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

Re: Proposed Rule Regarding 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 Secretary Countryman:

We appreciate the thoughtful consideration by the U.S. Securities and Exchange Commission ("Commission") of comments to advance the proposal to update the regulation of funds' use of derivatives (the "Proposal") under the Investment Company Act of 1940 ("1940 Act"). We submit this letter on behalf of an investment adviser (the "Adviser") to certain alternative strategy unlisted closed-end registered investment companies sold only to "qualified clients," as defined under the Investment Advisers Act of 1940[1] (the "Advisers Act" and "Qualified Client Funds") likely to be significantly affected by the adoption of certain parts of proposed rule 18f-4.

The Adviser supports the Commission in its efforts to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives and certain other transactions. However, the Adviser believes that certain restrictions in the proposal, namely the value-at-risk ("VaR")-based limit on fund leverage risk ("VAR limits"), would affect how Qualified Client Funds operate and the investment strategies Qualified Client Funds can pursue, which could significantly and negatively impact investment performance and create unnecessary costs for investors. We believe

1 Rule 205-3(d)(1) under the Advisers Act generally defines a "qualified client" as a: (i) natural person who, or company that, has at least $1 million under management with the investment adviser immediately after entering into the contract, (ii) a natural person who, or company that, the investment adviser reasonably believes has a net worth of more than $2.1 million at the time the contract is entered into (with exclusions for the person's primary residence and certain other assets), (iii) natural person who, or a company that, the investment adviser reasonably believes is "qualified purchaser" as defined under Section 2(a)(51) of the 1940 Act, or (iv) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser and certain knowledgeable employees of the investment adviser.

that these impacts are not warranted by the investor protection purposes underlying Section 18, given that all investors in Qualified Client Funds are required to meet the definition of "qualified client" under the Advisers Act and thus have the financial resources and sophistication to understand and assume the risks presented by Qualified Client Funds' use of derivatives.

For those and other reasons, as described herein, we respectfully request the Commission to consider the recommendation that proposed rule 18f-4 be modified to exempt Qualified Client Funds from the VaR limits.

VaR limits are not necessary to achieve the investor protection purposes underlying Section 18 with respect to Qualified Client Funds that use derivatives

The Proposal would require that a fund comply with the VaR limits. Under the VaR limits, a fund's VaR could not exceed 150% of the VaR of an unleveraged "designated reference index" (the "relative VaR test"). If the fund's derivatives risk manager is not able to identify an appropriate designated reference index, the fund's VaR could not exceed 15% of the value of the fund's net assets (the "absolute VaR test"). The Proposal states that the VaR limits were "designed to limit fund leverage risk consistent with the investor protection purposes underlying Section 18 and to complement the proposed risk management program." The Proposal highlights the Commission's belief that funds' use of derivatives may raise certain investor protection concerns, which the Commission believes should be addressed by the senior security provisions of Section 18 (*i.e.*, that funds' use of derivatives could raise undue speculation and asset sufficiency concerns).

We respectfully submit that, because all investors in Qualified Client Funds are required to meet the definition of qualified client, it is not necessary to require Qualified Client Funds to comply with the proposed VaR limits to address these investor protection concerns.

Investors that meet the definition of qualified client have long been viewed as financially qualified and able to bear the risks presented by certain sophisticated arrangements associated with the Qualified Client Funds in which they invest. In this regard, Rule 205-3 provides relief from a prohibition under the Advisers Act to permit an investment advisory contract with a Qualified Client Fund providing for compensation to the investment adviser on the basis of capital gains or capital appreciation of the Qualified Client Fund ("performance fees").[2] In adopting Rule 205-3 in 1985, the Commission concluded that it was "consistent with the protection of investors and the purposes of the [Advisers Act] to permit clients who are financially experienced and able to bear

2 *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. ("1985 Adopting Release"); *see also* Report on the Review of the Definition of "Accredited Investor" (December 18, 2015).

the risks associated with performance fees to have the opportunity" to bear the risks associated with such performance fee structures they "deem appropriate."[3]

We believe that fund investors that are qualified clients likewise should be viewed as able to understand and bear the potentially heightened derivatives risks that might be presented by a Qualified Client Fund's use of derivatives not subject to the VaR limits. A Qualified Client Fund would, of course, still be subject to the requirement that it adopt a derivatives risk management program, which the Commission has characterized as "foundational to providing exemptive relief under Section 18," as well as the Proposal's important recordkeeping, disclosure and board oversight and reporting requirements.

In addition, investors often invest in Qualified Client Funds because they expect such funds to pursue broad mandates utilizing a variety of investment strategies that continuously and dynamically adjust their portfolios' market, sector and geographic exposures based on changing macroeconomic and market conditions, with such exposures regularly achieved through entering into derivatives transactions (whether for hedging or investment purposes). For example, during recessionary periods a 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 Qualified Client Fund's market exposure may expand meaningfully.

Moreover, descriptions of any such derivatives use and related risk disclosures mean that such investors are well aware of the types of derivatives risks that the relevant Qualified Client Fund in which they are investing present. Each investor in a Qualified Client Fund is made fully aware of and fully acknowledges the risks embedded in pursuing the fund's broad investment mandate. Each investor is required to complete and sign an investor certification prior to investing that includes a representation that the investor has read the prospectus and understands that investment in the fund involves a considerable amount of risk and that the investor may lose some or all of their investment. As qualified clients, these investors are sophisticated and should also be viewed as generally aware of the types risks of investing in Qualified Client Funds based on the Commission's longstanding view on such investors' ability to bear heightened risks as discussed above.[4]

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[3] In adopting Rule 205-3, the Commission explained that, based on its review of the legislative history, the prohibition on such arrangements under the Advisers Act was designed "to protect clients of investment advisers from fee arrangements which in Congress' view could encourage advisers to engage in speculative trading practices while managing client funds in order to realize or increase an advisory fee." The Commission also stated that it believes that the conditions of Rule 205-3 "provide alternative safeguards to the statutory prohibition." *See 1985 Adopting Release*.

[4] As we note above, we recognize that the qualified client concept was conceived in the context of an investor or client having the sophistication to understand and negotiate investment advisory

VaR limits are impractical for Qualified Client Funds to implement

Under the relative VaR test, the Proposal would require a fund's designated reference index to "reflect the markets or asset classes in which the fund invests." As noted above, Qualified Client Funds often continuously and dynamically adjust their portfolio exposures based on changing macroeconomic and market conditions. Accordingly, if a Qualified Client Fund was complying with the relative VaR test, such a fund would need to frequently change its designated reference index, even if it were a custom blended index. As a result, we believe that requiring Qualified Client Funds to comply with the relative VAR test would be impractical and problematic for such funds, especially in light of the disclosure and board reporting requirements for a designated reference index under the Proposal.[5]

Similarly, we believe that the proposed absolute VaR test's 15% limit would be inappropriate and too constraining for Qualified Client Funds that are mandated to have investment strategies that require frequent exposure adjustments. Based on the Adviser's analysis of historical data, its Qualified Client Funds have had isolated periods where their VaR has exceeded 15%.[6] However, these Funds were generating positive returns during these periods and were at all times operating consistent with their investment objectives, strategies and restrictions, and the VaR exceedances

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contracts that involve a performance fee, but the term is no less relevant in this regulatory context. The Commission and courts have long recognized that particular classes of persons, such as accredited investors, which all natural person qualified clients are, 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."). It is our understanding that funds that limit their investors to accredited investors require prospective investors to certify to their accredited investor status in much the same way to how Qualified Client Funds have their prospective investors certify to their qualified client status.

5 It may be difficult for some derivatives risk managers to identify definitively whether there is or is not an appropriate designated reference index for certain funds. Accordingly, the Commission should provide guidance that such funds are the type of funds for which the Commission intended that the derivatives risk manager be able to determine that it is unable to identify an appropriate designated reference index.

6 The exceedances have ranged from 10 basis points to over 500 basis points from 2011 through 2019. During those periods, however, these Funds had more than sufficient assets to segregate with respect to their short sale and swap positions in line with current guidance under Section 18.

were driven by traditional long equities and not derivatives.[7] In short, the absolute VaR test's 15% limit could limit a fund's ability to generate positive returns for investors and affect how a fund invests or holds non-derivative instruments such as traditional long equities.

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

Therefore, requiring a Qualified Client Fund to comply with the absolute VaR test's 15% limit could prevent a 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 long equities and forego attractive investment opportunities, including long equity swaps, that would be consistent with the fund's investment objectives and strategies and that present the types of principal risks that have been disclosed to investors.[8]

7 Based on the Adviser'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 traditional long equities, especially if the positions have high volatility. In the event of an exceedance, selling those traditional long equities may be the most efficient way to reduce a portfolio's VaR, notwithstanding the potential impact on portfolio returns and investor interests and that such positions are not the instruments the Proposal is designed to address.

8 The VaR limits would also be impractical and inappropriate as a result of logistical considerations for investment advisers that both advise Qualified Client Funds that they sponsor and sub-advise Qualified Client Funds sponsored by third-parties using the same strategy. Depending on the applicable derivatives risk manager and the board's review of each fund's derivatives risk management program, such funds may have different VaR limits, even though they are managed to the same strategy. This could reduce efficiency for the fund and be detrimental to fund returns and investors.

Potential resulting harm to Qualified Client Funds and investors

The growth and success of Qualified Client Funds has been a benefit to sophisticated investors who meet the definition of qualified client and want to invest small amounts of capital in non-correlated assets.[9] As discussed above, the Proposal would disrupt these Qualified Client Funds and cause them to forego investment opportunities that would be consistent with their investment objectives and strategies. Thus, we believe that application of the Proposal's VaR limits would undermine the reason why qualified client investors chose to invest in these types of funds and would be to the detriment of Qualified Client Funds and their shareholders.

The likely effect of such changes would be to incentivize sophisticated investors to liquidate their Qualified Client Fund investments. Such investors would only be able to achieve equivalent investment exposures by investing in the exact same strategies offered in private Section 3(c)(1) and 3(c)(7) funds, which typically carry significantly higher investment minimums than Qualified Client Funds. Investors would therefore have to increase their total capital risk to these strategies, or not be able to have any exposure to such strategies, contrary to the ultimate goal of investor protection underlying the Proposal and Section 18.

Put simply, the effect of applying the VaR limits to Qualified Client Funds will be to move investors from registered to unregistered funds and to deprive them of the investor protections of the 1940 Act. To underscore this point, it is worth noting that an investor who meets the definition of an "accreditor investor" but not the more restrictive definition of a "qualified client" would be able to invest in a private 3(c)(1) fund that follows the types of Qualified Client Fund investment strategies described above without the protections of the 1940 Act, but would not be able to invest in a registered fund with the same strategies with these protections. Surely this result would be anomalous and not what the Commission intends.

Based on the above, we believe it is not necessary, and in fact counterproductive, to apply the VaR limits to Qualified Client Funds to achieve the investor protection concerns underlying Section 18. Moreover, it appears that the cost of disallowing investors that meet the definition of qualified client from the opportunity to invest in Qualified Client Funds would outweigh any incremental investor protection that would arise out of applying the VaR limits to these Funds.[10]

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

10 As part of the Proposal, the Commission has recognized that it would be appropriate to provide an exception to compliance with the VaR limits for other funds so long as investors are "capable of evaluating the risks" the funds present, which addresses the Commission views as to investor protections underlying Section 18. *See* Proposed Rule 18f-4(c)(4) and Proposed Securities Exchange

In summary, we respectfully request that Qualified Client Funds be exempted from VaR limits altogether, while remaining subject to other protective provisions of the Proposal. Subjecting Qualified Client Funds to the Proposal's VaR limits would incentivize their sponsors to offer only private Section 3(c)(1) and 3(c)(7) funds and drive investors away from the protective framework of the 1940 Act.

Act of 1934 Rule 15(l)(2) and Proposed Advisers Act Rule 211(h), which together would provide an exception to compliance with the VaR limits for leveraged/inverse investment vehicles (including funds) if investment advisers and broker-dealers comply with certain proposed sales practices rules, which "are designed to help ensure that investors in these funds are limited to those who are capable of evaluating their characteristics—including that the funds would not be subject to all of the leverage-related requirements applicable to registered investment companies generally—and the unique risks they present."

We believe that applying such sales practices rules to investors in Qualified Client Funds that are not leveraged/inverse investment vehicles (as defined in the Proposal) is not necessary as Qualified Client Funds generally do not present the unique structural considerations presented by leveraged/inverse funds as identified by the Commission in the Proposal. In addition, we note that the retail investors in leveraged/inverse funds are not screened for, nor would they necessarily meet, the sophistication thresholds to be a qualified client and thus be eligible to invest in Qualified Client Funds. Such measures of sophistication are long-standing and recognized by the Commission, and readily-applied and well-understood by industry participants.

Additionally, we believe that if the Commission requires other funds (not solely those that are by definition leveraged/inverse investment vehicles) that cannot currently meet the VaR limits to utilize the proposed sales practices rules, we suggest that investment advisers be allowed to choose whether to restructure their vehicle to comply with the VaR limits or to comply with the sales practices rules. We also note that as the population of vehicles that may be unable to meet the VaR limits due to their existing investment objective, strategy and restrictions, is unknown. As described herein, any adviser that chooses to take a position that varies from its benchmark can and will affect its VaR calculations, even though such positions (*e.g.*, long-only equity position) could be held in non-derivative instruments and have higher VaRs than derivatives. For these reasons, we believe it would be important for the Commission to engage in additional cost and benefit analysis to better understand the number of vehicles affected, as well as the reasons they cannot meet the VaR limits and their overall risk profile, prior to finalizing an alternative sales practices rule of potentially wider applicability.

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We appreciate the opportunity to comment on the Proposal. We appreciate the Commission's consideration and look forward to working with the Commission on these important matters. Please feel free to contact Philip T. Hinkle at [redacted] with any questions about this submission.

Sincerely,

/s/ Dechert LLP

Dechert LLP