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Brent J. Fields
Secretary
Securities and Exchange Commission (SEC)
100 F Street, NE
Washington, DC 20549-1090

Via electronic submission: rule-comments@sec.gov (File number S7-24-15)

28th March 2016

Dear Mr Fields,

Release No. IC-31933; File No. S7-24-15

Aspect Capital Limited (**Aspect**) welcomes the opportunity to respond to the SEC's proposed rule on the "Use of Derivatives by Registered Investment Companies and Business Development Companies" (the **Rule**) as set out in its proposing release no. IC-31933 (the **Proposing Release**).

By way of background, Aspect is a London-based investment manager specialising in systematic and quantitative investment management. Aspect was established in 1997 and currently manages USD6.6bn. The vast majority of those assets are invested in Aspect's systematic and diversified managed futures investment strategies. Aspect has been appointed as the sub-adviser to the Equinox Aspect Core Diversified Strategy Fund, which is registered as an investment company under the Investment Company Act 1940 (the **Act**), since November 2014.

Aspect's submission is attached.

Yours sincerely

Aspect Capital Limited
Director

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Aspect Capital Limited Submission

Summary

1. Aspect agrees with the need for the SEC to consolidate and harmonise the rules around the use of derivatives by registered investment companies (**RICs**) and therefore welcomes the Rule in this regard. There are a number of elements to the Rule that Aspect believes are well considered and is broadly supportive of. These are the new asset segregation requirements, the new proposed derivatives risk management program and the enhanced record-keeping requirements. However, there are a few elements to the Rule that Aspect has reservations about, especially the new proposed exposure based portfolio limits. Our concerns are set out in detail below, together with our suggestions as to more suitable alternatives.

Exposure based portfolio limits are unjustified, excessive and detrimental to investors

2. We are concerned that the proposed exposure based portfolio limits are unjustified and excessive and could have a detrimental rather than beneficial effect on investors.

3. The exposure based portfolio limits effectively reverse the current and long-standing rule-making of the SEC in relation to the use of derivatives by RICs. We understand that such a reversal by the SEC requires clear justification and we do not believe that such justification has been put forward. Examples have been provided of funds that have been forced rapidly to liquidate investments or close down entirely, causing harm to investors. However, such funds did not deploy the types of investment strategies that would be most affected by the exposure based portfolio limit. In addition, we are not aware of circumstances related to the use of derivatives by RICs that would justify such a complete departure from current SEC policy. We would therefore recommend that the SEC retains its well-established and accepted current position that a derivatives transaction for which a RIC has appropriately segregated assets should not be classified as a "senior security" for the purposes of the Act and that no exposure based portfolio limit should apply to such derivatives transactions. We would also point out that the activities of RICs are already extensively regulated under the Act, SEC rules and formal SEC guidance. As a result, we believe that the current rules, especially when complemented by the proposed new rules on asset segregation, a derivatives risk management program and enhanced record-keeping, impose sufficient requirements and obligations on RICs and their advisers to ensure that investment strategies deploying derivatives are subject to suitable risk controls and limits to safeguard the interests of investors.

4. We consider that the exposure based portfolio limits are excessive because calculating exposure on a gross notional basis significantly overstates the risk of investing in derivatives. For example, it is extremely rare that a party that has entered into a derivative is called upon to pay the gross notional value of such derivative. This problem is most acute with respect to fixed income derivatives, which are typically not very volatile and therefore present a relatively low risk. This lack of volatility and low risk is reflected in the small amount of initial margin set by exchanges to support fixed income derivatives trading. For example, a CME Eurodollar contract with a notional value of $1million would require only $300-$700 of initial margin. Unfortunately, a leverage limit based on notional value would prohibit RICs from entering into substantially sized fixed income contracts, even when such contracts would not present significant risk. Conversely, exposure based portfolio limits could encourage RICs and their advisers to concentrate risk in derivatives which are more volatile but which have lower notional values (such as equity index derivatives). Consequently, we believe that the limits are excessive because they have a prohibitive impact on RICs pursuing alternative investment strategies.

5. The prohibitive impact is significant because the exposure based portfolio limits would cause many alternative RICs to de-register or close down. This is detrimental for mutual fund investors because it reduces their investment choices and deprives them of the opportunity to receive the benefits of investing

in alternative strategies. Such benefits include access to markets not otherwise available and cheaper access to markets. Another important benefit is the diversification of investment risk via returns that are uncorrelated to more traditional investment strategies. This was demonstrated during the global financial crisis in 2008 when managed futures strategies performed strongly while global equities suffered extensive losses. Mutual fund investors clearly understand and welcome these benefits, as demonstrated by the significant growth in allocations to alternative RICs in recent years. In particular, allocations have risen from from $58billion in 2009 to $170billion at the end of 2014.[1] Finally, the exposure based portfolio limits would also be detrimental for investors who are currently invested in alternative RICs. This is because such RICs would be forced to close down (or to de-register and suffer large redemptions from non-accredited investors) and liquidate assets other than in accordance with their investment strategies, generating lower, zero or negative returns for such investors.

6. In light of the above, we are concerned that, despite the SEC's intentions, the exposure based portfolio limits would undermine investor protection and could also stifle competition and capital formation in the US mutual fund markets. In our view, the risk based and mark to market based coverage requirements that have been proposed would be sufficient given the implicit leverage limit that these requirements would impose. However, if the SEC was to proceed with an additional leverage limit then, as set out in further detail below, we suggest that an approach based on enhancing margin requirements is a more suitable and straightforward method of controlling excessive risk-taking through the trading of derivatives.

A new margin approach would be more suitable than exposure based portfolio limits

7. Rather than applying exposure based portfolio limits, we recommend that RICs should instead be required to maintain assets in an amount equal to two times the initial margin requirement for each derivative they trade (the **Excess Margin Assets**). In the case of futures contracts or other exchange-traded derivatives, this would be two times the exchange initial margin requirement of each contract. In the case of cleared OTC derivatives that are not exchange traded, this would be two times the clearinghouse initial margin for each contract. In the case of uncleared OTC derivatives, this would be the standardised minimum gross initial margin requirements for non-cleared swaps and non-cleared security-based swaps as adopted in the final rule for "Margin and Capital Requirements for Covered Swap Entities" by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and certain other prudential regulators (the **Prudential Regulators' Final Margin Rules**). The Prudential Regulators' Final Margin Rules are attached at Appendix A, for reference. We have no strong view as to whether the Excess Margin Assets should be limited to cash, cash equivalents or liquid securities (on the one hand) or (on the other hand) whether the universe of acceptable Excess Margin Assets should be broadened to include additional assets. Similarly, we have no strong view as to whether the Excess Margin Assets would be required in addition to the margin deposited with the applicable clearing counterparties or whether the amount of the Excess Margin Assets would be reduced by the amount of initial margin deposited with the applicable clearing counterparties. In any event, all Excess Margin Assets would be held in an account for the RIC with its custodian; and the RIC would not be required to set aside additional assets in order to meet the risk based coverage requirement in addition to the Excess Margin Assets.

8. We consider that this multiple of margin approach would be more suitable because the required margin is a more accurate and current reflection of the risk inherent in a derivatives transaction than the notional contract value. Further, requiring RICs to maintain liquid assets in an amount equal to at least two times the required margin naturally restricts the leverage that is available to the RICs via the trading of derivatives (because such assets cannot then be used to support the trading of more derivatives). However, importantly, it is not overly restrictive and would enable alternative funds to operate, albeit on a more limited basis than is currently the case.

[1] Investment Company Institute "2015 Investment Company Fact Book" 55th ed. at p44.

9. In addition, there are several other benefits to adopting a multiple of margin approach:

- For exchange traded derivatives, the margin requirement is independently and expertly determined by the exchanges and clearing houses and continuously reviewed and adjusted to reflect risk. For example, futures exchanges have typically increased initial margin requirements when markets are more volatile.
- For uncleared OTC derivatives, margin amounts would be based on the Prudential Regulators' Final Margin Rules. These rules were set following extensive review and analysis of appropriate collateral requirements for non-cleared OTC derivatives undertaken by the prudential regulators, the Commodity Futures Trading Commission ("**CFTC**"), and the SEC. Consequently, the SEC should be comfortable that such margin amounts are free from manipulation by market participants and are an accurate reflection of the risks inherent in such OTC derivatives.
- Using margin means that investment strategies or RICs that use a lot of fixed income derivatives are not unnecessarily disproportionately affected (see comment in paragraph 4 above).
- Using margin avoids the possible ambiguities associated with the various ways to calculate VaR.
- Margin is highly responsive to current market conditions.
- For futures contracts, margin takes advantage of and harmonises methods honed by the CFTC over the past four decades.
- Margin is straightforward to comply with. In addition, compliance is easy to track as the margin requirement would be auditable in real time.

If the SEC imposes exposure based portfolio limits, risk-adjusted exposure calculations should apply

10. If the SEC decides to proceed with implementing exposure based portfolio limits, we would recommend that the SEC permits the exposure calculation, for the purposes of such limits, to be risk-adjusted according to the type of the derivatives transaction entered into. We consider that this is an extremely important step to avoid overstating a RIC's derivatives investment exposure, which is especially of concern with respect to fixed income derivatives as described in more detail in paragraph 4 above and as identified by the SEC in the Proposing Release.[2]

11. We suggest that the calculation of the risk-adjusted exposure be based on the initial margin requirements of the Prudential Regulators' Final Margin Rules (attached at Appendix A). In particular, the risk-adjusted exposure for each derivatives transaction entered into by a RIC would be equal to the notional amount of such derivatives transaction multiplied by the applicable risk-adjustment factor for such derivatives transaction as derived from the Prudential Regulators' Final Margin Rules. The underlying asset class of the derivatives transaction would determine the applicable risk-adjustment factor to apply. In the interests of being prudent and conservative, we suggest using equities and commodities as a baseline for determining the risk-adjustment factors for the other asset classes. This is because the prudential regulators identified equities and commodities as the riskiest assets in their schedule of eligible collateral. Gross initial margin for a non-cleared swap referencing commodities or a portfolio of equities is 15% of notional exposure. For purposes of determining the risk-adjusted exposure for a RIC's portfolio, the notional amounts of derivatives referencing equities or commodities would receive no adjustment and would attract a 100% risk-weighting. The notional amounts of derivatives referencing other assets presenting less risk would accordingly receive smaller risk-weightings, as a percentage of the risk presented by equities or commodities. For example, a RIC's non-cleared swap referencing credit with a duration of up to two years would require 2% gross initial margin. We would determine the appropriate risk-adjustment factor for this swap by dividing 2 by 15, resulting in a 13.3% risk-adjustment factor. Consequently, a $100 million notional swap referencing credit with a two-year duration would have a risk-adjusted exposure of $13,300,000. A RIC's other derivatives transactions would receive a risk-weighting

[2] Proposing Release at 80908.

depending on the underlying asset class of the derivative through the same basic calculation. More information to explain the calculations for each asset class is set out in Appendix A.

12. We recommend this approach because it more accurately identifies and calculates the risks associated with investing in the different types of derivatives. In particular, it makes use of asset-specific risk analyses for derivatives that have been conducted and adopted by the prudential regulators as well as the CFTC and the SEC. The percentages also correspond with those in the BCBS-IOSCO framework that established minimum standards for margin requirements for non-centrally cleared derivatives.[3] In addition to the above, the calculations are simple to perform and not subject to discretionary input from a RIC, its board or its adviser.

13. The SEC also requested comment on whether it should consider requiring or permitting the notional amounts for interest rate futures and swaps to be adjusted so that they are calculated in terms of 10-year bond equivalents.[4] If the SEC does not adopt the risk-adjusted exposure approach set out in paragraph 11 above (which implicitly incorporates a duration adjustment) we would support this alternative risk-adjustment method and believe that the SEC should authorise this option for RICs in calculating their exposures with respect to both bond and interest rate derivatives. For example, we would determine the adjusted notional exposure for a 3-month Eurodollar contract with a $1,000,000 notional amount by dividing the contract duration in months by the 10-year duration in months and multiplying that quotient by the contract notional amount, as follows: $1,000,000 * (3/120) = $25,000. The result would be an adjusted notional exposure of $25,000, as opposed to $1,000,000. We believe this result would provide a more accurate assessment of a RIC's exposure to interest rate risk, as the full notional exposure of such derivative significantly overstates the RIC's actual exposure. Moreover, authorising this risk-adjustment method is consistent with the SEC's Form PF, which provides for the calculation of exposures of interest rate derivatives in terms of the 10-year equivalent duration-adjusted value for such positions.

Extension of 300% risk-based portfolio limit

14. If the SEC decides to proceed with implementing a 300% risk-based portfolio limit, we recommend modifying the conditions that would apply to enable a RIC to qualify for this limit, either by means of an absolute VaR test or a modified VaR test, each as set out below. For the avoidance of doubt, we suggest that the notional exposure calculations for the purposes of the 300% limit should also be conducted on the risk-adjusted basis described above. In addition, we also note that, on our reading of the examples on page 80909 of the Proposing Release, we understand that the 300% limit would authorise a Fund to have gross exposure of 400%, consisting of 100% direct exposure and 300% notional exposure, respectively. The references below to the 300% limit should be read in light of that interpretation.

(a) Absolute VaR Test

15. We strongly recommend that the SEC revises the Rule to permit RICs that operate within an absolute portfolio VaR limit of 20% of a RIC's net asset value to qualify for the SEC's 300% risk-based portfolio limit. A RIC's portfolio VaR would have to be less than 20% of its net asset value after entering into a derivatives transaction in order for the RIC to increase its derivatives exposure up to the 300% limit. We propose that the absolute VaR test be subject to SEC-approved parameters that would require a RIC to use a minimum 99% confidence interval, a time horizon of 10 to 20 trading days, and a minimum of three years of historical data.

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[3] BCBS-IOSCO "Margin Requirements for non-centrally cleared derivatives," issued on Sept. 2, 2013 (the "**BCBS-IOSCO Framework**"), available at: http://www.bis.org/publ/bcbs261.pdf.

[4] Proposing Release at 80908.

16. We consider that this extension would have the benefit of avoiding the serious issues of undermining investor protection and stifling competition and capital formation in the US mutual fund markets, as mentioned in paragraph 6 above, while also ensuring that only RICs that are subject to a stringent risk-management framework are able to obtain a greater amount of exposure. The adoption of SEC-approved parameters for this absolute VaR test would provide consistency across RICs, which in turn would help to facilitate the SEC staff's compliance oversight and enforcement. As an additional benefit, an absolute VaR test would subject a RIC's portfolio to both a limit on VaR (20%) and on risk-adjusted exposure (300%). The imposition of these hard limits should mean that they would be less prone to interpretation and manipulation. With regard to whether 20% is an appropriate maximum VaR level, we note that, amongst other things, the VaR for the mutual funds that track the S&P 500 Index generally accords with this level. We are not aware of the SEC having expressed a concern over the risks posed to investors in gaining exposure to such funds and therefore believe that a RIC that limits its use of derivatives in accordance with a 20% VaR limit would not pose undue risk to investors.

(b) Modified VaR Test

17. If the SEC does not wish to adopt the absolute VaR test above, we suggest a modified VaR test as an alternative (the **Modified VaR Test**). RICs meeting the Modified VaR test would qualify for the 300% risk-based portfolio limit.

18. To apply the Modified VaR Test, a RIC would compare the VaR of its total portfolio with the VaR of a subset portfolio that includes securities and derivatives exposure of up to 150% notional exposure. If the VaR of the total portfolio does not exceed the VaR of the subset then the Modified VaR Test is satisfied and, consequently, the RIC would be permitted to maintain up to 300% notional exposure. In other words, a RIC's use of derivatives in excess of 150% must be risk reducing to the RIC's portfolio in order for the RIC to qualify for the higher 300% limit. In this context we note that, on our reading of the examples on page 80909 of the Proposing Release, we understand that the 150% limit would authorise a Fund to have a gross exposure limit of 250% consisting of 100% direct exposure and 150% notional exposure.

19. We believe that the Modified VaR Test offers a good balance between achieving more flexibility for RICs and their advisers, for the benefit of investor choice and the mutual fund markets, while also ensuring that there are strict controls around the circumstances in which a RIC can obtain exposure in excess of 150% but no greater than 300% of its net assets. The Modified VaR Test also has the benefit of maintaining both the 150% exposure-based portfolio limit and the 300% risk-based portfolio limit that the SEC has proposed.

End of Business Day Calculations and Grace Periods for Passive Breaches

20. The SEC has requested comment on whether requiring a RIC to comply with the Rule's portfolio limitations immediately after entering into any senior securities transaction poses any operational challenges.[5] If the SEC adopts a notional-based exposure limit, we recommend that RICs be permitted to recalculate their notional-based exposures at the end of each business day, rather than immediately after they have entered into each derivatives transaction.

21. Given the frequency with which many RICs enter into derivatives on a daily basis, the operational burdens imposed on RICs to re-calculate their notional exposure after execution of each derivatives transaction throughout a trading day would be significant, costly and disproportionate when compared to doing so at the end of each business day. Further, calculating exposures at the end of each business day would be

[5] Proposing Release at 80925.

consistent with the Rule's requirements as to when a RIC should evaluate its compliance with the asset segregation requirements.

22. We also suggest applying a 30 day grace period, as the SEC suggests in the Proposing Release at 80925, to cure a breach of the applicable portfolio limit should the breach occur unintentionally. A grace period would permit RICs to reduce their holdings in an orderly manner thereby avoiding undue harm to investors that could arise if more immediate action required.

Scope of definition of a senior security

23. The SEC has requested comment on whether exposure calculations should exclude derivatives that would not generally be considered to involve senior securities because they do not involve a future payment obligation.[6] As mentioned in paragraph 3 above, we suggest that the SEC retain its well-established position that a derivatives transaction for which a RIC has appropriately segregated assets should not be classified as a "senior security" issued by a RIC in any event. However, to the extent that the SEC does reclassify derivatives involving a future payment obligation as "senior securities", we recommend that the SEC makes clear that any derivative or other similar transaction, such as a purchased option or a structured note, that does not require any future payment or delivery obligation by a RIC (thereby lacking any evidence of indebtedness) is outside the scope of the Rule.

24. Further, given the definitional impact of the above re-classification, we suggest that the SEC either: (i) clarifies that any derivatives that may be considered "senior securities" under the Rule are to be treated as such solely for purposes of Section 18 of the Act and not for any other section, including without limitation, Section 3, or otherwise under applicable SEC rules, regulations, or guidance; or (ii) provides a suitable safe harbour.

Grand-fathering period of 30 months for existing funds

25. The SEC seeks comment on whether providing a transition period after the effective date of the final rule would be appropriate, during which RICs could continue relying on past SEC guidance.[7] We support the inclusion of a transition period of 30 months from the effective date of the final rule for all existing RICs to come into compliance with the conditions of the final rule. We see no reason to differentiate RICs based on their size or assets under management in providing a transition period. We believe a 30-month transition period would provide RICs with sufficient time to restructure their investment portfolios in a responsible and efficient manner and to develop and receive board and shareholder approvals of new investment strategies as necessary in order to ensure their compliance with the final rule's new requirements. It would also allow RICs and/or their advisers to implement any necessary changes to their operational and administrative infrastructure to comply with exposure based portfolio limits or any other requirements in the Rule in a robust manner. Finally, the transition period would enable RICs and their advisers to de-register as necessary in an orderly manner and, to the extent that RICs are forced to de-register as such and operate as private funds, in a way that gives sufficient notice to investors who are not accredited investors and who would therefore be required to redeem their investments in the RICs in question.

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[6] Proposing Release at 80908.

[7] Proposing Release at 80953-4.

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Appendix A
Risk-Adjustment Factors for Calculation of Exposure

- Table A from the "*Margin and Capital Requirements for Covered Swap Entities*" adopted by the Comptroller of the Currency, Federal Reserve Board, FDIC, Federal Credit Administration, and Federal Housing Finance Agency on November 30, 2015.

TABLE A—STANDARDIZED MINIMUM GROSS INITIAL MARGIN REQUIREMENTS FOR NON-CLEARED SWAPS AND NON-CLEARED SECURITY-BASED SWAPS[1]

Asset Class	Gross initial margin (% of notional exposure)
Credit: 0–2 year duration	2
Credit: 2–5 year duration	5
Credit: 5+ year duration	10
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Cross Currency Swaps: 0–2 year duration	1
Cross-Currency Swaps: 2–5 year duration	2
Cross-Currency Swaps: 5+ year duration	4
Interest Rate: 0–2 year duration	1
Interest Rate: 2–5 year duration	2
Interest Rate: 5+ year duration	4
Other	15

- This table of gross initial margin requirements is based on an assessment of the relative risk of different asset classes.
- This table can serve as the basis for creating risk-adjustment factors. Equities and commodities (the riskiest asset classes) would have a risk-adjustment factor of 100%, and other asset classes would be scaled downward in proportion to their relative risk.

Asset Class	**Gross Initial Margin per Table A**	**Risk Adjustment Factor**	
Credit: 0–2 year duration	2	13.3%	= 2/15
Credit: 2–5 year duration	5	33.3%	= 5/15
Credit: 5+ year duration	10	66.7%	= 10/15
Commodity	15	100.0%	= 15/15
Equity	15	100.0%	= 15/15
Foreign Exchange/Currency	6	40.0%	= 6/15
Cross Currency Swaps: 0–2 year duration	1	6.7%	= 1/15
Cross-Currency Swaps: 2–5 year duration	2	13.3%	= 2/15
Cross-Currency Swaps: 5+ year duration	4	26.7%	= 4/15
Interest Rate: 0–2 year duration	1	6.7%	= 1/15
Interest Rate: 2–5 year duration	2	13.3%	= 2/15
Interest Rate: 5+ year duration	4	26.7%	= 4/15
Other	15	100.0%	= 15/15

Example:

- Exposure of an S&P 500 Futures Contract = Nominal Amount * 100%
- Exposure of a 2-year duration Treasury Futures Contract = Nominal Amount * 13.3%

Reference:

- Federal Register: 80 FR 74839