April 30, 2020

Via Electronic Delivery

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

RE: **Proposed Rule on 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**

Dear Ms. Countryman,

We appreciate the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "Commission") on its recent proposed rule regarding the use of derivatives by registered investment companies and business development companies (the "Proposed Rule").[1]

Executive Summary

I. We recommend that the exception available for currency hedging transactions should be expanded to include interest rate hedging and risk-reducing derivatives transactions, as demonstrated by measuring the reduction in incremental VaR created by such transactions.

II. We recommend extending the period for fund managers to execute risk-reducing trades to bring the portfolio in compliance following a breach of the applicable VaR test limit.

III. We recommend excluding reverse repurchase agreements from the definition of derivatives exposure and from the VaR calculations for all funds.

IV. We recommend allowing fund advisers to appoint not only the adviser's officers, but other qualified employees to serve as a fund's derivatives risk manager.

I. Modifying the Hedging Exception to Include Interest Rate Hedging and Risk-Reducing Derivatives Transactions

Derivatives can be an essential portfolio management tool for hedging a portfolio's risks, particularly interest rate, currency, and credit risks. Investors have long selected certain funds for investment with reliance on robust disclosure that derivatives are and will be used for hedging purposes as part of the fund's investment strategy. If a fund manager's access to these key risk management tools were to be limited, even as an unintentional consequence of the Proposed Rule's requirements, a fund's ability to effectively execute its investment strategy may be negatively impacted and the fund's performance could become more volatile.

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[1] Investment Company Act Release No. 34-87607; 85 Federal Register 4446 (January 24, 2020) ("Proposing Release").

We support the Proposed Rule's exception from the Derivatives Risk Management Program requirement and the VaR-based limit for funds that either: 1) limit derivatives exposure to 10% of net assets ("exposure-based exception"), or (2) use derivatives only to hedge certain currency risks ("hedging exception"). The Proposed Rule acknowledges that an exception for the use of certain derivatives for hedging purposes is appropriate. However, the hedging exception as currently proposed is limited to currency hedging only.

We believe the scope of the hedging exception should be broadened to include derivative transactions used for hedging interest rate risk.

Similar to currency hedging, as a part of a prudent risk management framework, funds may enter into derivatives contracts, including swaps and futures contracts, for the primary purpose of hedging interest rate risk. The overall effect on the portfolio of entering into such derivatives transactions is a reduction of risk. We believe that transactions that hedge and reduce interest rate risk do not raise the leverage and asset sufficiency policy concerns underlying Section 18 of the 1940 Act, consistent with the views of the SEC regarding transactions that hedge currency risk as stated in the Proposing Release. The risk reduction achieved through these hedging transactions can be demonstrated through the incremental VaR approach as described below. Therefore, we recommend that derivatives used solely for hedging interest rate risk be exempted in the same manner as currency hedging transactions under a broadened hedging exception.

We note that the hedging exception for funds that use derivatives transactions solely to hedge certain currency risks is not based upon the use of any particular instrument defined as a "derivatives transaction" under the Proposed Rule. We support the flexibility of funds to employ a range of instruments to hedge currency risks and suggest applying the same principle toward management of interest rate risk. For example, "to be announced" dollar rolls ("TBAs") are often used to hedge interest rate risk for mortgage-backed securities ("MBS"). The TBA market allows a fund to purchase or sell MBS securities with a price known today and a settlement date in the future. Therefore, mortgage originators can hedge the price risk of their mortgage production prior to sale. As such, TBAs and other derivatives instruments should be able to be used by funds under the proposed broadened hedging exception.

We support the Proposed Rule's requirement that funds falling under the limited derivatives user exception adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks.

In response to the requests for comments to specific questions listed on pages 4487-4488 of the Proposing Release under items 157 and 158 regarding the use of hedging to adjust derivatives exposure for purposes of the exposure-based exception, we provide the following responses, which we believe apply equally to our proposed modified hedging exception:

- **How to objectively define hedging derivative transactions.** We propose requiring funds that rely on the hedging exception to calculate the incremental VaR for all derivative transactions. If the purpose of a given transaction is to reduce risk, the incremental VaR calculation would be negative and could serve as evidence of the transaction falling within the hedging exception. In other words, risk of overall portfolio should be reduced after the hedging transactions are executed. Derivatives with positive incremental VaR, regardless of the declared purpose, would disqualify a fund from relying on the proposed modified hedging exception.

- **Would the compliance burden to calculate hedging transaction for purpose of such adjustments justify the benefits of permitting these adjustments?** The short answer is no. If the Commission adopts our recommended incremental VaR approach, the verification and monitoring of whether derivatives have the effect of reducing risk should be straightforward. The incremental VaR approach is objective and conducive to automation, allowing fund managers to efficiently monitor and maintain records of whether derivatives transactions result in reduced risk.

- **Should the Commission specify in the rule that a fund calculating its derivatives exposure for purposes of the exposure-based exception may net any directly-offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms?** We believe that transactions that are reasonably believed to create offsetting exposures, as shown through the incremental VaR approach described above, will not raise the leverage and asset sufficiency policy concerns underlying Section 18 of the 1940 Act. We recommend that funds be allowed the flexibility to determine which types of derivatives transactions may properly offset other derivatives transactions. For instance, a fund should be permitted to offset a futures contract against a swap, if the offset reduces exposure and risk, as measured by the incremental VaR approach.

II. Allowing for a Longer Period to Correct Breaches of the VaR Test Limits

The Proposed Rule requires a fund other than a limited derivatives user to determine its compliance with the applicable VaR test at least once each business day. When a fund falls out of compliance with its VaR test, it must return to compliance within three business days or the Fund is subject to reporting requirements on Form N-RN and must take certain remedial actions.

We appreciate the Commission's view that it would be inappropriate for a fund to purposefully exceed the applicable VaR-based limit. However, it is difficult to predict the magnitude of a risk-reducing trade as measured by VaR. This is because the VaR calculation is inherently subject to various sources of model errors. For example, correlation is one of the parameters that needs to be estimated in order to implement any parametric VaR model. Before a risk-reducing trade is executed, it is difficult to accurately estimate its correlation with the existing portfolio, and therefore its impact on the VaR calculation. While we can measure whether a given derivatives transaction will reduce risk through an incremental VaR calculation, it is not always possible to predict the magnitude of that risk reduction.

With a short, three-day opportunity for correction, a fund's portfolio managers may be inclined to overcompensate in order to ensure that VaR is reduced sufficiently to avoid a reporting obligation under the Proposed Rule and having to take the required remedial actions. Such overreaction could adversely impact a fund's performance. Therefore, we recommend a longer period, such as 5 business days, prior to the application of the reporting and remedial action requirements, as long as a fund can show evidence that risk reducing transactions were placed within a reasonably short period after the VaR limit was exceeded.

III. Excluding Reverse Repurchase Agreements from Derivatives Exposure and VaR Calculations

A reverse repurchase agreement is a transaction in which a fund transfers a security to another party in return for cash with an agreement to repurchase the security at a later date. The Proposed Rule would provide that the use of reverse repurchase agreements is a form of short-term borrowing which should be treated the same as bank borrowings in a fund's asset coverage calculation. Reverse repurchase agreements are an important portfolio management tool, particularly for liquidity risk management purposes.

The Proposed Rule allows limited derivatives users to exclude reverse repurchase agreements from their derivatives exposure calculation, while funds that cannot comply with the limited use exception would need to include the VaR created by the use of reverse repurchase agreements in their VaR testing. It would be inconsistent for a fund to enjoy a higher risk limit while another fund, with an identical investment strategy that also happens to use derivatives exposure that is more than 10% of the fund's net asset, may have to limit its use of an important portfolio management tool, simply due to a more inclusive calculation method for funds that are not limited derivatives users. To create a level playing field, we recommend that reverse repurchase agreements be excluded from the VaR calculation for all funds, in addition to being excluded from the definition of derivatives exposure.

IV. Allowing Qualified Employees to Serve as the Derivatives Risk Manager

The Proposed Rule requires that a fund adviser's officer or group of officers serve as the fund's derivatives risk manager. The Proposed Rule also requires that the fund's derivatives risk manager have relevant experience regarding derivatives risk management. To meet both criteria could prove challenging as many fund advisers may have employees who are well-qualified in this area, but who are not officers of the adviser. In addition, many fund advisers have highly functioning risk management committees comprised of qualified employees, who are not officers of the company, but who may be in a much better position to manage derivatives risk on behalf of funds.

While we fully support the Commission's desire to promote accountability, we recommend allowing fund advisers to appoint qualified employees, in addition to a fund adviser's officers, to serve as a fund's derivatives risk manager. This change would align the Proposed Rule with the approach taken in appointing the Liquidity Risk Program Manager under Rule 22e-4.

Conclusion

We support the overall objectives of the Proposed Rule and are pleased to provide recommended improvements based on our deep understanding of the benefits and risks of derivatives usage for fixed income portfolio management. Investment companies' use of derivatives and other transactions addressed under the Proposed Rule is an important portfolio management tool. We believe the final rule should allow for the beneficial use of hedging in its calculation of fund exposure to risk and support the use of the VaR model. The recommended changes to the Proposed Rule would allow funds to benefit from the use of derivatives but still properly manage the associated risks.

We thank the Commission for the opportunity to provide comments on the Proposed Rule. We would welcome any questions the Commission or its staff might have regarding our recommendations.

Respectfully submitted,

Lu Chang
Chief Risk Officer

Adam Langley
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