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March 24, 2020

Submitted electronically through http://www.sec.gov/rules/proposed.shtml

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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 Number S7-24-15**

Dear Ms. Countryman,

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed amendments to the rules under the Investment Company Act of 1940, as amended (the "1940 Act") regarding the use of derivatives and other transactions by registered investment companies and business development companies (the "Proposal").[2]

We fully support the Commission in its examination of the use of derivatives and leverage in the asset management industry and applaud its re-proposal of the Commission's 2015 Proposal on the Use of Derivatives by Registered Investment Companies and Business Development Companies (the "2015 Proposal"). We support the current Proposal and proposed Rule 18f-4 (the "Proposed Rule"), and the use of a value-at-risk (VaR) based leverage limit for funds engaging in derivatives transactions or other transactions covered by the Proposed Rule.

We also support the Commission's proposed framework to exempt derivatives transactions and other transactions covered by the Proposed Rule from being treated as senior securities

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[1] Fidelity is one of the world's largest providers of financial services, including investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 30 million individuals and institutions, as well as through 13,500 financial intermediary firms. Fidelity submits this letter on behalf of Fidelity Management & Research Company LLC, the investment adviser to the Fidelity family of mutual funds.

[2] *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, Release No. 34-87607; IA-5413; RIN 3235-AL60 (January 24, 2020) (the "Release"), *available at* https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

subject to the requirements of Section 18 of the 1940 Act[3] and to remove the asset segregation and coverage requirements for these transactions that were fashioned through the issuance of SEC Release 10666[4] and a variety of exemptive orders and no-action letters addressing Section 18 of the 1940 Act. As we noted in our letter commenting on the 2015 Proposal,[5] while this guidance was helpful in the past, it has not kept up with the pace, growth and innovation experienced in the derivatives market over the past decades. As a result, funds and their advisers have interpreted SEC guidance differently over the years, resulting in inconsistent application of the guidance.

Many Fidelity funds engage in various types of derivatives transactions and other transactions covered by the Proposed Rule in accordance with their relevant investment policies. Fidelity funds may use these instruments to hedge interest rate or currency risk or in some cases these instruments may be used to gain exposure to a market or markets in a manner that, in the judgment of the fund's portfolio management team, provides the safest avenue to such exposure.

Fidelity believes that a set of standard rules relating to the use of derivatives by funds would benefit the industry as a whole. Accordingly, we believe that this new framework proposed by the Commission removing asset segregation and cover requirements for derivatives and other transactions covered by the Proposed Rule, and instead focusing on the leveraging effect of these transactions as measured by a VaR calculation, is a significant step forward in regulating the use of derivatives. Focusing on leverage of funds as measured by true risk exposure and not simply the notional amount of a transaction provides a much more realistic view of the risk profile of any given fund engaging in the use of derivatives and the contribution of those derivatives to the risk profile.

I. EXECUTIVE SUMMARY

While we support the framework of the Proposed Rule, we recommend the following modifications to improve its effectiveness, as described in more detail below:

1. The Commission should permit money market funds that are regulated by Rule 2a-7 of the 1940 Act to enter into transactions covered by the Proposed Rule as long as such transactions are otherwise permitted under Rule 2a-7.

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[3] The Commission staff has issued more than 30 no-action letters addressing derivatives and financial commitment transactions. These include *Dreyfus Strategic Investment & Dreyfus Strategic Income*, SEC No-Action Letter (June 22, 1987) (permitting funds to cover future, forwards, options and short sales by segregating the full value of the potential obligation of the fund under the contract or position) and *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter (July 2, 1996) (the "Merrill Letter") (permitting segregated assets to include not only the specific instruments enumerated in Release 10666, but also any asset that is liquid and marked to market daily, regardless of type).

[4] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 ("Release 10666") 44 Fed. Reg. 25128 (April 27, 1978), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf

[5] *See* Letter from Fidelity Investments to Brent J. Fields (March 28, 2016), *available at* https://www.sec.gov/comments/s7-24-15/s72415-179.pdf

2. The Commission should modify the limited derivatives user exposure-based exception to exclude currency hedging transactions that hedge non-USD denominated assets held by a fund.

3. The Commission should exclude synthetic positions for which a fund holds cash and cash equivalents with a value equal to the notional amount of such derivatives from the limited derivatives user exposure-based exception.

4. The Commission should not deem funds that exceed the exception thresholds as a result of Routine Fund Events (as defined below) to be in non-compliance with the Proposed Rule.

5. The Commission should modify the definition of "derivatives transaction" to exclude (i) "when-issued" U.S. Treasury securities and (ii) forward settling securities for which a fund holds collateral against its forward settling exposure.

6. The Commission should modify the requirements of board oversight and approval of the derivatives risk manager such that the board may appoint the fund's adviser as the derivatives risk manager, akin to the requirements of the SEC's liquidity risk management rules.

7. The Commission should modify the backtesting and stress testing schedules to weekly and monthly, respectively.

8. The Commission should clarify the requirements for choosing a "designated reference index" in light of custom blended indexes.

9. The Commission should clarify how VaR limits should be applied to fund-of-funds.

10. The Commission should revise the cure period for a fund out of compliance with the VaR test to five consecutive business days and eliminate the lock-out for new derivatives trading.

11. The Commission should consider revising elements of the required Form N-PORT reporting which would provide more useful and accurate reporting of the fund's derivatives exposure.

12. The Commission should consider a two-year transition period under the Proposal.

II. ENHANCEMENTS TO RULE 18f-4

A. Scope of the Proposed Rule

Money Market Funds Should be Permitted to Enter into Transactions that may be Covered by the Proposal provided they are Permitted by Rule 2a-7

Fidelity agrees with the Commission excluding money market funds regulated under Rule 2a-7 of the 1940 Act ("money market funds") from the scope of the Proposal. Fidelity worked closely with the Commission during the time of Rule 2a-7 reform, and we believe that the final Rule 2a-7 has provided a strong and sound structure to regulate the money market industry.

In the Proposal, the Commission notes that it does not believe that money market funds "typically engage in derivatives transactions or other transactions permitted by rule 18f-4."[6] The Commission goes on to explain that it believes that use of these types of transactions "would generally be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, and especially if used to leverage the fund's portfolio."[7] In principal we agree with the Commission that money market funds do not generally use traditional types of derivatives that the Proposal is seeking to address due to their risk profile. Nor do we believe that the use of traditional derivatives governed by the Proposal would be permitted by Rule 2a-7.

However, money market funds routinely enter into transactions deemed by the Proposal to be "derivatives transactions" such as "when-issued" U.S. Treasury securities and securities and other transactions that may have a forward settlement convention, that are permitted by Rule 2a-7. Fidelity does not believe that the purchase of these securities or entry into these transactions by money market funds are inconsistent with the principals of maintaining a stable share price or limiting volatility and leverage. More importantly, these transactions are permitted by Rule 2a-7.

The purchase of "when-issued" U.S. Treasury securities, or short-term securities or other transactions which have a forward settlement convention are important to money market funds because they make up a significant portion of the short-term market. These very liquid short-term investment instruments provide a very important tool for money market funds to be able to fully invest the money shareholders invest into money market funds every year. As the money market fund industry grows, it will be even more important that money market funds have access to these very safe and liquid investments, as contemplated by Rule 2a-7. Prohibiting money market funds from purchasing these types of investments may also have a negative effect on the market for and the liquidity of these investments, given the significant volume of purchases of these instruments by money market funds.

Given that the Commission and industry participants have already spent significant time and effort to craft Rule 2a-7 to provide a strong and sound framework for money market funds to operate within, we strongly urge the Commission to exempt money market funds from having to

[6] Release at 37.
[7] *Id*.

comply with the Proposed Rule, while continuing to allow these funds to invest in securities and transactions permitted by Rule 2a-7.

B. The Derivatives Risk Management Program

1. The Limited Derivatives Users Exposure-Based Exception Should Exclude Currency Hedging Transactions

Fidelity supports the Commission's proposal to exempt limited derivatives users (i) with derivatives exposure that does not exceed 10% of its net assets (the "Exposure-Based Exception"), and (ii) who limit the use of derivatives transactions to currency derivatives for hedging purposes (the "Currency Hedging Exception"), as specified in the Proposed Rule,[8] from certain requirements of the Derivatives Risk Management Program (the "DRM Program").

Although we support the Commission's proposed exceptions, we suggest modifications to the Exposure-Based Exception to more closely align with the Commission's risk-based approach to regulating the use of derivatives under the Proposal. Specifically, we recommend that the Exposure-Based Exception exclude from the 10% notional calculation currency hedging transactions in a notional amount equal to the value of non-USD denominated assets held by a fund. The Commission explained in the Release that it fashioned the Exposure-Based Exception, which is based on the notional amount of the fund's derivatives transactions, to serve as "an efficient way to identify funds that use derivatives in a limited way,"[9] and created the Currency Hedging Exception to reflect the Commission's view that "using currency derivatives solely to hedge currency risk does not raise the policy concerns underlying section 18."[10] Given the stated rationales for these exceptions, Fidelity believes that it would more accurately align with the Commission's objectives to exclude currency hedging transactions from the Exposure-Based Exception such that a fund could engage in a notional amount of currency derivatives at least equal to the value of non-USD denominated assets, as well as a notional amount of other derivatives transactions not to exceed 10% of the fund's net assets. We believe that the Commission should reconsider this decision. Given that the Exposure-Based Exception is based on the notional amount of "derivatives transactions," which term is broadly defined under the Proposal, and not the mark-to-market value of such transactions, which would more accurately reflect the fund's exposure from such transactions, Fidelity believes it would be appropriate to exclude currency hedging transactions from the Exposure-Based Exception.

In addition to excluding currency hedging transactions from the Exposure-Based Exception, we believe that synthetic positions where a fund holds cash and cash equivalents with a value equal to the notional amount of the derivatives held by the fund, less any posted margin, should be excluded from the Exposure-Based Exception, as queried by the Commission in its request for comments.[11] These types of synthetic transactions, such as futures and interest rate

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[8] Release at 164.
[9] *Id.* at 150.
[10] *Id.* at 164.
[11] *Id.* at 159.

swaps, are routinely used by funds to fully invest shareholder funds where access to a particular market may be limited at any given time, or to manage large flows into a fund. As the Commission notes, when a fund is holding cash and cash equivalents, less any posted margin, equal to the notional amount of such derivatives, the fund is not creating any leverage. While counterparty risk may be present in these transactions, as also noted by the Commission,[12] funds already have policies and procedures in place to monitor and limit their exposure to their regularly vetted counterparties.

2. Exceedances of An Exception Limit during Routine Fund Events should not be deemed Violations of the Proposed Rule

Under the Proposed Rule, a fund that exceeds the Exposure-Based Exception on any given day would be required to "promptly" reduce its derivatives exposure or establish a DRM Program and comply with the VaR-based limit on fund leverage as soon as reasonably practicable.[13] Fidelity believes that the Commission should consider an exception for temporary exceedances of the limits resulting from routine fund events such as portfolio launch periods, portfolio rebalancings, large shareholder inflows or redemptions, roll periods for currency hedges and other instruments that are typically "rolled" forward (such as TBAs and mortgage dollar rolls), and redemptions in anticipation of a fund's liquidation or in conjunction with the liquidation or merger of a fund, for example ("Routine Fund Events"). This type of exception is also important in the context of the Currency Hedging Exception. For instance, during a "roll period" for currency hedges, funds may hold currency forwards with notionals in an amount equal to up to two times the value of non-USD investments held by the fund, prior to settlement of the old and new transactions (usually T+2 or T+3). A fund's exceedance of the relevant limited derivatives user exception limits as a result of a Routine Fund Event should not require the fund to reduce its derivatives holdings or establish a DRM Program. Also, we suggest that the investment adviser retain discretion to determine the duration of a limited derivatives user exception exceedance caused by a Routine Fund Event based on the fund's risk guidelines and market convention (e.g., security trade settlement period). Requiring a fund manager to either sell positions or enter into a DRM Program as a result of these temporary and routine events may result in a manager being deterred from using these instruments or having to sell out of positions at a time that is not in the best interest of the fund or its shareholders. A fund manager is not always able to anticipate when a shareholder may make a large contribution into or redemption from a fund, and derivatives provide a useful tool in investing shareholder money for the benefit of all shareholders in a fund at a time when it may be difficult to source comparable securities in a given market.

3. Narrow the Definition of Derivatives Transactions to Exclude When-Issued, To-Be-Announced and Other Forms of Forward Settling Securities

Fidelity supports the Commission's attempt to define what constitutes a "derivatives transaction" for purposes of the Proposed Rule with some specificity. As proposed, however, we

[12] Release at 159.
[13] *Id*. at 155.

believe that the definition of "derivatives transaction" is overly broad and could include transactions not traditionally considered "derivatives transactions."

For instance, the definition of "derivatives transaction" includes any "swap….or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise…."[14] We believe that this definition may inadvertently encompass "when-issued" U.S. Treasury securities, which do not share the same characteristics as traditional derivatives instruments. These "when-issued" U.S. Treasury securities are announced with all attributes of the issued security, such as issue size, auction date, settlement date and maturity date, and are purchased by various types of mutual funds on a regular basis. Given the argument that could be made that "when-issued" U.S. Treasury securities are within the definition of "derivatives transaction," Fidelity requests that the Commission clarify and confirm that "when-issued" U.S. Treasury securities will not constitute "derivatives transactions" under the Proposal.

Additionally, to-be-announced transactions (TBAs) have not traditionally been regulated as derivatives transactions. The TBA market is a highly liquid and stable market, fundamental to the trading of forward settling agency mortgage-backed securities.[15] Similar to synthetic positions discussed above, TBAs are required under FINRA Rule 4210 to be collateralized to prescribed thresholds.[16] As a result of this collateralization, funds mitigate any levering effect of these transactions when acting in accordance with the FINRA Rule 4210 margining requirements.[17] In addition, we believe that inclusion of TBAs in the definition of "derivatives transactions" could have a chilling effect on willing participants in the market and could inadvertently constrain liquidity in the residential mortgage market. Accordingly, Fidelity respectfully requests that the Commission reconsider the inclusion of TBAs in the definition of "derivatives transaction" for purposes of the Proposed Rule.

Finally, we are concerned that the broad definition of "derivatives transaction" could also inadvertently include a broad range of securities purchased by mutual funds that do not create the type of leverage that the Commission is attempting to regulate. For example, certain securities may be inadvertently included in the proposed definition because they do not settle on a traditional T+2 or T+3 basis but do settle within a customary period for these securities not exceeding 35 days. Including these types of transactions in the definition of "derivatives transaction" could have an unintended consequence of reducing purchases of these securities, which could have a detrimental impact on certain issuers, such as municipalities, that rely on the bond market as a funding source. Accordingly, we recommend that the Commission exclude

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[14] Release at 39.

[15] "The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans." SIFMA, *TBA Market Fact Sheet, 2015, available at* https://www.sifma.org/wp-content/uploads/2018/01/SIFMA-TBA-Fact-Sheet.pdf.

[16] FINRA Rule 4210(e)(H)(ii).

[17] Under amended FINRA Rule 4210, effective March 25, 2021 TBA and other "Covered Agency Transactions" will require full margining under the terms of a qualifying margining agreement. Amended FINRA Rule 4210 formalizes the margining best practices recommended by the Treasury Market Practice Group in 2013, which have been broadly adopted by the forward settling agency mortgage backed securities market.

from the definition of "derivatives transaction," delayed settlement transactions for which (i) the parties intend physical settlement (including through DTC or other electronic platforms), (ii) the standard settlement cycle is greater than T+2, and (iii) settlement occurs within 35 days. We note that excluding delayed delivery securities under these conditions, would also have the effect of excluding "when-issued" U.S. Treasury securities as discussed above.

4. Provide Additional Flexibility for Board Oversight and Approval of the Derivatives Risk Manager

The Proposed Rule would require a fund adviser's officer or officers to serve as the fund's Derivatives Risk Manager ("DRM") and it would also require the fund's board of directors to approve the designation of the DRM.[18] In the Release, the Commission notes that it used a variation of this approach when adopting Rule 22e-4 under the 1940 Act, which sets forth the requirements for certain funds to have liquidity risk management programs.[19] Under Rule 22e-4, the liquidity risk administrator may be the fund's "…investment adviser, officer or officers (which may not be solely portfolio managers of the fund…"[20] We encourage the SEC to more closely align the Proposed Rule with the approach used in Rule 22e-4 and allow the fund's board of directors to designate the fund's investment adviser as the DRM. Limiting the board to naming specific individuals rather than the fund's investment adviser is unnecessary. The investment adviser is responsible for a full range of services to the fund (including the management of derivatives risk) and is obligated by law and contract to meet high standards when carrying out its duties. In approving the investment management agreement, the fund's board of directors already considers, among many factors, the quality of the services provided by the adviser to the fund. Requiring the board to go further and name individuals does not create additional protections for funds or fund shareholders.

Furthermore, unnecessarily requiring the board to name specific individuals would impose procedural burdens on boards and fund management without a commensurate benefit. The frequency of fund board meetings varies across the industry. Between board meetings, an individual designated as a DRM may move into a new role with the adviser or may seek employment elsewhere entirely. This could create situations in which a fund does not have a DRM in place for several months until the next scheduled board meeting. Requiring the board to hold a special meeting to consider a replacement individual as the fund's DRM imposes burdens on the board and fund management as well as potential costs on shareholders. Further, requiring directors to evaluate the particular experience and expertise of a particular employee or officer of an investment adviser would be a significant shift in the nature of board oversight that goes beyond the obligations of a board in selecting an investment adviser.

If the Commission does require fund boards to designate individuals, we encourage the Commission to allow employees of the investment adviser to serve as the DRM in addition to officers of the adviser. The identity of an investment adviser's officers is a matter for the adviser's board of directors under state corporate law. Those boards may choose to elect only a

[18] Release at 48.
[19] *Id*. at 53.
[20] Rule 22e-4(a)(13) under the 1940 Act.

small number of individuals to serve as officers and these individuals may or may not be directly involved in the day-to-day management or oversight of the funds' investments in derivatives. Expanding the range of eligible persons to include employees of the adviser affords fund boards broader flexibility to designate the persons best suited to serve as the funds' DRM. Additionally, such a change does not impose any risks to the fund because these individuals are employed by an entity (i.e., the adviser) that owes a fiduciary duty to the fund.

5. The Proposed Backtesting, Stress Testing and VaR Leverage Limit Testing Schedules are Too Frequent

The Proposal would require a fund's DRM Program to provide for stress testing to evaluate potential losses to a fund's portfolio, at least weekly,[21] and for backtesting the results of the VaR calculation model used by a fund in connection with the relative or absolute VaR test, as applicable, daily.[22] While Fidelity agrees that stress testing can be helpful in managing the "tail-risks" of certain investments, we believe that a weekly stress testing requirement is too frequent and that the Commission should reconsider the frequency of the requirement, making it no less frequent than monthly. As noted by the Commission, a fund may determine that a more frequent testing schedule is warranted given the frequency of change in a fund's investments or changes in market conditions, but this decision should be left to the DRM who has the relevant experience in derivatives risk management. A monthly stress test, under normal market conditions, would be adequate and appropriate to accomplish the Commission's goals of providing a DRM with timely insight into a fund's derivatives risk. It should be left to the DRM, in accordance with the fund's risk guidelines to determine when market conditions may warrant a more frequent stress testing schedule.

Similarly, we believe that a daily backtesting requirement is excessive and ask the Commission to consider a weekly or longer backtesting requirement instead. In our view, the DRM will be able to adequately evaluate the effectiveness of the VaR model using 52 tests in any given year. The Commission notes that the backtesting requirement is being proposed in light of the role that VaR plays in the limit on leverage.[23] Fidelity submits that if a fund is in compliance with the VaR limits on leverage, weekly backtesting would be adequate and appropriate for a DRM to determine if the VaR model has any material deficiencies.

C. The Proposed Limit on Fund Leverage Risk

1. The Designated Reference Index Definition is Overly Restrictive

Under the Proposed Rule, the relative VaR test requires a fund to measure its VaR against the VaR of a "designated reference index." [24] The Commission explained that "a fund's designated reference index must be unleveraged and reflect the markets or asset classes in which

[21] Release at 64.
[22] *Id*. at 69.
[23] *Id*.
[24] *Id*. at 97.

the fund invests, among other requirements."[25] Further, the designated reference index cannot be a proprietary index created at the request of the fund or its investment adviser, unless the index is "widely recognized and used."[26] We acknowledge the Commission's concern that a proprietary index that is not widely recognized and used, could be designed with the intent to allow a fund to use additional leverage.[27] However, we believe those concerns are mitigated if the constituents of a proprietary index are themselves widely recognized and used.

With the growing popularity of target date funds and managed accounts, custom blended indexes have become common and are frequently used by investment advisers to match the fund's objectives to a tailored index, and are not designed to facilitate leverage.[28] While customized indexes are common, they may differ depending on a number of variables including the fund's objective and strategy. As a result, custom indexes are typically arranged by the investment adviser and may not be "widely recognized and used," therefore not qualifying under the Proposed Rule as a designated reference index. Fidelity believes that a suitable compromise would be to broaden the definition of designated reference index to allow custom blended indexes arranged by the fund or its investment adviser, provided the custom blended index' constituent indexes are either: (i) not administered by an affiliated person of the fund, its investment adviser, or principal underwriter, or (ii) are widely recognized and used indexes created at the request of the fund or its investment adviser. Permitting a fund to use a custom index that meets the criteria referenced above as its designated reference index would allow the DRM to efficiently select the fund's designated reference index. In doing so, the DRM will avoid an unnecessary analysis of whether an alternative designated reference index is available and whether the relative VaR test is suitable.

2. Funds that Invest in Other Registered Investment Companies Should Only Include Their Direct Derivatives Holdings in the VaR Calculations

The Proposal does not provide guidance concerning how fund VaR leverage limits should be applied with respect to investments in other registered investment companies (the "underlying funds"). Applying the VaR leverage limits to these types of investments is challenging because an acquiring fund's adviser may not have daily transparency into the holdings of underlying funds. As a result, the acquiring fund's adviser may not be able to calculate a holdings-based VaR for the underlying funds or monitor their derivatives use.

To address this concern, we suggest that the Commission confirm that funds need only comply with the requirements of the Proposed Rule if the fund itself directly engages in derivatives transactions and that a fund need not look through to the holdings of any underlying funds for purposes of calculating derivatives exposure. In addition, an acquiring fund that invests solely in registered underlying funds (i.e., fund of funds), including underlying funds that

[25] Release at 97.
[26] *Id*. at 99.
[27] *Id*. at 101.
[28] Custom indexes have gained popularity with investors in part because they provide access to specific investment strategies at a reasonable cost.

hold derivatives transactions under the Proposal, and does not otherwise directly trade derivatives, should not be subject to the requirements of the Proposed Rule.

Correspondingly, we ask that the Commission confirm that an acquiring fund that directly trades in derivatives transactions and also holds shares of other underlying funds that use derivatives, is allowed to calculate the VaR of the acquiring fund by taking into account the historic return of the acquiring fund, and is not required to calculate the acquiring fund's VaR based on the aggregate VaR of the underlying funds.

3. The Lock-Out Period on Trading Derivatives after Coming Back into Compliance with the Proposed Rule should be Eliminated

The Commission proposed that if a fund is out of compliance with the applicable VaR test for more than three business days, then the fund will not be able to enter into derivatives transactions (other than those designed to reduce the fund's VaR), until certain conditions are met, including the fund having been back in compliance with the applicable VaR test for at least three consecutive business days.[29] We believe that the cure period should be changed to five consecutive business days, and we also believe that this lock-out period on trading derivatives (other than those designed to reduce the fund's VaR) is unwarranted and unnecessary. Once a fund has come back into compliance with the applicable VaR test, we see no reason to limit a manager's ability to manage the fund in the best way possible for shareholders, which may include derivatives that do not necessarily reduce the fund's VaR. The Commission notes that if the lock-out period were eliminated, it could "potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test."[30] We believe that any persistent non-compliance with an applicable VaR test should be monitored by the DRM and addressed with the fund's board of directors, rather than implementing a lock-out period that may not be in the best interest of the fund or its shareholders.

III. RECOMMENDATIONS CONCERNING AMENDMENTS TO FORM N-PORT REPORTING REQUIREMENTS

The Proposal requires amendments to certain existing forms that are "designed to enhance the Commission's ability to oversee funds' use of and compliance with the proposed rules effectively, and for the Commission and the public to have greater insight into the impact that a funds' use of derivatives would have on their portfolios."[31] Specifically, the Proposal requires periodic public reporting on Form N-PORT of, among other information, the fund's derivatives exposure, highest daily VaR, median daily VaR, designated reference index, fund's highest daily VaR ratio for fund's subject to the relative VaR test, and number of VaR limit exceptions identified during the reporting period.

Fidelity commends the Commission for taking steps to add greater transparency concerning the risks associated with a fund's use of derivatives. However, publicly reporting highly

[29] Release at 131.
[30] *Id.*
[31] *Id.* 207.

technical risk management information such as the fund's highest daily VaR, median VaR, and highest daily VaR ratio may actually confuse investors concerning the risks associated with the fund's use of derivatives. To address this concern, Fidelity recommends that the Commission revise the proposed Form N-PORT reporting requirements by excluding the VaR-related information referenced above. We also recommend that proposed Form N-PORT be revised to allow a fund to report derivatives exposure based on either net notional (e.g., allowing netting of long and short positions) or mark-to-market exposure, which is a commonly used method for calculating derivatives exposure. Fidelity believes using either of these methods provides a more accurate measure of the fund's derivatives exposure.

Finally, we note that the current Form N-PORT description of "derivatives transactions" is not consistent with the Proposed Rule's definition, which includes transactions not customarily considered "derivatives" (e.g., TBAs). This could confuse fund investors as they attempt to reconcile information provided by proposed Form N-PORT with other public disclosures, such as shareholder reporting, that use a different definition of derivatives. Also, investment managers will incur the added administrative burden of tracking disparate definitions that calculate different amounts among various public disclosures. To avoid investor confusion and administrative cost, we recommend that the Commission undertake a review of impacted public disclosures to evaluate whether an existing and commonly used definition of derivatives transactions should be used for purposes of the revised Form N-PORT reporting.

IV. RECOMMENDATION CONCERNING PROPOSED TRANSITION PERIOD

The Proposal allows for a one year transition period from the date that the final rule is published in the Federal Register for funds to come into compliance with the requirements of the Proposal.[32] Accordingly, at the expiration of the transition period "(1) any fund that enters into the transactions permitted by rule 18f–4 would do so relying on that rule; (2) broker-dealers and investment advisers would be required to comply with the sales practices rules; and (3) leveraged/inverse ETFs could operate under rule 6c-11 and the current leveraged/inverse ETF sponsors' orders would be rescinded."[33]

Fidelity believes that a one-year transition period is not sufficient to implement necessary changes and recommends that the Commission extend the transition period to two years. To operate under the Proposal, fund companies will need to prepare to comply with the new requirements including: (i) developing and adopting a DRM Program across all impacted funds and designating a DRM; (ii) analyzing applicable exceptions and VaR leverage limits, and implementing methods and systems to ensure ongoing compliance; (iii) educating fund board members on their enhanced oversight responsibilities and arranging for continued board oversight; and (iv) seeking board approval of the DRM Program and DRM. Considered in isolation, the time necessary to perform the tasks associated with complying with the final rule will take more than one year. However, during this period of time fund companies will also need to prepare for the Commission's proposed rules relating to the use of derivatives by leveraged/inverse funds. This work will require a separate workstream to evaluate the impact of

[32] Release at 246.
[33] *Id.*

the final rule on these types of funds and potentially modifying strategies and fund offering documents, and repositioning portfolios to accommodate the associated limitations. Finally, recordkeeping procedures and form reporting requirements will also need to be updated to comply with the related requirements. This will include preparing for the alternative sales practices reporting rules that apply when offering leveraged/inverse funds to retail investors.

Considering the significant amount of work described above, we suggest a two-year implementation period is more appropriate.

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Fidelity would be pleased to provide further information, participate in any direct outreach efforts the Commission undertakes, or respond to questions the Commission may have about our comments.

Sincerely,

cc: The Honorable Jay Clayton, Chairman
The Honorable Allison H. Lee, Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner

Dalia Blass, Director, Division of Investment Management