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March 28, 2016

VIA ELECTRONIC MAIL

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

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

CME Group Inc. ("CME Group")[1] appreciates the opportunity to comment on the rules (collectively, the "Proposed Rules") proposed by the Securities and Exchange Commission (the "Commission") regarding use of derivatives by registered investment companies and business development companies.[2]

We are concerned that the Proposed Rules could potentially curtail legitimate risk management activities by registered funds. In short, we think the new portfolio limits are set too low, they don't measure risk or leverage accurately, and they are otherwise unnecessary given the proposal's asset segregation requirements. Calculating limits by aggregating notional derivatives exposure is simply the wrong metric to use. We therefore urge the Commission to consider certain amendments (discussed more fully below) before adopting the Proposed Rules.

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Prudent risk managers use derivatives because they are highly effective risk management tools. They allow fund managers to fine-tune exposures to their securities portfolios cheaply and efficiently. They facilitate liquidity management. For fixed income funds, these tools are absolutely necessary to help hedge duration and interest rate risk. For any funds with exposure to foreign markets, derivatives offer an inexpensive and efficient means of mitigating currency risk. Further, the exchange-traded, centrally cleared derivatives markets in the US are as regulated and transparent as any market structure in the

[1] For the record, CME Group is the holding company for four separate Exchanges, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME Clearing is one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts.

[2] See 80 FR 80883 – Proposed Rule, Use of Derivatives by Registered Investment Companies and Business Development Companies (December 28, 2015).

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world. All of these features have made derivatives an integral part of ordinary portfolio management processes for many funds. They simply help managers manage risk and meet fund investment objectives.

We acknowledge that there are legitimate regulatory concerns the Commission is attempting to address with the Proposed Rules. For example, initiating rulemaking in this area to replace staff guidance that is decades old (and that has apparently been applied inconsistently) is clearly warranted. There is obvious value in setting out clear rules that evenly apply standards for funds in this area. Additionally, if the Commission has evidence of widespread, unrestrained and excessive use of derivatives by registered funds, it is understandable that it would attempt to address that concern.

However, we believe the Proposed Rules actually have the potential to do much more than simply lay out new standards to replace old guidance and prevent unrestrained and excessive derivatives use. In fact, we believe the current proposal could actually disrupt normal course risk management activities, primarily because the new portfolio limits are simply set too low and use an inappropriate metric to calculate the limits. The Commission's estimates regarding the potential impact to the industry under the proposed new portfolio limits do not adequately reflect the significant impact to a wide segment of funds currently using derivatives at levels that would exceed the proposed limits, particularly in the fixed income sector. Many funds would have to alter their investment strategies to comply. This could increase transaction costs to shareholders and may also have unintended negative consequences from a risk management and liquidity perspective. We expect the Commission to receive significant industry comment providing detailed information and analysis further substantiating these assertions.

Below we offer our views on how the proposal could be made more workable and achieve the Commission's objectives in adopting it as we understand them.

The Portfolio Limits Must be Reconsidered Given Their Potential Impact

The Proposed Rules feature new portfolio limits that would place a ceiling on investment company derivatives use. These new outer limits would be measured by one of two optional tests: (1) a 150% limit on notional exposure; or (2) a prohibition against notional exposure exceeding 300% of net assets, provided that a fund can demonstrate the value at risk ("VaR") of a given portfolio is lower than the same portfolio without derivatives. Both proposed portfolio limits would limit a fund's aggregate notional exposure. [3] In calculating the aggregate notional exposure of derivative transactions, there is no "netting" or reduction of exposure calculations from hedging or risk-mitigating derivatives transactions. In addition to the portfolio limits, the Proposed Rules also codify a tandem requirement that would require funds to segregate liquid assets in certain amounts for all derivatives exposures under the limits.[4]

[3] The Proposed Rules would define "notional amounts" generally to mean either: (i) the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions); or (ii) the principal amount on which payment obligations under the derivatives calculation are calculated. Under the Proposed Rules, the notional amount of a derivatives transaction is required to be adjusted for purposes of applying the limits in three very narrow and limited circumstances.

[4] This asset segregation concept has been in practice in the industry based on informal staff guidance for years.

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As an initial matter, we think the Commission should consider whether there is any real need to adopt hard portfolio limits at all.[5] As mentioned above, the Proposed Rules feature asset segregation requirements – these are specifically designed to ensure that funds have sufficient liquid assets available at all times to meet all future obligations. As such, these requirements by their nature act as a restraint against excessive leverage. In our view, the asset segregation requirements by themselves accomplish the Commission's statutory mandate to address undue speculation and asset sufficiency adequately.[6]

If the Commission does proceed with portfolio limits, we strongly recommend amendments prior to proceeding to a final rule. Our first area of concern is the limit levels. We believe the impact and costs of the Proposed Rules are far greater than what the Commission may have anticipated. The proposed limits would obstruct prudent and standard risk management activities of hundreds of funds.

The rulemaking does not adequately explain how the proposed limit levels were selected. The Proposed Rules appear to be based, in part, on a study conducted by the Commission's Division of Economic and Risk Analysis ("DERA").[7] We anticipate that the Commission will receive industry comments showing a fairly widespread consensus that the results of the DERA analysis were flawed and did not provide an adequate basis for the Commission to evaluate the full impact of its proposal. For this reason, we understand the Investment Company Institute ("ICI") conducted a separate review of its membership to determine the potential impact. The study was comprehensive - its results included over 80% of covered funds. It concluded that 471 funds with over $613 billion in assets under management ("AUM") would exceed the 150% notional limit and of that 173 separate funds with $338 billion in AUM would exceed the 300% exposure limit.[8] These figures demonstrate that the potential impact of the Proposed Rules is considerable in scope.

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[5] Commissioner Michael S. Piowar has specifically suggested that there has been no data provided to the Commission that would indicate that specific portfolio limits are warranted. See Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015).

[6] With respect to the asset segregation requirements in the Proposed Rules, we agree with other industry commenters that the Commission should consider expanding the group of liquid instruments to select from for purposes of the segregation requirements, for example, to expand eligibility to all instruments eligible to be posted as margin with a central counterparty, or as defined by the prudential regulators' swap margin rules, and also including interests in mutual funds and ETFs. A broader set of qualifying coverage assets would allow managers to optimize portfolio holdings. Further, we also support changes to make it clear that funds should be able to calculate coverage amounts by netting derivatives transactions with offsetting exposures of the same type with the same maturity and material terms.

[7] See Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (2015) (''DERA White Paper''), available at http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

[8] See March 28, 2016 Letter from Investment Company Institute Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15) to Brent Fields, Secretary of the Securities and Exchange Commission, Appendix A.

Further, it appears the Proposed Rules disproportionately affect funds in the fixed income sector. Apparently, roughly 79% of the $613 billion in AUM that would exceed the 150% exposure limit currently resides in bond funds, a fact that was not noted in the DERA study and the Proposed Rules. It could have been overlooked because bond funds extensively use exchange-traded fixed income derivatives, which have relatively high notional values. As explained below in more detail, this is why we believe notional exposure is an unacceptable measurement Under the Proposed Rules.

From this perspective, the Proposed Rules will deter fairly plain bond funds from using exchange traded fixed income derivatives. In deriving the "appropriate" limit levels to propose, the Commission suggests it was trying to "balance flexibility against risks;" however, it appears the limit levels were selected arbitrarily and without regard to their real economic or risk profile impact. [9]

There can be no doubt that severely limiting the ability of funds to use these products would come with a real cost. CME Group's derivatives products serve very basic portfolio management objectives for our customers. Funds choose to use exchange-traded derivatives like the kind offered by our Exchanges because it is generally prudent for them to use them and because these products are better than the alternatives to manage portfolio risks. For example, a fund might choose to use a single derivative to obtain exposure to an index instead of having to engage in a series of transactions to acquire each of the index's constituents at a much greater cost to the shareholders. Further, a fund might choose to invest cash it receives immediately to gain exposure to a stock or bond market on a temporary basis, thus giving it time to accumulate the component shares gradually to help minimize any adverse pricing impacts associated with obtaining large direct positions. Finally, certain fund managers like to access certain asset classes via derivatives, for example, emerging market currencies or commodities, because they can do so at a lower cost and with greater efficiency; for example, a fund may not be able to access certain foreign markets directly but can obtain indirect exposures via derivatives like swaps.

Derivatives also have real advantages in the area of liquidity management. Consider a bond fund with a portfolio that includes treasury futures and another bond fund that has invested all its cash in bonds. The fund with futures can buy them inexpensively and maintain free cash. Because our treasury futures have a deep pool of liquidity, the fund can also sell them during periods of heavy redemptions quickly and efficiently with one or a few transactions. The cash bonds held by the other fund are less liquid and tie up cash. Having less cash on hand means that fund will be less well prepared to handle redemption obligations. The effect of a portfolio limit that is too low is to take away tools that funds use to reduce risk and manage liquidity and force funds into using tools that are less than optimal.

There are many other examples which demonstrate that the use of exchange-traded derivatives is often in the best interest of a fund's investors. We anticipate that several of them will be included in comments received by the Commission regarding the Proposed Rules. If the Commission went forward and adopted unnecessarily low limit levels, affected funds would be forced to manage their portfolios without these valuable tools. This would likely lead to the unintended consequences – funds making

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[9]See Proposed Rules at page 80903.

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investment decisions based not on what is in the best interests of the fund but rather what is the least bad option given that derivatives may not be available.

In addition to applying constraints to funds' risk management capabilities, adopting limits at levels that would result in hundreds of funds pulling back from the fixed income derivatives markets might also bring about other negative effects that are worth considering. As highlighted in the ICI survey, the Commission's current proposal disproportionately affects fixed income derivatives. The U.S. Treasury Department has recently called for public comment on the issue of liquidity conditions in the U.S. Treasury market. The request for comment is focused on current liquidity conditions and relevant stress factors, e.g., recent bank capital measures, electronification of markets, and lack of fully regulated market infrastructures. Adopting rules that disproportionately discourage regulated, fixed income futures trading by managers with hundreds of billions of dollars' worth of assets under management would not seem to help increase liquidity in these markets.

We respectfully request that, before moving forward with the Proposed Rules, the Commission explain why and how it selected the proposed limits levels and consider whether they are justifiable in light of the negative impact and cost to prudent risk management by registered funds.

Notional is the Wrong Way to Measure a Fund's Exposure to Derivatives

In the event portfolio limits are enacted, it is important to make sure that any such scheme does not unjustifiably limit the ability of fund managers to manage the risk of funds or otherwise force them to use less liquid, more volatile instruments to obtain exposure and meet fund investment objectives. The Proposed Rules fail on these counts because they aggregate notional exposures to establish the limits.

The Commission should not be concerned with imposing a limit on the amount of notional exposure taken on by a fund. Notional amounts are an unsophisticated measurement of risk and in fact can overstate risk. Two different derivatives may have the same notional value but very different risk profiles. A fund with high notional amounts of derivatives may actually have less risk, more risk or the same amount of risk as a fund with no derivatives at all. We are not aware of any regulator worldwide that has adopted a notional standard in a similar context, probably for these reasons.[10] The Commission itself recognized that "…a derivative's notional amount does not reflect the way in which the fund uses the derivative and the notional amount is not a risk measure. An exposure-based test based on notional amounts therefore could be viewed as a relatively blunt measurement in that different derivatives transactions having the same notional amount but different underlying assets….may expose the fund to very different potential investment risks."[11]

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[10] The Office of Financial Research ("OFR") recently issued a report specifically discussing the weaknesses of data based on notional exposure. See Office of Financial Research, 2015 Financial Stability Report (December 15, 2015), at p. 38, available at https://financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf.

[11] See Proposed Rules at page 80903.

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Simple examples can illustrate the flaws in using notional amounts as a proxy for risk. Consider the fact that the economic risk of $1 million of a 2-year interest rate swap is equivalent to $8 million of Eurodollar futures. This is because greater notional exposure does not mean greater risk. There is no reason to incentivize funds to use the less liquid instrument rather than the very liquid, cost effective Eurodollar futures that they may prefer to use. Conversely, the economic risk to a fund of a futures contract on a 20-year treasury bond is very different from the risks on a 2-year treasury note futures contract. But the Proposed Rules, with their notional test, would value the contracts identically, which is inconsistent with the economics of these instruments.

The Commission did articulate its rationale for proposing the notional standard - for ease of administration. While we agree that it will be relatively easy for staff to understand simple notional amounts when reviewing fund compliance with the rules, there can be no doubt that the notional amount of contracts does not accurately reflect the risks facing a fund in this context. Nor do we believe the ease of administration outweighs the cost to the funds that are impacted by such a restrictive measure.

Simply summing the notional value of a fund's derivative instruments would provide a distorted picture of risk and have negative impacts on a manager's ability to utilize instruments that are more liquid and cost effective based on the risk portfolios. Managers will be pushed to consider using instruments with low notional amounts rather than precise instruments that help them manage the assets of their funds in the most prudent and efficient way. Managers have fiduciary duties, they should be free to make investment decisions based solely on factors that they perceive are beneficial to fund investors, e.g., what products are most liquid, least costly, will most effectively mitigate risk, and will best help the fund achieve its investment objectives.

If the Commission is determined to adopt a portfolio limits scheme as proposed, it is imperative that it allow funds to make risk-based adjustments to the notional amounts attributable to derivatives based on the underlying asset classes. The concept of risk-based adjustments is well understood. For example, the Commission itself adopted joint rules with the Commodity Futures Trading Commission ("CFTC") in the swap dealer registration context that included a methodology that included adjustments to notional amounts depending on the underlying asset class.[12] The Commission will receive comments from significant industry participants making these same points. Calculating limits by aggregating notional exposure is faulty and therefore must be abandoned.

<u>Certain Adjustments Are Necessary Under Any Event</u>

The Commission must, at very least, make specific allowance for the risk characteristics of short-term interest rate ("STIR") futures. As explained above, the current proposal disproportionately affects bond funds relative to other types of funds, largely because bond funds make extensive use of STIR futures. Unlike long-term interest rate futures – such as CBOT Treasury Note or Bond futures, or Eurex German or French sovereign debt futures – for which contract prices typically are quoted and traded in terms of

[12] 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) at page 30668-30669, available at https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.

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the prices of the underlying contract-grade government securities – STIR futures prices typically are made in terms of money market interest rates.

Specifically, the prices of nearly all STIR futures contracts – such as CME Eurodollar futures, or CBOT 30-Day Federal Funds futures, or ICE Europe Short Sterling futures – are quoted on the basis of the IMM Index, as 100 minus the contract interest rate per annum. In each instance, the joint determinants of the futures contract are its notional size and the term to maturity of the contract-grade money market interest rate. For a CME Eurodollar futures contract, the embedded interest rate exposure is US dollar Libor for a 3-month term (or one quarter of a year). For a CBOT 30-Day Federal Funds futures contract, it is average daily effective federal funds interest for a term of one month (or one twelfth of one year). For an ICE Europe Short Sterling futures contract, it is UK sterling Libor for a 3-month term (one quarter of a year).

To address this contract characteristic in a way that makes the financial riskiness of such STIR futures meaningfully comparable to the riskiness of conventional long-term interest rate futures or cash fixed-income securities, the Proposed Rules should allow for the notional amount of a STIR futures contract to be normalized relative to the tenor of the corresponding contract-grade interest rate. As a general prescription, the effective notional size of the STIR futures contract should be calculated by multiplying its nominal notional size by the tenor of its contract-grade money market interest rate. For example, in the case of a CME Eurodollar futures contract, for which the nominal notional size is approximately $1 million per contract, the contract's effective notional size would be $250,000, equal to $1 million times ¼ of one year. For a CBOT 30-Day Federal Funds futures contract, for which the nominal notional size is approximately $5 million per contract, the contract's effective notional size would be approximately $416,667, equal to $5 million times 1/12 of one year.

We also urge the Commission to reconsider its treatment of currency hedges and financial commitment transactions if it moves forward with portfolio limits based on aggregate notional exposures. With respect to currency hedges that are clearly identifiable as pure hedging instruments, we do not believe such instruments should be included in a fund's aggregate notional totals. Instead, the Commission should permit funds to exclude foreign currency hedges that a fund can match against a portfolio asset from the set of transactions that need to be considered for purposes of any proposed portfolio limits. With respect to financial commitment transactions, we would urge the Commission to exclude these transactions from the exposure calculations for the portfolio limits because the proposed asset segregation requirement for such transactions itself should ensure that funds have sufficient assets to make their payment obligations.

The Proposed Rules Should Account For the Differences Between Cleared and OTC

There are real risk profile differences between exchange-traded, centrally cleared derivatives and pure OTC derivatives. Centrally cleared derivatives help clearing participants limit credit risk and achieve operational and financial efficiency. Our products are cleared at CME Clearing – market participants transacting on our exchanges obtain neutral risk management standards, transparent financial safeguards, a centralized margining system to secure positions and mitigate risk ex-ante, a twice daily mark-to-market system of cleared positions to remove risk ex-post, for example. These benefits have been widely recognized. Global regulators are increasingly mandating centrally cleared derivatives precisely because of the benefits.

Regulatory agencies across the globe have also made policy decisions to encourage the use of centrally traded and cleared instruments. The Proposed Rules do not. In fact, the notional test that discriminates against futures could actually encourage managers to reduce their use of exchange-traded and cleared futures in favor of uncleared, OTC swaps with lower notional values.[13] At a minimum, the Proposed Rules should be amended to make explicit that the initial and variation margin collected by a central counterparty should in all respects satisfy any applicable fund asset segregation requirements under the Proposed Rules.

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Derivatives, used prudently, allow asset managers to implement their investment strategies in highly regulated asset classes that are deeply liquid, cost effective, and subject to central counterparty clearing. Setting an absolute limit that is unnecessarily low could raise risk management costs for funds and therefore increase costs to investors. Although there are risks associated with using derivatives, as there are with any type of investment product, regulated funds that use them will all have managers with fiduciary duties to act in the best interests of their funds. These duties, in tandem with the Proposed Rule's asset segregation requirements, provide the necessary incentives and regulatory requirements to ensure that managers continuously evaluate and monitor all of the risks related to a fund's portfolio.

We appreciate the opportunity to comment on the proposal. If you or your staff has any questions regarding this letter, please do not hesitate to contact me at (312) 435-3687 or via email at bryan.durkin@cmegroup.com.

Sincerely,

Bryan T. Durkin
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CME Group Inc.

[13] As illustrated above, there may be large notional amount differences between comparable fixed income futures and interest rate swaps but no appreciable differences in risk.