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***<u>VIA ELECTRONIC SUBMISSION</u>***

April 21, 2020

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

**Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (File No. S7-24-15)**

Dear Ms. Countryman:

We appreciate the opportunity to comment on the Securities and Exchange Commission's (the "Commission's") above-referenced proposed rule governing use of derivatives and similar instruments by registered investment companies and business development companies (the "Proposal"). The Capital Group Companies is one of the oldest asset managers in the United States. Through our investment management subsidiaries, we actively manage assets in various collective investment vehicles and institutional client separate accounts globally. The vast majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies managed by Capital Research and Management Company, distributed through financial intermediaries and held by individuals and institutions across different types of accounts.

We strongly support the Commission's efforts to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and other transactions involving leverage. We believe the Proposal is an effective way to address the investor protection concerns underlying Section 18 of the Investment Company Act of 1940 and that it is a significant improvement over current asset segregation practices and the Commission's 2015 proposal on the same topic. In particular, we believe that creating leverage limits that constrain economic risk, coupled with a derivatives risk management program, is a better way to constrain leverage and prevent undue speculation by funds than limits based on the aggregate gross notional exposure of a fund's derivative transactions, as proposed in 2015.

While we support the general framework of proposed Rule 18f-4, we generally agree with the comments submitted by The Investment Company Institute (the "ICI Letter") and SIFMA-Asset Management Group (the "SIFMA Letter" and together with the ICI Letter, the "Industry Letters")[1], particularly on the following key issues:

1. **The leverage limits for the relative and absolute VaR tests should be increased to 200% and 20%, respectively.**

In order to allow funds to manage their portfolios effectively and to promote global harmonization, the leverage limits for the relative and absolute VaR tests should be increased to 200% and 20%, respectively. We understand that the Commission chose the 150% relative VaR limit based on analogy to the 300% asset coverage requirement for bank borrowings under Section 18. We do not think this analogy is appropriate. Whereas the restriction on bank borrowings isolates the leverage incurred to the bank borrowings, the VaR measurement includes leverage effects from non-derivative instruments and can also be impacted by other variables. For example, if a fund holds more assets in a volatile industry or geography (such as oil or emerging markets) or generally holds longer duration cash instruments than its "designated reference index," the VaR ratio would be impacted in ways unrelated to the leveraging impact from derivatives. In this way, the 150% relative VaR limit could limit funds' ability to use derivatives more severely than bank borrowings.

Moreover, a relative VaR test that is too tight could have an adverse impact on actively managed funds by encouraging such funds to match their benchmark as closely as possible in order to minimize any impact to relative VaR that is unrelated to derivatives. This would also frustrate investor choice, as actively managed funds are chosen by investors for the ability of the manager to choose investments (not simply match the benchmark) and potentially beat the market. In addition to the data presented in the ICI Letter, we note that additional flexibility past 150% is particularly needed in stressed market conditions when volatility is very high and relative VaR could be impacted by multiple factors, as discussed above. We have seen this play out recently as the markets have reacted to the COVID-19 pandemic – indeed, in recent days the relative VaR of certain funds have increased significantly for reasons unrelated to the impact of derivatives or leverage (for example, for funds that have additional weight relative to the benchmark in oil or travel-related companies).

We also believe there are significant benefits to harmonizing the limits with the requirements for managers of UCITs. We believe this harmonization should create operational efficiencies, facilitate compliance by global managers and ultimately result in lower costs for fund shareholders.

[1] Comment Letter of The Investment Company Institute, File No. S7-24-15 (April 20, 2020); and Comment Letter of SIFMA – Asset Management Group, File No. S7-24-15 (April 21, 2020).

**2. Funds should have five business days to remediate VaR test breaches.**

The Proposal requires that funds remediate VaR test breaches within three business days, after which time board reporting, analysis and updating of program elements and limitations on new derivative transactions would apply. We believe that this period of time is too short and could lead to sales and other actions that are not in the best interest of fund shareholders. This is particularly the case during times of high market volatility and market dislocation, such as we are currently experiencing. We would therefore propose to extend the remediation period to five business days, and generally echo the comments made in the Industry Letters in this regard.

**3. A fund's investment manager should be allowed to serve as the derivatives risk manager and the rule should also allow any qualified employee of the investment manager (not simply an officer) to be part of a derivatives risk manager group.**

We agree with the comments in the Industry Letters that additional flexibility should be allowed to permit a fund's investment adviser as an entity to serve as derivatives risk manager, consistent with Rule 22e-4 (the liquidity rule). We also believe that any employee of the investment manager (not simply an officer) should be permitted to be part of a derivatives risk manager group. To the extent that the derivatives risk manager consists of a group of persons, it would likely include associates from across the organization to ensure a broad perspective. Depending on the structure of the investment manager, certain associates may not have officer titles and we don't believe it would be beneficial to require funds to award officer titles simply for this purpose.

**4. Confirm that the fund board role is general oversight and require board reporting in summary format and only for material exceedances and matters.**

We echo the concerns raised in the Industry Letters regarding language in the Proposal that suggests that the fund board should take a more managerial role with respect to a fund's derivatives management program than under the corresponding board oversight role under Rule 22e-4 with respect to the liquidity risk management program, and that board obligations under the proposed rule would go beyond a board's oversight obligations under Rule 38a-1. For example, the Proposal states that the board "should understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program" and also states that the board should view oversight as an "iterative" process. We do not believe that fund boards should be assigned the responsibility of being actively engaged in the management and administration of the derivatives risk management function, as that role is more appropriate for the investment adviser and the derivatives risk manager. Requiring fund board involvement at this level would duplicate functions that the derivatives risk manager would perform and supervise. Accordingly, we request that the Commission clarify that the board's expected level of involvement is consistent with the general oversight role under Rule 22e-4 and Rule 38a-1.

Moreover, we agree with the comments in the ICI Letter that rather than requiring detailed reports to the boards on exceedances of risk guidelines and the results of certain stress testing and backtesting, the derivatives risk manager should instead be permitted to provide executive summaries of relevant findings, similar to the framework under Rule 22e-4. As opposed to requiring extensive reports and information, we agree that executive summaries would allow a fund's board to receive only relevant information and would allow them to better evaluate actual concerns raised by a fund's use of derivatives and request additional information as needed.

Relatedly, we note specifically that section (c)(5)(iii) of the proposed rule requires the derivatives risk manager to provide the fund board, at a frequency determined by the board, a written report regarding the manager's analysis of "any exceedances" relating to risk guidelines, and the results of stress testing and backtesting. Consistent with the comments in the Industry Letters, we do not believe that it makes sense to distract fund boards from their oversight role by providing analysis and discussion of non-material issues (for example, a risk guideline that is minimally exceeded and that is brought back into compliance on the same day). Moreover, while funds may desire to set derivatives risk thresholds at low levels, the requirement to disclose even an immaterial breach of such thresholds would have the perverse effect of discouraging such practices. For these reasons, we believe it would be more appropriate to limit regular board reporting to material exceedances or other material issues arising from the results of stress testing and backtesting.

**5. Add provisions for sub-advised funds.**

We agree with the comment in the SIFMA Letter that the proposed rule would create unique challenges in the case of sub-advisory relationships. The Commission should clarify that a derivatives risk manager may delegate derivatives risk management functions (for example, establishment of risk guidelines, stress testing and VaR backtesting) to the sub-adviser. In these cases, we believe it would be appropriate for the primary adviser to retain full responsibility for reporting to the fund board and for making required filings to the Commission (such as on Form N-RN).

**6. Do not require public disclosure of derivatives exposure, VaR results and VaR backtesting exceptions.**

We do not believe that it is useful to investors or appropriate to require funds to publicly report on Form N-PORT the following information for each reporting period: (i) derivatives exposure at the end of the reporting period, (ii) highest and median daily VaR, (iii) highest and median daily VaR ratio and (iv) the number of backtesting exceptions the fund identified. Instead, this information would be more appropriately reported non-publicly and to the Commission only. As discussed in more detail in the ICI Letter, we do not believe that a fund's derivatives exposure based on gross notional exposure is useful information regarding portfolio leverage or risk, and could therefore be misleading to investors. Moreover, given the technical nature of the VaR metric, it would be confusing to investors to provide VaR and VaR ratios without further context describing how these numbers should be interpreted. Information on backtesting exceptions could be similarly misleading. As the Commission noted in the Proposal, using a VaR model with a 99% confidence level, funds would be expected to experience backtesting exceptions approximately 2.5 times a year. If funds experience backtesting exceptions more or less frequently, this could suggest that there is an issue with the VaR model, but it could also be due to statistical variation. The vast majority of investors will not have the background to understand these nuances, including that 2.5 exceptions per year would be *expected*. For these reasons, without significant explanation, reporting of backtesting exceptions could cause misunderstanding about whether the fund is complying with its leverage limits.

**7. Extend the compliance date to 24 months after the effective date.**

We agree with the comments in the Industry Letters that the proposed implementation period of the Proposal of one year is too short. We note in particular that funds will need time to implement VaR models and create or modify current derivatives risk management programs and policies to incorporate all the required elements in the final rule. This will require system updates and other technological enhancements and potentially coordination with outside vendors. Moreover, as this rule poses similar complexities as the liquidity risk management and investment company reporting modernization rules, we believe that a similar implementation period of 24 months would be appropriate.

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We appreciate the opportunity to comment on the Proposal and are grateful for your consideration of our recommendations. If you have any questions regarding our comments, please feel free to contact Rachel V. Nass at (213) 615-0423.

Sincerely,

Mark E. Brubaker
Senior Vice President & Senior Counsel
Capital Research and Management Company

Rachel Nass

Rachel V. Nass
Vice President & Associate Counsel
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cc: The Hon. Jay Clayton, Chairman
The Hon. Hester M. Peirce, Commissioner
The Hon. Elad L. Roisman, Commissioner
The Hon. Allison Herren Lee, Commissioner
Dalia Blass, Director, Division of Investment Management