J.P.Morgan
Asset Management

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March 24, 2020

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)

Dear Ms. Countryman:

J.P. Morgan Asset Management ("JPMAM")[1] is pleased to respond to the Securities and Exchange Commission's (the "SEC" or the "Commission") proposal on the use of derivatives by registered investment companies and business development companies (the "proposed rule").[2] JPMAM currently offers 144 mutual funds and ETFs in the US (excluding money market funds), with a total of approximately $420 billion in assets under management at the end of February 2020.

JPMAM supports the SEC's goals of providing an updated and more comprehensive approach to the regulation of the use of derivatives and other transactions by registered investment companies and business development companies (collectively "funds"), and addressing the investor protection concerns underlying Section 18 of the Investment Company Act of 1940. The existing regulatory framework was established by the Commission in Investment Company Act Release 10666,[3] and has evolved over subsequent years through a number of no-action letters and staff guidance, generally

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[1] J.P. Morgan Asset Management is a marketing name for the investment management subsidiaries of JPMorgan.

[2] 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 Nos. 34-87607, IA-5413, IC-33704 (Nov. 25, 2019), 85 Fed. Reg. 4446 (Jan. 24, 2020) ("Proposing Release").

[3] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979) ("Release 10666").

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developed on an instrument-by-instrument basis. The absence of comprehensive, formal regulation has resulted in a wide range of market practices.[4]

During that time, the variety, volume, and availability of derivative instruments has grown substantially, and the derivatives markets have matured, especially in the years following passage of the Dodd-Frank Act.[5] These developments have brought great benefits to funds and their shareholders. Derivatives allow funds to efficiently hedge risk, manage liquidity, reduce transaction costs, gain exposure to markets and asset classes when direct investment is expensive or impracticable, and reduce or eliminate other exposures through offsetting transactions. Thus, the Commission's effort to modernize and clarify how funds may use derivatives is timely and welcome.

We support the SEC's proposed framework for regulating funds' derivatives use, which includes: 1) a formalized derivatives risk management program, individually tailored based on how each fund's use of derivatives may affect its investment portfolio and overall risk profile; and 2) an outer limit on fund leverage risk based on value at risk ("VaR"). JPMAM currently employs many of the proposed risk management elements. JPMAM also advises a total of approximately $200 billion, excluding money market funds, across a range of UCITS funds domiciled in Luxembourg, Ireland and the UK as of the end of February 2020,[6] many of which currently comply with a VaR-based risk limit under applicable guidelines.[7] Based on our experience, we believe the proposed framework will adequately address the Commission's concerns regarding the risks derivatives may pose.

Below we offer our comments and recommend several modifications to the proposed rule, including:

- We support the proposed risk management program, and in particular that it is designed to allow principles-based tailoring to a fund's particular risks; we urge the Commission to maintain this flexibility in the final rule. We recommend that the SEC allow, in addition to an officer or officers, a committee designated by a fund's adviser to serve as the derivatives risk manager.

[4] Proposing Release at 29.

[5] *See* Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] Rules for Undertakings for Collective Investment in Transferable Securities (UCITS) are encompassed in Directive 2014/91/EU (commonly known as UCITS V), available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014L0091.

[7] UCITS funds are subject to a VaR-based risk limit if the notional exposure-based "commitment approach" does not adequately capture the market risk of derivatives in each portfolio. *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788 (Jul. 28, 2010), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf ("CESR Global Guidelines").

- While we support the use of VaR to establish outer limits on fund leverage risk, we recommend increasing the relative and absolute VaR limits to 200% and 20%, respectively. We also offer comments on how a derivatives risk manager might identify circumstances in which an appropriate reference index may not be available, such that a fund may rely on the absolute VaR test.

- We agree that funds should be required to report on Form N-PORT their derivatives exposure and VaR test metrics; however, we do not think the VaR metrics should be made public as proposed.

- We recommend allowing money market funds to invest in firm and standby commitment agreements, and similar transactions, subject to certain requirements.

I. Derivatives risk management program

As fund strategies and investment techniques have become increasingly diverse, funds' use of derivatives has grown in volume and complexity over the past several decades. While derivatives can help funds efficiently achieve their objectives and manage investment exposures, they also raise a variety of market, liquidity, counterparty, and operational risks. These concerns may be amplified by derivatives' facilitation of leverage. Consequently, robust and comprehensive risk management practices are critical to mitigating the risks these instruments may pose.

The proposed rule would require funds that use derivatives in more than a limited manner to implement a formalized derivatives risk management program.[8] The program would establish a standardized framework that provides for certain elements, while permitting funds the flexibility to implement these elements in a way that takes into account the type, extent, and risk profile of its derivatives. Such flexibility is important, because it would enable funds to incorporate risk management practices already in place, avoiding the need to build a parallel structure to meet prescriptive compliance obligations.[9] We offer our comments on the program below.

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[8] The proposed rule would provide an exception from the risk management program requirement and VaR-based limit on fund leverage risk for funds that use derivatives in a limited manner. Funds that rely on this exception would implement policies and procedures to address relevant risks. *See* Proposing Release at 148. We support this exception.

[9] This is in contrast to Rule 22e-4 (17 C.F.R. § 270.22e-4), which set forth a prescriptive approach to the liquidity classification of fund assets that made it impractical to overlay that requirement with existing liquidity risk management programs, leading to duplicative and parallel systems. *See, e.g.*, Letter from George C.W. Gatch, CEO, Global Funds Management & Institutional, J.P. Morgan Asset Management to Brent Fields, Secretary, Securities and Exchange Commission, dated May 18, 2018, at p. 8, available at https://www.sec.gov/comments/s7-04-18/s70418-3665381-162427.pdf, ("Our risk and portfolio management teams determined that our existing [liquidity risk management] system was preferable, so we elected to develop a parallel system to comply with rule 22e-4."); Letter from Gregory Davis, CIO, Vanguard to Brent Fields, Secretary, Securities and Exchange Commission, dated May 17, 2018, at p. 6, available at https://www.sec.gov/comments/s7-04-18/s70418-3663821-162420.pdf ("Vanguard intends to continue using our in-

a. Derivatives risk manager: role and qualifications

The proposed rule would require an officer or officers of a fund's adviser to serve as the fund's derivatives risk manager ("DRM").[10] The fund's board must approve the designation of the DRM, taking into account the DRM's relevant experience regarding the management of derivatives risk.[11] The Proposing Release explains that identification of a DRM "is designed to centralize derivatives risk management and promote accountability."[12] In practice we expect the DRM to oversee and administer the program elements and associated policies and procedures – an important role as these elements may be performed across a firm's platform. For example, at JPMAM our independent risk team administers risk thresholds and stress testing, while other business control functions manage risks such as those related to operations or legal matters. We agree the DRM would be appropriately positioned to coordinate a derivatives risk management program, and oversee and escalate derivatives-related risks that may emerge across these functions.

We support the proposed approach of allowing multiple officers to serve as the DRM, as it reflects the benefits of including several individuals with a range of expertise. We recommend that the SEC also explicitly permit the DRM to be a committee established by the adviser. This is consistent with JPMAM's implementation of the liquidity risk management program under Rule 22e-4, and we understand other advisers have implemented a similar structure. Under this approach, an adviser could design a committee comprised of specified functions (e.g., head of risk, fixed income investment director) while allowing flexibility for individuals to be substituted without raising the possible need for board approval.

We believe the SEC provided the right degree of specificity by requiring that the DRM "must have relevant experience regarding the management of derivatives risk."[13] Requiring certain qualifications, training, or experience could lead to over-emphasis on criteria that may be less relevant to certain funds or strategies, and to selection of a DRM not optimally suited for the role.

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house principles-based practices to actually manage liquidity risk in our funds…we believe [rule 22e-4] classification requirement will neither contribute meaningfully to our liquidity risk management, nor provide useful insight into liquidity risk to the Commission or investors."); Letter from David Oestreicher, Chief Legal Counsel, T. Rowe Price Associates to Brent Fields, Secretary, Securities and Exchange Commission, dated May 18, 2018, at p. 1, available at https://www.sec.gov/comments/s7-04-18/s70418-3669416-162441.pdf ("Our [liquidity risk management] program…was in place prior to the Rule's adoption and will continue alongside new processes implemented to comply with the requirements of the Rule.").

[10] Proposed rule 18f-4(a).

[11] Proposed rule 18f-4(c)(5)(i).

[12] Proposing Release at 48.

[13] Proposed rule 18f-4(a).

On the other hand, requiring only "relevant experience" would be too vague and could raise questions about the type of experience that would suffice.

We recommend, however, that the adopting release clarify that the adviser bears the responsibility of articulating the qualifications of the DRM to the board for their approval; the board should not be in a position of comparing resumes, interviewing candidates, or otherwise conducting due diligence similar to that of a hiring manager. We note that permitting the committee structure we propose could facilitate the board's approval by bringing together specified functions and expertise.

b. Required program elements

Each fund would be required to adopt a written derivatives risk management program, which must include policies and procedures reasonably designed to manage the fund's derivatives risks and incorporate enumerated elements.[14] We appreciate the proposed flexibility for each fund to design its program based on how derivatives may affect the fund's investment portfolio and overall risk profile. Below we recommend certain changes and clarifications, which will facilitate implementation of the program.

Risk identification and assessment. The program would provide for the identification and assessment of the fund's derivatives risks, taking into account the fund's derivatives transactions and other investments.[15] These include leverage, market, counterparty, liquidity, operational, and legal risks, as well as any other material risks. We agree that a robust and comprehensive program should begin with risk identification and assessment.

Risk guidelines. A fund's program would be required to provide for the establishment, maintenance, and enforcement of "guidelines" that specify quantitative or otherwise measurable criteria, metrics, or thresholds of the fund's derivatives risks.[16] We generally support this requirement. Our existing risk framework employs guidelines based on a variety of market, liquidity, and counterparty risk measures. Based on our experience we offer two comments.

First, we appreciate that the proposed rule does not impose specific limits or guidance on how thresholds would be calculated. We believe thresholds should be continually reevaluated based on emerging (or declining) risks in light of the investment portfolio; it would not be practicable to maintain regulatory guidelines that are relevant across strategies and market conditions.

[14] Proposed rule18f-4(c)(1).

[15] Proposed rule 18f-4(c)(1)(i).

[16] Proposed rule 18f-4(c)(1)(ii).

Second, we believe that certain risks may be more effectively managed through business control processes than by quantitative risk guidelines. For example, to manage the type of legal risks discussed in the Proposing Release,[17] we have established business control processes to ensure approval, review, and ongoing oversight of derivatives contracts. We recommend that the SEC clarify in its adopting release that some risks identified in the assessment are not amenable to quantifiable metrics and may be managed through other practices.

Stress testing. The proposed rule would require the program to provide for weekly stress testing to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors.[18] We support this requirement. Our risk framework currently incorporates stress testing, and we find that it provides important information on how extreme but realistic conditions could impact a fund's performance and overall risk profile.

Stress testing will also complement the VaR-based limit on fund leverage risk. VaR relies on historical observations and correlations to estimate potential loss, whereas stress testing allows funds to estimate the impact of hypothetical scenarios most relevant to each fund. In contrast to VaR, stress testing is not based on past experience, and thus can provide a different and insightful perspective on a fund's risk exposure.

We believe that the proposed rule takes the right approach by not prescribing specific stress testing scenarios, magnitudes, or types of simulations. These determinations should be tailored to each fund's relevant risk factors. Also, any prescribed parameters could become less relevant over time and would thus inadequately address an evolving market structure or fund strategies.

Backtesting. The program would provide for backtesting the results of the VaR calculation model used by each fund. Each business day, the program would compare the fund's actual gain or loss with the corresponding VaR estimate for that day. Any instance in which the fund experienced a loss exceeding the VaR calculation's estimated loss would be identified as a backtesting exception.[19] The Proposing Release explains that backtesting "would assist a fund in confirming the appropriateness of its model and related assumptions and help identify when funds should consider model adjustments."[20] We support the requirement to backtest; however, we believe a monthly

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[17] "Legal risk generally refers to insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract." Proposing Release at 57.

[18] Proposed rule 18f-4(c)(1)(iii).

[19] Proposed rule 18f-4(c)(1)(iv). A VaR model with a 99% confidence interval would anticipate approximately 2.5 backtesting exceptions per year. *See* Proposing Release at 70. Additionally, the DRM's written report to the board would include an analysis of the backtesting exceptions. *See infra* at Section III.b.

[20] *See* Proposing Release at 69.

review of daily observations would be less onerous, and would be sufficient to accomplish this objective.

While a daily review of backtesting observations would more quickly alert a DRM of an exceedance, in practice we do not expect it would enable the DRM to more readily or efficiently adjust a fund's VaR model. In JPMAM's implementation of backtesting in UCITS funds,[21] any model changes require a preliminary analysis of market trends and risk factors by the risk team, a formal review by the model risk governance committee, and approval by a risk forum. This process can take several weeks to a month. Even if a daily review were conducted, we expect any model changes would be preceded by these steps.

It is important to note that even if the VaR model is only considered for adjustment monthly, the data on which the model relies is updated daily. That is, a fund's actual gains or losses will become embedded in its historical data, providing an updated VaR profile for each fund on a rolling basis. We believe the daily incorporation of market data is more critical than making model adjustments to promote the accuracy and effectiveness of a VaR model.

Internal reporting and escalation. The program must articulate circumstances under which the fund's portfolio managers will be informed regarding the operation of the program, including exceedances of risk guidelines and results of stress testing.[22] The DRM would escalate material risks in a timely manner to the fund's portfolio managers and, as appropriate, its board of directors.[23] We support this approach, and in particular the fact that the proposed rule does not prescribe the criteria or thresholds that trigger discussions with the portfolio management team or escalation to the board.

JPMAM employs a governance framework to identify, escalate, and resolve potential risk matters. Our independent risk team monitors a variety of risk metrics. Initial thresholds are set at a level to encourage discussion between risk and those responsible for portfolio management, and exceedances at this level may be reviewed on an ad hoc basis or at a regularly occurring forum. More substantial exceedances are promptly escalated to a senior officer. We believe setting initial thresholds relatively low, *i.e.,* at a level where they are more likely to be triggered, enhances robust discussion and oversight; however, if such exceedances required immediate escalation or board reporting we would be disincentivized from this approach.

[21] UCITS guidelines require a monthly review of daily backtesting results. *See* CESR Global Guidelines at 29.

[22] Proposed rule 18f-4(c)(1)(v)(A).

[23] Proposed rule 18f-4(c)(1)(v)(B).

With respect to informing a fund's board of material risks, we believe it is important to construe materiality narrowly, to ensure that such escalation does not cross the line into day-to-day management. For example, we believe board notification could occur following a material change in a fund's risk profile, a severe market disruption, or a critical operational concern. Escalating a broader set of risks to the board could misdirect their attention to matters appropriately handled by the fund's adviser.[24]

Periodic review of the program. The DRM would be required to review the program at least annually to evaluate the program's effectiveness and to reflect changes in risk over time.[25] This process would help assess the program's effectiveness, and provide an opportunity to consider whether any relevant market, regulatory, or fund-specific developments would necessitate program updates. We agree the DRM should evaluate the program's effectiveness, including each element discussed above, at least annually.

II. Limits on fund leverage risk

One of the SEC's goals in proposing this rule was to address the concern that funds' derivatives use—and thus potential leverage through derivatives transactions—does not appear to be subject to a practical limit. Evolving market practices, together with staff guidance over the years, have enabled funds to segregate large portions of their portfolios, while using mark-to-market exposure amounts for many instruments. This approach to asset segregation could result in a fund obtaining a significant degree of leverage. To address this concern, the Commission proposed a VaR-based test to establish an outside limit on funds' leverage risk.

We support this objective and agree that VaR is an effective tool. VaR will estimate potential loss, at a given probability of occurrence and timeframe. It can be used to evaluate a fund's overall level of market risk, and will provide a reasonably consistent and comparable estimate across different strategies, asset classes and instruments. Although VaR is a measure of market risk, not leverage risk specifically, a test that compares a fund's VaR to an appropriate unleveraged index can help assess whether a fund is using derivatives to leverage its portfolio, and also identify where a fund may be using derivatives to mitigate or target risk.[26]

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[24] *See, e.g.,* Speech by Dalia Blass, Director, Division of Investment Management, delivered at the ICI Securities Law Developments Conference on December 7, 2017, available at https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017 (articulating the SEC staff's ongoing concern that the proliferation of board responsibilities may distract from areas where director oversight is most valuable).

[25] Proposed rule 18f-4(c)(1)(vi).

[26] This is in contrast to a rule the Commission proposed in 2015, which would have set a limit on derivatives use based on notional exposure, thereby restricting a fund's ability to use derivatives to sufficiently mitigate or offset its risk exposure. *See, e.g.*, Letter from George C.W. Gatch, CEO, Global Funds Management & Institutional, J.P. Morgan Asset

As discussed in more detail below, we recommend certain modifications and clarifications that we believe will promote the SEC's goals while reducing the impact on existing funds. Many of these recommendations would also provide greater alignment with parameters required for UCITS. This would allow us to build on our existing program, providing efficiencies in operationalizing the VaR test and managing parallel fund structures.

a. Relative VaR test

The proposed rule would require each fund to calculate the VaR of the fund's portfolio and compare it to the VaR of a "designated reference index," unless such an index is unavailable.[27] The VaR of the fund's entire portfolio may not exceed 150% of the VaR of its designated index. We support the relative VaR test as the default approach because, as noted above, it effectively assesses whether a fund is leveraging its portfolio relative to an unleveraged index. However, we recommend the SEC revise the limit to 200%, for the reasons set out below.

As a preliminary matter, we do not think relative VaR is comparable to the borrowing limit under Section 18. As the Proposing Release explains, Section 18 permits a fund to borrow and reinvest up to 50% of its net assets, resulting in a net exposure of 150% relative to its unleveraged portfolio. However, a fund borrowing to this extent would not necessarily exhibit a relative VaR of 150%. A fund may invest its borrowed proceeds in assets that exhibit a differentiated risk profile, resulting in a much higher (or lower) VaR than the original, unleveraged portfolio. While we recognize the appeal of applying the Section 18 statutory limits in a rule promulgated thereunder, borrowings and relative VaR are simply not analogous.

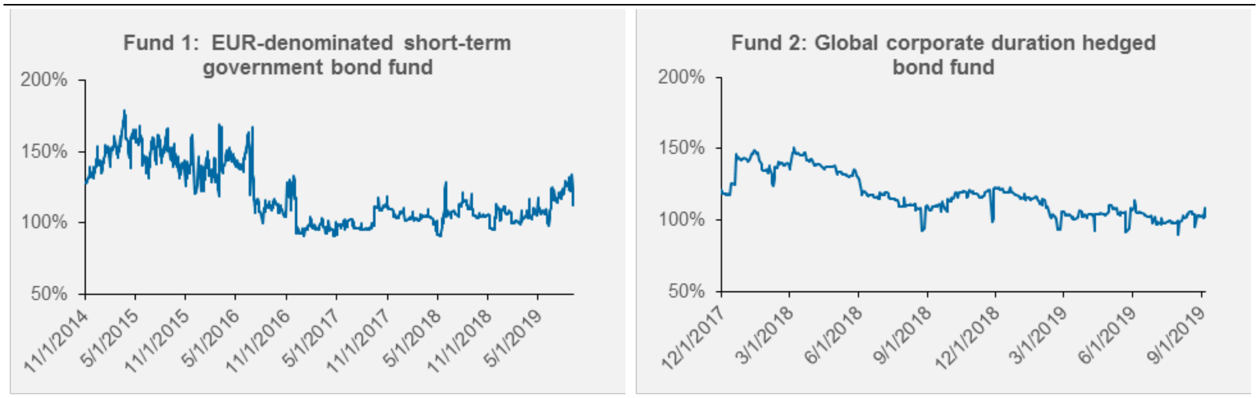
Perhaps more importantly, many strategies, even those with overall lower risk, could be challenged by a relative VaR limit of 150%, especially if they are actively managed. We analyzed strategies we currently offer as UCITS, and identified two examples, shown in figure 1 below, where a relative VaR limit of 150% would have been problematic: a Euro-denominated short-term government bond fund and a global investment grade corporate bond fund that hedges interest rate risk. On an absolute basis these are not high-risk funds. Over the time period shown, Fund 1 and Fund 2 exhibited median absolute VaR levels of approximately 0.5% and 1.5%, respectively. Precisely because they exhibit very low absolute VaR, any moderate deviation from the index can have a material impact on a relative VaR test.[28]

Management to Brent Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-119.pdf.

[27] Our views on determining availability of the designated reference index are discussed *infra* at Section II.c.

[28] The SEC staff analyzed the relative VaR of a number of funds as of December 31, 2018, and identified only six funds that would have failed relative VaR test. *See* Proposing Release at 276. However, as demonstrated in figure 1, VaR

Figure 1. Relative VaR for selected JPMAM UCITS funds



Fund VaR (absolute):	**Fund VaR (absolute):**
Median 0.5%, High: 1.6%, Low: 0.3%	Median 1.5%, High 2.1%, Low 1.0%

An overly restrictive relative VaR limit will disproportionately affect actively managed funds. Such funds, by definition, seek exposure that is differentiated from an index, thereby producing a higher relative VaR than an index-tracking fund in the same asset class. We are concerned that a relative VaR limit of 150% would unnecessarily constrain a fund's ability to differentiate itself from the benchmark against which it compares itself, which is precisely the investment strategy active funds pursue.

For these reasons we recommend the rule permit a fund to have a VaR up to 200% of the VaR of its designated reference index. We believe a 200% limit would meet the SEC's objective of setting a meaningful outer limit on fund leverage risk, while offering sufficient flexibility for funds whose reference indices have a low absolute VaR and actively managed strategies. A relative VaR limit of 200% would also align with the relative VaR test under UCITS guidelines. Our experience advising UCITS funds gives us comfort that this limit, combined with a robust derivatives risk management framework, can effectively protect against undue leverage risk. Such consistency would also better enable global firms to deploy a single framework, realize operational efficiencies, and manage strategies across these jurisdictions.

b. Absolute VaR test

If an appropriate reference index is not available, the fund would be required to comply with an absolute VaR limit set at 15% of the fund's net assets. We support the use of absolute VaR in these circumstances. However, we believe the analysis that led the SEC to the 15% limit does not adequately reflect increased market volatility over the past few decades, nor the wide range of

results can be volatile. This point-in-time snapshot likely underestimated the number of funds that could be challenged by a 150% relative VaR limit.

markets in which funds invest. As a result we believe the proposed limit is too low. We recommend instead that the SEC impose an absolute VaR limit of 20%. Where appropriate, funds could consider incorporating lower internal guidelines into their derivatives risk management program.

The Proposing Release explains that in selecting an absolute VaR limit, the Commission considered that many funds use the S&P 500 index for performance comparison and risk management purposes.[29] The SEC staff also found that S&P 500 exhibited a VaR of approximately 10.4% since the inception of the index in 1957. Thus, a fund that relies on the relative VaR test and selects the S&P 500 as its designated reference index would be permitted to have a VaR equal to 150% of the VaR of the S&P 500, or approximately 15%.

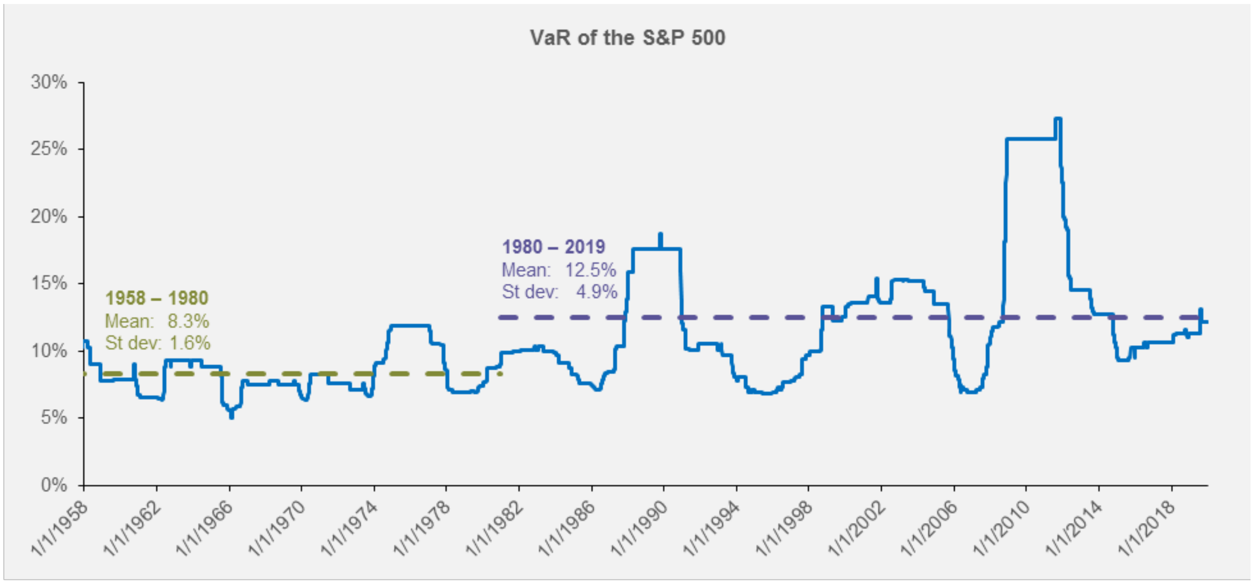
We believe that using a lookback period of approximately 60 years does not reflect more recent market developments. Consider the following:

- **1980s**: The rise of electronic trading, introduction of S&P 500 futures contracts, and the NYSE SuperDOT system allowing direct routing of orders up to 100,000 shares.
- **1990s**: The decline in the NYSE specialist business and the rise of online trading.
- **2000s**: Decimalization, algorithmic trading, and high-frequency trading.
- **2010s**: Post-crisis banking and financial market reforms that alter dealers' capacity to hold inventory.

This evolution in market structure has coincided with more volatile market conditions as highlighted in figure 2 below. The S&P 500's mean VaR increased to 12.5% in the period from 1980 to 2019. This is 50% larger than the period from 1958 to 1980, and a 20% increase over the entire period (1957 to 2019). The standard deviation observed from 1980 to 2019 is also larger, indicating that VaR observations are spread out over a wider range. In other words, using an observation period dating to 1957 averages out the effects of more recent variability. Since these market structure changes are secular, we expect increased volatility to continue. We believe a 20% absolute VaR limit would more accurately reflect recent and expected future market conditions.

[29] *See* Proposing Release at 114.

Figure 2. Historical VaR of the S&P 500[30]



Additionally, while many funds select the S&P 500 (or other broad-based large capitalization equities indexes) for performance comparison purposes,[31] not all do. Funds may look to other markets for performance comparisons, and indexes that reflect those markets may have substantially more volatility than the S&P 500. Mid and small-capitalization stocks are relatively more sensitive to economic cycles than large corporations. International and emerging markets face the potential for greater political or economic instability, fluctuations in currency exchange rates, and difficulty obtaining information. Funds could be challenged to gain exposure to these and other asset classes that exhibit increased volatility while complying with an absolute VaR limit of 15%.

We recognize that an absolute VaR limit of 20% may not be a meaningful outer limit for some funds, especially many fixed income strategies. The 10-year U.S. Treasury bond, which has a sensitivity to changes in interest rates that is similar to many fixed income funds, experienced a maximum VaR over the past 20 years of approximately 10%.[32] Such funds could consider setting an internal VaR threshold that is lower than the regulatory limit. The threshold would reflect the fund's

[30] VaR of the S&P 500 using Morningstar data from January 1, 1958 to December 31, 2019, based on daily VaR calculations, using three years of prior return data at a 99% confidence level for a 20-day trading horizon.

[31] Proposing Release at 115.

[32] Using data from January 1, 2000 to December 31, 2019, based on daily VaR calculations at a 99% confidence level for a 20-day trading horizon.

investment strategy and target risk profile. It could also be incorporated as a guideline in the risk management program, and subject to ongoing monitoring and review.[33]

c. Selection of the appropriate VaR test

A fund relying on the proposed rule would only be permitted to comply with the absolute VaR test if the fund's DRM is unable to identify an appropriate designated reference index.[34] Although we do not object to the Commission's use of relative VaR as the default test,[35] we are concerned that the Proposing Release underestimates the range of strategies that are not amenable to the relative VaR test.[36] We recommend that the adopting release acknowledge that there are a variety of circumstances in which an appropriate index may be unavailable, and confirm that the determination of the appropriate test rests with the DRM based on facts and circumstances. The adopting release might further describe factors a DRM may wish to consider in making this determination. Finally, the Commission should consider requiring the DRM approve, rather than select, the designated reference index.

When conducting its assessment of the VaR limits, DERA staff generally relied on the benchmark that a fund disclosed in its prospectus if the benchmark was broadly similar to the markets or asset classes in which the fund invests.[37] We do not think disclosure of a benchmark indicates the benchmark is appropriate for the VaR test. For example, the prospectus of the JPMorgan Unconstrained Debt Fund compares the fund's returns with the Bloomberg Barclays U.S. Aggregate Index, while describing its investment approach as "flexible and…not managed to or constrained by a benchmark."[38] Since neither the fund's investment approach nor its portfolio composition will consistently resemble this or any other index, we would anticipate that the absolute VaR test would be selected.

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[33] Guidelines for UCITS set forth a similar approach. "A UCITS must establish, implement and maintain a documented system of internal limits concerning the measures used to manage and control the relevant risks for each UCITS. The VaR limits should always be set according to the defined risk profile. In particular, CESR considers that there might be circumstances where, giving the agreed risk profile, the UCITS should set a VaR limit that is lower than the regulatory threshold." *See* CESR Global Guidelines at 22.

[34] Proposing Release at 114.

[35] *See supra* Section II.a.

[36] The Proposing Release provides just one example of a fund that would comply with the absolute VaR test: a multi-strategy fund that targets volatilities using a variety of investment strategies. *See* Proposing Release at 114.

[37] *See* Proposing Release at 275.

[38] JPMorgan Unconstrained Debt Fund, Summary Prospectus July 1, 2019, p. 2, available at http://www.jpmorganfunds.com/funddocuments. Each fund is required to compare its performance with a broad measure of market performance. Item 4(b)(2)(i) of Form N-1A.

We believe the SEC should clarify that the DRM has the authority to determine the appropriate VaR test.[39] In making this determination, the DRM should consider features of the fund's investment strategy, such as: fund composition by security selection, asset class, region, duration or market capitalization, consistency of investment approach over time, internal or disclosed constraints, and ability to materially deviate from its primary investment strategy. Using this approach, absolute VaR might be appropriate for strategies such as unconstrained, absolute return, and income-oriented funds. The Commission may wish to identify a non-exhaustive list of factors the DRM should consider to the extent relevant for each fund.

Finally, where a fund uses relative VaR, the Commission should consider requiring that the DRM "approve" the selection of a fund's designated reference index, rather than "selecting" the index. In practice we envision that determination of a fund's designated reference index would reflect input from a fund's portfolio management team, and/or product strategy (for new funds), among others. These groups would likely recommend an index to the DRM based on their market expertise and knowledge of the fund's investment strategy. We believe it would be appropriate in these circumstances for the DRM to review the recommendation and, if appropriate, approve it. Under the proposed rule, the written report to the board would identify the basis for such approval.

d. Implementation and remediation of VaR exceedances

The proposed rule would require a fund to determine its compliance with the applicable VaR test at least once each business day.[40] If the fund is not in compliance for three consecutive business days, the DRM must report to the fund's board, review the risk management program, and update program requirements as necessary; the fund also may not enter into any derivatives, *other than those designed to reduce the fund's VaR*, until the fund has been back in compliance with the VaR test for three consecutive business days and has satisfied the board reporting and program analysis requirements. We agree that the proposed daily testing frequency is appropriate. We also support the proposed approach of allowing funds to determine reasonable steps to come back into compliance, rather than imposing a requirement to sell assets or unwind transactions. Compelling funds to sell assets or unwind transactions during the remediation period could cause undue harm to investors and the market.

The Proposing Release is silent on how to determine that a derivatives transaction is designed to reduce VaR. We recommend the adopting release clarify that this determination can be met through

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[39] The proposed rule requires that a written report to the board include the DRM's basis for the selection of the designated reference index or, if applicable, an explanation of why the DRM was unable to identify a designated reference index appropriate for the fund. *See* Proposed rule 18f-4(c)(5)(ii). *See also infra* Section III.b. for a discussion of board reporting requirements.

[40] We support as proposed the requirements on the choice of VaR model and parameters for the VaR test, including the 99% confidence level, 20 day trading time horizon, and based on at least 3 years of historical market data. *See* Proposing Release at 118.

a pre-trade documentation by the portfolio management team of the intended impact of a derivatives transaction, which can be compiled and maintained by the DRM. We believe that a portfolio manager should be able to identify a derivatives transaction that reduces the fund's VaR. We do not believe requiring pre-trade analysis is appropriate. Calculating VaR is computationally intensive, and typically occurs overnight. Performing this analysis on a pre-trade basis, intra-day would require substantial technology enhancements. Further, VaR calculations during active markets are unlikely to be precise, especially in challenged conditions. The subsequent daily VaR calculation would determine the fund's VaR and whether the fund is in compliance with the relevant test.

III. Board oversight and reporting

The proposed rule would require: (1) a fund's board of directors to approve the designation of the fund's DRM, and (2) the derivatives risk manager to provide regular written reports to the board regarding the program's implementation and effectiveness. Throughout the Proposing Release and embedded questions, it is evident that the SEC carefully weighed the proper role of the board, consistent with its longstanding attention to this topic. As discussed in adopting Rule 38a-1,[41] the Commission has expressed a view that the proper role of the board with respect to compliance matters is to oversee the program without becoming involved in day-to-day administration. Board approval of the DRM and the regular written reports would facilitate the board's oversight role. We offer the following additional comments.

a. Board approval of the derivatives risk manager

The proposed rule would require a fund's board to approve the designation of the fund's DRM, taking into account the DRM's relevant experience regarding the management of derivatives risk.[42] We believe this approach is consistent with the board's oversight role. In practice we would expect that the fund's adviser would identify a DRM candidate, group of candidates, or committee (if permitted)[43] that meets this qualification, and propose that the board approve the recommendation. We recommend the adopting release clarify that the adviser bears the responsibility of articulating the qualifications of the DRM to the board for their approval. As noted above, the board should

[41] *See* Rule 38a-1 under the Investment Company Act; Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003), 68 FR 74714 (Dec. 24, 2003), at 74724.

[42] Proposed rule 18f-4(c)(5)(i).

[43] As noted above, we recommend that the SEC explicitly permit the DRM to be a committee established by the adviser. *See supra* Section I.a.

not be expected to compare resumes, interview candidates, or otherwise conduct due diligence similar to that of a hiring manager.[44]

b. Board reporting

On or before the implementation of the program, and at least annually thereafter, the DRM must provide the board a written report representing that the program is reasonably designed to manage the fund's derivatives risks.[45] The DRM's report to the board would reinforce that the fund and its adviser are responsible for derivatives risk management, while providing the board with the necessary information to exercise its oversight responsibilities. We support this approach.

The DRM must also provide the fund's board, at a frequency determined by the board, a report analyzing any exceedances of the fund's risk guidelines and results of the fund's stress testing and backtesting.[46] We recommend that the adopting release clarify that the DRM's report may consist of an analysis that summarizes the risk metrics, with appropriate context and detail to facilitate the board's oversight of the program. Providing the board with the details of each exceedance and results from ongoing stress testing and backtesting could overload directors with data, and distract from their broad oversight role.[47]

IV. Amendments to fund reporting requirements

The proposed rule would amend the reporting requirements applicable to Forms N-PORT, N-LIQUID (which would be re-titled N-RN) and N-CEN. Form N-PORT would require each fund to provide information on a fund's derivatives exposure and VaR-related metrics.[48] This information would be publicly available for the third month of each fund's quarter, with a 60-day

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[44] *See supra* Section I.a.

[45] Proposed rule 18f-4(c)(5)(ii).

[46] Proposed rule 18f-4(c)(5)(iii).

[47] *See, e.g.,* Response of the Chief Counsel's Office Division of Investment Management, Securities and Exchange Commission, Oct. 12, 2018, available at http://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm, responding to Letter from Amy B.R. Lancellotta, Managing Director, Independent Directors Council to Paul Cellupica, Deputy Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission, dated Oct. 12, 2018, available at https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218-incoming.pdf (agreeing with the IDC, with respect to affiliated transactions, that a board can effectively satisfy its oversight obligations without reviewing individual transactions.").

[48] A fund complying with the VaR test would report its highest daily VaR during the reporting period and its corresponding date, and median daily VaR for the monthly reporting period. The fund would also report the number of backtesting exceptions identified during the reporting period. If subject to the relative VaR test, a fund would also report its designated reference index, highest daily VaR ratio, and median VaR ratio.

lag. Form N-RN would be used to alert the SEC of a VaR limit exceedance that lasts longer than 3 business days, and funds would indicate reliance on the proposed rule on Form N-CEN. We support providing the Commission with this information, and support the exposure data on N-PORT and the proposed amendments to N-CEN being made public; however, we do not think the VaR-related metrics that would be provided on N-PORT are suitable for public reporting.

VaR reflects analysis from a fund's individual approach to risk management. It can also be volatile, even absent significant market stress.[49] The Commission expects and understands divergence across VaR models and estimates, and is equipped to understand such variability. In contrast, we are concerned that the VaR metrics would not convey useful information to investors. These metrics could be misunderstood as reflecting a fund's overall leverage risk. We note that to the extent a funds' use of derivatives has a material impact on its performance, a fund is already required to describe this impact in the management's discussion of fund performance ("MDFP") contained in the fund's annual report.[50] We think existing MDFP guidelines would already require this discussion, although this could be clarified.

V. Recommendations for money market funds

Money market funds ("MMFs") regulated under Rule 2a-7 under the Investment Company Act would not be permitted to rely on the proposed rule. They also would not be able to rely on Release 10666, which the Commission is proposing to rescind. As a result, MMFs would be prevented from engaging in derivatives and other transactions within the scope of the proposed rule. The Proposing Release explains that these 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."[51] While we agree that MMFs do not generally engage in derivatives such as futures and swaps, they may enter into transactions captured by the proposed rule, such as firm and standby commitment agreements, to obtain advantageous pricing and liquidity.[52]

We recommend the SEC permit MMFs to invest in firm and standby commitment agreements, and other similar transactions, subject to an asset coverage framework such as that set forth in Release 10666. The Commission could exempt these instruments from the scope of the rule when used by

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[49] *See supra* Figure 1.

[50] The MDFP requires a discussion of factors that materially affected the fund's performance during the most recently completed fiscal year. Item 27(b)(7)(i) of Form N-1A.

[51] Proposing Release at 37.

[52] JPMorgan Money Market Funds may seek to invest in a variety of securities and employ a number of investment techniques including reverse repurchase agreements, borrowings, when-issued securities, delayed delivery securities and forward commitments. *See* Statement of Additional Information, JPMorgan Money Market Funds, Jul. 1, 2019, at pp. 16-19, available at http://www.jpmorganfunds.com/funddocuments.

MMFs, subject to segregation of the full obligation of each transaction using highly liquid assets.[53] Although these instruments incorporate some features of leverage, we believe that maintaining segregated assets sufficient to cover the full obligation of each transaction would effectively address any leverage risk these instruments may present. This approach is also well understood by industry and incorporated in current practice.

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JPMAM appreciates the opportunity to comment on the Commission's proposed rule. We would be pleased to provide any further information or respond to any questions that the Commission or the staff may have.

Very truly yours,

/s/ George C. W. Gatch

George C.W. Gatch

Cc: The Honorable Jay Clayton, Chairman
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison H. Lee, Commissioner
Dalia Blass, Director, Division of Investment Management

[53] This would essentially reflect the regime set forth in Release 10666; however, we recommend the SEC proceed with rescinding Release 10666, and instead adopt this limited exemption for the instruments at issue.