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Via electronic mail (rule-comment@sec.gov)

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC Proposed Rule 18f-4 – Derivatives Use Risk Management Programs; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers’ Transactions in Certain Leveraged/Inverse Investment Vehicles, File No. S7-24-15

Dear Ms. Countryman:

Teachers Insurance and Annuity Association of America (“TIAA”), through its asset management arm Nuveen, LLC (“Nuveen”), appreciates the opportunity to comment on the Securities and Exchange Commission’s (the “SEC”) proposed Rule 18f-4 (the “Proposed Rule”) regarding the use of derivatives by registered investment companies and business development companies (“BDCs”).¹ We are writing to share our perspective on the Proposed Rule on behalf of Nuveen’s wholly-owned subsidiaries Nuveen Fund Advisors, LLC (“NFAL”), the investment adviser for the Nuveen open-end funds (“OEFs” or “mutual funds”), closed-end funds (“CEFs”), and exchange traded funds (“ETFs” and, collectively with OEFs and CEFs, “funds”), and Teachers Advisors, LLC (“Teachers Advisors”), the investment adviser for the TIAA-CREF OEFs.²

We support the SEC’s approach in the Proposed Rule to regulating funds’ use of derivatives (as that term is defined in the Proposing Release), which seeks to strike a balance between allowing funds to invest freely in derivatives without appropriate safeguards, on the one hand, and unduly restricting them from using derivatives to hedge risks or to obtain investment exposure in a manner that could benefit their shareholders, on the other. However, we respectfully submit that some aspects of the Proposed Rule are not properly calibrated to strike that balance. In our comments below, we offer suggestions as to how the Proposed Rule might be revised to better achieve a balanced regulatory approach that is neither too permissive nor too restrictive, and in turn enable funds to use derivatives more effectively to the overall benefit of fund shareholders.

¹ *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*, 85 Fed. Reg. 4446 (Jan. 24, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf> (the “Proposing Release”). Capitalized terms not otherwise defined herein shall have the meanings assigned to them in the Proposing Release.

² Another Nuveen subsidiary, Nuveen Churchill Advisors, LLC, serves as investment adviser to a BDC.

Nuveen representatives have participated in two industry working groups that have prepared and filed comment letters with the SEC: the Investment Company Institute (“ICI”), and the Securities Industry and Financial Markets Association’s Asset Management Group (“SIFMA-AMG”). We generally agree with the commentary and proposed alternative regulatory constructs contained in the ICI and SIFMA-AMG comment letters.

However, there are certain observations that we wish to make based on our experience in the fund marketplace. In particular, we present in this letter our own suggestions for different multipliers that we believe should be used in the relative VaR tests in the final derivatives rule adopted by the SEC (the “Final Rule”), and for the maximum absolute VaR that a particular type of fund should use. We also discuss other aspects of the rule about which Nuveen feels strongly, including treatment under the Final Rule of reverse repurchase agreements and tender option bonds; establishing workable criteria for designated reference indices; setting time-out and cure periods for exceedances; and consideration of currency forwards when establishing the derivative use threshold for limited derivatives users.

I. About TIAA and Nuveen.

Founded in 1918, TIAA is the leading provider of retirement services for those in academic, research, medical, and cultural fields. Over our century-long history, TIAA’s mission has always been to aid and strengthen the institutions, retirement-plan participants, and individual and institutional customers we serve and to provide financial products that meet their needs. Our investment model and long-term approach aim to benefit the five million individual customers we serve across more than 15,000 institutions. With our strong nonprofit heritage, we remain committed to the mission we embarked on in 1918 of serving the financial needs of those who serve the greater good.

To carry out this mission, we have evolved to include a range of financial services, including asset management and retail services. As TIAA’s asset management arm, Nuveen markets a broad spectrum of specialized investment solutions, including a wide range of funds, through several investment subsidiaries: Gresham Investment Management LLC, NWQ Investment Management Company LLC, Nuveen Asset Management, LLC, Santa Barbara Asset Management, LLC, Symphony Asset Management LLC, Teachers Advisors, and Winslow Capital Management, LLC. In total, Nuveen had more than \$1.3 trillion of assets under management as of December 31, 2019, including OEFs with approximately \$490 billion, CEFs with over \$60 billion, and ETFs with nearly \$1 billion. Nuveen has two separately branded fund complexes: the TIAA-CREF funds, all of which are OEFs, with over \$400 billion of assets under management; and the Nuveen funds, which include OEFs, CEFs and ETFs, with nearly \$150 billion of assets under management.

II. Background.

Funds are an important investment mechanism for retail investors, allowing them to pool their assets and gain access to a diverse range of investment options in a convenient and cost-efficient way. But investing in funds can also pose unanticipated risks for retail investors, as a fund’s investment adviser can make investment decisions that expose the fund to significant losses far beyond what the ordinary investor would expect. Derivatives present an attractive investment option for fund advisers seeking to increase their fund’s investment exposure, hedge risks in the portfolio, and gain better access to a variety of markets. However, an adviser’s decision to include derivatives in a fund’s portfolio can also raise the fund’s risk profile significantly, as funds that invest in derivatives for the purpose of generating additional investment exposure stand a higher chance of experiencing significant losses given the leveraged nature of derivatives exposure.

As noted in the Proposing Release,³ the SEC has historically and appropriately placed regulatory limitations on funds' use of derivatives and similar instruments and practices because of the additional risks that derivatives may pose. In the Proposing Release, the SEC has accurately attributed the danger generated by those extra risks as being associated with the leveraging effect of derivatives. In order to mitigate these risks, the SEC has proposed allowing funds to enter into derivatives transactions only subject to certain conditions, while also requiring them to manage the risks associated with those transactions, including by limiting leverage risk. In this way, the SEC has worked to ensure that funds have the freedom to invest in derivatives in a measured way, while still protecting retail investors from inappropriate risk-taking behavior.

As an overall matter, we believe this is the proper construct for a derivatives regulatory regime, and we are generally supportive of the Proposed Rule. In particular, we believe that building a regulatory framework focused on limiting the amount of leverage that derivatives can generate, and the quantitative level of risk that such leverage can in turn create, is the right approach. However, we believe that some aspects of the Proposed Rule need refinement to achieve the type of regulatory balance the SEC is seeking.

In the sections below, we offer suggestions as to how the Proposed Rule might be revised to enable funds to invest in derivatives more efficiently and effectively, while still maintaining important investor protections. We have an especially strong interest in the Proposed Rule's potential impact on CEFs, as Nuveen has the largest CEF complex in the United States (over \$60 billion in assets as of December 31, 2019). Given that the majority of Nuveen's CEFs employ significant amounts of leverage, we are perhaps uniquely focused on how the leverage limitations in the Proposed Rule, as currently constructed, would unduly impede CEFs' ability to simultaneously use derivatives for both leverage and risk-limiting purposes.

III. Specific Proposals to Improve the SEC's Proposed Derivatives Regulatory Scheme.

The following subsections describe our specific proposed changes to the Proposed Rule. We have ordered these proposals in descending order of their importance to our two fund complexes.

A. The 1.5x multiplier used in the relative VaR test in the Proposed Rule should be increased for all fund types, specifically to 2.0x for OEFs and ETFs.

The Proposed Rule requires a fund using derivatives that does not qualify for the limited derivatives user exception to comply with the relative VaR test, meaning that the fund must maintain a level of overall risk, measured by "value at risk", or "VaR", of no more than 1.5x⁴ the VaR of the fund's "designated reference index," or "DRI,"⁵ which we refer to as "Relative VaR." We believe that this 1.5x Relative VaR "multiplier" in the Proposed Rule should be increased for all fund types, as we are

³ *Id.* at 4448.

⁴ Although the Proposed Rule defines the relative VaR test in percentage terms (*i.e.*, a maximum of 150% of the VaR of the designated reference index), we prefer using the convention of a "multiplier" represented by the letter "x" (such as "1.5x"). Although the two conventions are substantively identical, we think that the "x" convention helps distinguish the relative VaR test from a "percentage limit", such as the 10% limit on the notional value of derivatives a fund must adhere to in order to qualify as a limited derivatives user under the Proposed Rule, and thereby makes the different concepts of multipliers and limits less confusing.

⁵ 85 Fed. Reg. at 4454.

concerned that, at its current level, it will unduly impede the ability of funds to use leverage and derivatives together in a measured, responsible way, even in a moderately volatile market.⁶

The SEC justified adopting a 1.5x Relative VaR multiplier for all fund types by reference to the fact that Section 18 of the Investment Company Act of 1940 (the “1940 Act”) currently limits debt leverage to 150% of assets.⁷ But Section 18 only restricts *leverage*; it does not place any limit on the volatility that a fund can assume *via its portfolio investments that are not derivatives* (“direct investments”). It is important to understand that an *unleveraged* fund that uses no derivatives could *easily* exhibit a VaR of 1.2x or 1.4x (or more) relative to its DRI. Indeed, [Appendix A](#) attached hereto sets forth several examples of Nuveen funds that use no leverage and no or nominal amounts of derivatives but exhibit a VaR far in excess of the VaR of their respective performance benchmarks.

Unlike Section 18’s limit on debt leverage, VaR measures the overall *risk* of a fund resulting from a combination of (A) the risks of direct investments⁸ in the fund’s portfolio, (B) the risks due to the fund’s derivatives use, and (C) the increase in risk due to the fund’s leverage from sources other than derivatives. The Relative VaR test seeks to place a limit on the leverage that a fund can derive from a combination of “B” and “C”, using a measure that reflects the additions of risk relative to the fund’s DRI not only from “B” and “C”, but also from “A”. We think the Final Rule should not limit derivatives use with a measure of overall risk that also reflects another, separate risk – the risk associated with the fund’s portfolio of direct investments relative to its DRI – without adjusting that measure to account for the risk of a fund’s portfolio without leverage.

We also believe it is appropriate to allow a fund’s VaR to exceed 1.5x that of the fund’s DRI because in many cases the benchmark index that most closely resembles a fund’s investment program may be inherently less risky (*i.e.*, have inherently less VaR) than the fund itself. Risk tends to be greatly impacted by the specific security selection and overall positioning of the portfolio relative to the benchmark, and active fund portfolio managers will often, due to either current investment team outlook or long-term strategic positioning of a fund relative to the rest of the market, position the portfolio with a higher (or lower) level of expected volatility than its benchmark. Additionally, risk can be reduced by diversification, all other things held equal, and benchmark indexes with thousands of constituent securities will, as a purely mathematical matter, often have lower VaRs than funds that select a few dozen individual securities from that benchmark.⁹ Moreover, an idiosyncratic event that involves one or a small handful of securities could spike the fund’s VaR relative to that of its DRI, whose VaR would be less affected given its large number of constituents and consequently lower concentration in the few affected securities. So benchmark index selection can in many cases render the Proposed Rule’s Relative VaR limit far more restrictive on a fund’s ability to effectively gain exposure via derivatives than the 150% leveraging maximum inherent in a 300% asset coverage ratio (as described in footnote 6 of this letter) used by the SEC to justify the Proposed Rule’s 1.5x Relative VaR multiplier.

⁶ As we discuss below, we also urge the SEC to adopt an *even higher* Relative VaR multiplier for CEFs and BDCs.

⁷ Section 18 of the 1940 Act limits the assets of a fund using debt leverage to 150% of starting assets by imposing a requirement that the fund maintain 300% asset coverage, which effectively means that for every \$100 of starting assets, a fund can borrow at most \$50, because the total assets (\$150) would equal 300% of the amount of debt (\$50). See also footnote 29 of the Proposing Release.

⁸ We use the term “direct investments” here to refer to securities bought with cash, in contrast to positions entered via derivatives.

⁹ See Meir Statman, “How Many Stocks Make a Diversified Portfolio”, *Journal of Financial and Quantitative Analysis*, 22 (September 1987).

Specifically, we propose that the SEC increase the Relative VaR multiplier for OEFs and ETFs to 2.0x instead of 1.5x, taking into account that direct investments themselves can reasonably and appropriately cause a fund's VaR to exceed that of its benchmark by 1.3x or more.¹⁰ Section 18 essentially limits OEFs and ETFs to leverage of 1.5x. Combining three concepts (the lack of statutory limits on portfolio volatility or risk, the normalcy of a fund having an unlevered, ex-derivatives portfolio VaR of 1.3x that of its benchmark index, and the 1.5x statutory limit on leverage applicable to OEFs and ETFs), one arrives at an appropriate regulatory limit on Relative VaR of $(1.3 \times 1.5 =) 2.0x$ for OEFs and ETFs. (See separate discussion of the appropriate Relative VaR multiplier for CEFs in Section III.B. below.)

B. The SEC should either (1) implement a separate derivatives rule for CEFs or (2) include more liberal Relative VaR multipliers for CEFs in the Final Rule.

1. The SEC should exclude CEFs from the Proposed Rule, and propose and adopt a separate derivatives rule for them.

The reasoning used by the SEC in the Proposing Release to explain the proposed derivatives regulatory regime appears to focus primarily on derivatives use by OEFs and ETFs, and the special considerations of CEFs seem to have been considered only in passing. CEFs offer unique opportunities and present unique risks that make them materially different from OEFs and ETFs. In particular, in our experience the use of leverage is far more prevalent among CEFs than OEFs and ETFs.¹¹ Recognizing these differences, the 1940 Act includes separate provisions for CEFs (and BDCs)¹² regarding various parameters, such as use of leverage (in Section 18) and the maintenance of portfolio liquidity (in Rule 22d-4).

The basis for the Proposed Rule's Relative VaR multiplier appears to be that 1.5x is the maximum theoretical leverage ratio for OEFs. However, unlike OEFs, CEFs are *not* limited to using only debt leverage of 1.5x (*i.e.*, requiring 300% asset coverage). Instead, CEFs are permitted by Section 18 to leverage themselves using *equity-based* leverage up to 2.0x (*i.e.*, requiring only 200% asset coverage). In other words, if the basis for limiting a fund's use of derivatives to a particular extent is the maximum theoretical leverage ratio applicable to that fund under applicable law, so that the limit on OEFs is 1.5x, then the Relative VaR multiplier for CEFs should be 2.0x, because a CEF can leverage itself by 2x under the 1940 Act. That this possibility was summarily dismissed by the SEC in the Proposed Rule,¹³ for reasons that we discuss in the following sub-section of this letter, reinforces our sense that CEFs need their own derivatives rule.

¹⁰ We chose 1.3x because a substantial number of funds we measured had portfolio-level relative VaRs that equaled or exceeded that level, and because a 30% adjustment struck us as providing an appropriate and sensible amount of "headroom" to fairly enable funds with moderately above-benchmark risk to still engage in derivatives use in conformity with the 1940 Act's limits on a fund's ability to leverage itself.

¹¹ We believe CEFs use leverage to a far greater extent than OEFs primarily because CEF common shares are not redeemable, which allows CEFs to maintain leverage without fear that investor redemptions will force them to reduce that leverage (and, correspondingly, exit portfolio positions). In addition, to date the SEC has, through the exemptive relief process, limited the ability of ETFs to employ leverage. For the remainder of this section, we will compare CEFs only to OEFs for the sake of simplicity.

¹² Many of the statements in this section about CEFs would also apply to BDCs. We do not believe that BDCs will be significantly impacted by the Proposed Rule, and so this discussion will generally omit reference to BDCs, but the SEC may consider the descriptions and proposals herein about CEFs to potentially also relate to BDCs.

¹³ See discussion in footnote 15 and surrounding text.

2. If the SEC decides not to exclude CEFs from the application of the Final Rule, the SEC should adopt in the Final Rule a separate, higher Relative VaR multiplier and Absolute VaR maximum for CEFs.

One premise of the SEC's rationale for proposing to limit the derivatives use of a fund of *any* type (OEF, CEF, or ETF) to a VaR that does not exceed 1.5x of the VaR of its DRI is that no fund should be able to expose itself to leverage, either via direct borrowing or via derivatives, at a level that exceeds the amount of debt leverage the 1940 Act allows investment companies to utilize.¹⁴ However, as we discuss immediately above, this premise is not applicable to CEFs, because unlike OEFs, they are not subject to a theoretical maximum leverage ratio of 1.5x (*i.e.*, requiring 300% asset coverage) under Section 18 of the 1940 Act, but instead are permitted to use equity-based leverage up to 2.0x (*i.e.*, requiring only 200% asset coverage). Therefore, if the SEC seeks to cap funds' use of derivatives at a level that matches the maximum theoretical leverage ratio applicable under the 1940 Act (1.5x for OEFs, for example), CEFs should be subject to a 2.0x Relative VaR multiplier.

We are not persuaded by the SEC's argument that, even though CEFs are permitted to leverage themselves by 2.0x under the 1940 Act, they should be subject to the same 1.5x Relative VaR multiplier as OEFs because derivatives represent "indebtedness leverage."¹⁵ While we agree that a CEF should not be able to escape Section 18's 300% asset coverage limit on debt-based leverage by using derivatives, we respectfully but forcefully maintain that (A) obtaining leverage due to derivatives is not tantamount to "indebtedness leverage"; and (B) even if derivatives are somehow tantamount to debt, a Relative VaR multiplier of 1.5x is not a methodologically sensible way to limit leverage derived from derivatives use in a fund type (*i.e.*, CEFs) that can legally use equity-based leverage to a greater extent than debt leverage. Such an approach would prevent CEFs that employ equity-based leverage from utilizing derivatives to help manage risks, a result that is both arbitrary and financially detrimental to shareholders.

- a. The leverage attributable to derivatives is not "indebtedness based."

Derivatives are not generally structured as "borrowings," and the notional amounts of derivatives do not create "indebtedness".¹⁶ If a particular derivatives position has negative "moneyness" (*i.e.*, that position is "out of the money"), that negative moneyness can fairly be labeled as "indebtedness," but that does not render the full *notional* amount of that derivatives position as "indebtedness". Derivatives are not directly addressed by the 1940 Act itself, and in our view it is not helpful when attempting to adopt appropriate regulations to try to fit the round concept of "derivatives" into the square statutory hole of "indebtedness leverage." Thus, in our view the 150% limit on CEFs' use of "indebtedness leverage" in Section 18 is not a relevant consideration to the appropriate regulatory limit on derivatives-derived leverage for CEFs.

¹⁴ For OEFs and ETFs, debt leverage is the only form of direct leverage available. By contrast, CEFs and BDCs can also utilize equity-based leverage.

¹⁵ See 85 Fed. Reg. at 4474: "We do not believe that a registered closed-end fund's ability to issue preferred stock, for example, suggests that registered closed-end funds should be permitted to obtain additional indebtedness leverage through derivatives transactions."

¹⁶ In the Proposing Release, the SEC observed that Rel. IC-10666 indicated that the SEC believed when Rel. IC-10666 was promulgated in 1979 that reverse repurchase agreements, firm commitment agreements and standby commitment agreements represented "evidence of indebtedness," and that therefore derivatives should similarly be considered "evidence of indebtedness." Our view is that that 1979 statement says virtually nothing about how derivatives should be viewed under the 1940 Act. While we might agree that those three types of arrangements can fairly be characterized as "evidence of indebtedness," they are not, in today's parlance, "derivatives". Therefore, we do not believe that this statement about those three types of arrangements indicates that today's derivatives – swaps, options, futures – represent "indebtedness."

- b. The Proposed Rule's application of the same Relative VaR multiplier to CEFs and OEFs places a far greater constraint on CEFs' derivatives use than it does on OEFs' derivatives' use, in a way that is unintended, arbitrary, and contrary to CEF shareholders' interests.

Even if the SEC is correct that derivatives should properly be regarded as “indebtedness leverage”, applying the same Relative VaR multiplier to CEFs and OEFs would in many cases prevent a CEF using the same amount of debt leverage as a similar OEF from engaging in derivatives to the same extent as that OEF. Moreover, that greater restrictiveness on CEFs' use of derivatives would prevent certain CEFs from using even risk-reducing derivatives to an optimal extent, to the detriment of shareholders' interests. We do not believe that the SEC intended this outcome.

Our point is best illustrated by an example comparing how the 1.5x Relative VaR multiplier would impact a hypothetical OEF and a hypothetical CEF, each with \$100 of “common share” assets, proportionately identical portfolios that have the same VaRs as their identical DRI, identical percentages of debt leverage, but different levels of equity leverage as permitted by their separate regulatory regimes:

- Assume that (A) the OEF has debt leverage of \$35 (for an asset coverage ratio of $(\$135/\$35 =)$ 386%, well in excess of the 300% minimum in Section 18), and (B) the VaR of the fund's portfolio (its “Portfolio VaR”; *i.e.*, the potential loss as a percentage of total assets, not as a percentage of common share net assets) is the same as the VaR of its DRI.¹⁷ Prior to entering into derivatives transactions, the OEF's VaR would be precisely 1.35x that of the DRI due to its 35% leverage. In this case, the OEF would be able to enter into an *unlimited* amount of derivatives, so long as its Relative VaR remained at or below 1.5x the VaR of its DRI. If those derivatives were hedges, that would (virtually by definition) reduce the OEF's Relative VaR below 1.35x. Even if those derivatives have the effect of adding exposure such that their use increases the OEF's overall risk and its Relative VaR above 1.35x, the OEF would still be in compliance with the Proposed Rule's Relative VaR test so long as the OEF's Relative VaR remained at or below 1.5x.
- Contrast that with a CEF that has (A) the same \$35 of debt leverage as the OEF, (B) preferred stock leverage of \$40, and (C) a Portfolio VaR the same as its DRI's VaR. The CEF would have a debt asset coverage ratio of $(\$175/\$35 =)$ 500%, well in excess of the 300% minimum in Section 18(a)(1), and an equity asset coverage ratio of $(\$175/\$75 =)$ 233%, well in excess of the 200% minimum asset coverage minimum in Section 18(a)(2). The fund's VaR would be precisely 1.75x that of the DRI (given the assumption that the CEF's Portfolio VaR is the same as the DRI's VaR, and the CEF has leverage of 75% of its starting assets). In this case, the CEF's 1.75x Relative VaR would already far exceed its Relative VaR multiplier of 1.5x, even before it enters into *any* derivatives transactions. The only way that CEF could invest *to any extent* in derivatives would be to rely upon the limited derivatives user exception and adhere to its 10% limit on notional derivatives use. The inappropriateness of this limitation is demonstrated by the fact that such a CEF could not enter into derivatives representing more than 10% of its assets for the purpose of hedging and reducing risk, unless that risk reduction were enough to cause the CEF's Relative VaR to be less than 1.5x that of its DRI.

So, even if the SEC is correct that derivatives should properly be regarded as “indebtedness leverage”, the operation of the Relative VaR test would impact similarly situated OEFs and CEFs

¹⁷ We discuss the implications of fund portfolio vs. DRI VaR divergence earlier in this letter, in the text after footnote 7, and in [Appendix A](#).

differently. An OEF similar to the one in the example would have an essentially *unfettered* ability to use derivatives so long as the use of those derivatives did not increase its Relative VaR by more than 15 percentage points (from 135% to 150%). By contrast, a CEF similar to the one in the example would be forced to rely on the limited derivatives user exception and limit its derivatives use to no more than 10% of its assets.¹⁸ Thus, the 1.5x Relative VaR multiplier will prevent such a CEF from using derivatives to fully hedge its portfolio or its leveraging instruments, as explained above, which is the exact opposite of what both logic and public policy considerations demand.

Our proposed solution to this undesirable (and we believe unintended) result is essentially the same as the approach prescribed in Section 18 itself when determining the asset coverage percentages for CEFs' debt-based and equity-based leverage. For CEFs that use both debt and equity leverage, the amount of equity-based leverage is not considered – in the sense that it is not included in the denominator – when calculating Section 18 asset coverage of the debt leverage. The CEF in our example had a Section 18 debt asset coverage ratio of ($\$175/\$35 =$) 500%; and note that the CEF's \$40 of equity leverage was not included in the denominator of the Section 18 asset coverage calculation, but was only included in the \$175 of total assets in the numerator. Our proposed solution for the Relative VaR multiplier applicable to CEFs is similar: when applying the Relative VaR test to a CEF that has used equity-based leverage, the leveraging effect of any equity-based leverage used by a CEF should either (A) not be considered, or (B) be adjusted for.

We propose two potential approaches for the Commission's consideration:

- i. The Final Rule could adjust the CEF's VaR by the proportion that the amount of the CEF's equity leverage bears to its total assets (*i.e.*, by removing it from the calculation in a manner closely analogous to the way that the equity leverage is removed from the debt asset coverage calculation under Section 18). In our example above, the CEF's Portfolio VaR was equal to the DRI's VaR for analytical simplicity. If we assume that the VaR of both the CEF's portfolio and the DRI is 3.0, then the CEF's VaR on a fully leveraged basis (taking into account both the debt and equity leverage) would be 1.75x the VaR of the DRI, or ($1.75 \times 3.0 =$) 5.25x. If instead the equity leverage were removed, conceptually, from the calculation of the CEF's Relative VaR, that "equity leverage-adjusted Relative VaR" would be equal to the Portfolio VaR (3.0x) times the ratio that total assets reflecting debt leverage bears to starting assets (1.35x), or ($3.0 \times 1.35 =$) 4.05x, *exactly as it would be* for the analogous OEF in our example above if that fund also had a Portfolio VaR of 3.0.¹⁹
- ii. Alternatively, the Final Rule could simply make the Relative VaR multiplier somewhat higher for CEFs than the Relative VaR multiplier for OEFs. This would be a simpler approach to achieving the same sort of regulatory result as that described in paragraph "i" immediately above, with fewer additional calculations required on the part of a CEF. Our preferred set of Relative VaR multipliers to serve this purpose would be 2.0x for OEFs and 2.5x for CEFs, as we have advocated above. However, if the SEC ultimately

¹⁸ That would be the case even if that CEF leveraged itself using solely equity-based leverage, *i.e.*, if *none* of the CEF's leverage were debt-based.

¹⁹ To operationalize the appropriate mathematical adjustment for a CEF using both debt leverage and equity leverage, start with the CEF's measured common share-level VaR, and multiply it by a ratio that the CEF's "common share assets" (\$100 in our example) bears to the sum of (common share assets + debt). In our example, the common share-level VaR was ($3.0 \times 1.75 =$) 5.25x. That figure would be multiplied by $100/135$, arriving at an equity leverage-adjusted VaR of ($5.25 \times (100/135) =$) 4.05, leading to a Relative VaR figure of ($4.05/3.0 =$) 1.35x.

adopts 1.5x as the proper Relative VaR multiplier for OEFs, we propose that the proper Relative VaR multiplier for CEFs be established as 2.0x.

We favor the simpler approach described in “ii” above.

- c. A separate, higher Relative VaR multiplier for CEFs is fully consistent with CEF investors’ risk expectations.

One of the arguments the SEC uses to justify the 1.5x Relative VaR multiplier in the Proposing Release is that investors expect funds having certain characteristics (e.g., an equity mutual fund) to expose their shareholders to only a limited degree of overall risk.²⁰ We essentially agree with, and are willing to accept, the general theory behind that justification. We respectfully submit, however, that investors typically expect CEFs to exhibit substantially *greater* degrees of overall risk than otherwise similar OEFs or ETFs, because CEFs tend to use more leverage and invest to a greater extent than OEFs and ETFs in illiquid or less liquid securities (which have a higher risk profile than more liquid securities). We believe that, in practice, CEFs use greater leverage and invest more in less liquid securities than OEFs largely because they do not need to stand ready to redeem their shares at any time, as do OEFs. We therefore believe that providing a larger Relative VaR multiplier for CEFs than for OEFs would be consistent not only with the higher leverage limits that apply to these funds under the 1940 Act, but also with general investor expectations that CEFs have a greater risk profile than otherwise similar OEFs.

- d. The application of this reasoning to the Absolute VaR test.

As explained above, our absolutely essential point is that CEFs should have a higher Relative VaR multiplier than OEFs. However, substantially the same argument as to why the Proposed Rule should not apply the same Relative VaR multiplier to CEFs and OEFs logically leads to the conclusion that the Final Rule should also not apply the same *Absolute VaR test* to CEFs and OEFs. The greater amount of leverage that a CEF can utilize, with its more liberal 200% asset coverage minimum (and the corollary limit of leverage to 100% of starting common share assets), relative to the debt-based leverage (with its 300% asset coverage minimum, and corollary limit on leverage of 50% of starting common share assets) that an OEF may use means there is a much greater chance that the VaR of the CEF’s common shares will fail the Absolute VaR test if it is the same for CEFs and OEFs. Those different asset coverage minimums effectively permit CEFs to obtain total exposure (\$200 for a CEF with \$100 of starting common share assets) equal to 1.33x the theoretical maximum total exposure that OEFs can obtain via debt leverage (\$150 for an OEF with \$100 of starting assets). Therefore, to put leveraged CEFs on the same regulatory footing as leveraged OEFs, the limit in the Absolute VaR test (the “Absolute VaR limit”) for CEFs in the Final Rule should be roughly 1.33x the Absolute VaR limit for OEFs. In other words, if the Absolute VaR limit for OEFs in the Final Rule is 15%, the Absolute VaR limit for CEFs should be (15% x 1.33x =) 20%.²¹

²⁰ See “Designated Reference Index” section of the Proposing Release, 85 Fed. Reg. at 4471.

²¹ If the SEC ultimately decides to adopt a Relative VaR multiplier of greater than 1.5x and a maximum Absolute VaR limit of greater than 15% for all funds in the Final Rule, as we and many industry commenters are advocating, we believe that any such increased limits for OEFs should be *further* increased with respect to CEFs, for the reasons described above. For example, if the SEC adopts in the Final Rule a general Relative VaR multiplier of 1.75x instead of the currently proposed 1.5x, we would ask that the SEC adopt a Relative VaR multiplier applicable to CEFs of roughly 1.33x that figure (again based on the 1.33x higher maximum leverage that a CEF can use relative to OEFs),

3. Specific methods by which the SEC might effectuate a more liberal set of Relative VaR and Absolute VaR standards for CEFs.

There are several ways in which the Final Rule might provide more liberal VaR standards for CEFs relative to those for OEFs. Here are three possibilities:

- i. *Adopt higher numerical VaR standards for CEFs.* Most simply and straightforwardly, the Final Rule could simply establish a higher Relative VaR multiplier and higher Absolute VaR limit for CEFs to reflect the more liberal ability of CEFs to leverage themselves (e.g., a Relative VaR multiplier of 2.5x of the DRI's VaR vs. 2.0x for OEFs²²; and an Absolute VaR limit of 20% vs. 15% for OEFs).
- ii. *Adjust for a CEF's actual leverage.* To similar mathematical effect, CEFs could adhere to the same Relative VaR multiplier of 1.5x and Absolute VaR limit of 15% as OEFs (or whatever higher standards are ultimately adopted in the Final Rule) but be permitted to effectively use a "leveraged benchmark" tied to the CEF's actual leverage level. Under this approach, a CEF would be permitted to use a liberalized risk standard determined by multiplying (X) the applicable standard (the DRI's VaR for Relative VaR, or 15% for the Absolute VaR limit) by (Y) the CEF's *actual effective leverage ratio*. For example, assume that the Relative VaR multiplier in the Final Rule remains 1.5x, and take a hypothetical CEF with an effective leverage ratio of 1.3x and a DRI with a "pre-leverage" VaR of 4.0%. In this "adjust for actual leverage" approach, our hypothetical CEF would be able to use as its Relative VaR baseline a "leveraged" version of the DRI's VaR equal to 5.2%, calculated by multiplying that 4.0% pre-leverage VaR by the fund's effective leverage ratio of 1.3x. Assuming a universal Relative VaR multiplier of 1.5x, that hypothetical CEF would be required to maintain its fund-level VaR below 1.5x of that 5.2%, or 7.8%.
- iii. *Conceptually adjust for greater CEF theoretical leverage maxima.* Because CEFs can leverage themselves by a factor of $(200\% \div 150\% =) 1.333x$ the amount of leverage that an OEF can use, CEFs could be permitted to use as their two VaR standards (Relative and Absolute) a pair of standards equal to a specified multiplier (such as 1.333x) of the standards applicable to OEFs, and otherwise adhere to the same VaR-based leverage-limiting rubric applicable to OEFs. Under this approach:
 - In the case of the Relative VaR test, a CEF must first determine the "Effective DRI VaR" of its DRI by applying the "conceptual adjustment" to be adopted by the SEC (we suggested 1.333x above), and then must maintain a daily VaR equal to or less than 1.5x of that "Effective DRI VaR." To illustrate with an example, if the CEF's DRI had a VaR of 3.0, the CEF's "Effective DRI VaR" would be 1.333x that DRI VaR, or $(3.0 \times 1.333 =) 4.0$, so that under the Relative VaR test that CEF must maintain a VaR of less than 1.5x that Effective VaR, or $(1.5 \times 4.0 =) 6.0\%$;

or 2.25x, to take into account not only the greater ability of CEFs to leverage themselves, but also the fact that investors expect CEFs to expose them to higher degrees of risk than OEFs.

²² Another possible, and acceptable, set of Relative VaR multipliers would be 2.25x for CEFs and 1.75x for OEFs.

- in the case of the Absolute VaR test, assuming that the Absolute VaR limit for OEFs is 15% in the Final Rule, the Absolute VaR of a CEF would need to be maintained at a level less than 1.333x of that 15% figure, or 20%.

We believe that any of the three potential solutions suggested above, if adopted by the SEC in the Final Rule, would correct the overly restrictive Relative VaR multiplier and Absolute VaR limit that the SEC has proposed – though we favor the first approach for its simplicity. As such, we respectfully urge the SEC to consider adopting higher VaR standards for CEFs pursuant to one of our three suggested methods.

C. Reverse repurchase agreements, tender option bond residual certificates, and any similar instruments are neither “derivatives” nor “senior securities representing indebtedness”, and therefore as utilized by CEFs should either (1) be considered a form of “stock” under Section 18 subject to 200% asset coverage, or (2) continue to be governed by the existing asset segregation regulatory regime.

Reverse repurchase agreements and tender option bond residual certificates (“TOB Residuals”)²³ do have the effect of increasing the economic exposure (*i.e.*, leverage) of a fund that engages in them. Therefore, it is appropriate for the SEC and its staff to place limits on funds’ use of those two instruments.

However, we think that neither reverse repurchase agreements nor TOB Residuals should be classified as “derivatives.” The SEC made clear in the Proposing Release that it was not limiting the scope of its derivatives rule to only those instruments or practices that have traditionally been understood to be derivatives. We agree with that position – anything that creates either leverage or “exposure” to something else should be characterizable as a derivative. For example, short sales of securities have not been universally regarded as “derivatives”, but because they create a “negative exposure” to something (the stock that was shorted), classifying it as a derivative seems fair to us. However, neither reverse repurchase agreements nor TOB Residuals do that:

²³ A TOB Residual is one of two classes of securities issued by a special purpose trust that holds an underlying bond (typically, a municipal bond), and effectively represents a leveraged investment in that underlying bond. One class is a floating rate security (sometimes referred to as a “floater” or “tender option bond” or “TOB”) that pays a short term interest rate, has a priority claim on the cash flows from the underlying bond, and is redeemable at par at the option of the holder on a periodic basis (subject to certain disqualifying conditions). The other class is the TOB Residual (sometimes also referred to as an “inverse floater”), which has a residual interest in such cash flows of the underlying bond as are not needed to pay interest on the TOB and other fees and expenses of the trust, and whose exposure to the underlying bond is leveraged by the amount of the purchase price of the TOB floaters. The holder of the TOB Residual thus receives interest payments that vary inversely with the payments made to the holder of the TOB, and bears the market risk associated with changes in the value of the underlying bond. A liquidity provider (typically a bank), provides the monies necessary to redeem any TOBs that have been tendered but not remarketed. A TOB Residual is “with recourse” if the holder of the TOB Residual is obligated to reimburse the liquidity provider to the extent that proceeds from selling the underlying bond are inadequate to pay the amounts that would be due to the TOB holders upon termination of the trust.

- A reverse repurchase agreement represents an actual sale (by a fund) and purchase (by a counterparty) of a security, and a later repurchase of that security at agreed-upon terms by the fund, that has the fully intended effect of freeing up cash with which the fund may purchase other securities during the term of the repurchase agreement. The value of the position is not “derived” from any reference asset or index, and it does not resemble an option, future or swap.
- A TOB Residual represents a self-contained investment that includes a financing arrangement that is “internal” to the instrument, much like an investment in the common stock of an operating company or a REIT that has itself borrowed an investment with an “internal” financing arrangement, which is a highly common practice for operating companies and REITs.

The only significant implication under the Proposed Rule of classifying reverse repurchase agreements and TOB Residuals as “not derivatives” is that they would not be counted against the 10% notional limit on derivatives for a fund seeking to qualify as a limited derivatives user, because the fund’s VaR would reflect the leveraging nature of the instrument and limit its use if the fund was subject to either the Relative VaR test or the Absolute VaR test under the Rule.

We also believe that neither reverse repurchase agreements nor TOB Residuals should properly be regarded as a “senior security representing indebtedness” under Section 18 of the 1940 Act.²⁴

- A reverse repurchase agreement entered into by a fund certainly has many of the same economic characteristics as a borrowing: as noted above, it leverages the fund, because the end result is that the transaction temporarily frees up cash that the fund can use to buy additional securities. However, unlike a standard borrowing or debt arrangement, a reverse repurchase transaction requires that the security serving as the “corpus” of the repurchase arrangement have its value marked-to-market on a daily basis, and that any shortfall of that value to the amount owed by the fund (plus any additional cushion or margin amount mandated by the terms of the arrangement) be trued up daily. Also, any sort of “default” by the fund would trigger much different remedies than those used by the creditor in a standard borrowing, which would either involve a bankruptcy proceeding, or some sort of legal action to enforce the creditor’s rights with respect to a lien on specified collateral. In contrast, the counterparty in a reverse repurchase agreement already has possession of the security representing the underlying “corpus” of the agreement and can choose to keep or freely dispose of that asset in its unfettered discretion.²⁵
- A TOB Residual purchased by a fund also does not resemble a standard borrowing, although like a reverse repurchase agreement it does also result in the leveraging of the fund. The analysis probably depends somewhat upon whether the trust that issues the TOB Residual (and the trust’s corresponding floaters) is structured as “recourse” or “non-recourse”²⁶ trust:

²⁴ See Question 229 of the Proposing Release, 85 Fed. Reg. at 4505.

²⁵ As support for our argument that a reverse repurchase agreement is not a borrowing, please note that a fund could in fact create exactly the same economics of a reverse repurchase agreement with a total return swap. Under the Proposed Rule, this total return swap would not be treated as a senior security representing indebtedness. A fund could borrow to 33%, and then enter into this sort of swap to 9.9%, and go well beyond the 1.5x leverage permitted for debt.

²⁶ Under a recourse TOB trust structure, a financial institution providing the liquidity backstop for the TOB trust’s floaters would have recourse back to the fund holding the TOB Residual for any amount representing the difference between the par amount of the TOB trust’s floaters and the underlying bond value. In contrast, under a non-recourse TOB trust structure, the liquidity provider would not be able to recoup its loss if it were required to repurchase the Floaters at par but realize only a lower amount upon liquidating the underlying bond.

- Under a *non-recourse* TOB Residual investment held by a fund, the maximum amount the fund could potentially lose would be just the amount the fund invested in the TOB Residual (*i.e.*, its “equity commitment”) and not the entirety of the underlying bond value. Indeed, since no party (not the TOB floater holder, nor the liquidity provider) has any claim on the fund’s assets, one can argue that the TOB Residual technically does not represent a “senior security” of any sort under Section 18, and many funds and fund sponsors have apparently taken that position over the years. However, the TOB Residual investment will have greater price and return volatility than the underlying bond, and it in essence acts (in price, volatility and return) like a leveraged investment. This is in part because, as a *practical* matter, the liquidity provider, if it observes the value of the underlying bond falling to the point where its excess in value relative to the amount of the TOB trust’s floaters falls below a comfortable “cushion” amount, will demand that the TOB Residual holder provide additional assets to the TOB trust to shore up the TOB Residual holders “equity” position, cause the trust to redeem some of the trust’s floaters, or precipitate the complete “collapse” of the TOB trust and effect the complete redemption of the floaters. The result of all that is that the TOB Residual holder ends up bearing the entire risk of gain and loss on the underlying bond. Nevertheless, the fund that owns the TOB Residual has not “borrowed” money from the floater holders, because those floater holders have no legal right to the TOB Residual holder’s assets if the liquidity provider fails to redeem or buy their floaters at par value.
- Under a *recourse* TOB Residual investment held by a fund, the maximum amount the fund could potentially lose includes not just the amount the fund invested in the TOB Residual, but also the amount of the floaters issued by the TOB trust (which, combined with the value of the TOB Residual the fund owns, would equal the value of the TOB trust’s underlying bonds). This means that the holders of the TOB floaters, or perhaps the liquidity provider, do have a senior claim on the assets of the fund, so the TOB Residual does appear to be a senior security under Section 18. But that fund’s obligation to the TOB floater holders and/or the liquidity provider is essentially secured or at least “covered” by the underlying bond in the trust, and the TOB Residual holder essentially owns the “equity” in a company (the TOB trust) that has issued debt (in the form of those TOB floaters).²⁷ The TOB Residual holder therefore has not “issued debt”, but rather has utilized a form of leverage that involves a “senior security which is a stock” – the TOB residual itself. Therefore, the TOB Residual should not be regarded as a “senior security representing debt.”

Even if the SEC ultimately concludes that a reverse repurchase agreement or a TOB Residual is a “derivative” or a “senior security representing debt,” we believe that it would still be appropriate for the SEC to distinguish in the Final Rule how reverse repurchase agreements and TOB Residuals are treated for OEFs versus CEFs. The SEC correctly pointed out in the Proposing Release that OEFs

²⁷ In our view, the fact that a TOB Residual is a residual interest in a company is a strong indicator that this form of leverage is not a form of “debt” but rather is a form of “equity” – a “stock.” It is not a coincidence that a common stock of an operating company represents the “residual” interest in the company at the bottom of the company’s “capital stack”, consisting of (in descending order of priority) senior debt, subordinate debt, preferred stock, and common stock, which represents “what’s left” after all the more senior securities have been satisfied. Similarly, the nomenclature for collateralized mortgage obligations, collateralized loan obligations, and similar vehicles refers to the residual of those structures’ capital stack as “equity.” The same nomenclature and principles apply to TOB Residuals.

are limited to leveraging themselves to 1.5x of their assets, so it seems reasonable to limit the amount of leverage that an OEF can generate using reverse repurchase agreements and TOB Residuals to that same 1.5x level, and characterizing them as “debt” under Section 18 when used by OEFs (and ETFs) would appropriately accomplish that result.

However, as discussed above, CEFs can theoretically leverage themselves to 2.0x under Section 18, at least if the instrument used to achieve leverage in excess of 1.5x is a “stock” Under current law (particularly with Release No. 10666 under the 1940 Act (“Rel. IC-10666”)²⁸ still being operative), a CEF could also use reverse repurchase agreements and/or TOB Residuals to obtain leverage in excess of the 1.5x theoretical limit applicable to senior securities representing debt, up to virtually 2.0x. This is because the asset segregation protocol of Rel. IC-10666 essentially allows a fund to use those instruments to double (2.0x) the exposure of the fund, because the fund merely needs to segregate its original assets to “cover” up to an equal amount of additional exposure generated by those instruments. For CEFs that have used reverse repurchase agreements and/or TOB Residuals to obtain exposure in excess of 1.5x, it would be a major step backward if the Final Rule were to suddenly render that above-1.5x utilization violative of the 1940 Act. Those instruments, because of their self-securing nature and other self-limiting features described above, have proven to be an efficient and cost-effective means for CEFs to leverage themselves, and many CEFs currently use them to obtain exposures in excess of 1.5x. We believe that a CEF’s use of reverse repurchase agreements and TOB Residuals to achieve above-1.5x leverage presents no more risk to investors than a CEF’s use of preferred stock to achieve above-1.5x leverage, because of the self-securing nature of those instruments.

To recap, we agree with the Proposing Release’s treatment of reverse repurchase agreements and TOB Residuals for OEFs and ETFs: treat them as debt subject to the 300% asset coverage requirement for debt, and therefore limit their usage (and that of any other form of debt) to 50% of a fund’s assets, so that the fund cannot gain more than 1.5x exposure using any leveraging instrument. That makes sense under Section 18, because debt is the only form of leverage that an OEF (or ETF) is permitted to use, and is subject to a 1.5x leveraging limit. It is therefore appropriate to limit all leveraging instruments (including reverse repurchase agreements and TOB Residuals) to that 50%, *i.e.*, to a total of 1.5x leveraged exposure.

In contrast, we believe that a CEF’s use of reverse repurchase agreements and TOB Residuals should either (1) be considered a form of “senior security representing stock” under Section 18 and therefore be subject to 200% asset coverage, or (2) continue to be governed by the existing asset segregation regulatory regime. As we explain above, reverse repurchase agreements and TOB Residuals are very different from bank borrowings, primarily because of their self-securing nature, and should not be considered “debt.” Rather, because both resemble in some regards a senior security that is “equity,” those instruments should be considered by any investment company type that is statutorily authorized to issue a senior security representing stock (*i.e.*, CEFs and BDCs) to be an “equity” instrument. Therefore, we respectfully urge the SEC to clarify that, specifically for CEFs (and potentially BDCs), reverse repurchase agreements and TOB Residuals will be treated as *equity* leveraging instruments, to permit a CEF (or BDC) to use them subject to only the 200% asset coverage requirement applicable to use of senior securities constituting “stock.” This would place the same limits on their use by CEFs as current law (*i.e.*, Rel. IC-10666), which permits a fund to use these instruments up to the amount of the fund’s assets, thereby reflecting a doubling (2.0x) of the fund’s investment exposure. This limit has served CEFs well over the 40-plus years since Rel. IC-10666 became effective. Alternatively, the SEC might exclude CEFs entirely from the reach of the Proposed Rule’s re-characterization of repurchase agreements and TOB Residuals, and let the asset

²⁸ *Securities Trading Practices of Registered Investment Companies*, Investment Company Act of 1940 Release No. IC-10666, 44 Fed. Reg. 25128 (Apr. 27, 1979), *available at*: <https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf>.

segregation requirements of Rel. IC-10666 continue to apply to CEFs, which would similarly limit a CEF to using reverse repurchase agreements and TOB Residuals, like other equity-based leveraging instruments, to 100% of the fund's assets, and therefore permit only a theoretical doubling of investment exposure through their use.

D. The Proposed Rule's protocols for the selection of a fund's DRI should be liberalized to avoid creating unfortunate mismatches between the DRI and the fund's investment program; the Final Rule should also make clear that a fund's reasonable determination that there is no suitable DRI should be afforded significant deference.

The Proposed Rule generally requires a fund that does not qualify as a limited derivatives user to limit its VaR to 1.5x of the VaR of a DRI selected by the fund. The Proposed Rule defines a DRI as "an unleveraged index that is selected by the derivatives risk manager, and that reflects the markets or asset classes in which the fund invests."²⁹ The requirement that the DRI reflect the markets or asset classes in which the fund invests is "designed to provide an appropriate baseline for the relative VaR test."³⁰ The SEC proposed this requirement based on the theory that differences between the fund's VaR and the VaR of the DRI are more likely to represent leverage than other factors, such as differences between the securities in the fund's portfolio and those in the index.

The closeness of the "fit" between a fund's DRI and its investment parameters and program is central to the concept of a DRI under the Proposed Rule. By limiting the VaR of a fund to a specified multiple (1.5x in the Proposed Rule) of the DRI's VaR, the Proposed Rule attempts to measure the contribution of derivatives to a fund's overall "investment exposure," as an indirect but more meaningful way to limit a fund's utilization of derivatives than directly limiting the fund's notional "amount" of derivatives.³¹ But if there is a significant mismatch between a fund's DRI and the fund's investment profile, the use of the fund's Relative VaR to the mismatched DRI VaR as a measure of the fund's investment exposure will be inaccurate. In this case, limiting the fund's VaR to 1.5x of the DRI's VaR will likely be inappropriate, because the fund's VaR may in large part instead be detecting the mismatch of the DRI to the fund's investment parameters and program. For these reasons, the Proposed Rule should as much as reasonably possible give a fund flexibility to select a DRI that closely fits its investment profile.

In an attempt to prevent funds and advisers from "gaming"³² the Relative VaR test, the Proposed Rule prohibits funds from selecting a DRI that is "created at the request of the fund or its investment adviser," but that restriction would not exclude such a self-requested "customized" index if "the index is widely recognized and used."³³ We strongly believe that this provision will inevitably cause greater problems that it was intended to prevent. Specifically, we are concerned that if a fund cannot select as its DRI a customized index that was created at the request of the fund or its adviser in order to closely match the investment program of the fund, the fund may be forced to use a more "broad-based" index that does not properly and closely mirror the fund's investment program. In many instances, this will result in the Relative VaR test failing to properly measure the contribution of derivatives to that fund's overall investment exposure, making it inappropriately restrictive (or permissive) with respect to the fund's use of derivatives.

In our experience, many broad-based market indices in the same asset class as a fund are over-broad relative to a specific fund, and include cohorts of securities in which the fund would not

²⁹ 85 Fed. Reg. at 4469.

³⁰ *Id.* at 4471.

³¹ *Id.*

³² *See Id.* at 4472: "We believe that the indexes permissible under the proposed rule would be less likely to be designed with the intent of permitting a fund to incur additional leverage-related risk."

³³ Proposed Rule 18f-4(a), definition of "designated reference index."

normally invest, or are unrepresentative of the fund's investment program for other reasons. Consequently, many funds – particularly fixed-income funds – and their investment advisers often adopt and use performance benchmark indexes that are “customized” via a process of collaboration between the fund's investment adviser and the index provider. These types of indexes would seem to be “created at the request of the fund or its investment adviser.”

For example, one major index provider's primary municipal bond index includes securities of *all* maturities, including securities with very short maturities and durations. A long-term municipal bond fund may quite reasonably maintain a portfolio that does not invest to a significant extent in bonds having shorter maturities and durations. In that case, the inclusion of those short-dated bonds in the primary index inevitably causes that index to exhibit parameters (including duration and, importantly for this discussion, VaR) that are far different from (and in this case, far less risky than) those of the fund's expected investment program. If the broad-based index is systematically and substantially less risky than the fund's investment program, it will not be suitable to serve as the fund's DRI, because the fund's portfolio before using derivatives or other forms of leverage will consistently have a higher VaR than that index. The fund described above might want to adopt as a performance benchmark a customized index that would exclude bonds at the short end of the primary index's bond list, because that customized index would much more closely match the expected characteristics (most notably, duration) of the fund's portfolio. The fund could similarly be expected to want to adopt and utilize that customized index as its DRI under the Proposed Rule.

Typically, a fund and its investment adviser that want to adopt and utilize a more tailored, customized index for performance comparison purposes might work closely with the index provider to craft a customized benchmark index that optimally mirrors the expected characteristics of the fund's portfolio. In the case of many actual funds, that consultation between the fund and adviser and the index provider to create such a customized index occurred many years ago, in some cases decades ago.³⁴ This consultative effort would appear to disqualify the use of that index as a DRI under the Proposed Rule, because that index would have been “created at the request of the fund or its investment adviser,” unless the index qualified as one that is “widely recognized and used.” The chances that such an index would qualify as “widely recognized and used” are slim at best; typically, no advisers (or their funds) outside of the adviser that originally consulted with the provider to develop the customized index will actually select that index as a benchmark index, or in the future under the Final Rule, as a DRI. Accordingly, it appears that such index would not qualify to be treated as a DRI in the Final Rule.

We believe that a fund should generally be able to use a representative “customized” index that represents a reasonable and methodologically legitimate³⁵ effort to mirror the risks and return expectations of a fund's portfolio as the fund's DRI under the Proposed Rule, rather than being forced to choose a more broad-based index that does not accurately match the fund's investment profile. Prohibiting a fund from choosing such an index simply because the fund or its adviser was involved in creating the index may create a Hobson's choice for many funds. A fund may be forced to choose between (A) selecting a broad-based index as its DRI, despite a potential mismatch between that index and the fund's portfolio characteristics over time, meaning the index's VaR may be substantially lower than the fund's VaR, and (B) declaring that no suitable index is available, meaning the fund would come under SEC scrutiny for making such a declaration, and would have to abide by the Absolute VaR limit set forth in the Proposed Rule. We do not see how this scenario would benefit funds, shareholders, or the market in general.

³⁴ NFAL manages several such funds, and has worked with a performance index provider to craft a tailored benchmark index that is appropriate for those fund's investment programs.

³⁵ By “methodologically legitimate,” we mean that the customized index must represent a true picture of some segment of a market separate from the fund itself. For example, a customized index that mirrors the fund itself would obviously not satisfy this standard.

Instead, we urge the SEC to give funds flexibility within the Final Rule to select a DRI that closely mirrors the investment parameters and program of the fund, even if the index was created and customized at the request of the fund or its adviser. While we understand the SEC's desire to curtail "gaming" of the DRI selection process by funds and advisers, we believe the negative consequences of prohibiting funds from selecting customized indices as DRIs outweigh the potential benefits. As such, we respectfully recommend that the Final Rule allow funds to select customized performance benchmark indices as their DRIs, so long as the customized index is reasonable and methodologically legitimate.

In a separate but related topic, we believe it is important for the SEC in the adopting release for the Final Rule to clearly acknowledge that (A) a fund's use of an index other than its performance benchmark as a DRI is appropriate in the Relative VaR test for the fund if so determined by the fund's derivatives risk manager; and (B) a fund's election to adopt an Absolute VaR test instead of a Relative VaR test is also appropriate if reasonably determined by the fund's derivatives risk manager.

We specifically draw the SEC's attention to some less common fund asset-class and fund-type combinations which might normally be expected to find the Absolute VaR standard to be the most appropriate test under the Proposed Rule, which we have set forth in Appendix B attached hereto.

E. The SEC should eliminate the "time out" on derivatives trading after a VaR test exceedance.

Under the Proposed Rule, if a fund does not come back into compliance with the applicable VaR test (Relative VaR or Absolute VaR) within three business days of a violation, the fund may not enter into derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's Relative or Absolute VaR) until the fund has been back in compliance with its VaR test for three consecutive business days.³⁶

We believe the SEC should eliminate this "time out." First, funds and their advisers and derivatives risk managers will find it difficult to determine whether a particular derivatives transaction will reduce a fund's VaR prior to or at the time of the transaction, especially during periods when market values of other fund investments fluctuate daily. More importantly, restricting a fund's ability to enter into certain derivatives transactions for at least three consecutive business days could be disruptive to a fund's investment strategy, particularly if a fund obtains significant investment exposure through derivatives transactions, or is prevented from using derivatives to react to changing portfolio investment liquidity or market dislocations. Such strategy disruption could harm the fund's shareholders and adversely impact the fund's performance.

We encourage the SEC to eliminate the time out and replace it with a requirement that funds include provisions in their policies and procedures and their derivatives risk management programs detailing steps to be taken following an exceedance that was not remediated within the adopted time period.³⁷ This would allow funds the flexibility to consider their individual investment strategies and derivatives use and how best to restructure their fund portfolios to remediate the exceedance without unduly harming their shareholders. One benefit of this approach is the visibility and accountability associated with the derivatives risk manager's oversight and communication with the fund's portfolio management team to determine the fund's path to VaR compliance. The SEC will have the benefit of

³⁶ 85 Fed. Reg. at 4479-4480.

³⁷ This would be analogous to treatments of exceedances in Rule 22e-4, the so-called "liquidity risk management rule", which requires when a 15% illiquid maximum is exceeded that a fund adopt a remediation plan requiring that the fund bring its illiquid percentage under the maximum within a reasonable period of time.

Form N-RN reporting of unremediated exceedances, and so will the fund's board. The fund and its shareholders benefit from being able to make sound tactical decisions without an artificial deadline; the layered oversight by the derivatives risk manager, fund board and SEC prevent the fund's portfolio manager from unduly delaying the steps necessary to bring the fund back into VaR compliance.

If the SEC determines not to remove the time-out restriction, we request that the Final Rule permit funds to enter into certain derivatives transactions during the remediation period that meet at least one of the following conditions: (1) rolling current holdings whose terms expire into a subsequent term; (2) meeting liquidity and redemption needs; (3) mitigating risks within the fund's portfolio more generally; or (4) responding defensively to abnormal market conditions or events. Use of derivatives in these situations either does not expose a fund to significant additional risk, or is devoted to mitigating risk or directly facilitating shareholders' interests.

F. In the Final Rule, the period within which a fund would need to come back into compliance after a VaR test exceedance should be extended from three to five business days, and the period within which a fund would need to come back into compliance with the 10% derivatives exposure threshold should be established as 14 days.

We urge the SEC to extend the proposed three business-day compliance period after a VaR test exceedance to five business days or seven calendar days. A three business-day window could lead to close-outs of over-the-counter ("OTC") derivatives transactions under conditions that are not in the best interest of fund shareholders. A period of more than three business days of non-compliance with the fund's VaR test is necessary to provide a sufficient indication either that the fund will be unable to comply with its VaR test, or that the fund bears too much leverage risk from its derivatives holdings. The proposed three-day period is insufficient for many funds to adjust their portfolios in a reasoned and thoughtful manner that will allow them to come back into compliance with a VaR test. The potential harm to a fund's shareholders that could result from a fund's being required to come back into compliance so quickly could mushroom in situations where market conditions have volatile effects on the value of a fund's investments, or where shareholder redemptions outstrip contributions.³⁸

Many funds use a seven calendar-day metric to coincide with Rule 22d-4 under the 1940 Act, pursuant to which a fund needs to reasonably expect to be able to sell or dispose of an investment in seven calendar days or fewer in order for the investment not to be considered "illiquid." Also, funds often negotiate early termination rights in their OTC derivatives agreements with that timeframe as a guideline. As such, funds may need more than three business days to terminate existing OTC derivatives transactions to come back into compliance with their VaR test. Increasing the number of days would be more consistent with market practice and existing regulatory standards, while still providing strong investor protection.

The Proposed Rule does not include any provision quantifying the time frame for remediation of exceedances of the 10% exposure threshold for funds relying on the limited derivatives user exception. The Proposing Release states only that a fund must "promptly" reduce its derivatives exposure to the 10% threshold or come into compliance with the derivatives risk management program.³⁹ We recommend that the SEC include a specific cure period of at least 14 calendar days for breaches of the 10% limit by limited derivatives users. This specific cure period will alleviate

³⁸ The recent market dislocation triggered by the COVID-19 health scare, commencing on March 9, 2020 and still ongoing as of this writing, presents a real-time example of a situation where a too-short remediation period could cause additional harm to funds.

³⁹ 85 Fed. Reg. at 4486.

uncertainty about how quickly a fund will be expected to unwind, close out, or terminate derivatives transactions, which would be particularly beneficial for funds with open derivatives transactions on foreign markets with different market closure days than the United States markets.

Finally, we believe that, whether or not the SEC ultimately incorporates the foregoing proposals into the Final Rule, any application of a time-limited cure period should be limited to “normal market conditions.” In other words, funds should be relieved from the obligation to effect a cure of an exceedance within the rule’s specified number of days if the fund declares that it is experiencing “distressed market conditions”.

G. The SEC should revise the definition of limited derivatives user to exclude FX forwards hedging portfolio holdings from the definition of “derivatives exposure” used to calculate the 10% test.

We understand that the SEC intends the exposure-based exception to be a simple way to assess and limit the extent to which a fund uses derivatives in its investment strategy. However, as the Proposing Release notes, using currency hedges solely to hedge currency risk does not raise the policy concerns underlying Section 18 of the 1940 Act that the Proposed Rule is intended to address.⁴⁰ If currency hedging transactions do not raise these concerns, the SEC should disregard them when determining whether a fund needs a derivatives risk management program or adherence to very limited leverage limits. The limited derivatives user exception is valuable to funds that qualify to use it, as it alleviates the cost and compliance burden associated with implementing and maintaining a derivatives risk management program. Placing some funds in the position of having to choose between hedging their non-U.S. dollar investment currency exposure and being able to use up to 10% of the fund’s net asset value in derivatives exposure means that many funds with extensive non-U.S. dollar investments will be unable to engage in other derivative transactions, even if those transactions reduce or do not materially change the risk profile of the fund. It is unclear why the SEC would place this disproportionate burden on funds that substantially invest in non-U.S. dollar denominated securities.

Accordingly, we urge the SEC to combine the two alternative tests in the proposed limited derivatives user exception into a single test and allow funds to subtract currency hedges of portfolio assets from their derivatives exposure for purposes of determining whether the fund’s derivatives exposure is less than 10% of the fund’s net asset value. In addition, instead of using the “negligible amount” standard,⁴¹ we believe the limited derivatives user exception in the Final Rule should establish a quantifiable standard and provide that the notional amount of currency derivatives not exceed the value of the hedged instruments by more than 10% of the value of the hedged instruments. Establishing a measurable standard will avoid the pitfalls of second guessing as to whether a difference in value is “negligible” and will mitigate disparate practices among funds and their managers concerning the “negligible amount” standard.

⁴⁰ *Id.* at 4488.

⁴¹ *Id.* at 4561.

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IV. Conclusion

We appreciate this opportunity to provide comment and input on the proposals and questions contained in the Proposing Release. If the SEC or its staff has any questions regarding our letter, please do not hesitate to contact me at [REDACTED]

Sincerely,



Gifford R. Zimmerman, CFA
Managing Director and Associate General Counsel, Nuveen Funds Advisors, LLC
Vice President, Nuveen Funds

Cc: The Honorable Jay Clayton, Chair
The Honorable Hester M. Peirce, SECer
The Honorable Elad L. Roisman, SECer
The Honorable Allison Herren Lee, SECer

Dalia Blass, Director, Division of Investment Management

Appendix A

Below are several examples of unlevered funds in the Nuveen fund complex using no leverage and no or nominal amounts of derivatives that exhibit VaRs far in excess of their respective performance benchmarks:

- A municipal short duration (~3.4 years) OEF with ~\$6 billion in net assets has a Relative VaR of 129% that of its performance benchmark, the S&P Municipal Bond Short Intermediate Index. The fund's average duration is ~0.25 years longer than that of its benchmark, and the fund overweight 'A' and lower rated credits relative to its benchmark. The absolute VaR of the fund was 0.93% as of 12/31/19. The fund does not use leverage and would qualify as a Limited Derivatives User.
- An international equity OEF with several billion dollars in net assets has relative VaR of 120% that of its performance benchmark, the MSCI EAFE index. The absolute VaR of the fund was 9.48% as of 12/31/19. The fund's predicted beta relative to the MSCI EAFE index was 1.13 at 12/31/19. The fund does not use leverage and would qualify as a Limited Derivatives User.
- A domestic large cap value equity OEF with \$373 million in net assets with a relative VaR of 121% that of the Russell 1000 Value Index. The fund's predicted beta relative to that index was 1.20 as of 12/31/19. The absolute VaR of the fund was 9.6% as of 12/31/19. The fund does not use leverage or a meaningful amount of derivatives and would qualify as a Limited Derivatives User.
- A smaller but more extreme example: a state-specific municipal unleveraged CEF with less than \$100 million in assets has a relative VaR of 156% that of its state specific S&P municipal bond benchmark index. The Absolute VaR of the fund was 2.4% as of 12/31/19. The fund's heightened VaR relative to the benchmark index's VaR was primarily due to its portfolio duration being ~1.5 years longer than that of its benchmark, and the benchmark VaR being unusually low. This fund does not use leverage and would qualify as a Limited Derivatives User.

Appendix B

Below are several descriptions of common fund asset-class-and fund-type combinations that might normally be expected to find the Absolute VaR test to be the more appropriate test than the Relative VaR test under the Proposed Rule:

1. Target term fixed-income CEFs. Target term CEFs have a specified termination date to which their portfolios must be managed. These CEFs therefore invest in fixed-income securities that have effective maturities roughly coterminous with the fund's termination date, and hold those securities (or similar replacement securities) until close to fund termination. This means that the fund portfolio securities will inevitably experience reduced duration (and therefore risk, and VaR) as they approach their maturity. This in turn leads to the CEF having higher relative VaR readings in the early years of its existence (due to a relatively long average portfolio duration) and declining relative VaR readings thereafter, especially as the CEF approaches its term date. Defining a widely used benchmark for these funds that remains accurate through the life of these funds is not really possible; using Absolute VaR makes sense.
2. Leveraged CEFs. Depending on whether or not, in the Final Rule, the SEC ends up increasing the Relative VaR multiplier for all fund types to be higher than 1.5x (as we advocate in III.A. above), or establishing a higher relative VaR multiplier for CEFs than the multiplier for OEFs and ETFs (as we advocate in III.B. above), it may be virtually impossible for a leveraged CEF to find a DRI that truly mirrors its ex-derivatives investment program and risk profile in a way that permits the CEF to engage in derivatives transactions that still generate less cumulative "leveraged exposure" than the 2.0x leverage permitted to a CEF under Section 18 of the 1940 Act. Consider a CEF that leverages itself via preferred stock such that its leverage ratio is 1.6x (still far less than the theoretical maximum leverage ratio of 2.0x for a CEF that leverages itself via senior securities representing equity, which requires 200% asset coverage under Section 18 of the 1940 Act). Especially if such a CEF cannot use a "leveraged index" as its DRI, that CEF simply cannot as a purely mathematical matter be expected to maintain its VaR within 1.5x of its unlevered benchmark if that benchmark exhibits a VaR equal to the fund's portfolio VaR, because that CEF would (all other things held equal) already have a relative VaR of 1.6x that of its DRI. Therefore, such fund should be able to declare that no unlevered benchmark is available that fairly represents the risks commensurate with that CEF, and should be freely able to elect to be governed by the Absolute VaR limit.⁴²
3. Equity funds with covered call overlays. These funds tend to use "covered call indices" as their most suitable performance benchmark; but under the Proposed Rule these funds may need to select an ill-fitting widely-used benchmark index as its DRI because the covered call indices may not constitute "unleveraged indices." Any guidance the SEC could provide in the adopting release of the Final Rule as to whether overwrite indices constitute leveraged or unleveraged indices would be helpful to the industry.
4. Fund-of-funds or multi-manager structures. Many of these funds would need to create and maintain a blended index to serve as a DRI for relative VaR testing. Selecting two or more broad-based, widely-used benchmark indices to fashion a custom blended index to use as a DRI is operationally complex and costly, because doing so involves, among other things, paying additional index providers for data feeds, programming operational systems to

⁴² This concern could of course be substantially reduced or even eliminated if the SEC adopts in its Final Rule a Relative VaR multiplier or an Absolute VaR maximum for CEFs that is much higher than the ones in the Proposed Rule.

incorporate this third benchmark for the fund, and tracking changes to the component indices to ensure that the custom blended Relative VaR benchmark index remains compatible with the fund strategy.