of 20 trading days. The Commission explains that, by requiring a relatively high confidence level and longer time horizon, the VaR model is designed to measure, and limit the severity of, less frequent but larger losses. The Commission notes that in proposing a relatively high confidence level and longer time horizon it considered whether the resulting VaR model would use fewer data points as compared to VaR models that use lower confidence levels and shorter time horizons, but ultimately concluded that fewer data points would exist only if a fund uses historical simulation and measures historical losses over non-overlapping 20 trading day periods (which the Proposed Rule does not require).[13]

Although using rolling, overlapping periods of 20 trading days would increase the sample size significantly, we think a fund's derivatives risk manager might reasonably prefer to implement a VaR model that uses a confidence level scaling technique to avoid statistical bias associated with the use of such overlapping periods. Confidence level scaling provides an alternative to the use of rolling, overlapping periods of 20 trading days, while also avoiding small sample size bias that can arise when measuring VaR at higher confidence levels with relatively longer, non-overlapping periods. Neither the Proposed Rule nor the Proposing Release explicitly prohibit a fund's VaR model from using confidence level scaling techniques (both are silent on the topic). However, the Proposing Release does explicitly acknowledge that many market participants calculate VaR using the separate but related statistical technique of time scaling, whereby VaR is calculated over a one-day time horizon and scaled to a longer time horizon (such as 20 trading days). The Commission

[13] See Proposing Release at 4479.

notes in the Proposing Release that time scaling would be appropriate under the Proposed Rule unless a particular fund's returns are not identically and independently normally distributed.[14]

To promote greater legal certainty, we think funds and their derivatives risk managers would benefit from an explicit acknowledgement by the Commission regarding the appropriateness of confidence level scaling in a fund's VaR model with respect to the 99% confidence level requirement. We request that the Commission include an explicit statement in final Rule 18f-4 or in its adopting release that appropriately implemented time scaling and confidence level scaling techniques can be used as part of a fund's VaR model.

E. Provide Additional Clarification and Guidance on Designated Reference Index Determinations and the Applicability of the Absolute VaR Test

Under the Proposed Rule, a fund must comply with the relative VaR test unless the fund's derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund, taking into account the fund's investments, investment objectives and strategy. Only if a fund's derivatives risk manager is unable to identify a designated reference index under this standard can the fund instead comply with the absolute VaR test. In the Proposing Release the Commission makes clear its preference for the relative VaR test as the "default" method of limiting a fund's leverage risk.[15] Additionally, in the Proposing Release's discussion of the absolute VaR test, the Commission identifies multi-strategy funds that manage their portfolios based on target volatilities, but implement a variety of investment strategies, as the only example of types of funds for which the absolute VaR test could be appropriate.[16] We think that without additional clarification and firmer guidance on designated reference index determinations and the application of the absolute VaR test, funds and derivatives risk managers might be reluctant to conclude that no appropriate designated reference index can be identified or select inappropriate designated reference indexes. By providing clarification and guidance in four areas we believe the Commission can mitigate these possibilities.[17]

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[14] See *id* at footnote 230.

[15] For example, the Commission states: "*We believe that investors could reasonably expect that their fund might exhibit a degree of volatility that is broadly consistent with the volatility of the markets or asset classes in which the fund invests, as represented by the fund's designated reference index. Requiring a fund to select a designated reference index that it publicly discloses would promote the fund's selection of an appropriate index that reflects the fund's portfolio risks and its investor expectations*." See *id* at 4472.

[16] See *id* at 4475.

[17] Additionally, we believe that some of the issues that we discuss below with respect to designated reference index determinations would be addressed if the Commission adopted our recommendation with respect to the relative VaR test and allowed a fund subject to the relative VaR test to elect to compute its VaR ratio using its securities VaR (as opposed to the VaR of a designated reference index).

First, we request that the Commission clarify that the requirement for a designated reference index to be "unleveraged" does not prohibit the use of indexes that include derivative instruments as constituents, such as commodity indexes that track the performance of physical commodity futures contracts or currency hedged equity indexes that include rolling currency forward contracts. The Commission could specify in final Rule 18f-4 or its adopting release that a leveraged index prohibited under the rule is one that measures a multiple of returns on specified index constituents, not one that includes constituents that are themselves derivative instruments. With this clarification, funds and their derivatives risk managers would better understand the universe of indexes that are eligible for selection as designated reference indexes.[18] For example, the derivatives risk manager for a commodity fund could confidently select a broadly recognized commodity index as the designated reference index for the fund.

Second, we ask the Commission to provide guidance in the final Rule 18f-4 adopting release that there is no presumption that an open-end fund should use its performance benchmark index as its designated reference index. While Item 4 of Form N-1A requires an open-end fund to compare its returns to the returns of an appropriate broad-based securities market index, the fund's performance benchmark index selected for this purpose might not be appropriate for Rule 18f-4 purposes. The prospectus requirement is intended to provide fund investors with an objective and convenient way of comparing and evaluating a fund's performance by displaying that performance alongside the returns of a recognized securities index. However, that performance benchmark index might not (and is not required to) reflect the investment strategies and risks of the fund. Consequently, we believe that funds and their derivatives risk managers would benefit from a statement by the Commission that emphasizes the separate purposes of a performance benchmark index and a designated reference index.

Third, we request that the Commission revise the Proposed Rule's definition of "designated reference index" to clarify that it must reflect, in addition to the markets or asset classes in which a fund invests, the fund's investments, investment objectives and strategy. This clarifying change would harmonize the definition with the standard for subjecting a fund to the absolute VaR test – namely, the inability of the fund's derivatives risk manager to identify an appropriate index taking into account the fund's investments, investment objectives and strategy. Additionally, requiring consideration of a fund's investments, investment objectives and strategy would provide the fund's derivatives risk manager greater ability to consider the fund's investment program holistically (and not just the markets and asset classes in which the fund invests) when selecting a designated reference index.

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[18] Because the definition of "designated reference index" requires that the index be either an "appropriate broad-based securities market index" or an "additional index", as these terms are defined in the instructions to Item 27 in Form N-1A, we are of the view that indexes that include constituents that are derivative instruments would otherwise qualify (assuming satisfaction of the other elements of the definition). The instructions to Item 27 in Form N-1A describe an "additional index" generally to include a narrowly based index that reflects the market sectors in which a fund invests or a non-securities index like the Consumer Price Index.

Fourth, we ask the Commission to provide guidance in the final Rule 18f-4 adopting release regarding categories of funds that it would not expect to have designated reference indexes and that would consequently operate subject to the absolute VaR test. While we appreciate the Commission identifying multi-strategy funds that use a variety of investment strategies and manage their portfolios based on target volatilities in the Proposing Release, we believe that the Commission could provide a non-exclusive list of other categories of funds expected to be subject to the absolute VaR test. We believe these other categories would include alternatives and multi-alternatives funds, market-neutral funds, long-short and relative value funds and funds focusing on diversifying asset classes (such as insurance and event-linked securities). Funds in certain of these categories will often implement their investment strategies through substantial use of derivatives transactions and hold primarily cash and cash equivalents. By identifying these categories of funds, we believe that the Commission can appropriately temper the Proposed Rule's preference for the relative VaR test and encourage desirable application of the absolute VaR test.

IV. Recommendations Regarding the Limited Derivatives User Exceptions

A. Combine the Two Alternative Limited Derivatives User Exceptions into a Single Exception

We believe that the Proposed Rule's two alternative limited derivatives user exceptions should be combined into a single exception that would except a fund from the derivatives risk management program requirement and VaR-based leverage limit if the fund's derivatives exposure is 10% or less of its net assets, excluding the notional amount of any derivatives transactions that constitute qualifying hedges of foreign currency risk. In the Proposing Release, the Commission explains that it considered, but declined to take, this combined approach to preclude a fund that is using a broad range of derivatives transactions from operating as a limited derivatives user.[19] We respectfully disagree with this concern.

As the Commission notes, use of foreign currency forwards to hedge foreign currency risk is uniquely identifiable as a hedging transaction (as opposed to a speculative or leveraging transaction) because it involves a single risk factor, currency risk, and requires that the notional amount of the derivative transactions be tied to, and not exceed, the value of relevant foreign currency denominated investments in a fund's portfolio.[20] By selling forward an amount of foreign currency equal to the value of foreign currency denominated investments, a fund effectively "locks in" the exchange rate at which the forward contract is executed, mitigating the risk of decline in the U.S. dollar value of these investments attributable to depreciation of the foreign currency against the U.S. dollar. Because the fund holds investments denominated in the relevant foreign currency and the short forward position in that foreign currency does not exceed the value of those investments, such derivatives transactions do not add leverage to a fund's investment portfolio and

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[19] See Proposing Release at 4488.

[20] See *id* at 4488.

are expected to be risk reducing. For this reason, we think derivatives transactions that constitute qualifying foreign currency hedges should always be disregarded in evaluating whether a fund is a limited derivatives user. In our view, a fund's combined use of derivatives transactions constituting qualifying foreign currency hedges and other derivatives instruments with derivatives exposure not exceeding 10% of its net assets does not justify the compliance costs and burdens of a derivatives risk management program and VaR-based limit testing. The risks of such use can be sufficiently addressed by the Proposed Rule's requirement that the fund adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks.

Maintaining the two exceptions as separate, mutually exclusive alternatives can also create inapposite outcomes. As an example, an international equity fund that hedges its foreign currency risk through qualifying foreign currency hedges and that from time to time uses short equity option strategies involving written calls on stocks it owns (i.e., covered calls) with a delta adjusted notional amount significantly less than 10% of its net assets would be subject to the Proposed Rule's derivatives risk management program and VaR-based leverage limit. The notional amount of the qualifying foreign currency hedges would preclude the fund from qualifying for the 10% exception and the use of written equity options would preclude the fund from qualifying for the foreign currency hedging exception. Yet this fund has arguably not incurred indebtedness leverage through its derivatives transactions because the short positions established through the derivatives are covered by investments actually held by the fund.

B. Provide Other Technical Changes and Guidance With Respect to the Limited Derivatives User Exceptions

We request that the Commission provide certain technical changes and guidance with respect to the exception for qualifying foreign currency hedging. First, instead of conditioning the exception on the notional amount of a fund's currency hedging derivatives not exceeding the value of the hedged instruments "by more than a negligible amount", we request that the Commission limit this difference to "not more than a reasonable amount giving due consideration to the price volatility of the hedged investments". When currency hedged investments have greater price volatility (as is the case for equity securities), a fund can incur additional and unnecessary trading costs if it must re-size its currency hedges frequently to ensure that the notional amount of the related derivatives transactions does not exceed the value of those investments by more than a negligible amount. Additionally, adjustments to an open-end fund's investment portfolio in response to shareholder flows can temporarily cause the notional amount of currency hedges to exceed the value of related hedged investments by more than a negligible amount. We think a reasonableness standard that allows for due consideration of the price volatility of the hedged investments would provide greater legal certainty for funds seeking to use the currency hedging exception, but still be sufficiently strict to prevent a foreign currency hedging program from inadvertently becoming speculative. Funds relying on the qualified foreign currency hedging exception could articulate in their policies and procedures appropriate thresholds for "reasonableness".

Second, we request that foreign currency denominated investments eligible for the hedging exception not be limited to "specific foreign-currency-denominated equity or fixed-income investments held by the fund". Certain investments, such as foreign currency itself, might technically not constitute an equity or fixed-income investment. Because a fund would still be required to hold an investment denominated in the relevant foreign currency, we think the exception can simply reference "specific foreign-currency-denominated investments held by the fund".

Third, we request that the Commission provide guidance in the final Rule 18f-4 adopting release on the availability of the qualifying foreign currency hedging exception to funds investing in ADRs. Although denominated in U.S. dollars, investors in ADRs are exposed to the risk that the currency in which the foreign security underlying the ADR is denominated will depreciate against the U.S. dollar, resulting in a lower U.S. dollar value of the ADR. This risk is equivalent to that incurred by investors directly investing in the foreign security. Consequently, we believe that a fund investing in ADRs should be able to avail itself of the foreign currency hedging exception notwithstanding that ADRs are not foreign-currency-denominated. We believe the Commission could clarify in the final Rule 18f-4 adopting release that a fund seeking to hedge foreign currency risk associated with its investments in ADRs is eligible for the qualifying foreign currency hedging exception and can "look though" the ADR to the underlying foreign security on deposit with the relevant depository bank, using the foreign currency value of that security for purposes of compliance monitoring.

With respect to the operation of both the qualifying foreign currency hedging exception and the 10% exception, we request that the Commission permit a fund to calculate its aggregate notional amount or its derivatives exposure (as applicable) after giving effect to notional amount netting in the limited circumstance where two or more derivative instruments are directly offsetting. Frequently, a derivatives transaction previously executed by a fund is exited through the fund's execution of an identical but offsetting transaction. For example, a fund that previously executed a foreign currency forward to express a bearish view on a foreign currency by agreeing to sell a specified amount of that foreign currency for a specified amount of U.S. dollars for settlement on a specified future date (the "**value date**")) that desires to exit the position before the value date would enter an offsetting forward contract to purchase an equivalent amount of that foreign currency for settlement on the value date. Upon execution of the offsetting forward, although the fund's gain (or loss) on the initial transaction becomes determinable and fixed, the notional amount of both forward contracts would be includable in the fund's derivatives exposure until the value date. This is the case notwithstanding that the second forward eliminates several derivatives risks associated with the initial transaction. If the notional amount of the second forward results in derivatives exposure greater than 10% of the fund's net assets, the fund would be required to comply with the derivatives risk management program requirement and VaR-based leverage limit.[21] To remedy this anomaly, we believe that the limited derivatives user exceptions

[21] For a fund that programmatically hedges foreign currency risk, an inability to net long and short notional amounts of offsetting foreign currency forwards as we suggest could be even more acute. The process of rolling expiring foreign currency forwards into the subsequent month frequently involves a fund (i) entering into an equal but

should permit a fund to net the notional amounts of two or more directly offsetting derivatives instruments that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.[22]

Finally, we request that the Commission explicitly address exceedance and remediation for both the 10% exception and the qualifying foreign currency hedging exception. If (i) the derivatives exposure of a fund relying on the 10% exception temporarily exceeds 10% of the fund's net assets or (ii) the notional amounts of a fund's currency hedging derivatives temporarily exceed the value of the hedged investments by more than the permitted amount (in either case, advertently through trading of derivative instruments or inadvertently because of decreases in the fund's net assets or in the value of foreign currency denominated investments), we believe that Rule 18f-4 should provide a remediation period for the fund to reduce the notional amounts of it derivatives to provide legal certainty that the fund need not immediately implement a derivatives risk management program and comply with the VaR-based leverage limit. Like the rectification period that we propose for a VaR test breach, we think a seven calendar day remediation period is reasonable and appropriate in these circumstances. Further, because a fund that is unable to accomplish remediation within such period would need to adopt and implement a written derivatives risk management program and comply with the VaR-based leverage limit (which would include fund board approval of a derivatives risk manager and designated reference index decisions), we believe that Commission guidance on the timings for a fund to complete such matters would be useful.[23]

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offsetting forward contract to the expiring contract shortly in advance of the expiring contract's value date and (ii) entering into a new forward contract to sell forward the relevant foreign currency with a value date in the succeeding month. This trading practice can result in the fund having an absolute notional amount across the relevant forward contracts that is approximately 300% of the value of the hedged investment for a very short period.

[22] If two or more uncleared derivative instruments satisfy this standard of offset, we believe that netting is appropriate even if the counterparties to the transactions are different. The limited derivatives user exceptions are designed to identify funds that use derivatives in a limited way, not to mitigate counterparty risk. Under the Proposed Rule, a fund that is a limited derivatives user would nonetheless need to consider whether its policies and procedures should be reasonably designed to manage counterparty risk.

[23] The Commission should also consider addressing the frequency with which funds must test compliance with the limited derivatives user exceptions. We note that the Proposed Rule is silent on this point. In doing so, the Commission should be cognizant that requiring frequent testing could be problematic for some funds. For example, an index fund that tracks the performance of a currency hedged equity index will generally invest in the index constituents, including foreign currency forwards, based upon the methodology and weightings of the index. If the relevant index provides for monthly rebalancing (as is typical for many indexes), the fund can incur tracking error if it must adjust its currency forwards more frequently to comply with the qualifying foreign currency hedging exception.

V. Recommendation Regarding Board Oversight and Reporting

A. Eliminate the Requirement that a Fund's Derivatives Risk Manager Provide an Affirmative Written Representation to the Fund Board

To facilitate board oversight of a fund's derivatives risk management program, the Proposed Rule would require the fund's derivatives risk manager to provide periodic reporting to the board, including a written report that includes a representation that the fund's derivatives risk management program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program. The written report must include the basis for the derivatives risk manager's representation and also include the derivatives risk manager's basis for the selection of the applicable designated reference index under the relative VaR test, or why the derivatives risk manager was unable to identify a designated reference index such that the fund is instead subject to the absolute VaR test.

Invesco is supportive of robust, periodic reporting by a fund's derivatives risk manager to the fund board to facilitate the board's understanding of the program and the risks it seeks to identify and manage, and to generally support the board's general oversight of the program. However, we are concerned that the Proposed Rule's requirement that a derivatives risk manager make an annual, written, affirmative representation to the board regarding the reasonableness of the program's design to manage derivatives risks and to incorporate required elements imposes an inappropriate responsibility on the derivatives risk manager. The role of a derivatives risk manager is to create, implement and manage a derivatives risk management program that complies with Rule 18f-4, that is reasonably designed to manage the fund's derivatives risks and that is operated with appropriate independence from fund portfolio management. The Proposed Rule should not require or suggest through an affirmative representation obligation that the derivatives risk manager is certifying or guaranteeing the effectiveness of a fund's program to manage derivatives risks, even if subject to a reasonableness standard and based upon due inquiry. This representation requirement would be particularly problematic if, during an annual period, a fund has experienced VaR test or risk guideline breaches, more than an expected number of backtesting exceptions or poor stress testing results, which have caused the derivatives risk manager to review and revise the fund's program or the fund to modify its investment program. In sum, we think this requirement could have a chilling effect on the willingness of qualified and experienced derivatives risk management professionals (or committees of such individuals) to assume derivatives risk manager roles and that it should be eliminated.

We think the Proposed Rule's goal of promoting board oversight of a fund's use of derivatives transactions and the management of attendant risks would still be met if the affirmative representation requirement is replaced with a requirement for the derivatives risk manager to provide the board a written report, at least annually, that (i) addresses the operation of the program, (ii) assesses the program's adequacy and effectiveness of implementation and (iii) discloses any material changes made to the program since the previous report. The report would need to include such information as is reasonably necessary to support the presentation of these items. We note that this periodic reporting requirement would be similar to the annual board reporting required by

program administrators regarding in-scope funds' liquidity risk management programs under Investment Company Act Rule 22e-4.[24] Like the proposed derivatives risk management program, the role of a board in a fund's liquidity risk management program is focused on program oversight. Accordingly, we believe that the board reporting obligations of risk managers overseeing the implementation of these two separate risk management programs under the Investment Company Act should be similar.

Finally, we support the Proposed Rule's requirement that a derivatives risk manager provide the fund board with the derivatives risk manager's basis for the selection of the fund's designated reference index or, alternatively, why no such index could be identified for the fund. We think this requirement is important to the board's understanding of how the VaR test will be applied to the fund. If the Commission adopts our recommendation with respect to the relative VaR test and allows a fund subject to the relative VaR test to elect to compute its VaR ratio using its securities VaR, we would also support a requirement that the fund's derivatives risk manager provide a basis for such election. However, we think there is little usefulness in the derivatives risk manager providing the basis for these decisions repetitively on an annual basis and request that the Commission eliminate this requirement. If a fund's derivatives risk manager changes the fund's designated reference index or elects to compute the fund's VaR ratio using its securities VaR rather the VaR of a designated reference index (or vice versa), we believe that the derivatives risk manager would need to provide the board with the basis for these determinations under our proposed requirement that material program changes be disclosed.

VI. <u>Recommendation Regarding Scope of Derivatives Transactions</u>

A. Exclude "When Issued" Transactions and Other Similar Delayed Delivery Transactions from the Derivatives Transactions Definition to Avoid Unintended Consequences for Money Market Funds

Invesco agrees with the Commission that money market funds regulated under Rule 2a-7 of the Investment Company Act do not typically engage in derivatives transactions or the other transactions addressed in the Proposed Rule. Consequently, we agree that money market funds should be excluded from the scope of Rule 18f-4. However, money market funds do routinely invest in "when issued" U.S. treasury securities that have a settlement period longer than the "T+1" settlement convention for secondary market U.S. treasury transactions. In these transactions, a fund purchases a U.S. treasury security on a "when issued" basis immediately following the announcement of a U.S. treasury auction but before the actual auction date. All of the material terms of the U.S. treasury security purchased on a "when issued" basis are known on the trade date but the transaction typically settles on the third business day following the auction date (when the U.S. treasury security is issued), resulting in a settlement period of up to seven calendar days. Because these "when issued" transactions provide important benefits to money market funds (including the potential for better pricing and access to supply of short term government securities)

[24] See Investment Company Act Rule 22e-4(b)(2)(iii).

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and to the U.S. treasury auction process generally, we request that the Commission clarify that "when issued" transactions are not captured by the "any similar instrument" definitional language.[25] Specifically, we request that the Commission provide in final Rule 18f-4 or its adopting release that "when issued" transactions and other similar security transactions with a forward settlement feature that is longer than the standard settlement period are excluded from the definition of "derivatives transaction" if they (i) have a relatively short settlement period and (ii) obligate a fund to make a fixed, known payment of an amount of cash or delivery of a quantity of securities that is established on the transaction's trade date. By doing so, the Commission would ensure money market funds' continued ability to engage in these important transactions, consistent with Rule 2a-7.

We do not believe that treating "when issued" and similar forward settling transactions as "derivatives transactions" under the Proposed Rule is appropriate or justified. While these transactions typically have settlement periods that are longer than secondary market transactions, the settlement periods are still relatively short as compared to TBAs and other forward contracts captured by the Proposed Rule's derivatives transaction definition. Additionally, a "when issued" transaction creates a fixed, known obligation for a fund on its trade date and has neither the purpose nor the effect of leveraging that the Proposed Rule seeks to address. In fact, a fund enters into a "when issued" transaction as purchaser because it desires to establish an unleveraged position in the related security on terms preferable to, or unavailable in, secondary market transactions. In Release 10666 the Commission acknowledged that the purchase of securities often involves a short delay between trade date and settlement date and that this settlement period does not implicate Section 18.[26] Similarly, in a "when issued" or similar transaction the delay between trade date and settlement date is reflective of the fact that the relevant security has not yet been issued and is not available for settlement, not a desire by the purchaser to benefit from gains on the security over the settlement period without having paid the purchase price. Accordingly, we urge the Commission to provide the requested clarification to avoid Rule 18f-4 from having unintended consequences for money market funds.

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[25] The Proposing Release refers to "when issued" transactions only once, but suggests in this single reference that they are derivatives transactions. See Proposing Release at 4455 ("*Do money market funds currently engage in any transactions that might qualify as derivatives transactions under the rule or any of the other transactions permitted by the rule? For example, do money market funds engage in reverse repurchase agreements, ''to be announced'' dollar rolls, or ''when issued'' transactions? If so, which transactions, to what extent, and for what purpose?*").

[26] See Release 10666 at 25130 ("*The Commission recognizes that, for example, in the ordinary purchase of equity securities there is often a delay of a few days between the purchase of the security, and clearance and settlement. This general statement of policy respecting Section 18 of the [Investment Company Act] is not intended to address arrangements involving the purchase of equity securities where the delay in delivery involves, for example, only the brief period usually required by the selling party and its agent solely to locate appropriate stock certificates and prepare them for submission for clearance and settlement…*").

VII. Recommendation Regarding Fund Reporting Requirements

A. Revise the Form N-PORT Amendments to Provide that None of the New Information is Made Publicly Available

The Commission proposes to make publicly available the new information reported by a fund in response to Items B.9 and B.10 of Form N-PORT for the third month of each fiscal quarter (60 days after the end of the fiscal quarter). This information includes derivatives exposure from both derivative instruments and short sales, as well as VaR information for the reporting period, the fund's designated reference index and backtesting results (as applicable). The Commission explains that, because this new information reported on Form N-PORT would be made publicly available on a delayed basis and would not provide details on backtesting exceptions other than the number of exceptions, it does not believe that the reporting requirement would produce adverse effects sufficient to justify confidential treatment.[27] We respectfully disagree and request that the Commission revise the reporting amendments to afford this information confidential treatment.

With respect to derivatives exposure reporting, while Invesco acknowledges that the Commission has legitimate use for this information (including verification of whether a fund qualifies for the limited derivatives user exception), we believe that public disclosure of the information has the potential to confuse and mislead fund investors. As Invesco and others commented in response to the 2015 Proposal (and as the Commission has recognized by revising the Proposed Rule to eliminate any derivative gross notional amount limit), notional amount does not accurately measure the risk of a derivative instrument and the aggregate gross notional amount of a fund's derivatives instruments is not a barometer of a fund's relative risk or expected volatility of returns. We believe that public disclosure of the aggregate notional amount of funds' derivative instruments on Form N-PORT, even giving effect to the Proposed Rule's duration and delta adjustments, will cause some fund investors to incorrectly gauge the riskiness of (and amount of leverage used by) funds by comparing reported derivatives exposure amounts on Form N-PORT. While funds report derivative notional amount information, organized by category of derivative instrument, as part of their periodic financial reporting, the presentation of this financial statement information generally includes greater detail that is helpful to understanding how a fund uses derivatives instruments as part of its investment program.[28]

With respect to VaR information reporting, we note that VaR is a sophisticated risk management tool used by financial risk managers and investment professionals. It is an inherently quantitative and statistical measure that we expect many fund investors do not have the expertise or experience to understand. Accordingly, the VaR related information reported by funds is

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[27] See Proposing Release at 4500.

[28] Item C.11 of Form N-PORT also requires funds to report notional amounts for certain derivative instruments, but together with other information regarding those derivatives and not on an aggregate basis.

unlikely to constitute understandable, useful information for many fund investors and, like public disclosure of derivatives exposure, risks confusing and misleading fund investors.[29]

In lieu of public disclosure of this new Form N-PORT information, we recommend that the Commission instead amend Form N-CEN to include a new reporting item requiring a fund to affirmatively identify whether it has adopted and implemented a derivatives risk management program and is subject to a VaR-based limit on leverage risk under Rule 18f-4. We think this information would be useful to fund investors to identify funds that are more substantial users of derivatives transactions and that must operate in compliance with Rule 18f-4.

Finally, we note that because the Proposed Rule would eliminate asset segregation requirements in respect of derivatives transactions and other leveraging transactions, the Commission should make a conforming amendment to Form N-PORT to eliminate Item B.8.[30]

VIII. Recommended Transition Period

A. Provide a 24-Month Transition Period

The Commission proposes a one-year transition period to provide time for funds to prepare to come into compliance with Rule 18f-4, following which funds could only enter into derivatives transactions, reverse repurchase agreements and similar financing transactions and unfunded commitment agreements to the extent permitted by Rule 18f-4. At the end of the one-year transition period, the Commission also proposes to rescind or withdraw Release 10666 and certain Commission staff no-action letters and guidance with respect to Section 18 of the Investment Company Act, which generally address asset segregation or coverage requirements for derivatives transactions and other leveraging transactions that would be replaced by Rule 18f-4. While we believe that many investment advisers using derivatives transactions more substantially in funds are already employing several elements of a derivatives risk management program required under the Proposed Rule as part of their existing investment and counterparty risk management infrastructures, we nonetheless expect that funds and advisers will require a transition period longer than one year. We believe that a 24-month transition period is necessary before funds are required to comply with Rule 18f-4 and before the Commission rescinds and withdraws Release 10666 and related staff no-action letters and guidance.

Following adoption of final Rule 18f-4, investment advisers will need to assess their existing derivatives risk management processes and risk and compliance infrastructures, modify or supplement those processes and infrastructures as needed to comply with final Rule 18f-4, develop and implement required written policies and procedures, provide program information to

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[29] We have no objection to public disclosure of a fund's designated reference index. However, the Proposed Rule separately requires that a fund disclose its designated reference index in its annual report. Accordingly, we recommend confidential treatment for all information reported in response to Item B.10 of Form N-PORT.

[30] See also Investment Company Act Rule 22e-4(b)(1)(ii)(C) and (b)(1)(iii)(B).

fund boards and have fund boards formally approve the designation of derivatives risk managers. Additionally, investment advisers will need to review each fund and its historical use of derivative instruments to identify those funds that are expected to qualify as limited derivatives users. Designated reference index decisions will be required for remaining funds in connection with the VaR-based leverage limit. Although larger investment advisers might already be employing elements of derivatives risk management programs required under Rule 18f-4, these advisers will also have greater numbers of funds to review and assess and design and implement programs for.

We believe that Investment Company Act Rule 22e-4 can again be instructive. The Commission originally provided a 24-month implementation period for funds within larger fund complexes and a 30-month implementation period for funds within smaller fund complexes to comply with Rule 22e-4.[31] Subsequently, in response to industry feedback and Commission staff engagement with funds and their investment advisers, the Commission, through an interim final rule, extended the compliance date for certain elements of fund liquidity risk management programs by six months.[32] This extension was granted in part because difficult interpretive questions requiring Commission staff guidance arose as funds developed liquidity risk management programs.[33] We anticipate that the design and implementation of derivatives risk management programs will be similarly complex so as to justify a transition period of 24 months. A longer period will also provide funds and their investment advisers and Commission staff greater opportunity to engage in constructive dialogue regarding program development and implementation and Commission staff greater opportunity to provide guidance when interpretive questions regarding a new, complex regulation invariably arise.

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[31] See Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, 81 Fed. Reg. 82142 (November 18, 2016) at 82229.

[32] See Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Investment Company Act Release No. 33010, 83 Fed. Reg. 8342 (February 27, 2018).

[33] See *id* at 8346.

Invesco appreciates the opportunity to comment on this important proposed rulemaking by the SEC, as well as the Commission's consideration of our comments shared in this letter. We are available to discuss our comments or provide any additional information or assistance that the SEC might find useful.

Sincerely,

Invesco Ltd.

Jeffrey H. Kupor

Jeffrey Kupor
Head of Legal, Americas
([redacted]