AMERICAN**BAR**ASSOCIATION

Business Law Section

321 N. Clark Street
Chicago, IL 60654-7598
T: 312-988-5588 | F: 312-988-5578
businesslaw@americanbar.org
ababusinesslaw.org

May 1, 2020

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

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:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section of the American Bar Association (the "ABA") with respect to the above-referenced release proposing a new Rule 18f-4 ("Rule 18f-4") under the Investment Company Act of 1940 (the "Investment Company Act"); and new rules 15*l*-2 under the Securities Exchange Act of 1934 (the "Exchange Act") and 211(h)-1 under the Investment Advisers Act of 1940 ("Advisers Act") (collectively, the "sales practices rules") and related amendments to other rules (Rule 18f-4, the sales practices rules and the related amendments to other rules are collectively referred to herein as the "Proposed Rules") and requesting comments on the Proposed Rules.

This letter was primarily prepared by the Committee's Task Force on Investment Company Use of Derivatives and Leverage. The members of the Task Force, which was formed in 2009 to prepare a report on the use of derivatives and leverage (the "Task Force Report")[1] at the request of the then Director of the Commission's Division of Investment Management and has continued to comment on the Commission's subsequent concept release and proposals, are practitioners with diverse views that represent funds, investment advisers, and independent trustees and directors of funds ("directors"), among others. The comments set forth in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and should not be construed as representing the policy of the ABA. In addition, this letter does not

[1] *The Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010).

represent the official position of the ABA Section of Business Law nor does it necessarily reflect the views of all members of the Committee.

The Committee thanks the Securities and Exchange Commission (the "Commission") for this opportunity to comment on the Proposed Rules. Set forth below is a general summary of the Committee's views, followed by specific comments related to the Proposed Rules.

Summary of Comments

The Committee commends the efforts of the Commission in establishing a streamlined regulatory framework for fund[2] use of derivatives and appreciates the Commission's endeavor to make such arrangements more flexible for funds. In the Committee's view, the Proposed Rules represent a significant advance over the Commission's 2015 proposal on the use of derivatives by funds (the "2015 Proposal"). Provided that the final rules reflect the modifications and clarifications summarized below, the Committee endorses the adoption of the Proposed Rules.

The Committee supports the Proposed Rules' framework for derivatives risk management in large part, but proposes several adjustments to soften unduly rigid requirements that fail to account for the differences between funds that would seek to comply with the Proposed Rules. We are specifically concerned that smaller firms may have significant difficulty complying with the Proposed Rules' requirement that derivatives risk management be segregated from portfolio management. We recommend that the Commission afford additional flexibility to smaller firms by allowing a fund's investment adviser to serve as its Derivatives Risk Manager ("DRM"), or in the alternative, permit an individual to serve as the DRM of multiple funds, an individual to serve as both liquidity manager and DRM, and/or a third-party service provider to serve as DRM.

In addition, we request that the Commission clarify that a DRM need not have expertise in all aspects of derivatives risk, and that the DRM may receive substantive input from others as appropriate, including investment advisory personnel and portfolio managers. We also suggest that the final rules grant a DRM substantial flexibility in the manner in which it reports material risks to a fund's board (for instance, the DRM of a smaller firm could report informally).

With respect to the structure and implementation of the derivatives risk management program ("Program"), the final rules should reflect that Programs will differ materially as between funds or portfolios. In particular, the final rules should provide that VaR may be calculated to account for, and risk limits may be expanded to account for, derivatives that may reduce extreme tail risks. Further, our view is that the final rules should not include a tailored version of the Program requirement, including the establishment of risk guidelines, for limited derivatives users. Additionally, the final rule should not include a requirement to adopt guidelines providing for quantitative metrics of the fund's derivatives risks, specify a menu of guideline categories or require funds to publicly disclose the guidelines that they use. We also request that in place of a weekly stress testing and daily back testing requirement, the DRM be required to conduct stress testing and back testing to the extent the DRM deems reasonably necessary.

[2] The term "fund" as used herein refers to mutual funds (other than money market funds), exchange-traded funds ("ETFs"), closed-end funds that are registered under the Investment Company Act, and companies that have elected to be treated as business development companies ("BDCs") under the Investment Company Act.

Additionally, we believe that the Commission should strongly consider harmonizing its proposal with the existing UCITS regime regarding derivatives risk management, including VaR limits and stress testing, as the UCITS regime is well-established and has thus far proved both workable and effective in mitigating risks associated with the use of derivatives. The Committee believes that the Commission should encourage the use by investors of closed-end funds as alternatives to unregistered hedge funds. As such, to the extent the Commission opts to impose leverage limits upon closed-end funds, it should expand the VaR limits for closed-end funds, and should not impose any limitations upon closed-end funds sold to "qualified clients" or in certain private offerings. Additionally, closed-end funds should not be required to maintain compliance for any time once they have cured a VaR limit breach.

The Committee appreciates the Commission's recognition that a fund board's role with respect to derivatives risk management is one of oversight and not management. However, we note that numerous requirements in the Proposed Rules would cause a board to become actively involved in a fund's Program, which could substantially burden directors and require them to develop an unrealistic degree of expertise in derivatives risk management. As a general matter, the final rules should reflect that a fund's board may reasonably rely on management, the fund's CCO and investment advisory personnel in discharging the board's oversight duties, including the board's initial approval of the DRM if that requirement is retained in the final rules; we recommend that it be deleted. Further, the final rules should clarify that there is no requirement for a fund's board to evaluate the adequacy of the Program and the effectiveness of its implementation, either initially or on an ongoing basis, and should omit the requirement that the DRM furnish a board with information reasonably necessary to undertake such an evaluation. The Committee also notes that the requirement that a board receive regular reports from the DRM on the Program (at a frequency determined by the board) would be unnecessary in light of the DRM's obligation to escalate material risks to the board.

The Committee supports the Proposed Rules' treatment of unfunded commitment agreements, including the proposed requirement that a regulated fund may enter into unfunded commitment agreements only if it has a reasonable belief that it will be able to meet its obligations under all of its unfunded commitment arrangements when due. This requirement is consistent with current industry practice, and represents an improvement over the 2015 Proposal's liquid asset segregation requirement.

The Committee wishes to express several fundamental objections to the proposed sales practices rules. As an initial matter, the proposed sales practice rules would be an unprecedented example of merit-based regulation, which would undermine the Commission's long-standing approach to securities regulation of implementing neutral, disclosure-based protections and would inappropriately substitute the Commission's judgment for that of fully informed investors. Further, the care obligation imposed upon broker-dealers by Regulation Best Interest, and the duties imposed upon investment advisers under the Commission's recent guidance concerning leveraged or inverse investment vehicles, suffice to protect investors against the risks of leveraged or inverse investment vehicles and obviate any need for the highly prescriptive sales practices rules.

The Committee questions why leveraged or inverse investment vehicles should be singled out for distinct treatment from other complex products, and is concerned that the adoption of the proposed sales practices rules could result in broker-dealers and advisers declining to offer leveraged or inverse products. Similarly, the Committee views the sales practices rules as particularly ill-fitting in the context of discretionary advisory relationships, in which the adviser's

role is to assess the risks of products on the client's behalf, rendering the proposed diligence requirements superfluous. The Committee therefore requests that the sales practices rules (even if modified) not be applied to discretionary advisory accounts. The Committee also believes that the rules should not apply to transactions in which no recommendation or investment advice is provided by a firm.

The Committee's detailed comments follow.

I. Derivatives Risk Management Program

The Proposed Rules would generally require a fund (other than a fund that is a limited user of derivatives) to adopt a written derivatives risk management program (the "Program") with risk guidelines that must cover certain elements, but that otherwise would be tailored based on how the fund's use of derivatives may affect its investment portfolio and overall risk profile.[3] The Committee supports the Proposed Rules' more principles-based approach to the regulation of fund use of derivatives (as compared to the more prescriptive approach in the 2015 Proposal) and believes that it appropriately recognizes that funds use derivatives in a variety of ways and to achieve differing goals (*e.g.*, as a means to gain desired investment exposures or as a tool for hedging). There are a few elements of the Program and management and oversight of the Program that the Committee believes could be further clarified and enhanced. These items are discussed below.

A. Separation of the Program from Portfolio Management

With respect to the separation of functions in the DRM, the Committee agrees with the Commission that segregating derivatives risk management from portfolio management may serve to mitigate potential conflicts of interest. However, we note that imposing requirements that do not take into account differing sizes and organizational structures of investment advisers to registered funds may disproportionately burden smaller advisers and reduce competition. In smaller firms, it may not be possible to rigidly segregate functions. In these firms, the portfolio managers may be the principal employees possessing the essential derivatives experience and hiring a person to be a separate DRM may not be economical (and may not represent full time employment). Potential DRMs with the requisite experience, as required by the Proposed Rule, are in demand in the marketplace and command significant salaries.

Our recommended approach is to permit a board to designate a fund's investment adviser as the DRM. This approach would provide the adviser the flexibility to designate the appropriate personnel to serve in this function, subject to the oversight of the board, and with the proviso that the DRM of any one fund cannot be the portfolio manager or member of the portfolio management team with respect to that fund. This approach would also place the burden on the investment adviser rather than the Board to assess the qualifications of individual personnel, as we believe the investment adviser is better positioned to perform this task.

Should the Commission not favor an approach that would allow the board to designate the fund's investment adviser as the DRM, we urge the Commission to provide for flexibility. For

[3] Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Release IC-33704 (December [24], 2019) ("Proposing Release").

example, the rule could contemplate allowing the portfolio manager of one fund to be the DRM of another fund. Just as the chief compliance officer of a fund cannot be expected to be an expert in corporate governance, law, accounting, valuation, portfolio management and distribution, it is unrealistic to set standards for an individual DRM that only the largest firms can afford to employ. Instead, we would urge the Commission to permit a fund to appoint a DRM who has sufficient knowledge of derivatives to oversee the Program and who is not the portfolio manager of the specific fund, or alternatively, to permit the function to be performed by a committee. In addition, given the costs involved and the fact that being a DRM may not be a full-time job at a smaller fund complex, we urge the Commission to consider permitting the same person to serve as liquidity risk manager and/or permitting third-party service providers to serve as DRMs, at least for smaller fund complexes.

We also urge the Commission to clarify that portfolio managers have important roles to play in providing input to the Program, just as they do for other aspects of compliance, liquidity[4] risk management and valuation. Anecdotal evidence from recent market events suggest that portfolio managers have a very important role to play in assisting funds in evaluating and reacting to market events, including in respect of matters relating to derivatives. These roles may be subject to the oversight of the DRM, but are no less important. We note that securities and derivatives markets can frequently change and those closest to day-to-day trading are often best positioned to assess changes, including changes to risks and the liquidity of instruments.

In response to the Commission's question as to whether advisory personnel should be prohibited from coercing or unduly influencing the DRM in the performance of its duties, we believe that substantially the same standards regarding undue influence should apply to the DRM as currently contained in Rule 38a-1(c), which prohibits specified persons from directly or indirectly unduly influencing a fund's chief compliance officer in the performance of his or her duties. We believe that having consistent standards will make a Program much easier to administer. In order to encourage healthy and constructive discussions among fund personnel, the Commission should clarify that a portfolio manager's providing views on risks or the appropriate use of derivatives does not, in and of itself, constitute coercion or undue influence.

B. Experience of the DRM

In response to Question 12 on what constitutes relevant experience for serving as a DRM, we note that the standard of "relevant experience regarding the management of derivatives risk" is vague, particularly in light of the risks identified in the Proposing Release.[5] We also note that any one person serving as DRM could have significant experience with one type of derivative (*e.g.*, futures) and have less or no experience with another (*e.g.*, swaps).[6] Operational risk, legal risk, liquidity risk, counterparty risk, market risk and leverage risk have very different components, requiring different skill sets, including skill sets normally associated with the investment advisory function. Many of these functions require detailed knowledge of a fund's portfolio. Therefore, we suggest that the Commission clarify that "relevant experience" is not a standard that requires

[4] We note that the Commission's Rule 22e-4 adopting release similarly recognized that portfolio managers have an important role in advising the administrator of a liquidity risk management program (the "Program Administrator"), but the Program Administrator should not be wholly comprised of portfolio managers as a safeguard against undue influence over the risk management function. Investment Company Liquidity Risk Management Programs, Release IC-32315 (October 13, 2016).
[5] Proposing Release at 56–57.
[6] Proposing Release at 52.

an individual have expertise in all aspects of the enumerated derivatives risks and that substantive input from others at an advisory firm is expected. We further believe that the final derivatives rule should permit investment advisory personnel to administer the DRM, provided the adviser establishes appropriate procedural safeguards. For example, safeguards could provide that advisory personnel responsible for the management of a particular fund may not serve as the DRM with respect to that fund. Similarly, we believe that an investment adviser should be able to serve as liquidity risk manager and that no amendment to Rule 22e-4 under the 1940 Act is necessary.[7]

C. Identification and Assessment of Risk

While we agree with the general framework provided by the Proposed Rule for the identification and assessment of derivatives risk, particularly the benefits of a "more-tailored derivatives risk management program," we request the Commission to clarify that it recognize that Programs across fund complexes may differ in significant ways. In particular, such factors as the specific use of derivatives, the nominal values of different positions, the overall fund portfolio and different types of derivatives may lead to very different assessments of risks across portfolios or fund complexes.

Further, as in other areas (custody risk, for example), some risks are inherent in the utilization of each type of derivative and a requirement for "management" or "mitigation" of risks should not effectively prohibit such utilization.[8] We note that certain "alternative investment" funds maintain strategies, *e.g.*, long-short strategies, intended to be protective in adverse market conditions but, given their use of "out of the money" derivatives, may show a higher daily VaR than less protected funds. For this reason, and because the most relevant reference indices may involve private funds that do not have daily marks, we recommend, in response to Question 101 (pp. 113–114), that the final rule provide explicitly that VaR may be calculated to account for, or that risk limits (including absolute as well as relative) may be expanded to take account of, derivatives that may reduce extreme tail risks for certain funds such as alternative investment funds. Moreover, we suggest that the Commission clarify that closed-end funds be permitted to measure compliance against broad indices that do not mimic their strategies or only at such time as a relevant index (*e.g.*, hedge fund index) is reported (*e.g.*, quarterly). See also other comments regarding closed-end funds, below.

D. Risk Guidelines

We agree with the Commission that fund complexes should adopt investment, risk management, or related guidelines that are tailored to the fund's particular circumstances. In response to Question 165,[9] we believe that adding a "tailored version of the proposed [derivatives risk management] program requirement" that might include, among other things, "establishing risk guidelines" for limited derivative users is neither warranted nor practical. Indeed, in some circumstances, it may discourage limited users from using any derivatives even when it might be beneficial to a fund to limit overall portfolio risk. Further, adding this requirement would seem to

[7] *See* Question 17, Proposing Release at pp. 53–54.
[8] *See* Release No. IC-24424 (May 3, 2000). (The Commission noted that depository risk is inherent in investing in some countries. "The decision to place fund assets with a depository does not have to be made separately, but may be made in the overall context of the decision to invest in a particular country").
[9] Proposing Release at 170.

contradict the philosophy of having "limited derivatives users" be subject to significantly reduced requirements.

We do not support inclusion of a requirement to adopt guidelines that provide for "quantitative or otherwise measureable criteria, metrics, or thresholds of the fund's derivatives risks."[10] Evaluating certain risks involves a degree of judgment that is not capable of being measured quantitatively. For example, both legal and operational risks are exceedingly difficult to quantify and any quantification of such risks would result in false precision, which could be misleading in rapidly changing market conditions. Moreover, some aspects of these risks are beyond the ability of fund groups to quantify.[11]

Further, to a large extent, quantitative measures are used, where appropriate, in the stress-testing components of the Proposed Rule, and mandating separate quantitative measures to gauge the same risks appears to be duplicative. We suggest, as an alternative, that the Program be required to include non-duplicative quantitative risk measures, as appropriate to the type of risk, in developing the Program.

We do not believe that the Commission should specify a menu of guideline categories.[12] We believe that a rigid application of such guidelines would both stymie the development of new more sophisticated measures over time, and be contrary to the intent of the Commission in encouraging fund groups to tailor their own Programs. We believe that flexibility instead of rigid "check-the-box" activity is better suited for the complexity and breadth of derivatives use, which will continue to develop over time. Even Rule 2a-7 under the Investment Company Act, which is designed to encourage funds to be managed similarly, permits money market funds to make their own evaluation of minimal credit risk.[13]

We do not believe that funds should publicly disclose the guidelines that they use.[14] We note that such disclosure would be inconsistent with the practice regarding other compliance guidelines and are of the view that such disclosure would not be particularly helpful to investors. Moreover, funds should be encouraged to revise and enhance their guidelines as risks and circumstances demand. A requirement to disclose each revision would be burdensome and discourage funds from revising guidelines as necessary. A requirement to periodically disclose guidelines would serve to make the guidelines more rigid and raise the costs associated with using derivatives, which may have the unintended consequence of reducing a fund's appropriate use of derivatives to the detriment of investors. Of course, any such guidelines will be available to OCIE upon request.

E. Stress Testing and Back Testing

The Proposed Rules provide for stress testing on at least a weekly basis, as well as back testing of a fund's VaR calculation model a minimum of once per business day.[15] We question

---

[10] Proposing Release at pp. 59–63.

[11] For example, DRMs will have difficulty assessing the effectiveness of regulation of clearing facilities or knowing in advance whether courts will appropriately apply protections in ISDA documentation.

[12] *See* Question 29, Proposing Release at 62.

[13] *See, e.g.,* Rule 2a-7(g)(3): "The written procedures must require the adviser to provide ongoing review of whether each security (other than a Government Security") continues to present minimal credit risks."

[14] *See* Question 31, Proposing Release at 63.

[15] Proposing Release at 64, 69.

whether mandated weekly stress testing and daily back testing will always be necessary for an appropriate assessment of a fund's compliance with its applicable VaR test. As such, in order to provide appropriate balance between providing guidance to funds in implementing stress testing without being too rigid or untailored for specific circumstances, we suggest that a fund's Program be required to provide for stress testing and back testing to the extent the DRM deems reasonably necessary to effectuate the Program.

In response to Question 36 related to whether funds should be required to conduct a particular type of stress testing,[16] we would urge the Commission to achieve an appropriate balance in the final rule by permitting funds to develop their own stress testing programs, including with respect to timing and methodology. Since market events will have varying degrees of impact based on a fund's investment strategy and use of derivatives, we believe funds should be in a position to adopt their own stress testing models and fine-tune them based on experience. As noted above, we suggest that the Commission consider permitting funds to conform stress testing standards to those that apply to UCITS as the UCITS regime has been in place for almost a decade and has proved both workable and thus far effective in mitigating risks and this would also help ease the administration and compliance costs of global asset managers.

Similarly, we generally support the requirement to regularly backtest the VAR model,[17] to the extent reasonably necessary to achieve the aims of a fund's Program. We believe that regular testing and updating of the VAR model will serve the interests of investors and can be an effective tool for continued evaluation of a Program. Nevertheless, we urge the Commission to establish a measured balance between providing guidance to funds regarding backtesting, while affording funds the flexibility to tailor backtesting to their unique needs and circumstances. We note, as one example, that daily backtesting may not be appropriate for a fund that uses derivatives only marginally more than a limited derivatives user. While we encourage the Commission to broadly consider how to strike this balance, we specifically suggest that the Commission permit funds to tailor their backtesting practices to individualized time horizons (rather than mandating a one-trading day time horizon for all funds).

F. Internal Reporting and Escalation

With respect to internal reporting and escalation, we agree that the DRM will be "best positioned to determine when to appropriately inform the fund's portfolio management and board of material risks."[18] We believe that DRMs should be afforded substantial flexibility as to the type and manner of reporting. In some smaller complexes, this reporting may be informal. In others, it may be conducted through, or with the assistance of, the legal or compliance departments. Therefore, we would urge the Commission to avoid mandating a "one-size-fits-all" reporting approach.

In response to Question 50, we do not believe that it would be advisable to require reporting of material risks to the Commission.[19] Fund companies may well over-report material risks to cover themselves for future (unknown) market events, and the resulting over-reporting would overwhelm the Commission staff with low-value information, without the staff being in a position

[16] Proposing Release at 67.
[17] Proposing Release at 69.
[18] Proposing Release at 74.
[19] Proposing Release at 75–76.

to provide any meaningful assistance. Since all trading in securities and other investments involves some material risks (as noted by the Commission's risk disclosure regime under the applicable securities registration forms), the reporting to the Commission may well become routine and boilerplate and thus would add costs and complexity without any substantial benefit.

G. Closed-end Funds

While we understand that the distinctions in Section 18 of the Investment Company Act between open-end and closed-end funds do not relate directly to the expansion of leverage through use of derivatives, we believe that the differentiation in Section 18 appropriately reflects that closed-end funds may bear additional leverage because they do not allow daily redemptions. Responding to Question 99, the Committee believes that it is appropriate, even obligatory, to reflect that distinction in a rule that attempts to limit *implicit* leverage through derivatives. We note that the Commission's previous guidance in Release IC-10666 applied only to open-end companies under Section 18(f), not to closed-end funds. If the Commission now determines to apply new limits to closed-end funds, despite their lack of parallel liquidity concerns, it should expand the VaR limits for them in Rule 18f-4 to parallel the asset coverage limits (200% vs. 300%) in Section 18 itself. In addition, other elements of the rule, such as the timing of comparison against indices and the frequency of stress testing could be adjusted for closed-end funds to parallel the specific frequency of their liquidity requirements.

Further, we recommend that the limitations be lifted entirely for closed-end funds sold exclusively to "qualified clients," as defined in Rule 205-3[20] under the Advisers Act, or in private offerings to "accredited investors" or "qualified purchasers." Alternatively, such funds could be required to set and disclose limits of their own choosing, without limitation. Such funds are already subject to heightened sales practices restrictions, including subscription agreements or other certifications that require representations as to sophistication and financial condition.

Registered closed-end funds may be, for certain investors, an alternative investment to unregistered funds, such as hedge funds. (Of course, all registered funds also benefit from protections of the Investment Company Act.) The Committee respectfully suggests that the Commission should encourage, rather than impose burdens on, registered closed-end funds that serve as private fund alternatives. An expanded framework for closed-end funds is consistent with the Commission's initiatives to open access to less liquid investments and to enhance the availability of capital to smaller companies. We believe that existing position reporting obligations will enable the Commission to monitor whether such funds exceed the risk boundaries they have disclosed to their investors. For smaller investment advisers, in particular, it would significantly ease operational mechanics if they could maintain consistency without regulatory impediment, between registered closed-end, private and UCITs funds they advise.

With respect to specific provisions of the proposed Rule, the Committee suggests that, to the extent that the rule would impose limits on closed-end funds, subsection (c)(2)(iii)(C)(iv) be changed for closed-end funds so that they do not have to maintain compliance for any period of time following their cure of a breach of their limits. Such funds should not be restricted for three

[20] When Rule 205-3 was adopted in 1985, the Commission explicitly stated that qualified clients could be "less dependent on the protections" provided by federal securities laws. *Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Release No. IA-996 (Nov. 14, 1985).

days from utilizing such tools, including derivatives, to the extent those tools could be viewed as helping them implement their investment strategies, since they do not have the constraint of needing to deal with daily redemptions. To the extent that these funds are designed to model "alternative investment" strategies to which few direct indices correspond (and fewer, if any, that can be computed daily), it would be appropriate to provide enhanced flexibility in the selection of a designated reference index for these and other closed-end funds.

II. Role of the Board

As an initial matter, we appreciate that the Commission has sought to address the concern raised in our comment letter to the 2015 Proposal (the "2016 Comment Letter") that the role of a fund's board under the new rule should remain one of oversight rather than management.[21] We applaud the Commission's statements in the Proposed Rules indicating that a board's appropriate role in the context of funds' derivatives risk management is one of oversight,[22] and we support in large part the role of a fund's board under the Proposed Rules. However, we would like to suggest several revisions to ensure that a board's role remains one of oversight rather than potentially frequent involvement in a fund's derivatives risk management activities, and that fund boards are not unduly burdened with further mandatory reports that they may not find useful in exercising their oversight responsibilities. The Committee notes in this regard that, over time, there has been a steady and substantial increase in the duties of fund directors and in the number of reports they must review, and the determinations and approvals they must make. The Committee believes that the Proposed Rules would add to this burden, albeit to a much lesser extent than the 2015 Proposal. The Committee urges the Commission to reconsider this aspect of the Proposed Rules, keeping in mind the responsibility of a fund's CCO in implementing the fund's compliance policies and procedures, including those relating to derivatives, which should generally limit the need for specific duties of fund boards in this area.

Significantly, the Proposed Rules would eliminate the 2015 Proposal's requirement that a fund's board approve the adoption of a Program, as well as subsequent material changes to the Program. The Committee supports the omission of these specific approvals, which would have risked involving fund boards to an inappropriate degree in active risk management.

The Proposed Rules would, however, require that a fund's board:

- approve the designation of the fund's DRM, "taking into account the [DRM's] relevant experience regarding the management of derivatives risk;"[23]

---

[21] *See* American Bar Association Business Law Section, Comment Letter to Mr. Brent J. Fields Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (April 8, 2016), *available at https://www.sec.gov/comments/s7-24-15/s72415-191.pdf*, at 13.

[22] *See, e.g.*, Proposing Release, at 4466 ("The proposed rule's requirements regarding board oversight and reporting are designed to further facilitate the board's oversight of the fund's derivatives risk management"), 4467 (noting that the Proposed Rules' reporting requirements are "designed to facilitate the board's oversight role, including its role under rule 38a-1").

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

- receive a report from the fund's DRM of every instance in which a fund is not in compliance with the applicable VaR test for three business days which explains how and when the DRM reasonably expects the fund to return to compliance;[24]
- receive an annual report from the fund's DRM, which would include a representation that the Program is reasonably designed to manage the fund's derivatives risks, the basis for such representation, and "such information as may be reasonably necessary to evaluate the adequacy of the fund's [Program] and the effectiveness of its implementation." The report must also present the DRM's basis for selection of the designated reference index or explain why the DRM was unable to identify an appropriate designated reference index for the fund;[25] and
- determine the frequency with which it would receive reports from the fund's DRM, analyzing any exceedances of the fund's risk guidelines, and for reports following the program's initial implementation, the results of the fund's stress tests and back testing.[26]

The Committee believes that these requirements are not necessary and may be inconsistent with a board's traditional oversight role, which the Commission has recognized as the proper role of a fund board. As noted in the 2016 Comment Letter, we encourage the Commission to avoid mandating that a fund's board deeply and routinely engage with subject matter that would as a practical matter require the board to rely upon the expertise of the fund's investment adviser or a third-party consultant.

We note that in Section II.A above, the Committee recommends that the final rules permit the appointment of the fund's investment adviser as the DRM. In the event the Commission does not accept our recommendation, the Committee notes that the fund's board, in any foreseeable scenario, would be following the recommendation of the fund's investment adviser in determining to approve an individual as DRM. Such recommendation would be based on the investment adviser's search process and diligence regarding a proposed DRM's qualifications. Some of the special considerations that may arise regarding the selection of a DRM are noted in Section II.A-B above. The DRM normally will be an employee of the fund's adviser, and is not required to be an officer of the fund, and as such, the Committee questions the benefit of requiring that such person be approved by the fund's board, and is concerned that this may unreasonably involve the fund board in day-to-day personnel decisions by the fund's adviser. Accordingly the Committee recommends that there be no requirement for fund board approval of a fund's DRM. At a minimum, we recommend that the Commission make it clear that a fund board may reasonably rely on the investment adviser's assessment of a DRM's relevant experience regarding the management of derivatives risk in determining to approve a proposed DRM.

The Committee is also concerned that the proposed risk escalation, annual reporting, and regular reporting requirements might be interpreted to effectively require a board to develop an in-depth understanding of the intricacies of a fund's highly technical VaR model, as well as the fund's stress testing and back testing procedures.

---

[24] Proposed rule 18f-4(c)(2)(iii). According to the proposing release, this escalation requirement is meant to "facilitate the board's oversight by requiring the [DRM] to report this information to the board." Proposing Release, at 4479.

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

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

Of most concern is the Proposed Rules' requirement that a fund's DRM provide the fund's board with "such information as may be reasonably necessary to evaluate the adequacy of the fund's [Program] and [after implementation of the Program] the effectiveness of its implementation", which can reasonably be read to mean that a fund's board is required to evaluate the adequacy of the fund's Program and the effectiveness of its implementation (otherwise, why require the board to be given such information?). Directors would need to develop substantial (and for most fund directors, highly unrealistic) proficiency in risk identification and assessment, stress and back testing procedures, and the technical details of VaR modelling to undertake such evaluations. This would be inconsistent with directors' oversight role and the practical capabilities of most fund directors. We additionally question the rationale for furnishing directors with the very extensive information specified in the Proposed Rules in light of the DRM's representation as to the adequacy of the Program and the CCO's responsibility to implement the fund's compliance policies and procedures relating to the new rule.

We ask the Commission to delete the requirement in the Proposed Rules that the DRM provide fund boards such information as may be reasonably necessary to evaluate the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation, and that the Commission clarify that the final rule does not require (even implicitly) that a fund's board make findings or determinations regarding the adequacy of the fund's Program or the effectiveness of its implementation, and that a board's oversight of the Program would be subject to the same standards that govern a board's oversight of other highly technical aspects of a funds' overall compliance program.

The proposed reporting requirements could also lead to fund boards being overburdened with new compliance-related reports, data and details, and being distracted from their central oversight responsibilities. Whether or not the Commission intends for a fund's board to evaluate the adequacy of a fund's Program, it is likely that a fund's board would review any materials provided by the fund's DRM. The proposed requirement that a fund's board specify the frequency of reporting on the fund's stress testing and back testing would unnecessarily burden boards with an enormous volume of data in new mandatory reports (daily back testing data for, at many complexes, a large number of funds, would be overwhelming) and frequency of reporting determinations, without any guidance as to the criteria upon which the frequency determinations should be based. Further, the proposed escalation requirement for exceedances of a fund's VaR limit for more than three business days could result in a fund's board receiving a significant number of mandatory updates from the fund's DRM, potentially during times of great market stress when fund management's attention may be urgently required in other areas.

While the Commission takes the position that the majority of funds should be able to comply with at least the proposed absolute VaR test,[27] members of the Committee understand that many funds could have significant difficulties complying with their applicable VaR tests under volatile market conditions (such as those that recently resulted from coronavirus concerns). In such a scenario, a fund's board could receive updates from the fund's DRM on a frequent and ongoing basis, at a time when the DRM, CCO and management will be working to comply with the Proposed Rules' requirements. In such circumstances, a board could be driven into an inappropriate hands-on risk management role.

[27] *See* Proposing Release, at 4485 (citing a 2015 Division of Economic and Risk Analysis study indicating that 80% of funds that file reports on Form N-PORT have derivatives exposure of less than 15% of NAV).

In order to preserve a board's oversight role, we request that the Commission omit the proposed escalation requirement, which appears to be redundant in light of the Proposed Rules' requirement that a fund's DRM "directly inform the fund's board of directors as appropriate, of material risks arising from the fund's derivatives transactions."[28] A fund's routine failure to comply with the applicable VaR test would very likely constitute a "material risk" that merits the attention of the fund's board, and as the Commission notes, "a fund's [DRM] is best positioned to determine when to appropriately inform the fund's ... board of material risks."[29] We additionally suggest that the final rule not include the requirements that a DRM's annual report include such information as is reasonably needed for a fund's board to evaluate the adequacy of a fund's Program in detail, and that a fund's board receive reports from the fund's DRM at a frequency of the board's choosing. In the event that the final rule includes the regular reporting requirement, the adopting release should include guidance from the Commission as to how a fund's board should determine the frequency of reporting.

In light of the ever-increasing demands on fund boards noted above, the Committee urges the Commission to undertake a comprehensive reconsideration of the role of fund boards under the Proposed Rules. Given that the utilization of derivatives will be ordinary course business for funds (subject to the restrictions in the final rule), the Committee believes that fund boards may reasonably rely on management and, in part, on the fund's CCO (who will have responsibility for implementing the compliance policies and procedures reasonably designed to ensure compliance with the final rule that are mandated by Rule 38a-1 under the Investment Company Act)[30] for detailed oversight of the fund's derivatives-related compliance policies and procedures.

In the experience of the Committee members, fund CCOs typically meet with a fund's independent directors in closed session on a quarterly basis, and independent directors are regularly apprised of any noteworthy compliance issues during such sessions. In addition, Rule 38a-1 requires that any material compliance issues be brought to the fund board's attention by the CCO.[31] In such circumstances, the Committee believes that the proposed rule need not, and should not, specify any special fund board duties, and instead should permit a board to oversee derivatives use as part of its general oversight function. This approach would relieve a board of the perceived obligation to review all information required to be provided to it by the DRM under the Proposed Rules, while leaving a board free to require any reports that it believes to be necessary or helpful to it in exercising its oversight responsibility. Under this approach, fund directors should not feel obligated to develop the technical proficiency to evaluate the sufficiency of the fund's Program. This would also maintain the board and CCO's respective traditional roles of oversight on the part of the board, and implementing the fund's compliance policies and procedures in respect of both derivatives and all other compliance matters on the part of the CCO.

III. Unfunded Commitment Agreements

We support the Proposed Rules' treatment of unfunded commitment agreements and believe this treatment should be included in the final, adopted rule. In the proposing release, the

---

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

[29] Proposal Rule, at 4465.

[30] *See* Proposing Release, at 4466 ("Rule 38a-1 would encompass a fund's compliance obligations with respect to proposed rule 18f-4.").

[31] *See* Rule 38a-1(a)(4)(ii) (requiring that a fund's CCO deliver a written report to the fund's board no less frequently than annually that addresses, among other things, any material compliance matter that occurred since the date of the previous report).

Commission noted that unfunded commitments are distinguishable from derivatives transactions because they are not used for speculative purposes or to leverage a fund's portfolio. Nevertheless, the Commission believes that unfunded commitment agreements can raise the asset sufficiency concerns underlying Section 18 of the Investment Company Act. Therefore, under the Proposed Rules, a regulated fund may enter into unfunded commitment agreements, notwithstanding the asset coverage requirements of Sections 18 and 61 of the Investment Company Act, if it reasonably believes, at the time it enters into an unfunded commitment agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to such agreement as it comes due. In order to have this reasonable belief, a fund must take into account reasonable expectations with respect to its other obligations and may not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of that investment or from issuing additional equity. A fund must document the basis for this reasonable belief, and the proposed rule includes certain specific factors that the fund must take into account.

We believe that the Commission's proposed adoption of a reasonable belief standard in determining if a fund has lawfully entered into an unfunded commitment transaction conforms with the current industry practice of business development companies and other regulated funds. The original derivatives rule proposal in 2015 would have treated these transactions as "financial commitment transactions" that required the segregation of liquid assets. We believe that the Commission correctly distinguishes unfunded commitment agreements from derivatives and reverse repurchase agreements in the proposed rule based on comments from participants in the industry and operating companies that rely on regulated funds as a source of revolving credit. We agree with the those commenters on the 2015 Proposal that distinguished unfunded commitment agreements from certain firm and standby commitment agreements, under which a fund commits itself to purchasing a security with a stated price and fixed yield without condition or counterparty demand. Those commenters argued that firm and standby agreements expose a fund to investment risk during the life of this transaction, because the value of the fund's commitment agreement will change as interest rates change. In contrast, unfunded commitment agreements are conditional, generally subject to satisfaction of certain financial metrics and performance benchmarks, among other requirements to funding. We also agree with the Commission's assessment that unfunded commitment agreements do not raise undue speculation concerns.

Both the reasonable belief standard, including that the reasonable belief be held at the time a fund enters into the unfunded commitment, and the factors to consider when considering that reasonable belief are appropriate and will provide additional clarity for how a fund should handle determining whether or not it should enter into unfunded commitment agreements going forward. As the Commission noted in the proposing release, BDCs and other regulated funds that enter into unfunded commitments generally represent to the staff during the review of their registration statements that they believe their assets will provide adequate cover to satisfy unfunded commitments when due. In other words, funds have experience complying with the reasonable belief requirement under the Proposed Rules.

We do not recommend that the Commission include additional limits in the final rule on a fund's ability to use unfunded commitment agreements. We recommend that the final rule treat unfunded commitment agreements in the same manner as the Proposed Rules.

IV. Other Provisions of the 1940 Act

The Commission and its staff have, over time, addressed the application of certain aspects of the 1940 Act regulatory framework other than Section 18 to funds that use derivatives. These include 1940 Act requirements regarding diversification, investments in securities issued by securities-related issuers, concentration, and fund names, among other requirements, and whether the regulatory framework "continues to fulfill the purposes and policies underlying the [1940] Act and is consistent with investor protection."[32] The Committee commented on these aspects of the framework in the Task Force Report, and asked that these issues be addressed in a principles-based fashion through Commission rulemaking or guidance.[33] The interpretive issues and disparate approaches to dealing with them by fund groups were noted and discussed at length in the Commission's 2011 Concept Release and Request for Comments on the use of derivatives by investment companies under the Investment Company Act (the "Concept Release").[34] The Committee also commented on these matters in its response letter to the Concept Release,[35] and continued to encourage the Commission to address these issues in the 2016 Comment Letter.[36]

Funds commonly consider a range of issues and face interpretive challenges in determining how to assess compliance with these requirements with respect to derivatives transactions and other transactions that are the subject of the Proposed Rules. These issues include identifying the appropriate value to assign to a derivatives transaction (that is, the current market or fair value, the notional value, or some other value) and the appropriate issuer or investment exposure to consider (that is, the counterparty, the reference asset, or both) for purposes of a specific requirement, among other matters.

In our collective experience, and as noted in the Concept Release, funds and their advisers have reached a number of good-faith interpretations intended to adapt these provisions to the risks presented by derivatives. They have been assisted by guidance from the Commission staff addressing the prohibition on purchase or acquisition of securities issued by securities-related issuers under Section 12(d)(3) of the 1940 Act and Rule 12d3-1 thereunder, which was, in part, designed to limit a fund's exposure to the entrepreneurial risks of securities-related issuers, and the "names rule" in Rule 35d-1 under the 1940 Act.

The Commission and its staff have not issued public guidance or addressed our comments on many of these challenging issues, however. While the Concept Release requested in-depth feedback from the public to help determine whether regulatory initiatives or guidance were necessary under certain of these requirements, the Proposed Rules (like the 2015 Proposal) do not provide for such regulation or guidance. Without further guidance from the Commission and its staff, issues and interpretive challenges will continue to arise under the requirements noted above.

---

[32] *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, Investment Company Act Release No. IC-29776, 76 Fed. Reg. 55237 (Sept. 7, 2011) at 55238.

[33] *See generally Task Force Report.*

[34] *See generally* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)].

[35] *See* American Bar Association Business Law Section, Comment Letter to Elizabeth M. Murphy Re: Use of Derivatives by Registered Investment Companies under the Investment Company Act of 1940 (November 11, 2011) *available at* https://www.sec.gov/comments/s7-33-11/s73311-47.pdf.

[36] *See* 2016 Comment Letter, at 14.

We believe that the Proposed Rules' derivatives risk management framework may appropriately address certain of these regulatory issues. The Proposed Rules would require the Program of a fund (other than a fund that is a limited user of derivatives) to address market, counterparty and liquidity risks, among others, to align the fund's risk profile with the fund's disclosed investment objectives, policies and restrictions. The Program would be required to provide for the establishment, maintenance and enforcement of investment, risk management and/or other guidelines that provide for quantifiable or otherwise measurable risk metrics or thresholds. The Proposing Release makes clear that these guidelines are intended to address market, counterparty and liquidity risks, among others. These are the same risks, and the same risk management tools, that are embodied in the provisions of the 1940 Act regarding diversification, investments in securities issued by securities-related issuers, concentration, and fund names.

We understand that the Program requirements are not intended to supersede these other provisions of the 1940 Act. Nonetheless, when the Program requirements are implemented, there may be less need to address these other issues when evaluating a fund's risk profile. Accordingly, we believe that funds would find it helpful if the Commission provided guidance to the effect that funds would satisfy the derivatives-related policy purposes of these sections of the 1940 Act by implementing a Program (or policies and procedures reasonably designed to manage the derivatives risks of a fund that is a limited user of derivatives and not required to implement a Program) meeting the requirements of the Proposed Rule, and that such funds could adopt and rely on a range of reasoned views in assessing compliance with respect to derivatives with these other provisions of the 1940 Act regulatory framework. Alternatively the Committee asks that the Commission address these matters in the adopting release for final rules or in separate guidance from either the Commission or the Commission's staff.

V. Sales Practices Rules

The proposed sales practices rules would mandate that all registered broker-dealers and investment advisers (i) require that an investor seeking to buy or sell leveraged/inverse investment vehicles complete a prescribed questionnaire and (ii) make an affirmative determination as to whether to approve a customer's account to buy or sell these products. These requirements would apply regardless of whether an investor is trading such products on an unsolicited basis. As discussed in more detail below, the proposed rules are inconsistent with (and duplicative of) the existing broker-dealer and investment regulatory frameworks, are overly prescriptive, and raise the specter of merit-based regulation.

A. The Sales Practice Rules are Inconsistent with Longstanding Commission Policy and Recent Rulemakings.

As an initial matter, it is problematic that the Proposed Rules place uniform obligations on broker-dealers and investment advisers with respect to transactions in leveraged or inverse investment vehicles. This approach is not consistent with the post-Regulation Best Interest regulatory scheme, which retains the distinction between the two roles.[37] Moreover, the proposal acknowledges that newly adopted Regulation Best Interest establishes a heightened standard of

[37] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 Fed. Reg. 33318, 33322 (July 12, 2019)] ("Regulation Best Interest") (declining to adopt a uniform standard applicable to broker-dealers and investment advisers because "adopting a 'one size fits all' approach would risk reducing investor choice and access to existing products, services, service providers, and payment options").

conduct on broker-dealers when making a recommendation to retail customers relating to securities but fails to justify the need for a different standard with respect to leveraged/inverse funds.[38]

In adopting Regulation Best Interest, the Commission imposed four component obligations that are designed to promote recommendations that are in the best interest of the retail customer. Among other things, Rule 15*l*-1(a)(2)(ii) (the "Care Obligation") requires a broker-dealer to exercise reasonable diligence, care and skill to understand the risks, rewards, and costs associated with its recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. Regulation Best Interest also requires a broker-dealer to have a reasonable basis to believe a recommendation is in the best interest of a particular retail customer based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation.[39] The adopting release for Regulation Best Interest explained that the Care Obligation requires broker-dealers recommending inverse or leveraged investment vehicles to understand the terms, features and risks before recommending such products to a retail customers.[40]

Similarly, investment advisers owe their clients a fiduciary duty and must provide advice to clients after "a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals."[41] The Commission's recent interpretive release cautions that inverse or leveraged investment vehicles may not be in the best interest of a retail client absent an identified, short-term, client-specific trading objective.[42] Moreover, even if the purchase of such products is in the best interest of a retail client initially, the Commission cautioned that investments in leveraged or inverse investment vehicles require daily monitoring by the adviser.[43]

We believe that the standards imposed by Regulation Best Interest and the Fiduciary Interpretation are sufficient to protect retail customers who wish to invest in leveraged or inverse investment vehicles and see no reason why the Commission should impose another layer of protection that would involve significant costs without a corresponding incremental benefit.[44]

Both Regulation Best Interest and the Fiduciary Interpretation are principles-based, acknowledging the benefit of allowing firms flexibility in gathering the information they need

---

[38] *Id.*

[39] 15l-1(a)(2)(ii).

[40] 84 Fed. Reg. 33318 at 33376.

[41] SEC Interpretation Regarding Standard of Conduct for Investment Advisers, Adv. Act Rel. No. 5248 (June 5, 2019) [84 Fed. Reg. 33669] (Jul. 12, 2019)] ("Fiduciary Interpretation").

[42] *Id.* at 33673-74.

[43] *Id.*

[44] As evidence that the existing regulatory framework is adequate to protect investors, we note the recent settlement against Wells Fargo. *See, e.g., In the Matter of Wells Fargo Clearing Services, LLC & Wells Fargo Advisors Financial Network, LLC,* SEC Rel. No. 34-88295 (Feb. 27, 2020) (settled order alleging violations of Sections 206(4) and 203(e)(6) and Rule 206(4)-7 under their Advisers Act , Section 17(a)(3) under the Securities Act of 1933, and Section 15(b)(4)(E) of the Exchange Act, for failing to design policies and procedures reasonably designed to prevent unsuitable recommendations and failing to supervise financial advisers recommendations of inverse ETFs); *In the Matter of Morgan Stanley Smith Barney, LLC*, SEC Rel. No. IA-4649 (Feb. 14, 2017) (settled order alleging violations of 206(4) and Rule 206(4)-7 under the Advisers Act for failing to implement compliance policies and procedures design to prevent unsuitable recommendations of single-inverse ETFs for advisory clients with non-discretionary advisory accounts).

from customers or clients to carry out their responsibilities. The current proposal is far more prescriptive. The proposal requires both broker-dealers and investment advisers, regardless of the pre-defined scope of the relationship, to obtain specific information before approving a retail investor's account to engage in transactions in leveraged or inverse investment vehicles.[45] The Commission fails to explain why prescriptive requirements are necessary with respect to leveraged or inverse investment vehicles. Nor does the proposal provide guidance as to how intermediaries should evaluate the required information in determining whether leveraged/inverse investment vehicles are "reasonable" for a customer's account or in recommending such products to clients.

We do not believe it is necessary or appropriate for the Commission to single out leveraged or inverse investment vehicles for disparate treatment from other complex products, some of which are riskier and more complex than leveraged and inverse funds. Broker-dealers and investment advisers are required to understand potential risks, rewards and costs associated with *all* products they recommend and make such recommendations based on a retail customer's particular investment profile. We fear that the prescriptive questionnaires contemplated by the rule will likely result in another check-the-box exercise, adding significant internal and external costs, inconveniencing investors, and adding little value or enhanced investor protection. Moreover, we are concerned that rather than incur the costs and potential liabilities that the sales practice rules would impose, many broker-dealers and investment advisers simply will not make available leveraged and inverse funds to their customers/clients, thus depriving them of an investment option that they may find desirable.

B. The Sales Practice Rules Should Not Apply to Discretionary Advisory Accounts

The Commission's requirements are particularly superfluous with respect to discretionary advisory accounts. As stated above, investment advisers serve as agents for their clients and are subject to a fiduciary duty. Agency law principles provide that an agent's (*i.e.*, the adviser's) knowledge of facts or information is generally imputed to the principal if the facts or information is material to the agent's duties to the principal.[46] Accordingly, it is not clear why, when an adviser is acting as agent for its client, the *client* must have knowledge and experience in financial matters or that he or she must reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles. *See* Proposed Rule 211(h)-1(b)(1). This is precisely *why* a client hires an adviser; so the client can rely on the adviser to make such judgements and provide advice accordingly, and the Commission Staff recently recognized this concept in its no-action letter issued to The Money Management Institute, Commission No Action Letter (pub. avail. Apr. 11, 2019) (concluding broker-dealers may deliver a mutual fund's statutory prospectus to an investment adviser managing a client's account on a discretionary basis). This proposal unwisely opens the door for the Commission to mandate similar due diligence for advisory clients that invest in other investments that involve risks. It is the role of the adviser to assess those investment risks, taking the client's needs into consideration. That is why the client

[45] This includes (i) investment objectives and time horizon; (ii) employment status; (iii) estimated annual income from all sources; (iv) estimated net worth; (v) estimated liquid net worth; (vi) percentage of the retail investor's liquid net worth that he or she intends to invest in leveraged or inverse investment vehicles; (vii) investment experience and knowledge regarding leveraged or inverse investment vehicles, options, stocks and bonds, commodities and other financial instruments.

[46] *See* Restatement (Third) Agency § 5.03; *Apollo Fuel Oil v. U.S.*, 195 F.3d 74 (2d Cir. 1999) (stating that, in general, "when an agent is employed to perform certain duties for his principal and acquires knowledge material to those duties, the agent's knowledge is imputed to the principal").

retains the investment adviser and to impose additional hurdles undermines the adviser's role. The proposed rule simply makes no sense in the context of the adviser-client relationship.

C. The Sales Practice Rules Should Not Apply to Unsolicited Transactions

Unlike Regulation Best Interest, the sales practice rules would apply to transactions where no recommendation or investment advice is provided by a firm. This requirement interferes with investor choice and imposes unnecessary responsibilities on intermediaries to substitute their views for those of their clients. We are also concerned that the proposed rule may subject firms to liability for losses in client accounts where the client made the investment decisions, in terms of being second guessed for determining account "approval" based on vague and amorphous criteria, which is patently unfair. The account approval requirement also creates a conflict of interest between the firm and the client; in making this decision, the intermediary may feel compelled to consider potential risks and liabilities to *itself* in approving a client account. Again, if adopted, we believe the sales practice rules will result in many fund distribution platforms removing these investment vehicles from their product menus in an effort to limit liability and avoid compliance costs, further limiting investor choice.

D. The Sales Practices Rules Raise the Specter of Merit-Based Regulation

The U.S. securities regulatory framework is fundamentally based on disclosure, not the substantive attributes or perceived risks of various products. Investors generally have the freedom to invest in any securities for which there is appropriate disclosure (and other regulatory requirements are met, as applicable). Most leveraged or inverse investment funds are Commission-registered investment companies and thus subject to extensive investor protection requirements.[47] Leveraged and inverse investment vehicles or instruments that are not investment companies are subject to the disclosure regime of the Securities Act of 1933. In either case, when purchasing these products, investors receive a prospectus describing all materials risks and other detailed information prescribed by the Commission.[48]

In singling out one type of product for additional sales practice scrutiny, the proposed sales practice rules appear to be an example of "merit regulation," where the Commission evaluates the relative benefits to the market place of certain prescribed products. This is not the appropriate role of the Commission. The Commission should not substitute its own judgement for the judgment of investors by imposing arbitrary obstacles on the sale of particular products that are otherwise offered in accordance with Commission-prescribed disclosure requirements. Though of course well-intentioned, the proposed sale practice requirements fly in the face of the Commission's longstanding approach of implementing neutral, disclosure-based protections and fostering investor education, which is designed to elicit material information and then to let investors evaluate the disclosures for themselves. We do not believe that making access to an asset class be a matter of privilege is an appropriate approach to investor protection.

---

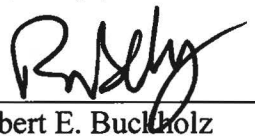
[47] The Investment Company Act provides a comprehensive framework for the federal regulation of investment companies. This includes substantive protections beyond the disclosure requirements, including the safekeeping and proper valuation of fund assets, restrictions of transactions among affiliates, and governance requirements.

[48] *See, e.g.*, Form N-1A, Form S-1.

VI. Conclusion

We are pleased to have the opportunity to comment on the Proposed Rules. We appreciate the effort of the Commission and its staff to create a uniform set of rules that would replace decades of releases, no-action letters and guidance that is sometimes duplicative and inconsistent, and we understand the enormity of the task. It is in this context that we offer these suggestions to help the Commission understand and address some of the consequences that believe may flow from the rules if they are finalized as proposed. We are happy to engage with the Commissioners and/or the staff to discuss any of these issues in greater detail.

Very truly yours,



Robert E. Buchholz
Chair, Federal Regulation of Securities Committee

Members of the Task Force on Investment Company Use of Derivatives and Leverage
Gariel S. Nahoum, Co-Chair
Jay G. Baris, Co-Chair
Ryan Brizek
Donald R. Crawshaw
Matthew J. DiClemente
Amy R. Doberman
Ronald M. Feiman
Alison M. Fuller
Nathan J. Greene
Benjamin J. Haskin
Mark D. Perlow
Robert A. Robertson
Lori L. Schneider