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*Submitted electronically*
Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

**Re: Use of Derivatives by Registered Investment Companies and Business Development Companies – File No. S7-24-15**

Dear Mr. Fields:

We appreciate the opportunity to provide our comments to the Securities and Exchange Commission (the "Commission") on its recent proposal regarding the use of derivatives by registered investment companies and business development companies.[1] Dearborn Capital Management, L.L.C. ("Dearborn"), an Illinois limited liability company, is a registered investment adviser under the Investment Advisers Act of 1940, as amended, as well as a commodity pool operator ("CPO") and a commodity trading advisor registered under the Commodity Exchange Act of 1936, as amended. Dearborn is also a member of the National Futures Association. Dearborn serves as the investment adviser and CPO to a variety of investment companies registered under the Investment Company Act of 1940, as amended ("1940 Act"), including two mutual funds and two privately offered registered investment companies (together, the "1940 Act Funds").[2]

Three of the funds make extensive use of derivatives, including Grant Park Multi Alternative Strategies Fund, the Grant Park Managed Futures Strategy Fund and the Grant Park Absolute Return Fund. Each fund allocates its investments across a variety of investment strategies, many of which exclusively use derivatives. Through a sub-adviser, the Grant Park Multi Alternative Strategies Fund seeks to allocate its assets among four distinct investment strategies: long/short global financials, dynamic commodities, upside capture and unconstrained interest rates. The Grant Park Absolute Return Fund seeks to allocate its assets between independent, underlying strategies: an investment growth strategy and a fixed income strategy. In pursuing the growth strategy, the fund's sub-adviser will buy and sell futures to gain exposure to the return of U.S. and European economic indices using an actively

[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 FR 80884 (Dec. 28, 2015) (the "Proposing Release") (proposing new Rule 18f-4).

[2] Grant Park Absolute Return Fund, Grant Park Fixed Income Fund, Grant Park Managed Futures Strategy Fund and Grant Park Multi Alternative Strategies Fund are each a series of the Northern Lights Fund Trust.

managed, statistically driven quantitative program that uses model-based investing strategies to identify and capture short-term price trends across a variety of market conditions. Certain of the 1940 Act Funds utilize a wholly-owned subsidiary in order to provide the fund with exposure to non-financial commodity interests.

The Grant Park Managed Futures Strategy Fund seeks to allocate its assets between a managed futures strategy and fixed income strategy. The managed futures strategy is designed to produce capital appreciation by capturing returns related to price trends in the commodity markets and financial (equity, interest rate and currency) markets by investing primarily in securities of (1) limited partnerships, (2) corporations, (3) limited liability companies and (4) other types of pooled investment vehicles that are globally-oriented trading companies, including commodity pools (collectively, "Underlying Funds") and derivative instruments, such as swap contracts, structured notes or other securities or derivatives, that provide exposure to the managers of Underlying Funds. In making investment decisions for the managed futures strategy, Dearborn may invest exclusively in any of the investments named above, or by using a combination of such investments. In addition to its mutual fund products, Dearborn also serves as the sponsor, CPO and general partner of a multi-advisor commodity pool registered for offer and sale under the Securities Act of 1933, as amended.

Dearborn appreciates the Commission's concerns regarding the use of derivatives by funds registered under the 1940 Act and strongly supports the efforts of the Commission and its staff to implement a comprehensive overhaul of the framework governing the use of derivatives by registered investment companies under the 1940 Act. The current regulatory framework is based on the principles set forth in a 1979 Commission release with respect to the use of reverse repurchase agreements, standby commitments and when-issued securities.[3] The staff of the Commission has subsequently issued dozens of no-action letters applying the principles of Release 10666 to derivative transactions.[4] The Commission staff also sets forth its views through the disclosure review process and the examination process, which are not necessarily applied equally to all registrants. Regulatory guidance has not kept pace with the proliferation of derivatives instruments and products developed by market participants and, as a result, there is no definitive guidance with respect to many widely used derivatives instruments. As a result of this uncertainty, registrants may apply different practices with respect to the same or similar instruments, which disadvantages certain market participants. Dearborn believes that all registrants will benefit from a level playing field and greater certainty with respect to their compliance and risk management processes regarding the use of derivatives.

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3 *Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666*, 44 FR 25128 (April 27, 1979) ("Release 10666").

4 Notwithstanding that Release 10666 did not address derivative instruments, the analysis contained in Release 10666 has served as the foundation for the Commission staff to provide subsequent no-action guidance involving a wide array of derivatives transactions and their treatment under Section 18 of the 1940 Act. A select bibliography of the subsequent SEC staff no-action letters is available at http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

While Dearborn strongly supports the goals of Proposed Rule 18f-4 ("Proposed Rule"), we believe that key provisions of the Proposed Rule are unduly broad and restrictive, are not necessary to achieve the stated goals, and could result in constraints that severely restrict investor access to products that have broad market appeal because of the potential benefits investors seek. In particular, while we appreciate the Commission's concern regarding the use of derivatives by registered funds, the proposal to both (i) impose a limit on the magnitude of derivatives exposure/risk and (ii) require the maintenance of qualifying coverage assets is duplicative and unnecessary. We note the extreme examples created by investments that are singularly focused by either positively or inversely leveraging an index are not representative of the overall class of funds that operate in the liquid alternatives marketplace.

We believe the senior securities risk is addressed so long as a fund maintains sufficient asset coverage. The industry has operated this way without significant incident since Release 10666 was issued over 30 years ago. Imposing the proposed exposure-based test is, as the Commission concedes, a blunt measurement that fails to take into consideration the different investment risks and payment obligations of the fund.[5] In addition, the risk-based test is narrowly tailored to look only at a fund's "securities VaR" versus the "full portfolio VaR." The existing industry-wide practice measures an entire portfolio's Value at Risk.

The proposed portfolio limits described in the Proposed Rule has two fundamental problems. First, the Proposed Rule incorrectly initiates its risk-based tests by assuming that a portfolio only contains securities and would only use derivatives to hedge the risk of the securities in the portfolio. That supposition is unfounded and creates the most severe defect in the Proposed Rule. Second, as the Commission concedes, the use of notional exposure without qualification for different investment risks and payment obligations of a specific contract fails to reflect the way in which a fund may use derivatives. Using the blunt measure of notional value, for example, while ignoring the actual risk-related characteristics of sovereign, short-term interest rate contracts, in particular, would significantly misrepresent a portfolio's exposure.

Many liquid alternative funds that invest using derivatives-based instruments are created on the core assumption that the preservation of investor capital is a paramount priority, and that risk management drives the selection of all investment decisions as a means of pursuing a fund's investment objective. The portfolio that results from the application of that principle reflects the optimum combination of investments available within an investment strategy; the investments are explicitly <u>not driven</u> by a core portfolio of investment holdings. In essence, the "core" of a liquid alternative investment is the risk management protocols associated with the manner in which a portfolio is constructed and operated. This concept explains the fundamental reason why liquid alternative funds generally and the Grant Park funds in particular consistently demonstrate little or no correlation to equity- or fixed-income markets.

[5] Proposing Release at 70.

I. **Background and Summary of Comments**

A. *Alternative Investment Strategies*

Alternative investment strategies, including managed futures, have been successfully used by institutional investors for more than 30 years and by Dearborn's funds since 1989. We launched our first 1940 Act Fund in 2011, devoting significant human capital and financial capital to develop the necessary operational, compliance and risk systems and processes to launch and actively manage that product. Our fund strategies historically exhibit low correlation and lower volatility than products that represent traditional asset classes. These funds provide retail investors with access to investment strategies through a familiar structure (a mutual fund) and through customary mutual fund distribution channels. Our 1940 Act Funds, for example, provide access to multiple diverse strategies which retail investors could not otherwise access directly. We believe the tremendous growth of funds across the liquid alternative funds category demonstrates the broad appeal these types of products offer to retail investors.[6] These features are borne out by statistical evidence that indicates alternative investments may provide value to any investor's portfolio and should not be limited to high-net-worth or institutional investors.[7]

The Commission's assumption that derivative investments create excessive leverage, and are inherently more volatile, therefore exposing investors to significantly greater risk, does not appear to be valid. A review of Morningstar data that summarizes performance characteristics across all investment categories is insightful. The volatility for managed futures and multi alternative categories – which include funds that use derivatives extensively – were most similar to long-term government bonds; this is contrary to a key underlying assumption which drove the creation of the proposed rule.[8] The Morningstar category averages for managed futures and multi alternative mutual fund categories, in particular, indicates that these investments pose less risk and similar rewards, as does an investment in a product linked to the S&P 500 Total Return Index.

The Morningstar data demonstrates the "portfolio effect" of diversified alternative investment portfolios, whereby a portfolio that invests across a broad range of highly liquid

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[6]Total assets in U.S. managed futures were $7.5 billion as of the end of 2011, up from $4.3 billion in 2010 and $2.7 billion in 2009 (Morningstar).

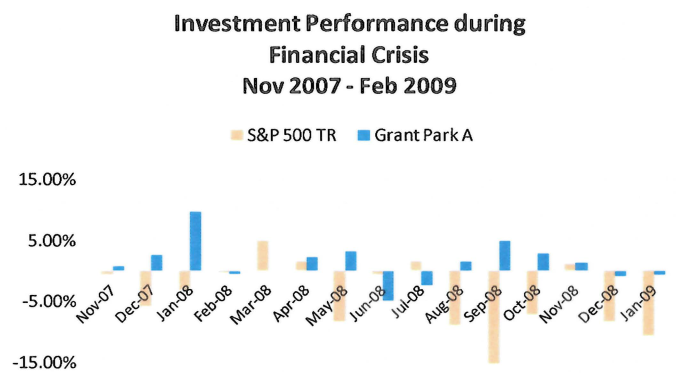
[7] The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management (McKinsey & Company June 2012) ("...confronted with volatile financial markets and the underfunding of their own retirements, [retail investors] follow the path blazed by institutional investors. Fueling this trend is a shift in investment frame-works from relative to absolute return and convergence of traditional and alternative asset classes, investment managers and products").

[8] Morningstar data from Jan 1, 2006 through Dec 31, 2105 was used to analyze the annualized standard deviations (Ann SD) for each of the Morningstar categories. The Ann SD for selected categories was: Long-term government bonds (>6 yr duration) was 14.91%, World bond was 11.09%, Managed futures was 12.35% and Multialternative was 9.03% . The Ann SD for the S&P 500 tracking category was 28.37%. The single- sector Inverse or Leveraged Equity categories were highest, at 62.28% and 61.18%, respectively.

derivatives markets can produce a portfolio profile that yields performance similar to the S&P 500 Total Return Index with substantially lower volatility.

Significantly, using a Value at Risk ("VaR") analysis for each Morningstar category, based on a 200 day moving average and 95% confidence level, the VaR of the managed futures and multi alternative categories is almost half of the S&P 500 Total Return Index.[9]

During the period of the financial crisis (November 2007 to February 2009), the performance of alternative investment strategies offered a safe haven for investors. Unlike the S&P 500 Total Return Index, which was down 50.95% during such period, managed futures products, in particular, delivered superior, positive performance. The following table uses the reported returns for the Grant Park Fund managed futures Class A units[10] for comparison.




| | S& P 500 TR | Grant Park A |
|---|---|---|
| Total Return | -50.95% | 17.83% |
| Ann. Return | -41.39% | 13.09% |
| Ann. Standard Deviation | 19.62% | 11.38% |
| Ann. Sharpe Ratio | -2.57 | 1.14 |
| Ann. Sortino Ratio | -2.15 | 2.58 |

As Commissioner Piwowar noted in his dissent, absent data indicating that a separate specified leverage limit is warranted, there is no justification for imposing any additional requirements or burdens on funds which will result in limiting investor choice for products designed to dampen volatility in times of market stress.[11]

As noted above, the 1940 Act Funds use a variety of alternative investment strategies. Dearborn and/or its sub-advisers execute their strategies by investing in a wide range of

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[9] Sources: Morningstar and Dearborn for the period of Jan 31, 2006 to Dec 31, 2015. The VaR was calculated based on daily reported performance. The actual VaR values for each category are: S&P 500 tracking 2.82%, Managed futures 1.28% and Multialternatives 0.94%.

[10] Sources: Morningstar and Grant Park A: A Units of the Grant Park Futures Fund LP. We note that 1940 Act registered mutual funds which utilize derivatives to execute investment strategies such as managed futures did not generally become available until at least 2010.

[11] Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (December 2015).

derivative products, including futures. In the case of the Grant Park Managed Futures Strategy Fund, access to managers of the Underlying Funds is provided through total return swap products offered by investment banks (each, a "Swap"). Through the Swap, the fund gains exposure to the returns of trading strategies managed by third-party trading advisors.

The Swap is a type of derivative instrument based on a customized index (the "Index") designed to replicate the aggregate returns of the managers selected by Dearborn. The Swap is based on a notional amount agreed upon by Dearborn and the counterparty. Dearborn may add or remove managers from the Index or adjust the notional exposure between the managers within the Index on a limited basis. Generally, the fees and expenses of the Swap are based on the notional value. The Index is calculated by the counterparty to the Swap and includes a deduction for fees of the counterparty as well as management and performance fees of the managers. Unlike certain other derivatives transactions, the Swaps are negotiated with individual counterparties, but are structured in a manner that limits the losses of the fund to an amount that can be substantially less than the notional amount (the "Maximum Loss Limit").

The Swap operates in a manner similar to a purchased option or structured note, in that the fund's losses under the Swap cannot exceed the amount posted to its tri-party custodial agreement for purposes of entering into the Swap – i.e., the Maximum Loss Limit. Although the Swap involves interim payments through the potential posting of margin from the custodial account, the payment obligations cannot exceed the Maximum Loss Limit. As a result, we believe the Swap should be afforded the same treatment as a purchased option or structured note. Under the Proposed Rule, the Commission "...would not limit economic leverage created through derivatives (e.g., purchased options) that would generally not be considered to involve the issuance of senior securities (i.e., because these transactions do no involve a payment obligation."[12]

As the Commission requested information about whether funds would be able to comply with the Proposed Rule, we believe that if the Proposed Rule is adopted without correcting the defects contained therein, some alternative investment funds would have difficulty complying with either of the risk-based or exposure-based tests. Depending on how the final rule is implemented, funds may need to alter the manner in which derivatives exposure is obtained, which may result in increased portfolio volatility and lower overall returns. Ultimately, the proposed limits seem to create a host of new compliance complexities without addressing any enumerated market risk created by alternative mutual funds.

B. *Summary of Comments*

A summary of the key elements of our comments, which are discussed in detail below, is as follows:

- We believe that the exposure-based limitations in the Proposed Rule, which are premised on notional value, are unnecessary and overbroad in scope. In

[12] Proposing Release, at p. 263, fn 508.

particular, imposing an exposure-based limit based on notional value is duplicative of the proposed asset coverage requirements. Accordingly, as supported by Commission Michael S. Piwowar, we recommend that such test be eliminated from any final rule.[13] If it is retained, we recommend that such a test must allow funds to take into account (1) the different investment risks and payment obligations under a derivative contract, (2) the maximum loss potential of a derivatives contract similar to the treatment of purchased options, if less than the notional value, and (3) a broader range of hedging and netting arrangements.

- As noted above, the Swap should be afforded the same treatment as a purchased option or structured note. Given that no additional payment obligation is required beyond the Maximum Loss Limit, a fund employing the Swap has already limited its exposure and any senior security risk.

- The look-through requirement for calculating the notional amount is unnecessary and significantly overstates a fund's actual derivatives exposure.

- While we disagree with the need for a risk-based portfolio limit for derivatives, we believe such an approach, if adopted, should reflect industry accepted standards for measuring portfolio risk. The notion of creating a "securities VaR" incorrectly assumes that all derivatives are used for hedging a core securities portfolio. This spurious assumption would make the 300% test difficult for many alternative mutual funds that use derivatives to gain investment exposure. The risk-based test must be compared against a more standardized and industry acceptable metric. If adopted, a VaR-based methodology should be applied at the portfolio level and should be based on already existing industry-wide standards and best practices. Adopting the proposed risk-based portfolio limit will only serve to create additional compliance complexity, particularly for those firms with similar products in non-U.S. jurisdictions that impose different risk-based portfolio limits.

- If a risk-based portfolio limit is adopted, we believe that the standardized VaR methodology should be based on a diversified VaR formula, which takes into account diversification benefits between portfolio components.

- Qualifying coverage assets should be expanded to include, at a minimum, equities with appropriate haircuts, as other regulators have permitted for margin.

- As noted above, the performance of liquid alternatives during the recent financial crisis appears to empirically prove derivatives-based investment

[13] See note 11. "Therefore, absent data indicating that a separate specified leverage limit is warranted there is no justification for imposing any additional requirements or burdens on funds."

strategies operate in an entirely different manner than the Proposed Rule supposes.

## II. Summary of Proposed Portfolio Limits and Asset Coverage Requirements

The two areas of the Proposed Rule that are of the greatest concern to Dearborn are the portfolio-based limits and asset coverage requirements. To provide context to our comments, we have briefly summarized the provisions of the Proposed Rule with respect to the tests below.

### A. *Overview*

The Proposed Rule is intended to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives. The Proposing Release states that Congress's concerns underlying Section 18 were focused on: (1) excessive borrowing and the issuance of excessive amounts of senior securities by funds, which unduly increased the speculative character of their junior securities; (2) funds operating without adequate assets and reserves; and (3) potential abuse of the purchasers of senior securities.[14] The arbitrary portfolio limitation requirements of the Proposed Rule are designed primarily to address concerns about a fund's ability to obtain leverage through derivatives transactions, while the asset coverage requirements of Proposed Rule are designed primarily to address concerns about a fund's ability to meet its obligations.[15]

Proposed Rule would permit a fund to enter into senior security transactions,[16] provided that the fund:

- Complies with one of two alternative portfolio limitations with respect to senior security transactions, an exposure-based limitation or a risk-based limitation;
- Maintains a certain amount of "qualifying coverage assets" with respect to its derivatives transactions and financial commitment transactions; and
- Establishes a formalized derivatives risk management program, administered by a designated derivatives risk manager approved by the fund's board, if a fund engages in more than a limited amount of derivatives transactions or uses any complex derivatives transactions.

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14 Proposing Release, at p. 14.

15 Proposing Release, at p. 55.

16 A "senior security transaction" includes (1) any derivatives transactions (as defined in the Proposed Rule), (2) any financial commitment transactions (as defined in the Proposed Rule), and (3) other senior securities such as borrowings and the issuance of preferred stock.

B. *Exposure-Based Portfolio Limit*

The exposure-based portfolio limit focuses solely on the level of a fund's exposure to derivatives and to senior securities. Under the exposure-based portfolio limit, a fund would be required to limit its aggregate exposure to senior securities transactions to 150% of its net assets. A fund's "exposure" is the sum of:

- the aggregate notional amounts of the fund's derivatives transactions;
- the aggregate obligations of the fund under its financial commitment transactions; and
- the aggregate indebtedness (and, with respect to any closed-end fund or business development companies, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the fund pursuant to Section 18 or 61 of the 1940 Act.

The notional amount of a derivatives transaction is either (i) the market value of an equivalent position in the underlying reference asset (expressed as a positive amount for both long and short positions) or (ii) the principal amount on which payment obligations under the derivatives transaction are calculated.

C. *Risk-Based Portfolio Limit*

The risk-based portfolio limit is intended to provide an alternative portfolio limitation that focuses primarily on a risk assessment of a fund's use of derivatives transactions. Under the risk-based portfolio limit, a fund would be permitted to increase its aggregate exposure to senior securities transactions to 300% of its net assets, but only if the fund's derivatives transactions, in the aggregate, result in the fund being subject to less market risk than if the fund did not use such transactions. Risk would be evaluated using a test based on VaR.

Under the Proposed Rule, VaR is an estimate of potential losses on an instrument or portfolio, and it must:

- take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as appropriate, risks such as equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk, as well as the sensitivity of the market value of the fund's derivatives transactions to changes in volatility or other material market risk factors;
- use a minimum 99% confidence interval and use a time horizon of not less than 10 and not more than 20 trading days; and
- use a minimum of three years of historical data to estimate historical VaR.

Under the Proposed Rule, to satisfy the VaR test, a fund's "full portfolio VaR"[17] would have to be less than the fund's "securities VaR[18]" immediately after the fund enters into any senior securities transaction. While the Proposed Rule does not specify that a fund must use any particular type of VaR model, any VaR model used by a fund must satisfy the subjective and objective requirements for a VaR model described above.

D. *Asset Coverage Requirements*

Under the Proposed Rule, with respect to each derivatives transaction, a fund would be required to maintain "qualifying coverage assets" to cover (i) the fund's mark-to-market obligations under the transaction and (ii) an additional amount designed to address potential future losses and resulting payment obligations under the transaction. The mark-to-market amount is the amount payable by the fund if the fund were to exit the derivatives transaction at the time of determination, which would generally be the fair value of any liability. With limited exceptions, the fund's qualifying coverage assets for its derivatives transactions would be required to consist of cash and cash equivalents. The total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.

## III. **Discussion and Comments on Proposed Rule**

A. *The Exposure-Based Portfolio Limits Are Unnecessary and Unduly Restrictive*

Dearborn believes the exposure-based test, which is premised exclusively on notional value, is unnecessary, is unduly restrictive, and will result in products which are less sound than those currently offered; the combination of overstating the value of the underlying contracts, incorrectly applying risk management and VaR measures, and ignoring the volatility associated with each instrument and across an entire portfolio could create inappropriate constraints which reduce a fund's ability to achieve its stated investment objective(s).

The limit is unnecessary and the senior securities risk is addressed so long as a fund maintains sufficient asset coverage. The industry has operated this way without significant incident since Release 10666 over 30 years ago. This position is supported by Commissioner Piwowar, who notes that "the proposed asset segregation requirements should function as a leverage limit on funds and ensure that funds have the ability to meet their obligations arising from derivatives. Therefore, absent data indicating that a separate specified leverage limit is warranted there is no justification for imposing any additional requirements or burdens on funds. This is particularly the case given that our current guidance to funds concerning their derivatives transactions rests solely on asset segregation." Accordingly, we strongly recommend that the Commission reconsider an exposure-based portfolio limit.

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[17] A fund's "full portfolio VaR" is the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions.

[18] A fund's "securities VaR" is the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions.

The Commission concedes the imposition of a proposed exposure-based test is a blunt measurement that fails to take into consideration the different investment risks and payment obligations of the underlying reference asset.[19] The Proposed Rule lacks understanding of fundamental factors that create the distinct characteristics of each derivatives contract. For example, energy contracts are susceptible to significant price swings due to geopolitical events; grains prices can vary widely due to weather. Each contract's performance profile is created by the influences of its markets. Short-term interest rates, in particular, are least susceptible to such market vagaries; they are set by central bank policies, are broadcast to market participants, and scrupulously analyzed by all market participants for any signs of change. Consequently, and as seen in the table below, the daily VaR for these instruments is extraordinarily low on a daily basis.

The vast majority of the leverage associated with managed futures funds, in particular, is attributed to sovereign short-term interest rate contracts, which are used to reduce a portfolio's volatility and to reduce an investor's value at risk. The Proposed Rule could severely restrict their use, thereby removing a low-risk investment that offsets more volatile investments, as shown in the table below. Arbitrarily limiting the prudent use of these contracts would impair well-established investment strategies and result in creating investments that are both more volatile and less able to achieve an individual's investment objective. If implemented, any proposed change should remove or adjust the degree to which these investments are included in any leverage calculation.

It is especially important to note that, in the case of short-term interest rate contracts, notional value is not a useful measurement of risk. This is primarily because the maximum amount the owner could possibly lose is not the notional value of the contract. Each time a fund posts additional margin to maintain a trade, the fund is making an investment decision to continue the trade. If the fund failed to post margin, the trade would be closed and a final determination would be made on losses. Historically, the Commission has generally accepted this concept through its asset coverage requirements under Release 10666. Now, the Commission appears intent on imposing a structure that ignores the investment risk created by the contract.

Further, using notional value is neither a measure of the potential leverage effect of an instrument nor a measure of the potential losses to a fund, and does not take into account the risk profile of the derivative investment. For example, a fund may use forward currency contracts to hedge currency risk, interest rate swaps to hedge interest rate risk or manage duration, and a total return swap to seek investment exposure. We submit that each of these three instruments and their particular uses present very different risk profiles, and that the notional value of these instruments is an ineffective measure of the potential risk to the funds.

For alternative mutual funds that seek exposure to a variety of derivatives to create a diversified portfolio, the notional value of the contacts may have little to no impact on how the

[19] Proposing Release, at p. 70.

firm evaluates leverage and risk management. Set forth below is an example of how using notional value creates a fundamental error in evaluating leverage and potential losses.

| Sector | Contract | Market Price | Tick Value | Face Value* | One Day 99% VaR | VaR $ value/ one contract 99% VaR | Correlation to S&P 500 |
|---|---|---|---|---|---|---|---|
| Energies | Natural Gas | 2,261 | 10.00 | $22,610.00 | 8.49% | $1,920.15 | 0.01 |
| Equities | E-Mini SP500 | 1,925 | 50.00 | $96,250.00 | 2.57% | $2,474.25 | 1.00 |
| Long term interest rates | US 30 Year | 157.5625 | 1000.00 | $157,562.50 | 1.41% | $2,221.25 | -0.54 |
| Short term interest rates | Eurodollar | 9,668.50 | 25.00 | $241,712.50 | 0.08% | $191.40 | -0.20 |
| | Euribor | 11,028 | 25.00 | $275,700.00 | 0.02% | $66.27 | -0.30 |
| | Euroswiss | 10,094 | 24.75 | $249,851.49 | 0.03% | $81.26 | -0.42 |
| | Euroyen | 9,987 | 21.09 | $210,589.57 | 0.01% | $17.87 | 0.02 |

The preceding table[20] reflects market data during January 2016 and allows for the following observations:

- Using the 150% leverage limit proposed by the Commission and applying a 99% confidence standard, an equity only portfolio exposure (represented by an E-Mini SP 500 contract) would have a one day VaR of 3.85% (2.57 x 1.5).
- This type of concentrated risk portfolio is *exactly* what a multi-sector, liquid alternative mutual fund seeks to avoid. Many liquid alternative strategy mutual funds are constructed from inception with the aim of creating a portfolio with an equalized risk weighting across a broad basket of market sectors and specific derivative contracts that exhibit low correlation to each other.
- This combination of market sectors results in a portfolio with substantially lower risk than an equity only portfolio or a portfolio of equities plus unleveraged fixed income investments.
- The impact of including sovereign, short-term interest rates is especially critical. This sector exhibits a negative correlation to the S&P and considerably reduces the volatility of an equities-only portfolio.
- For example, in order to equalize (or reduce) a portfolio's risk and volatility, a fund would need to add 13 Eurodollar contracts for each E-Mini SP 500 contract it purchases. (The one-day VaR value for each E-Mini SP 500 contract is $2,474, whereas the one-day VaR value per Eurodollar contract is $191.) This 13:1 ratio reflects the low-risk, low volatility, low-correlation attributes of the very short term interest contracts the Proposed Rule would severely restrict.
- This empirical, risk-reduction technique would be severely limited by the "one size fits all" notional value approach included in the Proposed Rule.

[20] Source: Dearborn.

Limiting leverage to limit risk is a concept that should be used selectively and, for example, in the specific case of sovereign short-term interest rates, should be used based on an accurate understanding of their use, purpose and risk within a broad, diversified portfolio.

As the Commission expressly acknowledged in the Proposing Release, its "one-size-fits-all" notional exposure limit fails to consider the significantly different risk profiles among reference assets, and overstates the magnitude of a fund's exposure. In particular, the Commission noted that for very short-term derivatives transactions, such as Euribor and Eurodollar futures, calculating the notional amount without dividing by four could be viewed as overstating the magnitude of the fund's investment exposure. The Commission asked whether the Proposed Rule should permit or require adjustment as a better way to measure a fund's exposure, and whether there are other futures contracts or standardized derivatives for which an analogous adjustment should be made. If the Commission intends to adopt an exposure-based limit, we strongly recommend the Commission adopt a test that considers the risk profile of the individual instrument.

We recommend the Commission adopt a "risk-adjusted exposure" calculation instead of one based on notional amounts. The risk-adjusted exposure would reduce the amount of exposure for purposes of the calculation, in proportion to the risk of the derivative contract. Such an approach would recognize the lower risk of Eurodollar futures and fixed income investments. We believe there are a number of viable methods to calculate risk-adjusted exposure.

B. *Exposure-Based Limit Should Consider Dollar Based Exposure or Exclude Products with No Additional Payment Obligation*

In addition to correcting the manner in which the exposure-based test should be measured, if adopted, the test should also consider whether the fund has offset the position or includes an embedded Maximum Loss Limit. With respect to the Grant Park Managed Futures Strategy Fund, the Swaps it employs utilize Maximum Loss Limits. Under the Maximum Loss Limits, the fund is not exposed beyond amounts posted with the counterparty to the Swap. Accordingly, the requirement of a look-through to the Swap's reference asset on a notional basis would result in a substantial overstatement of the fund's derivatives exposure. If it is adopted, we believe the exposure-based limit should be amended to provide for this common sense approach to measuring exposure – *that exposure cannot exceed the fund's potential dollar loss under the contract*. To that end, we also recommend that the Commission consider permitting a broader range of hedging exclusions and netting techniques.

We note that the Swap is essentially the equivalent of a "basket option" transaction. As noted by the Commission in the Proposing Release, a basket option would not be subject to the derivatives limit requirement. As the Commission noted, basket swaps can be documented in the form of an option contract but are similar to a swap transaction. The Commission asked whether such basket options should be subject to the exposure test. Since basket options, like the Swap, involve only a deposit by an investor of cash "premium" that functions as collateral for the transaction and no interim payment obligation exists, there is no senior security risk. We believe that the proposed treatment of basket swaps is consistent with the Commission's historical practices on derivatives and should be expanded to including products like the Swap – which do not subject a fund to additional payment obligations beyond the posting of the initial collateral for the trade.

Furthermore, the look-through requirement for calculating the notional amount is unnecessary and, with limited ability to offset positions, it will substantially overstate exposure. In addition, the look-through requirement appears to create an unusual result whereby an investment in an unaffiliated fund would not require a look-through, while an investment in a derivative would require a look-through. As noted above, in such a situation, the actual exposures to the fund could be exactly the same. Again, we recommend that the Commission consider adding provisions to expand hedging exclusions and netting techniques.

C. *The Proposed Risk-Based Portfolio Limit Should Be a Uniform Standard that Applies Equally to All Market Participants*

While we disagree with the need for a risk-based portfolio *limit* for derivatives, such an approach, if adopted, should actually measure portfolio-level risk. VaR calculates the maximum loss expected (or worst case scenario) on an investment, and is computed over a given time period and resolved to a specified degree of confidence. By measuring VaR against "securities VaR," the risk-based portfolio limit necessarily assumes that all derivatives are used for hedging. This fundamental and flawed assumption will make the 300% test difficult for many alternative mutual funds to comply with, as such funds use derivatives to gain investment exposure and not for hedging. We strongly recommend that the Commission reconsider this assumption.

As the Commission noted in the Proposing Release, "relative VaR" is utilized by UCITS funds. Under the relative VaR approach, the VaR of the UCITS fund's portfolio cannot be greater than twice the VaR of an unleveraged benchmark. We believe the risk-based test, if adopted, must not result in an overly narrow view of portfolio risk. Given that many firms have products subject to both the 1940 Act and UCITS regimes, we recommend the Commission consider adopting a uniform standard. Adopting the UCITs standard would avoid market confusion and would allow firms to leverage off the compliance and risk infrastructure already in place.

Accordingly, we propose that the VaR test compare the VaR of the fund's portfolio with either (i) a benchmark similar to UCITs funds or (ii) a diversified VaR-based calculation that is applied at the investment portfolio level.

Ultimately, the VaR test should be clearly delineated and should be standardized across all market participants in order to foster greater transparency and to promote a level playing field. Otherwise the new regulatory regime will be susceptible to the same pitfalls as the current regulatory framework – i.e., registrants will be free to implement many versions of the VaR model, and practices will necessarily vary across market participants.

If the goal is to limit portfolio risk, the above proposal will achieve the desired results. For example, as set forth below, the proposals will limit funds with investments that are singularly focused by leveraging either positively or inversely an index. These funds are not representative of the overall class of funds that operate in the liquid alternatives marketplace and, in particular, are quite different than our diversified alternative investment funds. Put another way, we believe the final rule should prohibit outsized directional market bets on singularly focused investments, which subject retail investors to significant risks.

D. *The Risk-Based Portfolio Limits Should Be Based on a Diversified VaR Approach that Effectively Captures Portfolio Level Risk*

If the Commission implements a risk-based test, it should be based on existing, accepted standards that are currently utilized across the investment industry. The Commission has asked whether a fund should use a 99% confidence level, or should the Commission permit a lower confidence level. Either is acceptable and both are widely used, but confidence intervals are secondary to the critical standard.

We recommend that any risk-based standards be calculated using Diversified VaR applied at the portfolio level, without the segregation described in the Proposed Rule. From a risk-management perspective, the investment decision is driven by the characteristics of the entire portfolio over time, and the common sense approach is to utilize a measure that evaluates risk at the portfolio level over an extended timeframe.

The Commission has asked whether at least 10 trading days, but not more than 20 days is appropriate, or whether a specific number is necessary. Since VaR measures the relationship of risk by comparing performance over multiple time horizons, we would avoid the "one size fits all" approach. We recommend any final rule require fund operators to explicitly state which time horizons are used to measure risk within a fund, thereby allowing an investor to evaluate the investment choice based on a rational measure that is appropriate for the specific fund. In the case of Dearborn's funds, we typically use formulas that compare performance between 20 trading days and 200 trading days, which is equivalent to comparing one month's performance against the past 12 months' performance.

*The Risk-Based Portfolio Limits Should Be Independent from the Exposure-Based Limits*

Under the Proposed Rule, a fund that satisfies a VaR test that meets the principles set forth in the Proposed Rule is permitted to increase its exposure-based limits to 300% of net assets. Accordingly, a fund that satisfies the VaR test must still comply with the exposure-based limits only at a higher level. Accordingly, all the pitfalls discussed above with respect to the exposure-based limits would apply.

We recommend the Commission implement an independent VaR test, which is a superior measure of investor risk than the notional value test contained in the Proposed rule;

the accuracy of the VaR test is precisely why it already is the industry standard measure of risk.[21]

IV. **Comments on Asset Coverage Test**

Dearborn strongly supports the use of mark-to-market approach with respect to the proposed asset coverage test. We believe that such an approach will eliminate certain anomalies that have developed under the current regulatory framework and industry interpretations thereof, which have resulted in mark-to-market based coverage for certain instruments and notional coverage for other instruments. That being said, qualifying coverage assets should be expanded to include, at a minimum, equities with appropriate haircuts, as other regulators have permitted for margin. Both the CFTC and SEC's Division of Trading and Markets have issued guidance on appropriate haircuts for margin.

As noted elsewhere in our letter, mark-to-market asset segregation should be sufficient to address the Commission's concerns set forth in the Proposing Release – (1) excessive borrowing and the issuance of excessive amounts of senior securities by funds; (2) funds operating without adequate assets and reserves; and (3) potential abuse of the purchasers of senior securities. We support Commissioner Piwowar's position that proposed asset segregated requirements in and of themselves are sufficient to address the risks of senior securities. No additional portfolio limits are necessary to address these risks.

V. **Significant Impact on Alternative Investment Funds**

The Proposed Rule seems to ignore the benefits of alternative investment strategies, which employ derivatives by imposing blunt measurements focused on individual derivative positions while ignoring the risk profile of the fund's overall portfolio. The consequences of limiting investor choice by eliminating certain alternative investment funds are significant and should be considered by the Commission before issuing any final rule. As Commissioner Piwowar noted in his dissent, the derivatives limit under the Proposed Rule should be backed by data. To our knowledge, the Commission has failed to provide any data to support the proposed limitations. Moreover, while there are a variety of examples of mutual fund collapses, including the recent junk bond related failure of the Third Avenue Fund and the historic collapse of The Reserve Primary Fund, none of these spectacular collapses involved a liquid alternative fund.

VI. **Commission Is the Appropriate Regulator**

Dearborn further believes that the Commission is the appropriate regulator for multi alternative and managed futures funds and similar products because such products implement their strategies using both securities and futures. Currently, the SEC and CFTC share jurisdiction over many derivatives products, including certain futures contracts. If multi alternative and managed futures funds were forced to convert to a public or private commodity pool, the SEC

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21 *Cf. [UCITS regime].*

would no longer have jurisdiction over such funds, even though the fund may use fixed income securities to a significant extent. If an everyday investor was able to access such a fund outside a 1940 Act product, the investor would lose the significant board governance oversight that the 1940 Act provides. Moreover, the mutual fund structure is the best structure to enable everyday investors to gain access to important strategies which will diversify their overall portfolio. Without the use of the mutual fund structure, everyday investors will likely be closed off from such strategies.

Thank you for the opportunity to contribute to a fact-based discussion designed to ultimately create a rule that effectively deals with a series of important issues. I endorse and support SEC Chair White when she recently spoke about the need for regulatory initiatives to be carefully and deliberately considered. As she commented: "The worst thing you can do is look at something that superficially seems to make sense but you really don't have the data to justify going forward on."[22] I trust this document can add to the depth of the analysis and a clarification of the essential elements that must be correctly identified for the Proposed Rule to be effective.

Sincerely,

David Kavanagh
President

[22] Wall Street Journal, *SEC's White Says Stock-Market Overhaul Won't Happen This Year* (March 8, 2016).