



**OppenheimerFunds®**

The Right Way  
to Invest

March 28, 2016

Mr. Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-9303

Re: **Use of Derivatives by Registered Investment Companies and Business Development Companies**  
**Release No.:** IC-31933; **File No.:** S7-24-15

Dear Mr. Fields:

OppenheimerFunds<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed rulemaking on Use of Derivatives by Registered Investment Companies and Business Development Companies (the "Proposal")<sup>2</sup>. The Proposal would permit registered open-end and closed-end investment companies (including ETFs that are organized as open-end investment companies) and business development companies (collectively, "funds") to enter into derivatives transactions and financial commitment transactions so long as the funds comply with the conditions of proposed Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act"). Those conditions would include (i) compliance with either of two portfolio limitations designed to impose a limit on leverage that a fund may obtain, (ii) identification and segregation of certain assets by a fund, in amounts determined pursuant to the Proposed Rule, designed to ensure that the fund can meet its financial obligations under derivatives transactions and financial commitment transactions and (iii) if a fund makes more extensive or complex use of derivatives transactions, establishment of a formalized derivatives risk management program.

OppenheimerFunds shares the SEC's concern that funds using derivatives manage the risks arising from the use of those derivatives, including the risk of leverage that the Commission notes throughout the Proposal as implicating the "undue speculation" and "asset sufficiency" concerns expressed in Sections 1(b)(7) and 1(b)(8), respectively, of the Investment Company Act. However, as the investment adviser to several funds that use derivatives as part of their

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<sup>1</sup> OppenheimerFunds is a registered investment adviser, providing investment management and transfer agent services to approximately 100 registered investment companies. OppenheimerFunds has been in the investment advisory business since 1960, and with its subsidiaries, has more than \$200 billion in assets under management as of February 29, 2016.

<sup>2</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (December 11, 2015), 80 Fed. Reg. 80883 (December 28, 2015).

investment strategies, we are also concerned that any regulation of funds' use of derivatives preserves the ability of funds to use derivatives as an important portfolio management tool. As we noted in our comment letter to the SEC's 2011 Concept Release on the Use of Derivatives by Investment Companies under the Investment Company Act of 1940<sup>3</sup>, many funds regularly use derivatives to gain investment exposure, including to unique markets or asset classes when access through other instruments is difficult, costly, or impossible, to mitigate investment risks, including to hedge the risk of other positions held in their portfolios, to manage or equitize cash and to enhance liquidity, including when derivatives are more liquid than traditional securities. Indeed, the use of derivatives by alternative funds, taxable fixed-income funds, commodity-focused funds and currency hedged funds, among others, is indispensable to the ability of these funds to meet their investment objectives. At the same time, these funds offer important benefits to the retail investing public, including access to investment strategies that are traditionally uncorrelated to equities and thus diversifying or that provide risk-managed exposure to fixed-income and equity markets in both the developed and emerging world.

Although OppenheimerFunds supports the SEC's goal that funds manage the risks arising from their use of derivatives, we are concerned that certain components and requirements of the Proposed Rule, particularly the operation of the portfolio limitations and the definition of qualifying coverage assets, will impede legitimate and effective use of derivatives in certain funds<sup>4</sup>. This will ultimately result in costs to fund investors, directly through reduced returns if some funds must modify their portfolios so as to use derivatives in compliance with the Proposed Rule, but also indirectly if other funds, unable to comply with the Proposed Rule, must liquidate, deregister or dramatically alter their investment strategies, with a concomitant loss of diversification and investment opportunities for fund investors generally. Consequently, we support adoption of the Proposed Rule with the following recommended modifications, which we discuss in further detail in the remainder of this letter:

- While we generally support the Proposed Rule's asset segregation framework and related provisions establishing the amounts of qualifying coverage assets that a fund must identify and segregate in connection with derivatives transactions and financial commitment transactions, we offer certain suggestions for improving the framework. Importantly, we recommend that, subject to certain conditions, funds be permitted to determine net risk-based coverage amounts at the portfolio level rather than just at the netting agreement level. We also provide suggestions for clarifying the term netting agreement, particularly in the context of cleared derivatives transactions.
- With respect to the Proposed Rule's separate portfolio limitations:

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<sup>3</sup> Letter from Ari Gabinet, General Counsel, and Geoffrey Craddock, Chief Risk Officer, OppenheimerFunds, to Elizabeth Murphy, Secretary, SEC (November 7, 2011) (the "OppenheimerFunds Concept Release Comment Letter").

<sup>4</sup> See Letter from David W. Blass, General Counsel, Investment Company Institute ("ICI"), to Brent J. Fields, Secretary, SEC (March 28, 2016) (the "ICI Comment Letter") and the results of the study conducted by ICI to determine the effect of the Proposed Rule's portfolio limitations on funds that are discussed therein (the "ICI Study").

- The risk-based portfolio limit should be revised so as to provide a suitable alternative for funds that make more substantial use of derivatives transactions and financial commitment transactions. We recommend reformulating the risk-based portfolio limit to prohibit a fund's full portfolio VaR from exceeding 150% of its securities VaR.
  - The risk-based portfolio limit should be revised so as to require a fund operating under the limit to calculate its full portfolio VaR and securities VaR once each business day based on positions held by the fund as of the close of business on that day. Additionally, should a fund fall out of compliance with the comparative VaR requirement, the risk-based portfolio limit should provide an explicit cure period over which the fund can regain compliance before being regarded as in violation of the Proposed Rule.
  - The risk-based portfolio limit should provide greater flexibility in permitted VaR models, specifically with respect to time horizon.
  - The aggregate exposure calculation should allow for the application of specified discounts to the notional amounts of certain derivatives transactions to reflect and recognize the relative risk of these transactions.
  - An open-end fund that is noncompliant with the portfolio limitation under which it operates should nonetheless be permitted to engage in traditional borrowings that are effectuated for temporary purposes to assist in meeting shareholder redemptions. We suggest certain related conditions on a fund's ability to borrow in such circumstances.
- The definition of qualifying coverage assets should be revised so as to permit a broader group of assets that a fund can identify and segregate on its books and records against both derivatives transactions and financial commitment transactions.

## 1. Discussion of Proposed Rule's Asset Segregation Framework and Related Requirements

### *General Support for the Proposed Rule's Asset Segregation Framework*

In the OppenheimerFunds Concept Release Comment Letter we explained our view that the current asset segregation and "coverage" regime applied by funds to derivatives transactions and financial commitment transactions is insufficient to address the risks created by these instruments. Because Investment Company Act Release 10666 and the more than thirty no-action letters and other SEC staff guidance provided to funds in the years since have generally focused on asset segregation or "coverage" of obligations on an instrument-by-instrument basis, today funds often apply significantly different asset segregation requirements to instruments with substantially similar economic characteristics. For example, we understand that many funds currently segregate assets equal to the purchase price of a long futures position that is contractually required to physically settle (i.e., the notional amount), but would segregate assets equal to the negative mark-to-market value (if any) if the equivalent economic exposure were obtained through an over-the-counter, uncleared synthetic future that is contractually required to

cash settle. This would be the case notwithstanding that the listed futures contract might be extremely liquid and capable of close-out by the fund at any time, while the over-the-counter position is relatively less liquid, requiring the agreement of the swap dealer counterparty (or the agreement of another swap dealer counterparty to take the opposite synthetic future position) to close-out. Additionally, because much of the Commission's guidance with respect to asset segregation and "coverage" over the past 36 years has been in the form of no-action letters and other SEC staff correspondence directed to certain funds, we also understand that different funds sometimes apply different asset segregation requirements to the same or similar instruments. For these reasons, we expressed our opinion in the OppenheimerFunds Concept Release Comment Letter that the current regime both over-regulates and under-regulates derivatives risk.

The Proposed Rule would replace the current asset segregation and "coverage" regime with a requirement that funds manage the risks of derivatives transactions and financial commitment transactions by identifying and segregating a risk-based amount of qualifying coverage assets. For each derivatives transaction, a fund would be required to maintain qualifying coverage assets with a value equal to the amount that would be payable by the fund if it were to exit the transaction at the relevant time of determination (the mark-to-market coverage amount, which would generally correspond to the amount of the fund's liability (if any) with respect to the derivatives transaction) plus an additional amount representing a reasonable estimate of the potential amount payable by the fund if it were to exit the transaction under stressed conditions (the risk-based coverage amount). A fund's determination of the risk-based coverage amount in respect of a derivatives transaction would follow a principles based approach in which the fund applies policies and procedures that account for the relevant structure, terms and characteristics of the derivatives transaction and underlying reference asset to establish the appropriate amount. As compared to the current regime, the mark-to-market coverage amount would eliminate the "physically settled vs. cash settled" distinction, which in our view over-regulates the risk of physically settled derivatives transactions and other derivatives transactions currently requiring "full notional" segregation, to the detriment of funds using these transactions extensively. At the same time, the Proposed Rule's inclusion of the risk-based coverage amount would require that funds identify and segregate an additional buffer with respect to each derivatives transaction, reflecting that the fund might incur future losses on the derivatives transaction that exceed the amount of its current liability. As compared to the current regime, the risk-based coverage amount addresses the under-regulation of the risk of a derivatives transaction by requiring that a fund reasonably quantify and segregate assets against an estimated potential future loss on the transaction, even when the mark-to-market coverage amount in respect of the transaction is zero.

For each financial commitment transaction, a fund would be required to maintain qualifying coverage assets with a value equal to the amount of the related financial commitment obligation, which is the amount that the fund is conditionally or unconditionally required to pay or deliver under the transaction. Because the contractual terms of financial commitment transactions such as reverse repurchase agreements, short sale borrowings and unfunded commitment obligations generally require a fund to conditionally or unconditionally pay or deliver an amount certain (such as the repurchase price under a reverse repurchase agreement or

the security sold short in the case of a short sale borrowing), the Proposed Rule sensibly requires that the fund identify and segregate assets equal in value to the fund's full obligations.

Importantly, the Proposed Rule would prohibit the total amount of a fund's qualifying coverage assets from exceeding its net assets. This prohibition would prevent a fund from engaging in leveraging transactions, such as traditional bank borrowings or reverse repurchase agreements, to increase the amount of its qualifying coverage assets, which would then be available to support additional derivatives transactions and financial commitment transactions. The Proposed Rule would also prohibit a fund from segregating the same qualifying coverage assets simultaneously against a derivatives transaction and a financial commitment transaction.

Subject to certain suggestions set forth below in this Section 1, we support the provisions of the Proposed Rule that would establish the amounts of qualifying coverage assets that a fund must identify and segregate in connection with derivatives transactions and financial commitment transactions, including the definitions of mark-to-market coverage amount, risk-based coverage amount and financial commitment obligation and the related requirement that a fund's total amount of qualifying coverage assets not exceed its net assets. Unlike the current asset segregation regime, we believe that these provisions would require a fund to apply a risk-based approach in determining appropriate amounts of assets to be identified and segregated against liabilities, both absolute and contingent, that arise in connection with derivatives transactions and financial commitment transactions and that the Proposed Rule neither over-regulates nor under-regulates the risks of these transactions.

By requiring that a fund identify and segregate assets equal in value to both the mark-to-market coverage amounts and risk-based coverage amounts in respect of derivatives transactions and the fund's full obligations in respect of financial commitment transactions, the Proposed Rule's asset segregation requirements would adequately address "asset sufficiency" concerns by ensuring that a fund at all times maintains qualifying coverage assets in an aggregate amount at least equal to (i) its current liability in respect of derivatives transactions plus a reasonable estimate of its potential future losses on those derivatives transactions and (ii) its maximum payment or delivery obligations under financial commitment transactions. Additionally, because the amount of a fund's qualifying coverage assets cannot exceed its net assets and because a fund cannot "double-count" qualifying coverage assets by simultaneously segregating them against multiple transactions, the Proposed Rule's asset segregation framework provides an absolute limit on the aggregate amount of a fund's mark-to-market coverage amounts, risk-based coverage amounts and financial commitment obligations. A fund seeking to use derivatives transactions and/or financial commitment transactions to excessively leverage, raising "undue speculation" concerns, would be constrained by the amount of its qualifying coverage assets and the related limit thereon. Indeed, even if a fund could confine its senior securities transactions solely to derivatives transactions that appreciate in value (so as to avoid any mark-to-market coverage amounts), the fund might still be constrained from excessively leveraging by operation of the related risk-based coverage amounts, which we would expect to be greater for those derivatives transactions having more complex structures, relatively less liquidity, more volatile reference assets, longer tenors or other characteristics that raise greater "undue speculation" concerns. Consequently, we believe that the asset segregation provisions of the Proposed Rule would also provide a limit on the amount of speculative trading and leveraging that a fund may

accomplish through derivatives transactions and financial commitment transactions, mitigating the “undue speculation” concerns.<sup>5</sup>

*Suggestions for Improving the Proposed Rule’s Asset Segregation Framework*

Although we support the Proposed Rule’s asset segregation framework and related provisions that would establish the amounts of qualifying coverage assets that a fund must identify and segregate in connection with derivatives transactions and financial commitment transactions, we offer the following suggestions for improving the Proposed Rule<sup>6</sup>:

- The Proposed Rule’s definitions of mark-to-market coverage amount and risk-based coverage amount would allow a fund to (i) determine the relevant amount on a net basis for derivatives transactions covered by a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions and (ii) reduce the mark-to-market coverage amount and risk-based coverage amount by the value of assets representing variation margin/collateral and initial margin/collateral, respectively, pledged by the fund in respect of derivatives transactions. Subject to the comments in the bullets below, we agree with these provisions because they allow a fund to calculate its mark-to-market coverage amounts and risk-based coverage amounts consistent with, and giving effect to, netting agreements and margin/collateral arrangements.

However, as the Commission is aware, global regulatory changes over the last six years require or incentivize derivatives market participants to clear at clearing houses certain derivatives traditionally maintained bilaterally, with a goal of reducing counterparty and systemic risk. As U.S. entities, funds use an agency model for clearing in which a futures commission merchant (FCM) or clearing broker member of the relevant clearing house holds and clears the relevant instrument (which might be a futures contract, option on a futures contract, swap or exchange-traded option on a security or securities index) on behalf of the fund. Although a clearing house will generally make both initial and variation margin calls to the FCM/clearing broker in respect of all of the fund’s positions cleared at that clearing house and that are held in the same regulatory clearing account class (which in turn are satisfied by the fund transferring assets to the FCM/clearing broker), it is uncertain whether the clearing agreement between the FCM/clearing broker and the fund in fact constitutes a “netting agreement.” Nonetheless, because derivatives transactions cleared by a fund through the same clearing house in the same regulatory clearing account class are risk managed and margined by the clearing house and the FCM/clearing broker on an aggregate net basis, we believe that a fund should be able to both (i) determine the mark-to-market coverage amount and risk-based coverage amount on a net basis for derivatives transactions that are cleared through the same clearing house and FCM/clearing broker in the same

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<sup>5</sup> We further note that, even if the SEC were to accept our suggestion in Section 3 to expand the types of assets that would constitute qualifying coverage assets, the definition would still permit only a limited set of asset types as eligible for identification and segregation against derivatives transactions and financial commitment transactions. Because, in many cases, a fund’s portfolio is unlikely to be composed entirely of these assets, the definition of qualifying coverage assets will provide another practical limit on the amount of leverage that a fund can achieve through use of these transactions.

<sup>6</sup> We also provide comments on the definition of qualifying coverage assets in Section 3 below.

regulatory clearing account class and (ii) reduce the mark-to-market coverage amount and risk-based coverage amount in respect of those cleared transactions by the value of assets representing variation margin/collateral and initial margin/collateral, respectively, pledged by the fund to the FCM/clearing broker in respect of the transactions. We suggest that the SEC revise the definitions of mark-to-market coverage amount and risk-based coverage amount so as to allow the determination of these amounts on a net basis for derivatives transactions cleared through the same clearing house and FCM/clearing broker in the same regulatory clearing account class and to allow a fund to reduce each such net amount by variation margin/collateral and initial margin/collateral, respectively, provided to the FCM/clearing broker in respect thereof. The SEC could accomplish this by revising the Proposed Rule to clarify that, in these circumstances and for Purposes of the Proposed Rule, a clearing agreement between an FCM/clearing broker and a fund constitutes a netting agreement<sup>7</sup>.

- Because a netting agreement will often allow a fund to net its payment obligations with respect to multiple derivatives transactions and other derivatives that are technically not “derivatives transactions” under the Proposed Rule (such as purchased options or other instruments where the fund will have no future payment or delivery obligation), we believe that the Proposed Rule should permit a fund to determine its mark-to-market coverage amount and risk-based coverage amount for derivatives transactions subject to the netting agreement on a net basis giving effect to all transactions subject to that netting agreement (not just derivatives transactions subject to that netting agreement). Similarly, because a fund might simultaneously clear both derivatives transactions and other derivatives (such as purchased options on futures or purchased swaptions) at the same clearing house and in the same regulatory clearing account class, we believe that a fund should be permitted to determine its mark-to-market coverage amount and risk-based coverage amount for such derivatives transactions on a net basis giving effect to all transactions cleared at that clearing house in the same regulatory clearing account class<sup>8</sup>.
- It is unclear whether the references to “a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions” in the definitions of mark-to-market coverage amount and risk-based coverage amount are intended to capture “payment/delivery netting” (an agreement between solvent counterparties during the ordinary payment/delivery cycle to set-off cash flow or delivery obligations owed on a given day under transactions subject to the netting agreement so that only one net payment or delivery

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<sup>7</sup> Though it is uncertain whether a clearing agreement between an FCM/clearing broker and a fund in fact constitutes a “netting agreement”, we note that the liquidation provisions in these agreements generally require the FCM/clearing broker, after formally designating a default by the fund, to liquidate the fund’s cleared positions and to offset costs and gains incurred/realized to determine a net amount owing by, or due to, the fund. By providing for netting of payables and receivables upon liquidation of cleared positions, clearing agreements share an important similarity to agreements recognized as “netting agreements.”

<sup>8</sup> We note that a similar issue arises in the Proposed Rule’s definition of exposure, which permits a fund to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. If, for example, a fund writes call options on a security and subsequently purchases an equivalent number of call options on the same security with the same expiration date, the definition would seemingly not permit netting of these positions because the long call options are not “derivatives transactions”.

is made across one or more such transactions) or “close-out netting” (a process under which obligations owing between counterparties in respect of transactions subject to the netting agreement are terminated upon the default of one counterparty and positive and negative replacement values for all transactions subject to the netting agreement are determined and combined into a single net payable or receivable). Although industry standard netting agreements such as the ISDA Master Agreement and MSFTA (defined below) provide both types of netting rights (with payment netting across multiple transactions sometimes being applicable only upon affirmative election of the parties), we believe that the SEC should clarify the scope of “netting agreement” in this regard. In our view, the Proposed Rule should require close-out netting, which allows a fund to offset its gross replacement value payables and receivables in respect of transactions subject to the relevant netting agreement to a single net amount that would be owed by, or be due to, the fund in the event all such transactions are terminated (representing the net liability or net asset associated with all such transactions). Payment/delivery netting, on the other hand, is simply a mechanism by which payment/delivery streams in respect of certain transactions subject to the relevant netting agreement are offset as a matter of administrative convenience.

- We believe that the SEC should permit funds to determine the risk-based coverage amount on a net basis for certain derivatives transactions, even in the absence of a single netting agreement covering all relevant positions. Funds that are more substantial users of derivatives will often pair derivatives transactions together, with other derivatives that are not technically “derivatives transactions” under the Proposed Rule (such as purchased options) and/or with other holdings as part of a trading strategy. While one leg of the trading strategy might be an uncleared derivatives transaction with a particular counterparty, the other leg might be an uncleared derivatives transaction (or derivative) with a different counterparty, a cleared derivatives transaction (or derivative) or a securities holding. Under the Proposed Rule, a fund would be required to determine an individual risk-based coverage amount for each derivatives transaction involved in the trading strategy, on an instrument-by-instrument basis, because the aggregate positions are not covered by a netting agreement with the same counterparty. Yet the pairing of the positions together functions to limit the fund’s potential for losses from any derivatives transaction involved in the trading strategy.

A fund engaging in options strategies might pair written options with purchased options, or with securities holdings, that partially or completely eliminate the market risk arising from the written options. For example, the fund might simultaneously buy over-the-counter call (put) options at a specific strike price and sell the same number of over-the-counter calls (puts) at a higher (lower) strike price, with both the long and short options having the same expiration date and underlying asset but different counterparties. In this case, although the long options completely eliminate the market risk arising from the short options, the fund would be required to determine an individual risk-based coverage amount in respect of the short options because all of the options are not subject to a netting agreement with the same counterparty (and, as discussed in the preceding bullet, because the long options are not “derivatives transactions” under the Proposed Rule). Alternatively, the fund might sell over-the-counter call options on securities it owns, with the number of written options equaling the number of securities held long. Although any market risk that the fund incurs from the short



options is completely offset by its long position in the securities, the fund would need to determine an individual risk-based coverage amount in respect of the short options because the securities holdings are not covered by a netting agreement. As another example, a fund pursuing a relative value trading strategy might sell credit protection on a single investment-grade reference entity through an uncleared credit default swap and simultaneously purchase credit protection in an identical notional amount through a cleared credit default swap on the Markit CDX North American Investment Grade Index (which, under rules of the U.S. Commodity Futures Trading Commission (“CFTC”) must be cleared by the fund). Although the index credit default swap has eliminated some of the market risk associated with the fund’s sale of credit protection (and vice-versa), the fund would be prohibited from determining a net risk-based coverage amount in respect of the two swaps because they are not subject to a netting agreement with the same counterparty (even if the single name credit default swap were cleared and portfolio margined with the index credit default swap at the same clearing house in the same regulatory clearing account class through the same FCM<sup>9</sup>, for the reasons discussed in the preceding bullet it is uncertain whether the fund could determine a net risk-based coverage amount in respect of the two swaps).

More generally, we note that the Proposed Rule is conservative in permitting a fund to determine a net risk-based coverage amount in respect of a derivatives transaction and one or more instruments that partially or completely eliminate the derivatives transaction’s market risk only if all are covered by a netting agreement with the same counterparty. Unlike the mark-to-market coverage amount, which represents a fund’s current liability in respect of a derivatives transaction and for which the Proposed Rule appropriately permits a fund to determine on a net basis only for derivatives transactions covered by an agreement that provides for netting of payables and receivables with the relevant counterparty, the risk-based coverage amount is a risk-based buffer that accounts for the possibility that a fund might ultimately be required to pay an amount greater than the mark-to-market coverage amount to extinguish that transaction. As such, a fund’s ability to determine a net risk-based coverage amount in respect of a derivatives transaction should depend less on the presence of a netting agreement and more on whether the fund holds other derivatives transactions, derivatives, securities or other instruments in its portfolio that decrease the fund’s potential risk of loss in the event it were to exit the derivatives transaction under stressed conditions (accounting for inverse correlations and anticipated gains in these other positions under those stressed conditions).<sup>10</sup>

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<sup>9</sup> See Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 34-68433 (Dec. 14, 2012), 77 Fed. Reg. 75211 (Dec. 19, 2012).

<sup>10</sup> We also note that, by permitting determinations of net risk-based coverage amounts only in respect of derivatives transactions covered by a netting agreement with the same counterparty, the Proposed Rule encourages funds to consolidate uncleared derivatives trading with fewer counterparties. Because a fund cannot determine risk-based coverage amounts on a net basis across counterparties and netting sets, the greater the number of counterparties and netting agreements used by a fund, the less capital efficient the fund’s derivatives transactions will be under the Proposed Rule’s asset segregation framework. While we understand that the primary focus of the Proposed Rule is not funds’ management of counterparty credit risk, we do not believe that the Proposed Rule’s asset segregation

For these reasons, we believe that the SEC should revise the Proposed Rule to permit funds to determine a net risk-based coverage amount in respect of one or more derivatives transactions at the portfolio level. Because funds choosing to calculate net risk-based coverage amounts in respect of paired positions at the portfolio level would likely be more substantial users of derivatives, the SEC might consider allowing only funds that have adopted derivatives risk management programs to do so. Funds operating with derivatives risk management programs will have adopted and implemented policies and procedures that are reasonably designed to assess, among other risks, the market risks and counterparty risks associated with derivatives transactions, which assessments are important in the context of portfolio level net risk-based coverage amount determinations. Funds operating without a derivatives risk management program would be permitted to determine a net risk-based coverage amount only in respect of derivatives transactions covered by a netting agreement with the same counterparty, as the Proposed Rule currently provides. We suggest that, if the Proposed Rule were so revised, that any fund choosing to determine net risk-based coverage amounts at the portfolio level be required to specify in its board approved policies and procedures regarding maintenance of qualifying coverage assets the methodologies that it will employ in making such determinations. As examples, these might include specification of the broad asset-class categories within which portfolio level net risk-based coverage amount determinations can be made by the fund (such as equity, credit, interest rate, foreign exchange and commodity), a requirement that the fund identify on its books and records paired positions involving derivatives transactions in respect of which net risk-based coverage amounts will be determined and specification of a VaR model and its minimum criteria that the fund will use to determine net risk-based coverage amounts in respect of paired positions in each such asset class category.

- The Proposed Rule defines financial commitment transactions to include “firm commitment agreements”, representing transactions in which a fund commits itself to purchase or sell a security on a delayed delivery basis. We believe that the substantial majority of firm commitment agreements in which funds participate occur in the market for forward-settling U.S. government agency and government sponsored enterprise mortgage-backed securities (customarily referred to as the “to-be-announced” or “TBA” market, and related transactions, “TBAs”). In 2012, The Treasury Market Practices Group (TMPG), a Federal Reserve Bank of New York sponsored group of market professionals committed to supporting the integrity and efficiency of the U.S. treasury, U.S. government agency debt and U.S. government agency and government sponsored enterprise mortgage-backed securities markets, recommended that market participants in the TBA market exchange variation margin/collateral in respect of TBAs to “prudently manage counterparty exposures”<sup>11</sup>. As of the date of this letter, the SEC is considering amendments proposed by the Financial Industry Regulatory Authority, Inc. (FINRA) to FINRA Rule 4210 that would, among other things, require members of FINRA to collect margin in respect of TBAs<sup>12</sup>. As a result of these

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framework should incentive funds to concentrate their uncleared derivatives trading activity with a limited number of counterparties.

<sup>11</sup> See <https://www.newyorkfed.org/tmpg/margining.html>.

<sup>12</sup> Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, Release No. 34-76148, File No. SR-FINRA-2015-036; Order Instituting Proceedings To

initiatives, many funds active in the TBA market have executed or will execute documentation governing the trading, netting and margining of TBAs with their dealer counterparties<sup>13</sup>. Although physical settlement of transactions is the expectation of participants in the TBA market, the MSFTA is a netting agreement that provides for close-out netting upon the default of a counterparty, as well as payment/delivery netting of long and short positions that settle on the same date<sup>14</sup>. Consequently, in light of the regulatory initiatives underway in the TBA market, the related increase in MSFTAs that funds have or will have in place with their dealer counterparties and the robust trading liquidity in the TBA market, we believe that the Proposed Rule should allow a fund to treat a TBA as a derivatives transaction rather than as a financial commitment transaction when the transaction is subject to a netting agreement. As derivatives transactions, a fund would be required to identify and segregate mark-to-market coverage amounts and risk-based coverage amounts against its TBAs, determined on a net basis with respect to each MSFTA, and would be permitted to reduce such amounts by the value of variation margin/collateral and initial margin/collateral, respectively, that the fund has provided under those MSFTAs.

Finally, on this point we also note that firm commitment agreements, such as TBAs, are simply securities forward transactions. The Proposed Rule's definition of derivatives transaction includes "forward contracts", raising a question as to why the Proposed Rule should treat TBAs differently from other types of forward transactions (such as currency forward contracts). While the Proposed Rule's treatment of firm commitment agreements as financial commitment transactions might be premised on the expectation that the transactions will physically settle, requiring a fund to pay the full purchase price or to deliver a security, or on their historical treatment under Investment Company Act Release 10666, we believe that the presence of an MSFTA is sufficient to overcome this presumption for TBAs and to justify treatment of TBAs as derivatives transactions for purposes of the Proposed Rule.

## 2. Discussion of Proposed Rule's Portfolio Limitations

We believe that the Proposed Rule's portfolio limitations are a more problematic component of the Proposed Rule and are likely to suppress legitimate and valuable use of derivatives transactions by certain funds. In particular, we believe that revisions to the risk-based portfolio limit are essential so as to provide a suitable alternative for funds that make more substantial use of derivatives and financial commitment transactions.

We do not offer specific comments solely regarding the exposure-based portfolio limit. Nonetheless, we do not wish to suggest that we agree with a fundamental principle on which the exposure-based portfolio limit is based – namely, that each dollar of notional amount of a fund's

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Determine Whether To Approve or Disapprove Proposed Rule Change To Amend FINRA Rule 4210 (Margin Requirements) To Establish Margin Requirements for the TBA Market, as Modified by Partial Amendment No. 1, Release No. 34-76908, File No. SR-FINRA-2015-36.

<sup>13</sup> The 2012 SIFMA Master Securities Forward Transaction Agreement (the "MSFTA") is the industry standard document used for these purposes. See <http://www.sifma.org/services/standard-forms-and-documentation/mra,-gmra,-msla-and-msftas/>.

<sup>14</sup> See Sections 7 and 9(a) and Section 10(iii) of the MSFTA, which provide "close-out netting" and "payment/delivery netting" rights, respectively.

derivatives transactions represents incremental leveraging and “risking” by the fund, analogous to a dollar of indebtedness leverage<sup>15</sup>. On this objection, we offer comments below in this Section 2 regarding the application of specified discounts to the notional amounts of certain derivatives transactions for purposes of calculating aggregate exposure under both the exposure-based portfolio limit and risk-based portfolio limit. Despite this major shortcoming, we agree with the SEC’s conclusion that many funds that use derivatives transactions could operate under the exposure-based portfolio limit without modifying their derivatives usage (and likely without modifying their usage of financial commitment transactions and traditional senior security transactions)<sup>16</sup>. Additionally, we believe that the exposure-based portfolio limit provides an objective test that most funds using derivatives transactions should be able to monitor compliance with, as a fund would only need to calculate its aggregate exposure by summing the notional amounts of its derivatives transactions, its financial commitment obligations and the principal amounts of its traditional senior security transactions and to compare that aggregate exposure to its net asset value.

#### *Issues with the Proposed Rule’s Risk-Based Portfolio Limit*

We believe that those funds using derivatives transactions and financial commitment transactions more substantially, which in our experience would include alternative funds, taxable fixed-income funds and commodity-focused funds, are unlikely to be able to comply with the exposure-based portfolio limit. We believe that many of these funds will exceed the 150% aggregate exposure limit, at least from time to time, making the exposure-based portfolio limit an unacceptable alternative. Unfortunately, we also believe that these funds are unlikely to be able to achieve and maintain compliance with the risk-based portfolio limit. This is because the risk-based portfolio limit, while permitting a fund to maintain aggregate exposure of up to 300% of the value of its net assets (representing two times the aggregate exposure a fund would be permitted under the exposure-based portfolio limit), would also require that the fund’s derivatives transactions be in aggregate risk reducing, as measured by comparing its full portfolio VaR to its securities VaR. Although these funds might represent a minority of funds using derivatives, we disagree that these funds, unable to operate under either portfolio limitation, should be forced to modify, curtail or cease legitimate and valuable use of derivatives transactions, or liquidate or deregister, with a concomitant loss of diversification and investment opportunities for fund investors.

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<sup>15</sup> See Shelly Antoniewicz, ICI Viewpoints, Derivatives - Please Don’t Let Them Be Misunderstood (2016), available at [https://www.ici.org/viewpoints/view\\_16\\_derivatives\\_imf](https://www.ici.org/viewpoints/view_16_derivatives_imf). This article refutes an International Monetary Fund blog posting that concludes, using a measure of leverage that compares gross notional amount exposure to total assets, that many bond mutual funds have relatively high leverage and sensitivity to the returns of U.S. fixed-income benchmarks. Using a chart from the IMF posting, the article illustrates that the vast majority of the relevant bond mutual funds that use derivatives actually have betas between 0.00 and positive 1.00, meaning that their returns are less volatile than those of the Barclays U.S. Aggregate Bond Index, and that the funds with the highest “leverage” have negative betas, meaning that a decline in the benchmark index would tend to reward investors in these funds. Indeed, we believe, as the article notes, that a fund with high notional amount exposure “may be more risky, less risky, or equally as risky as a fund that has no exposure whatsoever to derivatives.”

<sup>16</sup> We note that this would more certainly be the case if the SEC adopted our comments below in this Section 2 regarding (i) the application of specified discounts to the notional amounts of certain derivatives transactions and (ii) the ability for open-end funds to engage in traditional borrowings that are effectuated for temporary purposes to assist in meeting shareholder redemptions even when noncompliant with the relevant portfolio limitation.

We note that under the exposure-based portfolio limit, there is no consideration of, or limitation on, the types of derivatives transactions that a fund can use or the effect that those derivatives transactions might have on the fund's portfolio; so long as the fund's aggregate exposure does not exceed 150% of the value of its net assets the fund would be compliant with the portfolio limit. For example, a fund seeking to use derivatives transactions for the explicit purpose of obtaining leveraged exposure to equities could enter into long single-share total return swaps or long single-stock futures contracts so long as the aggregate notional amount of those derivatives transactions does not exceed 150% of the value of its net assets. Conversely, a fund with the same net asset value seeking to use derivatives transactions with aggregate exposure exceeding 150% for more sophisticated purposes, including gaining certain investment exposures while simultaneously hedging currency risk, hedging credit risk and reducing duration, would be prohibited from doing so if the transactions, in aggregate, are not risk reducing as measured by a comparative VaR analysis (this would occur if the reduction in the fund's full portfolio VaR resulting from the derivatives transactions that hedge currency and credit risks and reduce duration are insufficient to offset the increase in the fund's full portfolio VaR resulting from the derivatives transactions that provide investment exposure). This would be the case even if the fund's aggregate exposure in respect of the desired derivatives transactions was only 151% of the value of its net assets. We believe that the fundamental flaw in the risk-based portfolio limit is that it requires, as a quid pro quo for any fund seeking to attain aggregate exposure in excess of 150%, that derivatives transactions only be used to in aggregate reduce risk of loss. Yet the risk of loss incurred by the first fund through its permissible use of derivatives transactions to achieve leveraged exposure to equity securities is likely to be substantially greater than the risk of loss incurred by the second fund through its more sophisticated, multi-purpose (but impermissible) use of derivatives transactions.

Other examples of the operation of the risk-based portfolio limit provide similarly unsatisfying outcomes. Consider two fixed-income funds that as part of their stated investment strategies undertake to maintain a duration of five years. The first fund's investment objective provides for capital preservation, and so the fund invests in short-term, high-grade fixed-income securities and seeks to use long treasury bond futures to extend its duration to five years. The second fund's investment objective provides for maximization of yield, and so the fund invests in longer maturity, high-yield fixed-income securities and seeks to use short treasury bond futures to reduce its duration to five years. The first fund seeking to use long treasury bond futures to achieve its duration target could not operate under the risk-based portfolio limit and would need to limit its futures positions to 150% aggregate exposure, even if insufficient to achieve that target. Because the risk of the securities portion of the fund's portfolio is so low, the long futures positions would be risk additive and incompatible with the risk-based portfolio limit. Conversely, the second fund seeking to use short treasury bond futures to achieve its duration target could operate under the risk-based portfolio limit and incur 300% aggregate exposure. Because the risk of the securities portion of the fund's portfolio is high, the short futures positions would be risk reducing and compatible with the risk-based portfolio limit. This result is alarmingly inapposite for two funds seeking to use treasury bond futures for the same purpose (adjustment of duration) – the operation of the risk-based portfolio limit allows the high-yield fund to incur twice as much aggregate exposure than the high-grade fund. This comparative example highlights another shortcoming of the risk-based portfolio limit – namely, that a fund

with a riskier securities portfolio that seeks to use derivatives to reduce risk to a desired target can operate under the risk-based portfolio limit while a similar fund with a less risky securities portfolio that seeks to use derivatives to increase risk to the same desired target cannot.

*Recommended Reformulation of the Risk-Based Portfolio Limit and Other Suggestions for Its Improvement*

Unlike the exposure-based portfolio limit, the risk-based portfolio limit would permit use of VaR, a sophisticated risk management tool that measures the amount of risk in a fund based on the past performance of securities and other instruments (including derivatives transactions) in the fund's portfolio. As we noted in the OppenheimerFunds Concept Release Comment Letter, a key advantage of VaR is that it measures the overall risk profile of a fund's portfolio, including a quantification of the risk that different types of derivatives contribute to the fund. Rather than requiring, as the condition to a fund's aggregate exposure exceeding 150%, that the fund's use of derivatives transactions be in aggregate risk reducing, we believe that the risk-based portfolio limit would better harness VaR's value as a risk management tool if reformulated to require that:

- (i) the aggregate exposure of the fund does not exceed 300% of the value of its net assets; and
- (ii) ***the fund's full portfolio VaR does not exceed 150% of its securities VaR.***

Under our proposed reformulation, a comparative VaR analysis would be used to determine the additional risk of loss created by a fund's use of derivatives transactions. The fund's ability to have aggregate exposure exceeding 150% would instead be conditioned upon a determination, based on the comparative VaR analysis, that the fund's derivatives transactions create an additional risk of loss that is not greater than 50% of the fund's risk of loss without those derivatives transactions. Because VaR is capable of measuring risk across a fund's entire portfolio, giving effect to the interaction of derivatives transactions with other derivatives transactions, with derivatives and with securities and other instruments held by the fund, we do not believe that an aggregate exposure limit of 300% is essential to our proposed reformulation. Rather, the determination of the incremental risk of loss created by a fund's derivatives transactions, as measured by a comparative VaR analysis, and the related limit thereon are the more critical components to ensuring that a fund's derivatives transactions do not result in an inappropriate increase in the speculative character of the fund. Nonetheless, we understand from the Proposal that the Commission regards an outside aggregate exposure limit as an important feature of the risk-based portfolio limit to address concerns regarding the effectiveness of VaR in all possible circumstances. For this reason, we maintain the 300% aggregate exposure limit in our reformulated risk-based portfolio limit.

We believe that permitting a fund's full portfolio VaR to be up to 150% of its securities VaR is appropriate based on the conceptual underpinnings of Section 18 of the Investment Company Act and its application to open-end and closed-end funds. Under Section 18(a)(1)(A) and Section 18(f)(1), such funds can engage in traditional borrowings (i.e., indebtedness leverage) so long as they maintain 300% "asset coverage" for all such borrowings. This requirement allows a fund to borrow up to 50% of the value of its net assets at any time – for

example, an open-end fund with net assets of \$100 can borrow up to \$50 and remain compliant with Section 18(f). If that fund were to squander the proceeds of such a borrowing, for example by investing them in the equity securities of issuers who immediately go bankrupt, the fund's net asset value would decline by 50%<sup>17</sup>. Consequently, Section 18 can be regarded as permitting such a fund to incur indebtedness leverage that puts up to 50% of its net asset value at the time of borrowing at risk of loss. Similarly, our reformulated risk-based portfolio limit would allow a fund to incur additional risk of loss attributable to derivatives transactions that is up to 50% of the fund's risk of loss without those derivatives transactions, as determined by a comparative VaR analysis.

Additionally, we suggest the following other changes to the risk-based portfolio limit to enhance its utility for funds using derivatives transactions and financial commitment transactions more substantially:

- The Proposed Rule would require, as a condition to a fund's ability to enter into derivatives transactions, that the fund comply with the risk-based portfolio limit immediately after entering into a senior securities transaction. As such, if a fund operating under the risk-based portfolio limit desired to enter into a derivatives transaction or a financial commitment transaction or to borrow money and that senior security transaction would cause the fund not to comply with any requirement of the risk-based portfolio limit, then that senior securities transaction would be prohibited. On the other hand, if market depreciation or shareholder redemptions cause a decrease in the fund's net asset value or market events cause a change in the fund's full portfolio VaR or securities VaR and, as a result, the fund ceases to be in compliance with the risk-based portfolio limit, the fund would not be required to take remedial action. However, if the fund subsequently desired to enter into a senior securities transaction, it would be required to take remedial action in response to these "external" events before it could consummate the senior securities transaction.

We are unaware of any pre-trade compliance system that can compute in real-time the impact of a proposed derivatives transaction, financial commitment transaction or traditional borrowing on a fund's full portfolio VaR and securities VaR. To be effective, such a compliance system might also need to compute in real-time changes in the contribution of the fund's "non" senior securities transactions and holdings to its full portfolio VaR and securities VaR<sup>18</sup>. For these reasons, we believe that a fund's compliance with the comparative VaR requirement of the risk-based portfolio limit (including as we have proposed to reformulate it above) should not be tested at the time of each desired senior securities transaction. Rather, a fund operating under the risk-based portfolio limit should be required to calculate its full portfolio VaR and securities VaR once each business day based

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<sup>17</sup> Immediately after the borrowing, the fund would have total assets of \$150, liabilities of \$50 and net assets of \$100. After losing the entire amount of the borrowed proceeds, the fund would have assets of \$100, liabilities of \$50 and net assets of \$50.

<sup>18</sup> For example, a proposed derivatives transaction that would comply with the risk-based portfolio limit's 300% aggregate exposure limit and that on its own would be risk reducing might nonetheless be impermissible if reductions in the risk of the fund's securities portfolio cause the fund's derivatives transactions to no longer be in aggregate risk reducing. The Proposed Rule suggests that a comparative VaR model might need to be capable of making such real-time calculations and assessments.

on positions held by the fund as of the close of business on that day. Should the end of day testing indicate that the fund is noncompliant with the comparative VaR requirement, the fund would be required to take remedial action (subject to our suggestion below that the fund be provided with a cure period to regain compliance before being regarded as in violation). Additionally, if an end of day test indicates that a fund is approaching noncompliance with the comparative VaR requirement, we would expect compliance personnel to disseminate a warning to the fund's portfolio manager(s). That warning would cause the portfolio manager(s) to more acutely analyze the VaR impact of desired portfolio changes and to take affirmative steps to prevent future noncompliance. Accordingly, we do not believe that a revision to the Proposed Rule requiring a fund to calculate comparative VaR once each business day based on end of day positions, instead of at the time of each desired senior securities transaction, will impact the effectiveness of the portfolio limit. However, such change would dramatically ease the operational burden on those funds seeking to operate under the risk-based portfolio limit.<sup>1920</sup>

- In conjunction with our suggestion that the risk-based portfolio limit be revised to require comparative VaR testing once each business day based on end of day positions, we also believe it is imperative, should a fund fall out of compliance with the comparative VaR requirement (including as we have proposed to reformulate it above), for the Proposed Rule to grant a period of time over which the fund can take remedial action to regain compliance with the comparative VaR requirement before being regarded as in violation. Providing such a cure period would be analogous to the operation of Section 18(f)(1), which generally provides a three business day cure period for an open-end fund to regain compliance with the 300% "asset coverage" requirement for its bank borrowings. But because determining the appropriate remedial action to regain compliance with the comparative VaR requirement might involve detailed analysis of a fund's portfolio holdings, including derivatives transactions, and their contributions to VaR, we believe that the Proposed Rule should offer a cure period that is longer than the three business days provided under the Investment Company Act for an open-end fund to simply repay a borrowing. We believe that a ten business day cure period would be appropriate.
- Even when a fund is noncompliant with the risk-based portfolio limit, we believe that it should be permitted to enter into derivatives transactions and financial commitment

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<sup>19</sup> We also suggest that a fund, whether operating under the exposure-based portfolio limit or the risk-based portfolio limit, be required to calculate aggregate exposure only once each business day based on positions held by the fund as of the close of business on that day. Though less problematic than a real-time comparative VaR requirement, we believe that funds will be operationally burdened by a requirement to calculate, on a pre-trade basis, the contribution of a desired senior securities transaction to aggregate exposure. Should the end of day testing indicate that the fund is noncompliant with the aggregate exposure limit, the fund would be required to take remedial action (and we would similarly suggest that the fund be provided with a cure period (discussed in the next bullet) to regain compliance before being regarded as in violation). If the SEC nonetheless decides not to change the Proposed Rule on this point, it should at minimum clarify that, when determining whether a desired senior securities transaction complies with the 150% or 300% aggregate exposure limit, as applicable, a fund should use its net asset value calculated as of the close of business on the immediately preceding business day.

<sup>20</sup> A change to the Proposed Rule to allow funds to test compliance with the portfolio limitations at the close of each business day would necessitate a change to the Proposed Rule's recordkeeping requirements set forth in Rule 18f-4(a)(6)(iv).



transactions that are consummated with an intention, reasonably formed, of regaining compliance. For example, if a fund that is noncompliant with either the 300% aggregate exposure limit or the comparative VaR requirement identifies a specific uncleared swap that is a significant (but not the only) source of such non-compliance, it might seek to enter into an exactly offsetting swap to completely eliminate the instrument's exposure or risk contribution, as applicable. Because the offsetting swap, even if transacted with the same counterparty as the original swap, would be a derivatives transaction, the Proposed Rule suggests that the execution thereof by the fund would be prohibited unless immediately following the execution the fund has regained compliance with the 300% aggregate exposure limit or the comparative VaR requirement, as applicable<sup>21</sup>.

- We believe that the Proposed Rule should provide greater flexibility in permitted VaR models for funds operating under the risk-based portfolio limit. Specifically, we disagree with the Proposed Rule's requirement that a VaR model use a time horizon of not less than 10 and not more than 20 trading days. We understand that the Commission has proposed this time horizon to promote consistency in VaR models across funds operating under the risk-based portfolio limit and out of concerns that VaR models using very short time horizons (such as one day) or very long time horizons (such as one year or greater) can understate potential losses. We note that the risk-based portfolio limit (including as we have proposed to reformulate it above) does not use VaR to provide an absolute measure of a fund's potential losses. Rather, the risk-based portfolio limit requires a comparative VaR analysis designed to focus on the relationship between a fund's full portfolio VaR and its securities VaR. We believe that the use of a comparative VaR analysis substantially mitigates the SEC's concerns regarding an appropriate time horizon. While different funds might use different time horizons in their VaR models, the time horizon used by a particular fund in calculating its full portfolio VaR and its securities VaR must be consistent (for example, a fund could not use a time horizon of 10 trading days when calculating its full portfolio VaR and a time horizon of 20 trading days when calculating its securities VaR). Additionally, even if the time horizon used by a fund in its VaR model could potentially understate losses as a result of being either too short or too long, that understatement would occur both in the fund's calculation of its full portfolio VaR and its securities VaR, minimizing any impact on the results of its comparative VaR analysis.

At the same time, we believe that funds (and their investment advisers) currently using VaR as a risk-management tool employ varying time horizons in their models that, in some cases, would not comport with the Proposed Rule. In response to the Proposed Rule, these funds would be required to modify their VaR models, including coordinating time horizon changes with third-party vendors providing investment risk information and quantitative analytics used in the models, with associated costs. We do not believe that these costs would be

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<sup>21</sup> In the context of the exposure-based portfolio limit, we believe that the SEC should also address this situation. Market movements or shareholder activity might result in the aggregate exposure of a fund operating under the exposure-based portfolio limit exceeding 150%. In response, the fund might seek to close-out multiple derivatives transactions through offsetting positions that will reduce its aggregate exposure below 150%. If the execution of any one of those offsetting derivatives transactions on its own would not reduce the fund's aggregate exposure accordingly, each transaction would seemingly be prohibited under the Proposed Rule, as the fund would be noncompliant with the 150% aggregate exposure limit immediately after entering into any of them.

justified, particularly because the risk-based portfolio limit's use of comparative VaR greatly mitigates the SEC's concerns associated with use of very short or very long time horizons. For these reasons, we recommend that the Proposed Rule be revised so as to allow funds operating under the risk-based portfolio limit greater flexibility in selecting a time horizon for use in their VaR models. However, recognizing the Commission's concerns, we also recommend that the Proposed Rule continue to provide a range of trading days from which funds can select a time horizon, and suggest an increased range of between 5 and 30 trading days.

*Other Suggestions for Improving the Proposed Rule's Portfolio Limitations*

We suggest the following other changes to both the risk-based portfolio limit and the exposure-based portfolio limit:

- As stated above, we disagree with a fundamental premise of the portfolio limitations that each dollar of notional amount of a fund's derivatives transactions represents incremental leveraging by the fund, analogous to a dollar of indebtedness leverage. We acknowledge that certain derivatives transactions can be viewed as providing a fund with economic exposure to an underlying reference asset that is equivalent to what the fund could achieve by borrowing money and investing in that reference asset. For these derivatives transactions, each dollar of notional amount can be viewed as equivalent to a dollar of indebtedness leverage by the fund. Derivatives among this type include long equity total return swaps and long single-stock and security index futures. However, the notional amount of other derivatives transactions cannot be analogized to indebtedness leverage. This is particularly true of interest rate derivatives, such as interest rate swaps and interest rate futures, and foreign exchange derivatives, such as currency forwards. While such derivatives transactions could have some leveraging effect on a fund (depending on how they are used by the fund), it is inaccurate to view such a transaction as equivalent to a borrowing by the fund of the transaction's notional amount and the investment of those borrowed proceeds in the underlying reference asset. Additionally, because the portfolio limitations simplistically equate notional amount to indebtedness leverage without any refinement to give effect to the nature of the underlying reference asset, the Proposed Rule's aggregate exposure calculation is not risk-based. For example, under the relevant aggregate exposure limit one fund using treasury bond futures to adjust its duration is viewed as equivalent to another fund using long total return swaps in the same notional amount to obtain leveraged exposure to small capitalization equity securities.

For these reasons, we recommend and support a methodology under the Proposed Rule pursuant to which funds would apply, for purposes of calculating aggregate exposure, specified discounts to the notional amounts of certain derivatives transactions to reflect and recognize both the relative risk of these transactions and that they are not analogous to indebtedness leverage. We direct the Commission to the comment letters of the Asset Management Group of the Securities Industry and Financial Markets Association ("AMG") and the ICI (collectively, the "Trade Organizations") on the Proposed Rule<sup>22</sup>, each of which

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<sup>22</sup> See Letter from Timothy W. Cameron, Head, AMG, to Brent J. Fields, Secretary, SEC (March 28, 2016). See ICI Comment Letter.

similarly supports the application of discounts to the notional amounts of certain derivatives transactions for purposes of the aggregate exposure calculation. The methodologies recommended by the Trade Organizations would draw on and derive from conservative frameworks used in other regulatory contexts that recognize the varying risk profiles for derivatives with different underlying assets.

One suggested methodology would use the standardized initial margin “look-up tables” included in the recently finalized rules of the U.S. banking regulators (the “Prudential Regulators”) and the CFTC regarding margin requirements for uncleared derivatives<sup>23</sup>. The tables set forth initial margin requirements for uncleared derivatives in various asset classes, expressed as a percentage of notional amounts. Using these tables, the suggested methodology proposes application of specified discount multipliers to the notional amounts of derivatives transactions based on asset class, and in some cases tenor, to calculate “risk-adjusted notional amounts” that would be used in the aggregate exposure calculation. Importantly, the methodology proposes no application of a discount multiplier to the notional amounts of derivatives transactions in those asset classes regarded by the Uncleared Swap Margin Rules as having the greatest relative risk (generally equity and commodity). Derivatives transactions in the other asset classes would be subject to discount multipliers derived using a “scaling factor” that recognizes the relative risk of these derivatives transactions implicit in the tables and the Uncleared Swap Margin Rules. While the notional amount of derivatives transactions in the equity and commodity asset classes would be unadjusted, the risk-adjusted notional amount of a derivatives transaction in the interest rate asset class would range between approximately 7% and 27% of its unadjusted notional amount (depending on tenor) and the risk-adjusted notional amount of a derivatives transaction in the foreign exchange asset class would equal 40% of its unadjusted notional amount. As noted above, we believe that the Proposed Rule’s use of unadjusted notional amounts for interest rate derivatives and foreign exchange derivatives in the aggregate exposure calculation in particular overstates the risk of these transactions.

The second suggested methodology would use the SEC and CFTC joint rules defining which entities must register with the SEC and the CFTC as “major security-based swap participants” and “major swap participants”, respectively<sup>24</sup>. These rules permit entities to

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<sup>23</sup> See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839 (Nov. 30, 2015) (Prudential Regulators); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (CFTC) (collectively, the “Uncleared Swap Margin Rules”). The SEC has proposed, but as of the date of this letter not finalized, rules regarding margin requirements for security-based swap dealers and major security-based swap participants not subject to regulation by a Prudential Regulator in respect of uncleared security-based swap activities. We note that the Uncleared Swap Margin Rules are generally consistent with a framework previously agreed upon by global regulators for establishing margin requirements for uncleared derivatives. See The Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions’ Margin requirements for non-centrally cleared derivatives, available at: <http://www.bis.org/bcbs/publ/d317.htm> (March 2015) (the “BCBS/IOSCO Framework”). Appendix A to the BCBS/IOSCO framework sets forth the recommended initial margin requirements for uncleared derivatives in various asset classes, expressed as a percentage of notional amounts, on which the Uncleared Swap Margin Rules’ look-up tables are based.

<sup>24</sup> See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and Eligible Contract Participant,” 77 Fed. Reg. 30596 (May 23, 2012).

apply specified discount factors to the gross notional amounts of their swaps and security-based swaps, based on asset class, in calculating whether they exceed specified thresholds of “aggregate potential outward exposure”. Like the Uncleared Swap Margin Rules, the rules recognize that the notional amount of all derivatives should not be treated equally and provide for adjustment based on asset class. Like the above, the suggested methodology proposes application of specified discount multipliers, derived by applying a “scaling factor” to the rules’ discount factors, to the notional amounts of derivatives transactions based on asset class and tenor to calculate risk-adjusted notional amounts that would be used in the aggregate exposure calculation. Under the methodology, the notional amounts of derivatives transactions in those assets classes regarded by the rules as riskiest would be subject to limited or no adjustment (generally commodity, equity and credit/debt). Also like the above, the notional amounts of derivatives transactions in the interest rate and foreign exchange asset classes would be subject to the greatest adjustment.

The methodologies proposed by the Trade Organizations would result in risk-adjusted notional amounts for certain derivatives transactions that we believe better reflect and recognize the relative risk of the transactions, including the fact that many do not create indebtedness leverage. At the same time, the methodologies are objective and derive from frameworks already used by U.S. financial regulators for similar purposes. However, if the SEC decides not to adopt either of these methodologies for determining discounts to be applied to the notional amounts of certain derivatives transactions, we urge the SEC to provide an alternative methodology that would allow funds to at a minimum discount the notional amounts of interest rate and foreign exchange derivatives transactions when calculating aggregate exposure so as to better reflect and recognize the risk of these transactions<sup>25</sup>.

Relatedly, the ICI Comment Letter proposes three direct hedging scenarios in which a fund should be permitted to exclude entirely the notional amount of derivatives transactions from its aggregate exposure calculation, including currency derivatives that provide short exposure to a foreign currency in which a security held by the fund is denominated (so long as the short exposure does not exceed the value of the security). We agree with ICI that a fund’s use of derivatives transactions in these enumerated hedging scenarios does not raise any “undue speculation” concerns and, consequently, that the fund should be permitted to exclude them so that its aggregate exposure calculation better reflects and recognizes the relative risk of its derivatives transactions. At the same time, we believe that the proposed

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<sup>25</sup> We highlight the comments of the ICI that, as a fallback, funds at least be able to normalize the notional amounts of interest rate derivatives transactions to ten-year bond equivalents and divide the notional amount of Eurodollar futures contracts by four to reflect the trading convention of these contracts. We also note that the ICI Comment Letter suggests that the SEC increase the aggregate exposure limits under the exposure-based portfolio limit and the risk-based portfolio limit to 200% and 350%, respectively, citing the results of the ICI Study and the inherent arbitrariness of the selection of any exposure limit. Although we believe that application of specified discount multipliers to calculate risk-adjusted notional amounts is the more intellectually sound way to reflect and recognize the relative risk of a fund’s derivatives transactions, we acknowledge that the same outcome could be achieved by increasing the aggregate exposure limits and support this suggestion if the SEC decides not to permit risk-adjusted notional amounts.

hedging exclusions are sufficiently objective and narrowly tailored such that evaluating a fund's compliance with them would not be difficult.

- We believe an open-end fund that is noncompliant with the portfolio limitation under which it operates should nonetheless be permitted to enter into traditional senior securities transactions (i.e., bank borrowings pursuant to Section 18(f) of the Investment Company Act) that are effectuated for temporary purposes to assist in meeting shareholder redemptions. We note that many open-end funds maintain lines of credit with bank providers for liquidity purposes, drawing on such lines only during periods of substantial shareholder redemption activity. For open-end funds investing in assets with extended settlement periods, these lines of credit are critical to the fund's ability to manage the risk arising from the time it takes asset sales to settle and for the fund to receive cash. While Section 18(g) of the Investment Company Act excludes from the definition of "senior security" any borrowing by an open-end fund that is for temporary purposes only (presumed if the loan is repaid within sixty days and is not extended or renewed), any such borrowing is limited to 5% of the fund's total assets at the time of the borrowing. Consequently, while an open-end fund that is noncompliant with its portfolio limitation might be permitted to borrow under a line of credit for temporary purposes to assist in meeting shareholder redemptions under the Proposed Rule (assuming the borrowing would not be a transaction involving a senior security pursuant to Section 18 and, thus, not a senior securities transaction), the amount of that borrowing would be extremely limited.

We believe that the policy considerations behind the Proposed Rule (addressing "asset sufficiency" and "undue speculation" concerns arising in connection with a fund's use of derivatives transactions and/or financial commitment transactions) are justifiably overridden, for a temporary period, so as to ensure that an open-end fund can meet its shareholder redemption obligations under Section 22(e) of the Investment Company Act. We suggest a revision to the Proposed Rule's portfolio limitations that would permit an open-end fund to borrow even when it is noncompliant with the relevant portfolio limitation if the borrowings are for temporary purposes to assist in meeting shareholder redemptions. Specifically, the Commission should (i) clarify that any borrowing excluded from the definition of senior security pursuant to Section 18(g) is not a senior securities transaction under the Proposed Rule and (ii) provide that any other borrowing by an open-end fund that is for temporary purposes (presumed if the loan is repaid within sixty days and is not extended or renewed) to assist in meeting shareholder redemptions and that otherwise complies with the 300% "asset coverage" requirement of Section 18(f)(1) is always permissible under the relevant portfolio limitation. In conjunction, we also suggest that the SEC expand the Proposed Rule's recordkeeping provisions so as to require any open-end fund that borrows when it is noncompliant with the relevant portfolio limitation to maintain written records reasonably substantiating that the borrowings were used to meet shareholder redemptions and repaid within sixty days without extension or renewal.

### 3. Discussion of Proposed Rule's Definition of Qualifying Coverage Assets

Qualifying coverage assets are those assets that are eligible to be identified and segregated against derivatives transactions and financial commitment transactions under the

Proposed Rule's asset segregation framework. For derivatives transactions, qualifying coverage assets would be limited to (i) cash and cash equivalents and (ii) for any derivatives transaction that permits the fund to satisfy its obligations by delivering a particular asset, that asset. For financial commitment transactions, qualifying coverage assets would include (i) cash and cash equivalents, (ii) for any financial commitment transaction that permits the fund to satisfy its obligations by delivering a particular asset, that asset and (iii) assets that are convertible to cash or that will generate cash, equal in amount to the related financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or assets that have been pledged with respect to the related financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board<sup>26</sup>. Citing the FASB Accounting Standards Codification, the SEC notes in the Proposal that U.S. generally accepted accounting principles define cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. The SEC further notes that examples of cash equivalents include U.S. treasury bills, U.S. government agency debt securities, bank deposits, commercial paper and shares of money market funds.

*The Definition of Qualifying Coverage Assets Should Be Revised so as to Permit a Broader Group of Assets that a Fund Can Identify and Segregate*

For derivatives transactions, the Proposed Rule is a dramatic departure from the SEC's current asset segregation and "coverage" regime, under which a fund can generally segregate any asset that it determines is liquid<sup>27</sup>, rather than just cash and cash equivalents and any asset that is deliverable under a particular derivatives transaction. Even for financial commitment transactions the Proposed Rule would take a more conservative approach as compared to the Merrill Lynch Letter by requiring that a qualifying coverage asset be convertible to cash or otherwise cash generating in an amount equal to the related financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation. We acknowledge the SEC's concern articulated in the Proposal that assets other than cash and cash equivalents might be more likely to experience volatility in price or to decline in value in times of stress, potentially at the same time that the fund's derivatives transaction liabilities are increasing as a result of that market stress. In such instance, we understand that the SEC is concerned that, if such assets are segregated by the fund against those transactions, they might be insufficient to cover the fund's related obligations. Nonetheless, we believe that other

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<sup>26</sup> For derivatives transactions, although the definition of qualifying coverage assets does not similarly include assets that have been pledged with respect to the transaction, the Proposed Rule's definitions of mark-to-market coverage amount and risk-based coverage amount would allow a fund to reduce each amount by the value of assets representing variation margin/collateral and initial margin/collateral, respectively, provided by the fund in respect thereof. In this sense, the Proposed Rule can be viewed as permitting variation margin/collateral and initial margin/collateral that a fund has provided in respect of a derivatives transaction as equivalent to qualifying coverage assets.

<sup>27</sup> See Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "Merrill Lynch Letter"), in which the SEC stated that "[I]t would be consistent with the language and policy of Section 18(f) [of the Investment Company Act] and Release 10666 to permit a Fund to place any asset, including equity securities and non-investment grade debt, in a segregated account, so long as the asset is liquid and marked to the market daily."

considerations justify a revision to the definition of qualifying coverage assets so as to permit a fund to identify and segregate a broader group of assets against both derivatives transactions and financial commitment obligations, and that the application of risk-based discounts to the value of non-cash/cash equivalent assets can effectively address the SEC's concern. At the same time, we are concerned that an overly conservative definition of qualifying coverage assets will conflict with the investment objectives and strategies of many funds that use derivatives transactions and financial commitment transactions, in particular equity funds and non-government bond funds, by requiring that they hold significant quantities of cash and cash equivalents, and also will create a "cash drag" on the performance of these funds by preventing them from being fully invested.

First, we note that, while the SEC's current asset segregation and "coverage" regime permits a fund to segregate only the mark-to-market liability associated with many types of derivatives transactions (equivalent to the Proposed Rule's mark-to-market coverage amount), the Proposed Rule's asset segregation framework would be risk-based and require a fund to segregate, for all derivatives transactions, the transaction's mark-to-market liability plus a reasonable estimate of the potential amount payable by the fund if it were to exit the derivatives transaction under stressed conditions (the risk-based coverage amount). As such, the Proposed Rule's asset segregation framework already includes a risk-based buffer that accounts for the possibility that a fund might ultimately need assets with a value greater than a derivatives transaction's current mark-to-market liability to extinguish the transaction. The inclusion of the risk-based coverage amount requirement should assuage concern that the high-quality assets that the fund has segregated against the derivatives transaction might decline in value. Additionally, the Proposed Rule would require that qualifying coverage assets be identified and segregated on the books and records of the fund against derivatives transactions and financial commitment obligations at least once each business day. Consequently, a fund is subject to the risk of only a single business day's decline in the value of its qualifying coverage assets. If a fund's qualifying coverage assets decline in value over the course of a single business day such that their aggregate value is less than the fund's mark-to-market coverage amounts, risk-based coverage amounts and financial commitment obligations, the fund is required to identify and segregate additional qualifying coverage assets on the next business day to remedy that shortfall. Because the total amount of a fund's qualifying coverage assets cannot exceed its net assets, if a fund's qualifying coverage assets are declining in value over a series of consecutive business days, a fund might ultimately be required to close-out some of its derivatives transactions or financial commitment transactions (the fund would be prohibited from engaging in leveraging transactions, such as traditional bank borrowings or reverse repurchase agreements, to increase its qualifying coverage assets to offset any such declines in its existing qualifying coverage assets).

Second, we view the Proposed Rule as inconsistent in its treatment of qualifying coverage assets and assets that have been provided by a fund as margin/collateral in respect of derivatives transactions and financial commitment transactions. As noted above, for derivatives transactions, qualifying coverage assets would generally be confined to cash and cash equivalents, but funds would be able to reduce their mark-to-market coverage amounts and risk-based coverage amounts by the value of assets provided as variation margin/collateral and initial margin/collateral, respectively, for such transactions. For financial commitment transactions,

qualifying coverage assets could include assets that have been pledged with respect to the related financial commitment obligations and that can be expected to satisfy such obligations, determined in accordance with policies and procedures approved by the fund's board (regardless of whether those pledged assets would otherwise constitute qualifying coverage assets under the definition). While the SEC cites to the ISDA Margin Survey (August 2015) as evidence that cash and cash equivalents are commonly used as collateral or margin for derivatives, including 77% of the collateral received for uncleared derivatives, we disagree that funds routinely use only cash and cash equivalents as margin/collateral for derivatives transactions. As the SEC highlights, 90% of the respondents to the ISDA Margin Survey were banks or broker dealers, who more routinely use cash as variation margin/collateral in respect of uncleared derivatives<sup>28</sup>.

Instead, our understanding, based in part on our experience as investment adviser to several funds that are active in the derivatives markets, is that funds routinely provide assets as margin/collateral in respect of derivatives transactions and financial commitment transactions that would not qualify as cash or cash equivalents. For uncleared derivatives transactions as well as TBAs subject to MSFTAs, these assets often include U.S. treasury notes and bonds, U.S. treasury inflation protected securities (TIPs), longer maturity U.S. government agency and government sponsored enterprise debt securities and mortgage-backed securities guaranteed by a U.S. government agency or government sponsored enterprise. For certain cleared derivatives transactions, several of these same non-cash equivalent assets are used as initial margin/collateral. For exchange-traded options on securities and securities indices, we understand that funds generally provide eligible equity securities as margin/collateral to their clearing brokers. For short sale borrowings, we understand that funds generally provide a combination of cash and eligible equity securities as margin/collateral to their prime brokers<sup>29</sup>. Consequently, under the Proposed Rule a fund would be permitted to use a broader range of assets in meeting its asset segregation requirements when those assets are provided by a fund as margin/collateral for the relevant transactions than when the assets are identified and segregated on the funds books and records. This disparity in treatment is unjustified as the purpose of the assets under the asset segregation framework, whether provided as margin/collateral for the relevant transactions or identified and segregated on the fund's books and records, is identical – namely, ensuring that the fund has sufficient high-quality assets available to satisfy in full the liabilities arising from those transactions.<sup>30</sup>

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<sup>28</sup> With respect to the survey's results regarding cleared derivatives and the use of cash variation margin/collateral by 100% of the respondents, we note that the three major clearing houses registered with the CFTC accept only cash as variation margin/collateral for cleared swaps.

<sup>29</sup> For TBAs and short sale borrowings, we believe it is reasonable and likely that a fund would conclude in its board approved policies and procedures that the above-described margin/collateral provided in respect of these financial commitment transactions can be expected to satisfy the related financial commitment obligations.

<sup>30</sup> As the SEC notes in the Proposal, under the Uncleared Swap Margin Rules only some funds will be required to provide initial margin/collateral in respect of uncleared swaps and security-based swaps subject to the rules. Under the rules, a fund must have "material swaps exposure" (generally \$8 billion of average aggregate notional amount of uncleared swaps, security-based swaps, foreign exchange forwards and foreign exchange swaps measured over certain specified days of a calendar year) before a swap dealer counterparty is required to collect initial margin/collateral from the fund in respect of uncleared transactions. Indeed, the operation of the material swaps exposure threshold is likely to result in only a substantial minority of funds providing initial margin/collateral in respect of uncleared swaps and security-based swaps. This is relevant to the definition of qualifying coverage assets



Third, the definition of qualifying coverage assets is inconsistent with the evolving global regulatory regime for uncleared derivatives. As previously noted, the BCBS/IOSCO Framework represents global regulators' agreement on a conservative framework for establishing margin requirements for uncleared derivatives, including the types of eligible margin/collateral that should be exchanged in respect thereof. Key principle 4 of the BCBS/IOSCO framework defines the key policy goals in regulating the types of eligible margin/collateral and provides:

*“[T]o ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the requirements from losses on non-centrally cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress...[I]n addition to having good liquidity, eligible collateral should not be exposed to excessive credit, market and FX risk...[T]o the extent that the value of the collateral is exposed to these risks, appropriately risk-sensitive haircuts should be applied.”*

The BCBS/IOSCO framework then provides examples of assets that would satisfy Key principle 4, including cash, high-quality government and central bank securities, high-quality corporate bonds, equities in major stock indices and gold.

In the U.S., the Prudential Regulators and the CFTC recently finalized the Uncleared Swap Margin Rules. Drawing upon the recommendations in the BCBS/IOSCO Framework, the final rules provide a broad group of eligible assets for both initial and variation margin/collateral for transactions between swap dealers and financial end users such as funds. These assets include cash, U.S. treasury securities, U.S. government agency and government sponsored enterprise debt securities, mortgage-backed securities guaranteed by a U.S. government agency or government sponsored enterprise, certain foreign sovereign and central bank debt securities, certain publicly traded debt securities and publicly traded common equities that are included in the Standard & Poor's Composite 1500 Index or certain foreign stock indices. The final rules also specify certain discounts to be applied to the value of these assets when used as margin/collateral for uncleared derivatives, which range from 0.5% to 25% (with sovereign debt generally receiving lower discounts and equity securities receiving higher discounts).

Although the Uncleared Swap Margin Rules are not directly applicable to the use of derivatives transactions or financial commitment transactions by funds under the Investment Company Act, we believe that the policy considerations underlying the rules should inform the Proposed Rule. The policy goals of the Proposed Rule's qualifying coverage assets definition and the Uncleared Swap Margin Rules' specification of eligible margin/collateral are similar – namely, ensuring that assets used to back derivatives and related exposures are sufficient to satisfy those exposures in full even in times of market stress (whether provided to a counterparty

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because any fund that is not required to provide initial margin/collateral under the Uncleared Swap Margin Rules would be unable to reduce its risk-based coverage amounts for relevant uncleared derivatives transactions and instead would need to identify and segregate on its books and records qualifying coverage assets against those entire amounts.

in the form of margin/collateral or, in the case of the Proposed Rule, identified and segregated on a fund's books and records). Indeed, the similarity in policy goals is demonstrated by the fact that the Proposed Rule permits a fund to treat margin/collateral as qualifying coverage assets (in the case of financial commitment transactions) or to reduce the amount of qualifying coverage assets that it must otherwise identify and segregate by the value of margin/collateral (in the case of derivatives transactions). We further believe that the Uncleared Swap Margin Rules reflect a consensus view among U.S. financial regulators that specified assets regarded as satisfying Key principle 4 of the BCBS/IOSCO framework can appropriately be used to support market exposures created by derivatives, subject to the application of appropriate risk-based discounts to their values. Because these assets, with appropriate discounts, are regarded as suitable and sufficient to support derivatives in other critically important regulatory contexts, we believe that the assets should likewise constitute qualifying coverage assets under the Proposed Rule.

We believe that these considerations in aggregate strongly support a revision to the Proposed Rule's definition of qualifying coverage assets that would permit a fund to identify and segregate against derivatives transactions and financial commitment transactions, in addition to cash and cash equivalents, ***any asset that the fund determines to be highly liquid and capable of maintaining its value in a time of stress, after accounting for an appropriate risk-based discount, as determined in accordance with policies and procedures approved by the fund's board.*** Should the SEC decide not to give funds this level of discretion in determining qualifying coverage assets, we alternatively request that the SEC at a minimum revise the definition of qualifying coverage assets in respect of both derivatives transactions and financial commitment transactions so as to explicitly include (i) the eligible margin/collateral assets under the Uncleared Swap Margin Rules after application of the relevant discounts to the value of those assets and (ii) shares of open-end funds and ETFs after application of an appropriate risk-based discount to the value of the shares. Because many funds, as part of their investment strategies, regularly hold shares of open-end funds and ETFs pursuant to permissible fund of funds structures, we believe it is important that funds be permitted to identify and segregate these shares against derivatives transactions and financial commitment transactions. At the same time, we believe that the liquidity of these shares justifies their inclusion as qualifying coverage assets, particularly after the application of an appropriate risk-based discount to their value.<sup>31</sup>

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<sup>31</sup> With respect to the SEC's concern that assets other than cash and cash equivalents might be more likely to experience volatility in price or to decline in value in times of stress, potentially at the same time that the fund's derivatives transaction liabilities are increasing, we note that risk-based discounts are routinely applied to non-cash collateral assets in financial transaction collateral arrangements to address this very same concern. Relevant discounts applied to non-cash collateral can be established by regulation (see, e.g., Uncleared Swap Margin Rules, FINRA Rule 4210), by clearing houses (in the case of cleared derivatives) or bilaterally between counterparties. In all cases, application of the discounts effectively addresses the risk that non-cash assets might decrease in value and ultimately be insufficient to support relevant market exposures by, in effect, requiring parties to overcollateralize those exposures. Our recommendation would, in effect, require funds to "over-segregate" on their books and records for derivatives transactions and financial commitment transactions when using non-cash/cash equivalent assets. For example, a fund might determine that equity securities included in the Standard & Poor's 500 Index are sufficiently liquid and capable of maintaining value in a time of stress after application of a 15% risk-based discount to their value (the same discount applicable to such securities under the Uncleared Swap Margin Rules) so as to constitute qualifying coverage assets. For each dollar of derivatives transaction exposure or financial commitment obligations in respect of which the fund must identify and segregate assets on its books and records, the fund would

Finally, we note that if the SEC expands the definition of qualifying coverage assets as we suggest above, the change would also alleviate an administrative concern associated with financial commitment transactions. While qualifying coverage assets are broader for financial commitment transactions than for derivatives transactions<sup>32</sup>, the utility of this broadening is questionable, particularly when a financial commitment transaction is approaching its maturity. For example, if a fund executes a long TBA transaction that matures in thirty days, it could initially identify and segregate in connection with the transaction a highly liquid investment-grade corporate bond with a value at least equal to the TBA's purchase price. However, beginning on the second business day preceding the TBA's maturity date, because the corporate bond is convertible to cash only on a "T+3" basis under the standard settlement cycle, the Proposed Rule suggests that the fund would need to identify and segregate another asset against the TBA's purchase price. If the fund were to liquidate its position in the corporate bond on or after the second business day preceding the TBA's maturity date, it would not receive cash from that sale until after the TBA's maturity date. We think the administrative burden of a requirement that, in effect, requires a fund to substitute other qualifying coverage assets with cash or cash equivalents as a financial commitment transaction approaches its maturity is unjustified<sup>33</sup>. Further, we do not believe that a goal of the Proposed Rule's asset segregation framework is to ensure cash-flow matching in which each dollar of a fund's liabilities arising from derivatives transactions and financial commitment transactions are at all times covered by assets capable of being converted to cash in time to satisfy those liabilities in full. Rather, we understand the goal of the Proposed Rule's asset segregation framework to be ensuring that a fund at all times maintains sufficient high-quality assets in respect of derivatives transactions and financial commitment transactions so as to effectively address "asset sufficiency" and "undue speculation" concerns under the Investment Company Act.

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be required to identify and segregate \$1.18 of these equity securities. Assuming that the securities can experience daily volatility as high as 2%, the 15% discount seems suitably conservative, particularly because the Proposed Rule's requirement that the fund identify qualifying coverage assets at least once each business day subjects the fund to the risk of only a single business day's decline in the value of the securities. We believe this would be the case even if the equity securities are identified and segregated against a long derivatives transaction referencing an S&P 500 constituent. In this situation, even if a significant decline in equities on a particular day results in the value of the qualifying coverage assets decreasing 2% simultaneously with a 2% increase in the fund's mark-to-market coverage amount in respect of the derivatives transaction, the discount would still provide approximately 13% "over-segregation".

<sup>32</sup> By reason of including, for financial commitment transactions, assets that are convertible to cash or that will generate cash, equal in amount to the related financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation (determined in accordance with policies and procedures approved by the fund's board).

<sup>33</sup> We further note on this point that many of the assets cited by the SEC as examples of cash equivalents might not be convertible to cash on a "T" or "T+1" basis.

Brent J. Fields  
March 28, 2016  
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OppenheimerFunds appreciates the opportunity to comment on this important proposed rulemaking by the SEC, as well as the Commission's consideration of our comments and views shared in this letter. We are available to provide any additional information or assistance that the SEC might find useful. Please do not hesitate to contact Cynthia Lo Bessette at [REDACTED] or [REDACTED].

Sincerely,

/s/ Cynthia Lo Bessette

Cynthia Lo Bessette, Esq.  
Executive Vice President & General Counsel  
OppenheimerFunds

/s/ Geoffrey J. Craddock

Geoffrey J. Craddock  
Executive Vice President & Chief Risk Officer  
OppenheimerFunds