Kramer Levin

Ronald M. Feiman
Partner
T 212.715.9550
F 212.715.8250
[redacted]

1177 Avenue of the Americas
New York, NY 10036
T 212.715.9100
F 212.715.8000

March 24, 2020

Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Attention: Vanessa A. Countryman, Secretary

Re: File No. S7-24-15

Ladies and Gentlemen:

We welcome the opportunity to comment on Release IC-31933, *Use of Derivatives by Registered Investment Companies and Business Development Companies* (the **"Proposal"**) proposed by the Securities and Exchange Commission (the **"Commission"**) with respect to the use of derivatives by registered funds. We are pleased to submit these comments developed in consultation with certain clients that are, sponsor or advise registered closed-end funds that focus on alternative investment strategies. A number of closed end funds focused on alternative strategies are sold exclusively to high net worth qualified clients, as defined under Rule 205-3 promulgated under the Investment Advisers Act of 1940, who are also accredited investors, as defined under Regulation D promulgated under the Securities Act of 1933 (**"Registered Qualified Client Funds"**).

We generally support the Commission's efforts to develop a formal framework for regulating the use of derivatives by registered funds. The U.S. fund system is the envy of the world, in part because a predictable, rules-based regulatory system has enabled innovation in all sectors of the industry. Among the types of innovative funds that have been brought to market over the past few decades are Registered Qualified Client Funds that use derivatives to achieve cost-effective exposure to investments, to provide non-correlated returns to traditional, long-only products and for hedging and risk management purposes. Historically, many of these products were only available to individuals and institutions willing to invest large sums through 3(c)(1) and 3(c)(7) funds (**"private funds"**), but the framework that the Commission has created since Release 10666 in 1979 has enabled these products to be offered to high net worth sophisticated investors who want to invest small amounts of capital in non-correlated assets within the protective framework of the Investment Company Act of 1940 (the **"1940 Act"**).

In the following, we first ask the Commission to consider modifications to the Proposal's VaR limits framework for closed-end funds broadly, and we then recommend a more specific exemption for Registered Qualified Client Funds from the Proposal's imposition of VaR limits.

We appreciate the Commission's anticipated thoughtful consideration of our comments to advance the Proposal.

I. Recommended Modifications to the Proposal's VaR Limits for Closed-End Funds

We recommend the Commission consider the following modifications to the Proposal's VaR limits framework for closed-end funds in recognition of Section 18's longstanding disparate treatment of closed-end and open-end fund structures:

1. As the Commission is aware, currently closed-end funds are treated differently from open-end funds under Section 18. Importantly, this disparate treatment of closed-end funds has allowed for the successful growth of alternative closed-end funds, which are able to implement alternative strategies through the more relaxed leverage limitations they are afforded under Section 18. Therefore, ***relaxing the VaR limits for closed-end funds to 200% for relative VaR and 20% for absolute VaR*** would not only be consistent with the current regulatory framework of providing closed-end funds more flexibility under Section 18, but also, and more importantly, it would ***preserve investor access to alternative strategies within the protective framework of the 1940 Act***, instead of incentivizing sponsors and investors to pursue these strategies through private funds.

2. Increasing the VaR limits to 200%/20% for closed-end funds would not only be consistent with the existing regulatory framework and investor risk tolerances but also would be in accord with the limits already in place for regulated UCITs funds in Europe, which have been ***successfully implemented and tested for years***. If such limits were not aligned, managers who often employ identical strategies for UCITs and closed-end funds would experience unnecessary strategy deviations and return "drifts" in their portfolios. And ultimately, U.S. closed-end fund investors should be able to access the same risk/return exposures as their European counterparts.

3. We also note that closed-end funds, because they do not have daily liquidity obligations, are currently able to invest in smaller, less liquid, companies as part of their alternative strategies. As a result, ***closed-end funds have been seen to enhance capital formation, one of the annunciated Commission goals***.[1] At a minimum, expanding the VaR limits for closed-end funds would preserve those Commission goals without imperiling investors who depend on daily liquidity.

4. Finally, we recommend the Commission modify proposed Rule 18f-4(c)(2)(iii)(C)(iv) to reduce the stay period for closed-end funds from three business days to one before a fund can trade derivatives that are not reasonably designed to reduce VaR following a VaR breach of three consecutive business days. Given the Proposal is already requiring, one, disclosure of any VaR breach on Form N-Port, and two, any three-day

1 *See*, Release Nos. 33-10649, 34-86129, IA-5256, IC-33512, File No. S7-08-19 (June 18, 2019), beginning at p.172.

breach be reported to a fund's board and the Commission and trigger a mandatory review of the Derivatives Risk Management Program, we believe the proposed three-day stay period is too restrictive and that ***sufficient investor protections (in fact, enhanced protections compared to the existing regulatory framework) are realized through a one-day stay period combined with the Proposal's disclosure and reporting obligations***.

II. Recommendation to Exempt Registered Qualified Client Funds from the Proposal's VaR Limits

The growth and success of Registered Qualified Client Funds has been a benefit to sophisticated investors who want to invest a small portion of their portfolio (which may be amounts of capital lower than private fund minimum investments) in non-correlated assets.[2] As it stands, the Proposal may disrupt these Funds as it may incentivize sophisticated investors to liquidate their Registered Qualified Client Fund investments, only to invest much larger amounts in the same strategies offered in private funds, which would not be constrained by VaR limits. These private funds, which are often run identically (*pari pasu*) to Registered Qualified Client Funds, typically require a significantly higher minimum investment amount than Registered Qualified Client Funds. Investors would therefore end up increasing their total capital risk to these strategies, contrary to the Proposal and the Commission's ultimate goal of investor protection.

Importantly, along with requiring sophisticated investors to both certify their high level of minimum net worth and acknowledge all of the risks involved in investing in these Funds in writing prior to initiating an investment, ***Registered Qualified Client Funds have been seen to enhance capital formation, one of the annunciated Commission goals***.[3]

Consequently, in addition to the recommendations detailed in Section I, the Commission should also consider exempting Registered Qualified Client Funds from the Proposal's VaR limits altogether for the reasons set forth below.[4] However, should the Commission decide not to exempt Registered Qualified Funds from the Proposal's VaR limits, we request that these Funds be subject to the same rules under the Proposal as other registered funds and not be subject to any additional restrictions, which could imperil capital formation and the ability of sophisticated investors to access these Funds on which they have come to rely.

1. Unlike mutual funds, Registered ***Qualified Client*** Funds are only offered to ***sophisticated***, high net worth investors (with a $2.1 million net worth minimum), who not only certify as to their financial wherewithal but also acknowledge all of the risks involved in investing in such Funds. Moreover, and also unlike mutual funds, Registered ***Qualified Client*** Fund investors have to complete an ***extensive***

---

2 We note that none of the funds cited in the proposing release as giving rise to the Proposal were Registered Qualified Client Funds.

3 *See, supra* note 1.

4 Under our proposal, Registered Qualified Client Funds would only be exempted from the Proposal's VaR limits, while remaining subject to the other protective provisions of the Proposal. Importantly, the defined term "Registered Qualified Client Fund" only encompasses closed-end funds sold to qualified clients, as the recommendations here are not applicable to mutual funds, since stricter, more standardized leverage limitations may be necessary to secure adherence to the daily liquidity requirements to which those funds are subject.

subscription document each time they invest certifying that, one, they are qualified clients, two, they are fully aware of the risks of investing (including the risk of loss of principal) and, three, they have received and read the Fund's prospectus. This is similar to private funds that also require their investors to certify that they are, at a minimum, accredited investors.

2. Unlike mutual fund investors, Registered Qualified Client Fund investors are, by rule (based on their minimum $2.1 million net worth), eligible to invest in sophisticated structures. In fact, when Rule 205-3 was adopted in 1985, the Commission explicitly acknowledged the financial sophistication of qualified clients and their ability to be "less dependent on the protections" provided by certain aspects of the federal securities laws.[5] Moreover, all of these Funds are sold only to accredited investors, who Congress and the Commission have deemed as sufficiently sophisticated to invest in all private investment vehicles, regardless of the level of derivatives or leverage such vehicles use.

3. Various Registered Qualified Client Funds also have a stated mandate to pursue a flexible investment strategy that may utilize a variety of different securities, including derivatives. Registered Qualified Client Funds often use derivatives as insurance instruments for hedging market risk. Such instruments substantially protect principal during a major market correction by capping fund losses at a certain level (e.g., a 5% or 10% maximum loss), yet ***do not meaningfully reduce daily VaR*** prior to such a correction, while such positions remain "out of the money".

4. In this connection various Registered Qualified Client Funds ***continuously adjust their net exposure*** based on varying market conditions. For example, during recessionary periods a Registered Qualified Client Fund may (and is often expected by its investors to) substantially contract net market exposure. On the other hand, during economic growth periods, a Registered Qualified Client Fund's market exposure may expand meaningfully to fully capture market upside.[6]

Considering all of the above, and as shown in the table below, ***Registered Qualified Client Funds are more similar to private funds than typical mutual funds.***

---

5 *See,* Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Release No. IA-996 (Nov. 14, 1985) at Sections I.C and II.B. We recognize that the qualified client concept was conceived in the context of having the sophistication to understand and negotiate investment advisory contracts that charge a performance fee, but the term is no less relevant in this regulatory context. Importantly, qualified clients are almost universally accredited investors by definition, given most rely on the net worth test of $2.1 million, which is more than double the current accredited investor net worth test of $1 million. The Commission and applicable case law have long recognized that particular classes of persons, such as accredited investors, are not in need of certain investor protection features of the federal securities laws. *See SEC v. Ralston Purina Co., 346 U.S. 119, (1953)* and Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015 (Jan. 30, 1987)] ("Historically, the Commission has stated that the accredited investor definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of [certain aspects of the federal securities laws] unnecessary".)

6 While some mutual funds have similar investment strategies, in our experience, these strategies are disproportionally represented by closed-end funds, including Registered Qualified Client Funds.

	Private Funds	Registered Qualified Client Funds	Mutual Funds
High Net Worth Qualification	Yes	Yes	No
Extensive Subscription Document with Investor Certification	Yes	Yes	No
Flexible Investment Mandate	Typically Yes	Typically Yes	Typically No
Dynamically Adjusting Exposure depending on Market Conditions	Typically Yes	Typically Yes	Typically Fully Invested

Moreover, application of the Proposal's VaR limits to Registered Qualified Client Funds with flexible investment mandates would be impractical for these Funds. In particular, given the continuously and dynamically adjusting exposures of various Registered Qualified Client Fund portfolios, which their underlying investors not only expect but also have mandated their managers to pursue, the Proposal would require these Funds to frequently change their designated reference index (even custom ones) for measuring relative VaR, thereby rendering the use of relative VAR limits impractical (particularly in light of the disclosure and board reporting requirements for a designated reference index under the Proposal).

Similarly, the proposed absolute VaR limit would be inappropriate and too constraining for Registered Qualified Client Funds that are mandated to have investment strategies that require frequent exposure adjustments. An imposition of such limit could result in a violation of these Funds' existing mandates, undermining the very reason why sophisticated investors chose Registered Qualified Client Funds in the first place.

For example, based on one of our client's analysis of historical data, a Registered Qualified Client Fund had isolated periods where its VaR exceeded 15%.[7] During those isolated periods, the fund was generating positive returns, and the VaR exceedances were driven by traditional long equity securities and not derivatives.[8] In short, the absolute VaR test's 15% limit could limit a fund's ability to generate positive returns for investors and affect how

---

7 The exceedances have ranged from 10 basis points to over 500 basis points from 2011 through 2019. It is worth noting that during these periods, the fund was "over covering" its short and swap positions in line with current Section 18 guidance.

8 Based on our client's analysis, each security in a portfolio has some marginal impact on absolute VaR. For a net long portfolio, the top marginal contributors to VaR can be cash long positions, especially if the positions have high volatility, and to reduce VaR in the event of an exceedance, selling those cash long positions may be the most efficient solution, notwithstanding the potential impact on portfolio returns and investor interests.

a fund invests or holds non-derivative instruments such as traditional long equity securities and may prevent a fund from purchasing synthetic longs on swap.[9]

In addition, the client examined periods of market stress (such as the current market environment), and its fund's VaR was significantly below the 15% limit, with derivative instruments (such as short sales and swaps) contributing to reducing portfolio VaR.

Therefore, requiring a Registered Qualified Client Fund to comply with the absolute VaR test's 15% limit could prevent a Registered Qualified Client Fund from pursuing its continuously and dynamically adjusting investment strategy and generally force funds that seek to participate more on the upside and less on the downside (compared to broader market indices) to sell traditional equity long positions and cause a fund to forego investment opportunities that would be consistent with its investment objectives and strategies.

We appreciate the opportunity to reflect our support for the idea of codifying guidance on the use of derivatives for registered funds and to identify ways in which the Proposal can be enhanced to reflect variations among funds. Adapting the rule to encompass such variances will benefit investors, as it will enable continuation of existing fund structures offered to suitable classes of investors, while at the same time reflecting appropriate investor protections intended by the Proposal.

Sincerely,
KRAMER LEVIN NAFTALIS & FRANKEL LLP

Ronald M. Feiman

RMF:ng

9 Assuming a breach of three consecutive days and that for a net long portfolio, a synthetic long would not reduce portfolio VaR (whereas a short sale or short swap would).