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VIA E-MAIL RULE-COMMENTS@SEC.GOV

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S-7-24-15)

Dear Mr. Fields:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("**Federated**") with respect to the recent issuance by the Securities and Exchange Commission (the "**Commission**") of a release (the "**Release**") proposing new regulations for the use of derivatives in registered investment companies and business development companies (the "**Proposed Amendments**").[1] Federated is one of the largest investment management firms in the United States (the "**U.S.**"), managing approximately $221 billion in registered money market fund assets and $360 billion in total assets as of December 31, 2015. With 122 mutual funds and a variety of separately managed account options, Federated provides comprehensive investment management to more than 8,400 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

I. EXECUTIVE SUMMARY

While we acknowledge the constructive elements of the Proposed Amendments, some of which could be deemed to be a liberalization of certain requirements, Federated opposes elements of the Proposed Amendments in their current form.

a. **Portfolio Limitations.** Federated agrees with the need for an updated framework to strengthen and clarify derivatives regulation which, as proposed, can have benefits that include the elimination of ambiguities or inconsistencies in the

[1] SEC, Release No. IC-31933, Use of Derivatives by Registered Investment Companies and Business Development Companies (2015), https://www.sec.gov/rules/proposed/2015/ic-31933.pdf (hereinafter "**Release**").

current regime. However, Federated strongly disagrees with the proposed adoption of a rules-based regime that employs fixed limits on notional exposure and disallows the netting of most hedges. Federated instead proposes a principles-based regime employing a risk management framework that achieves the Commission's objectives while avoiding the disadvantages of fixed limits**.**

b. **Asset Segregation and Eligible Coverage Assets.** Federated agrees with the proposed asset segregation requirements but disagrees with the proposed requirement that eligible coverage assets are limited to cash and equivalents. Federated instead proposes that eligible coverage assets should consist of cash, cash equivalents and other securities considered to fall within the 1-3 Day Liquid Bucket as defined in the Commission's proposed Liquidity Rule[2] (or within an equivalent successor concept as outlined in the forthcoming final rule).

c. **Risk Management Program.** Federated generally agrees with the proposed requirement for derivatives risk management programs but disagrees with the proposal that advisers may adopt lesser standards in all circumstances where notional derivatives exposure is less than 50% of fund net assets. Federated proposes that a formalized risk management program should be required whenever: (i) derivatives notional exposure exceeds 50% of fund net assets; (ii) or the use of derivatives is intended to implement a strategy in which a fund is systematically or dynamically levered to a material extent with respect to one or more market risk factors; or (iii) when derivative exposures are less than 50% but contribute a material degree of risk to fund returns or represent a principal investment strategy, unless the board of directors, including a majority of independent directors, determines that such program is not in the best interest of shareholders. Federate disagrees with the requirement that *any* use of a complex derivative would necessitate a formalized risk management program as this could be unduly burdensome or have an undesirable effect on innovation. Federated instead proposes that a formalized risk management program be required as a result of any use of complex derivatives unless the board of directors, including a majority of independent directors, determines that such a program is not in the best interest of shareholders.

Set forth below is a summary of our specific comments and suggestions with respect to the Proposed Amendments.

II. PORTFOLIO LIMITATIONS

Federated appreciates that the Proposed Amendments clarify and simplify the regulation of derivatives while eliminating inconsistencies arising from differing settlement characteristics of derivative instruments or the varied interpretations of Release 10666 and applicable no-action

[2] SEC, Release Nos. 33-9922; IC-31835, Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release 44–45 (2015), https://www.sec.gov/rules/proposed/2015/33-9922.pdf (hereinafter "**Liquidity Release**").

letters.[3] However, Federated strongly disagrees with the proposed adoption of a rules-based regime that employs fixed notional limits and disallows the netting of most hedges.[4] Federated instead proposes a principles-based regime employing a risk management framework that achieves the Commission's objectives while avoiding the limitations of fixed limits.

a. A VaR-based approach can fulfill the Commission's objectives without the disadvantages of the proposed rules-based regime.

An effective principles-based risk management framework is regarded by academicians and practitioners alike as a far more effective means of measuring and controlling derivatives risk within an overall portfolio. It can be designed to avoid the pitfalls of a rules-based regime, some of which are outlined below. Furthermore, U.S. fund managers have extensive experience with the UCITS regulatory framework, which is generally viewed as a successful regime.

The Commission itself demonstrates a clear appreciation of the benefits of a VaR methodology with its discussion in section III.B.2.a of the Release, which describes the Commission's justification for using VaR as the basis for determining whether a fund may adhere to a risk-based portfolio limit. In that section, the Commission seeks comment on whether VaR could be used as a more general means of setting risk-based limits within the alternate test allowing up to 300% gross notional exposure:

> The risk-based portfolio limit would require a fund's full portfolio VaR to be less than its securities VaR. Should the test be more restrictive or less restrictive? For example, should we permit a fund's full portfolio VaR to exceed its securities VaR up to a specified limit (e.g., allow the fund's full portfolio VaR to exceed its securities VaR by not more than a specified percentage)? For example, would it be appropriate for the fund's full portfolio VaR to exceed its securities VaR by 10% or 20%?[5]

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[3] For instance, the Release states that:

> Under the current approach, different funds may treat the same kind of derivative differently, based on their own application of our staff's guidance and observation of industry practice, which at least one commenter noted 'may unfairly disadvantage some funds.' Where there is no specific guidance, or where the application of existing guidance is unclear, funds may take approaches that involve a more extensive use of derivatives and that may not address the purposes and concerns underlying section 18 of the Act, as discussed above. The lack of guidance addressing some derivatives may create competitive pressures for funds to take approaches that involve a more extensive use of derivatives. The current approach, having developed over time, may treat similar derivatives in a manner that results in substantially different amounts of segregated assets, and may itself influence funds' investment decisions.

Release, *supra* note 1, at 49.

[4] The Proposed Amendments only disregard derivatives entered into for hedging purposes from the calculation of notional exposure if the reference asset, date of maturity, and all economic terms are identical and offsetting (*i.e.*, the only variation may be the counterparties to the legs of the hedges).

[5] Release, *supra* note 1, at 131–32.

In fact the Commission then requests comment on whether the VaR method would in general be a preferred framework that could essentially replace the entire system of limits proposed in the Release:

> For purposes of the risk-based portfolio limit, should the proposed rule use an approach such as (or similar to) the relative VaR or absolute VaR approach for UCITS funds, instead of or as an alternative to the proposed VaR test? Why or why not? Would it be more efficient to allow funds to use such an approach – e.g., because some advisers already use this approach for UCITS funds? Under a relative VaR approach, what sort of benchmarks would or would not be appropriate, and how should the benchmarks be chosen? Under an absolute VaR approach, what would be an appropriate VaR limit (e.g., 20%, as for UCITS funds, or a higher or lower limit)? Would a relative VaR or absolute VaR approach appropriately address the undue speculation concern underlying section18? Why or why not?[6]

In light of the Commission's clear appreciation for the benefits of the VaR methodology as employed in the UCITS framework, one is left to wonder why the Proposed Amendments are based on a regime of: (i) a strict notional limit of 150%; or (ii) a strict notional limit of 300% provided that the full portfolio VaR (including derivatives) is less than the securities portfolio VaR (without derivatives). There are four primary explanations that can be found in the Release and each suffers from significant flaws:

1. *A fixed limit regime is more "administrable" and would better facilitate compliance and examinations.*

We do not believe that this argument can be accepted at face value. We understand the Commission believes that a fixed regime would be "administrable" in that it should be easier to identify and track the total notional value of all derivatives within a fund's portfolio and determine whether that amount exceeds 150% or 300% of the NAV of the fund. However, the Commission's proposed regime is actually quite burdensome in practice because it would require that VaR be calculated: (i) for the fund's actual (full) portfolio, (ii) for a theoretical "securities portfolio" (*i.e.*, the fund's portfolio without derivatives), (iii) on each occasion that the fund enters into a derivatives transaction; all in order to ensure the fund is less volatile with derivatives than without. Furthermore, if this VaR test shows that the fund's use of derivatives does not reduce the volatility of the fund's portfolio, it is unclear what remedial actions the fund would be able to take under the rule, or would be required to take under the rule. Must the fund enter into new derivatives or securities transactions that enable it to meet the VaR test, or decrease positions in derivatives to comply with the 150% limit, or take some other action? In Federated's experience, the administrative burden of creating and running compliance tests on

[6] *Id.* at 132.

hypothetical portfolios and adhering to a regime with unclear expectations would exceed the administrative burden of complying with a more straightforward principles-based approach. We do not believe that the proposed regime is less sensitive to errors, and even if it was, we do not consider it appropriate to select a compliance regime based on administrative ease when alternatives exist that may be better suited to investor protection and capital market efficiency.

2. The Commission lacks the authority to impose general risk limits.

Notwithstanding the above-referenced request for comment regarding on whether a VaR-based regime might in general be preferable, in section III.b.2.a of the Release, the Commission outlines its belief that it has limited authority to adopt a UCITS-type regime[7]:

> First, we believe that the VaR test under the proposed rule is more consistent with the policies and provisions of the Investment Company Act, which restricts in section 18 a fund's ability to issue senior securities but otherwise generally does not impose limitations on a fund's ability to invest in risky or volatile securities investments, provided that such investments are consistent with the investment strategy described to investors. Using the fund's own portfolio as the baseline for the VaR test under the proposed rule—and thus providing a risk assessment of the fund's use of derivatives in the context of the fund's investment strategy disclosed to investors, which may include risky or volatile securities—would be more consistent with the Act. A relative VaR test, by contrast, could be viewed as a limitation on risk or volatility generally — as opposed to a limitation on the issuance of senior securities — because it would measure the VaR of a fund's portfolio, including non-senior securities investments, against a hypothetical reference portfolio, and such non-senior securities investments could cause the fund to fail a relative VaR test.[8]

If the Commission believes that its authority in this area is constrained by this limitation of the Investment Company Act, then Federated proposes a very simple remedy. Our alternative proposal would allow funds requiring a formalized risk management program to elect either of two VaR-based compliance regimes: (i) the **Relative VaR** election would likely be that chosen by funds whose underlying assets are largely invested in risky assets, which we believe represents the vast majority of funds; and (ii) the **Absolute VaR** election that would likely be chosen by funds whose underlying assets or portfolio benchmark have low risk compared to the riskiness of the overall portfolio including derivatives.

i. The Relative VaR Test

For funds that elect the Relative VaR test, instead of the proposed requirement that:

[7] Pursuant to a UCITS-type regime, funds adopting the Relative VaR standard must maintain a portfolio VaR (including derivatives) that is no more than double the VaR of an applicable benchmark (excluding derivatives).
[8] *Id.* at 125.

(VaR of portfolio with derivatives) – (VaR of portfolio without derivatives) < 0 **(1)**

the Commission could adopt the requirement that:

{(VaR of portfolio with derivatives) / (VaR of portfolio without derivatives)} < X **(2)**

The expression shown in equation (2) above is identical to the UCITS framework for Relative VaR except that in quantity in the denominator is the VaR of the securities portfolio *excluding* derivatives rather than the VaR of the benchmark. Federated has successfully employed this type of comparison and has presented a similar type of data to fund directors for many years. The choice of **X** in equation (2) would determine the amount of risk from derivative-related leverage that the Commission believes should be permitted consistent with section 1(b)(7) and section 18. This could be determined using similar reasoning as was employed to arrive at the current 150% notional test. Setting X = 1.5 would imply a strict implementation of section 18; setting X = 2 would be suggested by Release 10666. The Commission's 150% proposed notional limit of 150% would suggest X = 2.5 (although the current proposal excludes hedges whereas the VaR methodology inherently captures hedges based on a respected statistical methodology for netting risks).

ii. The Absolute VaR Test

For funds that elect the Absolute VaR test, instead of the proposed requirement that:

(VaR of portfolio with derivatives) – (VaR of portfolio without derivatives) < 0 **(3)**

the Commission could adopt the requirement that:

{(VaR of portfolio with derivatives) – (VaR of portfolio without derivatives)} / (Net Assets) < Y **(4)**

In equation (4) the expression in the numerator is the amount of additional loss that the portfolio could realize (at the confidence level selected, *e.g.*, 99% over 10 days) owing solely to the presence of the leveraging impact of derivatives, stated as a fraction of fund net assets. Section 1(b)(7) provides ample latitude for the Commission to adopt a requirement of this form. The variable **Y** in equation (4) would be the maximum loss (at the adopted VaR percentile) that the Commission could determine is allowable solely arising from the use of derivatives.[9]

Federated believes that the methodologies presented above are an effective alternative to the Proposed Amendments' regime of fixed notional limits. They retain the benefits of a principles-based risk management framework and avoid the inconsistencies and inherent pitfalls of a rules-based regime that is rife with arbitrary standards and the potential for unintended results that are injurious to shareholders. Regarding the Commission's presumed lack of authority to regulate overall portfolio risk, but only that arising from leverage, the proposed

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[9] The UCITS determination of this amount, under its corresponding absolute VaR test, is 20% at the 99% confidence level over 1 month.

Relative VaR and Absolute VaR tests do not entail placing a limit on total risk, but instead place limits on only the additional risk arising from the inherent leverage of derivatives. Finally, by not employing benchmarks anywhere in the calculations, the proposal completely neutralizes the Commission's stated concern regarding the alleged difficulty in identifying a benchmark, which we further address below.

3. There would be difficulty in defining appropriate benchmarks for use in a UCITS-type Relative VaR regulatory regime.

Although Federated's proposal as outlined above in section II.b.2.i-ii does not require the identification of an appropriate external benchmark, there may be useful variations on the above proposal for which a portfolio benchmark would be necessary. In these situations, the Commission could reasonably regulate a fund's use of derivatives by imposing a Relative or Absolute VaR regime on only those funds required to have formalized risk management program. A Relative or Absolute VaR regime is also a better way to assess whether a fund's use of derivatives has caused the fund to become unduly speculative because these regimes assess the volatility (*i.e.*, risk) of the fund's portfolio, rather than its notional exposure, which is shown herein to be a poor proxy for actual risk. A determination that the Commission has the authority to implement Relative and Absolute VaR tests that are not materially different in outcome from the UCITS VaR framework would also have the added benefit of establishing a regime equivalent to the UCITS framework, which promotes harmonious cross-border regulation.

Setting aside the question of the Commission's authority to implement a UCITS framework, Federated also disagrees with the Commission's concerns regarding benchmarks stated in the Release:

> Second, we are also concerned that under a relative VaR approach it would be difficult, in light of the wide range of fund strategies and potential benchmarks, to require funds to select benchmarks that are appropriate (particularly in connection with alternative strategies), are unleveraged, and would otherwise serve as an appropriate baseline against which the relative VaR should be measured.[10]

In fact, Federated does not believe that identification of a benchmark for a UCITS-type VaR regime would pose any difficulties. The introduction of the Absolute VaR test described in II.b.2.ii above as an election available to Alternative funds addresses the Commission's concern with respect to these funds. All U.S. registered funds, including those regarded as Alternative funds, are already required to select an appropriate broad-based securities market index as a performance benchmark,[11] and investors have a clear understanding of their meaning. Furthermore, many U.S. fund families, including providers of Alternative funds, have experience

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[10] *Id.* at 125–26.
[11] *See* SEC, Form N-1A Pt. 4.b.2.iii, https://www.sec.gov/about/forms/formn-1a.pdf (last visited Mar. 21, 2016).

with UCITS regulation and the identification of appropriate benchmarks has not posed undue difficulty.

4. Potential limitations of the VaR methodology.

The Release has already provided a detailed assessment of both the benefits and limitations of the VaR methodology.[12] The Commission has concluded that the benefits outweigh the costs in its proposal to employ the VaR methodology as part of the 300% notional test to determine whether a fund complies with the risk-based portfolio limit. Federated believes that the net benefits of VaR as prescribed by the Proposed Amendments are equally if not more applicable to Federated's proposed principles-based risk management regime as outlined in section II.b.2.i-ii. Furthermore, the UCITS VaR-based regime has stood the test of time and provides a methodologically sound and rigorously implemented model that serves to reduce the regulatory challenges for adoption in the U.S.

b. The rules-based system of notional portfolio limits proposed by the Release is inferior to a principles-based risk management framework.

1. *Fixed limits may damage shareholders by preventing the timely application of derivatives for risk management or hedging purposes – an application for which they are ideally suited.*

The Release in part justifies the proposed portfolio limitations using a finding of the DERA study that relatively few funds would be impacted by a 150% notional limitation.[13] We believe that the methodology employed by the DERA study, namely a snapshot of each sampled fund at a point in time, may not adequately reflect the actual use of derivatives in the funds. In Federated's experience, overall derivatives usage in a given fund may fluctuate with market conditions and with the opportunities and risks presented over time. A fund that has gross notional exposure of less than 150% most of the time may employ a strategy that causes that exposure to exceed 150% intermittently. Consequently, a much larger percentage of funds than was found in the DERA study may be impacted by the proposed limits.

Furthermore, one of the most common and beneficial uses of derivatives is to hedge market exposures when risk conditions warrant. The Commission's Liquidity Rule proposal anticipates that portfolio managers will proactively increase portfolio liquidity when stressed market conditions suggest heightened redemption risk, and this could also entail the use of derivatives.[14] The DERA study failed to examine fund usage of derivatives under such

[12] Release, *supra* note 1, at 115–49.
[13] *See id.* at 98.
[14] *See* Liquidity Release, *supra* note 2, at 38–39 ("Funds observed by the staff that have implemented procedures for assessing and classifying the liquidity of their portfolio assets also often have developed controls to manage fund portfolio liquidity risk and the risk of changing levels of shareholder redemptions, such as holding certain amounts of the fund's portfolio in highly liquid assets, setting minimum cash reserves, and establishing committed back-up lines of credit or interfund lending facilities. . . . We have observed that some of the funds with the more thorough

conditions and the conclusions that can be drawn from it are therefore quite limited. Under the Proposed Amendments with gross notional limits that do not allow netting of most hedges, an adviser may be unable to implement a protective hedge because it could push the fund over the 150% gross notional limit. It would be contrary to shareholder interests for the Commission to implement a limitation on derivatives usage that prevented an adviser from hedging risks because of a fixed limit regime that failed to allow most hedges to be netted when calculating overall notional exposure.

2. *A regime of fixed limits will reduce the economic efficiency of fund management, reduce the effectiveness of risk management and lead to lower portfolio returns and greater costs. Cost/benefit analysis favors an alternative principles-based risk management regime that achieves the Commission's objectives without sacrificing efficiency.*

A key factor underpinning the use of derivatives in risk management is that many instruments have been specifically designed to capture the market or sector risks that are central to modern investment methodology. This has been and remains the dominant force in the evolution of the derivatives market. The derivatives types that flourish are those that best enable portfolio managers to efficiently manage exposure to targeted risks.[15]

Derivatives have grown in use because – when effectively employed in the context of a rigorous oversight function – they improve the efficiency of portfolio management. Specifically, derivatives are used as tools: (i) for risk management; (ii) for more effectively expressing certain views on the markets – often with much lower transaction costs – which improves returns; and (iii) for facilitating the creation of new products the design of which depends on the efficient transfer of market risks.[16] Within broad parameters, portfolio managers may therefore be indifferent to whether derivatives are used in a fund's portfolio, provided that prudential standards are met and the portfolio's overall risk/return profile is improved. A regime of fixed limits could impair the ability of a portfolio manager to use derivatives to both (i) more effectively express views on the markets; and (ii) reduce or manage a portfolio's risk through the

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liquidity risk management practices have appeared to be able to better meet periods of higher than typical redemptions without significantly altering the risk profile of the fund or materially affecting the fund's performance . . . ."); *see also id.* n.100 (noting the use of derivatives to manage liquidity).

[15] It is important to understand language of modern finance and the role this has played in the evolution of the derivatives market. A central objective of financial economics (since the earliest days of portfolio theory in the 1950s), has been to effectively measure and portray the risks in a portfolio in their true economic form – reduced to their most basic terms of market, sector or security risks that succinctly capture the economic essence of the portfolio. Within the analytic systems now used, securities that may have complex structures – including implicit borrowing – are deconstructed to measure their constituent market, sector and security risks so that aggregate portfolio risk measures can be accurately stated as a statistical summation of these underlying risk categories across securities. Portfolio managers are trained to think in these terms – specifically, to focus primarily on the impact that individual securities have on total portfolio risks (both absolute and relative to the benchmark), rather than on the collection of individual security risks in isolation.

[16] Financial economists view derivatives favorably as they can improve the efficiency of markets in allocating risks. Regulators generally permit the use of derivatives, with appropriate disclosure and safeguards, viewing them as useful portfolio management tools.

use of derivatives, because the risk-based notional limit is only available for funds whose use of derivatives reduces the volatility of the portfolio in the aggregate. In practical terms, this may prevent funds that use derivatives to gain market exposure from also using derivatives to appropriately hedge those positions.

The Release acknowledges that the proposed regime of fixed notional limits, which excludes netting of most hedges, is a "relatively blunt measurement." This is an understatement. The discussion above illustrates that the use of derivatives seamlessly blends into overall portfolio and risk management. A regime of fixed limits can have the effect of inserting an artificial barrier that may undermine the efficiency gains that modern finance brings to fund management with the effect of reducing the efficacy of risk and liquidity management, thereby reducing shareholder returns. These factors may particularly manifest during stressed markets when advisers need the maximum flexibility. This is far too high a price to pay when the Commission's objectives can be achieved using an alternative principles-based risk management framework that does not incur such costs.

3. *Fixed notional limits are inherently arbitrary and will lead to undue complexity and inconsistency in derivatives usage and regulation.*

The Release outlines the range of factors that the Commission evaluated in determining the proposed limits. While it is apparent that the Commission looked beyond criteria that could have led to a more restrictive outcome, the Proposed Amendments are nonetheless arbitrary with the attendant risk that at some future point in time they will seem as dated as Release 10666 seems today. The proposed treatment of complex derivatives illustrates this point.

The Release mandates that if a fund uses any "complex" derivative it would not be exempt from the requirement of a formal risk management program; and that the notional amount attributed to this derivative would be the aggregate notional value of the derivative positions necessary to hedge the complex derivative.[17] It is presumed that the complex derivative itself is defined in relation to some underlying reference asset and that other non-complex derivatives exist that could be used to hedge the complex derivative.[18]

In fact, while there are certain complex derivatives mentioned in the release for which this approach may be realistic, other complex or innovative new derivative types may not have an obvious reference asset. Even if there was an appropriate reference asset, there may be not be

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[17] *See* Release, *supra* note 1, at 79 ("Under this approach, the notional amount of a complex derivatives transaction would be equal to the aggregate notional amount(s) of other derivatives instruments, excluding other complex derivatives transactions (together, 'substituted instruments'), reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction at the time the fund enters into the transaction.").

[18] *See id.* at 75 ("The proposed rule would define a complex derivatives transaction as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.").

other derivatives available to perform the hedge analysis, or the analysis may itself be complex and give rise to incongruous results. Indeed, a motivating factor in the creation of new derivative types is that the risk factors they succinctly capture cannot be easily replicated through a combination of other traded instruments, or that the other traded instruments must themselves be dynamically adjusted through time to produce the same outcome as the complex derivative (such that no single combination of other hedge instruments reflects the risk of the complex derivative). In relevant part, the Release attempts to correct the defect relating to the circumstance where the equivalent hedge basket changes through time by allowing this computation to be done at the time of original transaction and not regularly updated. This of course could produce a highly inaccurate estimate for precisely those instruments about which the Commission appears most concerned.

For these reasons, the proposal on complex derivatives would be inaccurate and cumbersome, and would tend to dissuade usage (and therefore the creation) of new innovative derivatives types because advisers would face challenges in "reverse engineering" the instrument; or the computed aggregate notional exposure of other derivatives could be extraordinarily high (if netting is not permitted); or the adviser would instantaneously face a daunting regulatory requirement (of a formal risk management program) even for a de minimis use of the complex derivative. It should be apparent that the complexity of this process would inevitably lead to confusion and gaming for many years to come; and that these adverse outcomes would result from the attempt to force what should and naturally would be a risk-based calculation of exposure into a rules-based system of notional limits.

c. The Proposed Amendments are arbitrarily derived from an amalgam of alternative theories, incomplete analysis and surprising interpretations of authority.

The Release acknowledges that, while a framework of notional limits is a "relatively blunt measurement," the Commission's preference for the 150% limitation is based on a range of factors that include: (i) the belief that a notional limits framework, with narrowly defined netting, is more "administrable" and more likely facilitate compliance and examinations, and remarkably, that this factor dominates other substantive issues; (ii) appeals to policy statements in section 1(b)(7) of the Investment Company Act of 1940 (the "**1940 Act**") regarding inappropriate speculative risks for common shareholders arising from excessive borrowing; (iii) the very limited and incomplete DERA study finding that relatively few funds would be adversely impacted by the proposed limits;[19] and (iv) an unusual interpretation of the comportment of the proposal with limitations on leverage.[20] In particular, the Release rejects a 50% limit which

[19] *Id.* at 98.

[20] *See* Release, *supra* note 1, at 95 ("We note that setting the exposure limitation at 150%, as proposed, would allow the fund to use derivatives transactions to obtain a level of indirect market exposure solely through derivatives transactions that could approximate the level of market exposure that would be possible through securities investments augmented by borrowings as permitted under section 18.").

would be suggested by the section 18's 300% asset coverage requirement[21]; or a 100% limit that could be suggested by a Release 10666 asset segregation analysis. According to the Commission, the 150% limit reflects a balance of factors that includes the objective of a simple measurable framework that is not "encumbered" by other more complex methods of defining leverage or netting hedges, and the fact that derivatives are used for many purposes, including hedging, not all of which create leverage or investment risk. While comprehensive in its recitation of potentially applicable facts, the proposed outcome is arbitrary, fails to adequately consider other viable approaches having fewer limitations, and unnecessarily creates significant risk and potential harm to shareholders.

The Commission also proposes in the Release that an alternate risk-based limit may be adopted in which a fund may use derivatives with notional value up to 300% of fund net assets provided that the VaR of the portfolio **with** derivatives is less than the VaR **without** derivatives (that is, calculated using only the securities portfolio and cash). The Release justifies this proposal with the reasoning that VaR is a useful general tool for measuring portfolio risk; and if the portfolio VaR with derivatives is less than the VaR without, it is unlikely that the portfolio is taking on undue leverage or speculative risks that implicate the policy considerations recited in section 1(b)(7). The Release recognizes that VaR is incomplete as a risk measure insofar as it does not capture "tail" events, counterparty or other risks; but when combined with the 300% notional limit, the Commission believes it can be reasonably confident that the overall risks of the portfolio are adequately contained.[22] In particular, the Commission argues, some of the deficiencies of VaR when used as an absolute calculation are mitigated when VaR is used to compare two portfolios wherein any biases are common to both figures.

In fact, Federated believes that very few advisers, if subject to the Proposed Amendments, would have the objective of creating up to 300% notional derivatives exposure in order to have less risk than the underlying portfolio. Nor could this objective be justified based on a theory that the incremental notional exposure over 150% that is allowed by this alternative is predicated on the manager hedging as a normal practice or in stressed conditions. This is because the adviser could hardly be confident that the risk target in such a strategy would always be a lower risk level than that of the underlying portfolio. Consequently, this portion of the rule

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[21] We note that the Commission's staff has clarified that the proceeds of a borrowing may be considered when calculating a fund's total asset value for purposes of section 18's 300% asset coverage requirement, effectively permitting an open-end fund to borrow money from a bank in an amount up to 50% of its asset value before the borrowing. *See, e.g.,* Data Concepts Fund, Inc., SEC No-Action Letter (pub. avail. Aug. 25, 1980).

[22] Release, *supra* note 1, at 127-28 ("Under the proposed rule, however, VaR would be used to focus primarily on the relationship between a fund's securities VaR and its full portfolio VaR, rather than on the absolute magnitude of the potential loss of any particular investment or the fund's portfolio as a whole. We believe that this use of VaR—to assess whether a fund's derivatives as a whole directionally increase or mitigate risk, rather than to precisely estimate potential losses—mitigates some of the concerns that have been expressed about the use of VaR. In addition, the VaR test under the risk-based portfolio limit would be coupled with an outside limit on exposure, which, as discussed in section III.B.2.c below, would provide an independent limit on a fund's use of senior securities transactions under the proposed rule that would not be based on VaR.").

proposal is largely a theoretical exercise by the Commission, while nonetheless contradicting the logic used by the Commission to establish the 150% notional limitation.

In explaining why the Commission does not propose a Relative VaR approach for establishing limits similar to the UCITS framework, the Release essentially, and surprisingly, suggests that the Commission lacks the authority to do so. In the UCITS framework, funds adopting the Relative VaR limitation must be managed such that the VaR of the portfolio with derivatives is at most two (2) times the VaR of the applicable benchmark. The Release argues that this constitutes a limitation on overall portfolio risk, rather than on leverage alone, and that the 1940 Act does not empower the Commission to impose such limitations.[23] Furthermore, the Commission expresses concern that the identification of a benchmark for Relative VaR purposes may be problematic, particularly for alternative strategies.[24] For the reasons described in section II.b.2.ii above, we believe that these assertions are flawed. The VaR approach underlying UCITS regulation is comparable in outcome to a small variation of this technique that clearly falls within the Commission's authority, and advisers are already required to employ the relevant benchmarks for other reasons.

III. ASSET SEGREGATION AND ELIGIBLE COVERAGE ASSETS

Federated generally agrees with the Proposed Amendments regarding asset segregation requirements and qualifying coverage assets. The current regime is outdated, as amply described in the Release.[25] The proposed mark-to-market coverage amount puts all derivative instruments on the same basis, thus cleaning up inconsistent treatments of cash versus physically settled instruments, as one example. Federated also agrees with the concept of the risk-based coverage amount, with the proviso that advisers should be allowed to use their reasonable judgment and experience in determining what such amounts should be.[26] However, Federated disagrees with the requirement that eligible coverage assets (other than for financial commitment transactions) must be cash and cash equivalents. Federated instead proposes that eligible coverage assets

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[23] *See id.* at 125 ("First, we believe that the VaR test under the proposed rule is more consistent with the policies and provisions of the Investment Company Act, which restricts in section 18 a fund's ability to issue senior securities but otherwise generally does not impose limitations on a fund's ability to invest in risky or volatile securities investments, provided that such investments are consistent with the investment strategy described to investors. Using the fund's own portfolio as the baseline for the VaR test under the proposed rule—and thus providing a risk assessment of the fund's use of derivatives in the context of the fund's investment strategy disclosed to investors, which may include risky or volatile securities—would be more consistent with the Act. A relative VaR test, by contrast, could be viewed as a limitation on risk or volatility generally—as opposed to a limitation on the issuance of senior securities—because it would measure the VaR of a fund's portfolio, including non-senior securities investments, against a hypothetical reference portfolio, and such non-senior securities investments could cause the fund to fail a relative VaR test.").

[24] *See id.* at 125–26 ("Second, we are also concerned that under a relative VaR approach it would be difficult, in light of the wide range of fund strategies and potential benchmarks, to require funds to select benchmarks that are appropriate (particularly in connection with alternative strategies), are unleveraged, and would otherwise serve as an appropriate baseline against which the relative VaR should be measured.").

[25] *See id.* at 49.

[26] This proviso appears to be endorsed by the Commission, with its requirement that fund directors adopt policies and procedures related to the determination of risk-based coverage amounts. *See id.* at 167.

should consist of cash, cash equivalents and other securities considered to fall within the 1-3 Day Liquid Bucket as defined in the Commission's recently proposed rule regarding open-end fund liquidity risk management programs ("**Liquidity Rule**") (or within an equivalent successor concept as outlined in the forthcoming final rule).

In the proposed Liquidity Rule, the Commission defines liquidity risk as "the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."[27] In fact, a fund has many financial obligations, including obligations to portfolio senior securities, that must be met under both normal and stressed market conditions. The fund's portfolio manager would manage fund liquidity accordingly.[28] The Commission should also consider the fact that much of the asset segregation requirement created under the Proposed Amendments will derive from the risk-based coverage amount established by the fund as a precaution for the possibility that the fund may need to close positions in stressed market conditions. Under normal conditions, the amounts associated with this portion of the requirement will idly remain in cash and equivalents, under the Commission's proposal.

For these reasons, Federated believes that the provision of liquidity to meet asset segregation requirements for derivatives should be accorded the same priority and treatment as liquidity for redemptions, and that the eligible coverage assets should consist of cash, cash equivalents and other securities that are considered to constitute the 1 – 3 Day Liquid Bucket under the proposed Liquidity Rule (or within an equivalent successor concept as it may be proposed in the forthcoming final rule).

As a final observation on this subject, we note that the Release repeatedly clarifies that the intent of the asset segregation requirement is to enable a fund to meet its obligations created by portfolio senior securities. For instance, the Release states:

> The proposed rule's conditions are designed both to impose a limit on the leverage a fund may obtain through the use of derivatives and financial commitment transactions and other senior securities transactions, and to require the fund to have assets available to meet its obligations arising from those transactions, both of which are central investor protection purposes and concerns underlying section 18.[29]

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[27] *See* Liquidity Release, *supra* note 2. In September 2015, the Commission proposed a new rule designed to standardize liquidity risk management by open-end funds. The proposed Liquidity Rule would require most open-end management investment companies to, among other things, adopt liquidity risk management programs, including classification of each fund holding into one of six liquidity categories and establishment of a minimum amount of assets a fund must hold in three-day liquid assets.

[28] One might question whether the Commission should devote an entire rule to creating a liquidity risk management regime that addresses only one of the many liquidity requirements experienced by registered funds. It is possible that the Commission should reconsider its assessment of liquidity to encompass a broader array of liquidity needs.

[29] Release, *supra* note 1, at 9.

In fact, the proposed requirement that eligible coverage assets should consist of cash and cash equivalents is a further means of controlling economic leverage, as well as a provision for liquidity. In concert with the portfolio limits of the Proposed Amendments, this creates an additional and redundant degree of control on leverage with the disproportionate adverse effect of reducing portfolio efficiency by requiring excess amounts of cash and cash equivalents. The Commission should clearly distinguish between leverage risk and liquidity risk, comprehensively treat each within the separate respective rulemaking efforts underway, and not conflate these distinct risks within the Proposed Amendments related to derivatives.

IV. RISK MANAGEMENT PROGRAM

Federated generally agrees with the risk management requirements of the Proposed Amendments. In particular, we agree that the requirement of a formalized program approved by fund directors to assess, monitor and control the major dimensions of derivatives risk, including leverage, liquidity, market, counterparty and operational risks, is a beneficial and appropriate framework for the protection of fund shareholders. However, Federated would propose a number of amendments to the proposed requirements:

1. *Systematic or Dynamic Leveraging Strategies.*

The Proposed Amendments do not address the question of whether funds' use of derivatives may entail strategies that contribute to a more rapid or systematic selling of securities in declining markets than a general use of leverage might generally suggest.[30] While the Commission was thorough in identifying the key risks (referenced above) that a formalized derivatives risk management program must consider, systematic or dynamic leveraging strategies can entail distinct and exacerbated risk to shareholders. There can certainly be heightened investment risk in these strategies, but they also expose shareholders to execution risks if fund advisers were to experience market disruptions that prevented timely trading, or a business continuity or other event that prevented scheduled trading from taking place. Federated recommends that the Commission consider additional investor disclosure with respect to uses of derivatives that are intended to implement strategies in which the fund is systematically or dynamically levered to a material extent with respect to one or more market risk factors.

2. *Derivatives Risk Disclosure.*

In its general discussion of derivatives risk, the Commission acknowledged that under the Investment Company Act it has the authority to regulate risk due to leverage, but not to otherwise set limits on investment risk. Nonetheless, there is a degree of ambiguity in interpreting how the Commission balanced the various factor in arriving at the 150% and 300% notional tests since they do not precisely correspond to a statutory limit and appear to reflect a

[30] Option replication (*e.g.*, portfolio insurance strategies) or 2x / 3x strategies illustrate this concern. Such strategies, if widespread in use, could be perceived as contributing to systemic risk or increasing the prospect of "fire sales."

degree of judgment by the Commission that will necessarily impact the overall investment risk presented by affected funds.

For example, 3x levered funds would appear to now be inadmissible under the Proposed Amendments. These funds would be an example of a systematic or dynamic leveraged strategy referenced above. If such a fund were effectively managed, it would have option characteristics that could be appealing to some investors. There is certainly a risk of loss of principal in such strategies, but an investor may seek to hold a larger portion in fixed income securities in their portfolios along with a smaller allocation to levered equity. This is not necessarily irrational or imprudent. A 3x fund enables that investor to construct the contemplated payoff pattern without resorting to transactions in listed or over-the-counter options, which could be complex and expensive to undertake. If the 3x strategy is effectively managed, and surmounts the execution challenges identified above, the dynamic trading of positions internal to the fund, subject to a robust oversight program, would cause this degree of leverage to pose less risk to the shareholder than that of a similar fund that was not dynamically managed. The fund would not become insolvent due to margin calls since the levered position would be managed carefully in a market decline. For this reason, the fund would pose less risk due to this degree of leverage than would have been anticipated under section 1(b)(7) and 1940-era management techniques.

Based on this general reasoning, the Commission may wish to consider a form of designation or disclosure for more highly levered funds that alerts investors to the potential risks that they contain. A heightened disclosure regime could complement the Proposed Amendments by providing additional investor protections while not ruling out valid investment strategies. For instance, for funds adopting the principles-based regime suggested in section II.a.2 above, but whose notional exposures exceed the 150% as proposed in the Release, the Commission could require an additional derivatives risk statement alerting investors to the heightened degree leverage contained in the fund.

3. *The requirement for a formalized risk management program.*

Federated generally agrees with the requirements for a formalized risk management program as specified in the Proposed Amendment. However, we believe that the requirement should be somewhat more contextual than currently provided in the Release, leading to additional circumstances in which a formal risk management program should be required. Conversely, Federated also believes that requirements with respect to complex derivatives should be relaxed, under some circumstances.

Federated proposes that a formalized risk management program should be required whenever: (i) derivatives notional exposure exceeds 50% of fund net assets; (ii) the use of derivatives is intended to implement a strategy in which a fund is systematically or dynamically levered to a material extent with respect to one or more market risk factors; or (iii) when derivative exposures (when representing less than 50% notional exposure) contribute a material degree of risk to fund returns or represent a principal investment strategy, unless the board of directors, including a majority of independent directors, determines that such program is not in the best interest of shareholders.

Conversely, Federated believes that the use of a complex derivative in a fund should not automatically necessitate a formalized risk management program. While it is prudent to require a degree of sophistication when using complex derivatives, they are now a relatively familiar concept and are part of the standard curriculum in a typical MBA course on financial instruments. Federated believes that this requirement could create an undue burden for funds making *de minimis* use of complex derivatives. Furthermore, such a requirement could have a chilling effect on innovation – in both the use and creation – of new types of derivatives that could be deemed complex derivatives under the Proposed Amendments. Instead of an automatic requirement, Federated proposes that a formalized risk management program be required as a result of any use of complex derivatives unless the board of directors, including a majority of independent directors, determines that such a program is not in the best interest of shareholders, provided that the board adopts policies and procedures with respect to monitoring and reporting for such instruments.

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Federated hopes that the Commission finds these comments helpful and constructive and is happy to provide additional information relating to our comments or discuss any questions you may have.

Yours very truly,

Michael R. Granito
Chief Risk Officer

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

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