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November 7, 2011

Via E-Mail: rule-comments@sec.gov

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940; File Number S7-33-11

Dear Ms. Murphy:

OppenheimerFunds, Inc. ("OppenheimerFunds") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its concept release (the "Concept Release") regarding the use of derivatives by investment companies registered under the Investment Company Act of 1940 ("1940 Act").[1] Many of OppenheimerFunds' managed portfolios regularly use a variety of exchange traded and over-the-counter ("OTC") derivatives in furtherance of their investment objectives and policies.

## I. INTRODUCTION

Many mutual funds regularly use derivatives to obtain investment exposure, mitigate risk and for hedging purposes. Derivatives should not be viewed as dangerous instruments appropriate only for sophisticated investors; they are useful portfolio management tools that mutual funds can use to help mutual fund shareholders reach their financial goals. Nonetheless, as observers of the financial market turmoil of the last several years, we applaud the SEC's recognition of the need to manage the risks associated with

[1] OppenheimerFunds is a registered investment adviser, providing investment management, transfer agency, and, through its wholly owned subsidiary, OppenheimerFunds Distributor, Inc., distribution services to approximately 95 registered investment companies. OppenheimerFunds, with more than $170 billion under management (including subsidiaries), has been in the investment advisory business since 1960.

derivatives, and of the limitations inherent in trying to apply a seventy-year-old statute to modern financial markets.

The historically-rooted conceptual underpinning of SEC staff guidance to mutual funds' covering their use of derivatives is now struggling to accommodate the continuing evolution of financial instruments. The SEC's regulation of mutual funds' use of derivatives is based on the regulatory foundation governing the issuance of "senior securities" and the related SEC staff guidance on borrowing and leverage. Although understandable from a historical perspective, this is not necessarily the most logical and sensible way to approach the topic of fund use of derivatives as it has evolved in today's markets. Leverage – whether balance sheet or "merely" economic – is only one aspect of derivative risk, and the impact and importance of that one aspect varies widely from derivative to derivative. Not all derivative risks fit the conceptual framework of senior securities, and the inadequacy of the evolutionary approach is increasingly evident. Even before the financial crisis of 2008, the SEC staff was expressing discomfort with derivatives, culminating in the informal moratorium on granting ETF exemptive orders that did not disclaim the use of *all* derivatives.

A fresh approach is called for. The Concept Release provides an excellent opportunity to consider the appropriate regulation of derivatives from the ground up. OppenheimerFunds begins with the proposition that the success of mutual funds over the years as the investment vehicle of choice for individual investors, both directly and through their retirement savings plans, is attributable in large part to legislated risk limitations that are unique in our predominantly disclosure-based system of securities regulation. In 1940, Congress declared that investors are adversely affected when mutual funds "operate without adequate assets or reserves" and "unduly increase the speculative character" of their junior securities. See 1940 Act §§1(b)(7) and (8). Congress' focus on borrowing, adequacy of assets and excessive senior securities was responsive to abuses of that time – abuses which made investments in the common shares of funds "unduly speculative." Today, it is fair to say, there is a concern that derivatives are another, and more modern, potential means by which a mutual fund may become "unduly speculative."

In 1940, Congress also expressed its concerns about investors' ability to understand and monitor the value of their investments in mutual funds, noting the adverse impact on investors when they do not receive "adequate, accurate, and explicit information" about their investments, and when funds "employ unsound or misleading methods" of accounting for and valuing their securities. See 1940 Act §§ 1(b)(1) and (5). These concerns also arose from the abuses particular to that time; but they raise concerns no less acutely today by uncertainty over the best ways to disclose, value and account for certain classes of derivatives.

OppenheimerFunds believes that regulation of investment companies' use of derivatives should be tailored to the particular concerns the regulation is intended to address – risk management, valuation, clarity of disclosure – and should be sensitive to the variety and continued metamorphosis of investment instruments that derive their value from other instruments or measures. In our view, each fund should manage its derivative exposure through a fund-specific value at risk ("VaR") model, approved and overseen by the fund's board of trustees/directors (the "board"), implemented by its risk management staff or comparable group and adequately disclosed in the fund's prospectus. To the extent that particular derivatives' values may be affected by counterparty risk, methodologies exist, and we believe could be implemented, to factor counterparty risk into the valuation of those derivatives. Counterparty risk, however, should not be factored into calculations of diversification, industry concentration, or securities related issuer limits. Counterparty risk is a separate matter of interest to fund shareholders, and to the extent that there are meaningful measures of counterparty risk, that risk should be a separate disclosure item.[2]

## II. DERIVATIVE RISK MANAGEMENT: A BIFURCATED APPROACH

Asset segregation guidance by the SEC staff, which is currently derived from the law of senior securities, both overregulates and underregulates derivatives risk. Derivatives come in too many varieties with too many different types of risk to be shoehorned effectively into a model based on Depression-era investment concepts. Accordingly, we advocate the use of VaR for measuring and mitigating the potential exposure and risks of derivatives in an investment company's portfolio for funds making sophisticated and extensive use of derivatives. For funds and advisers lacking the resources to run a VaR-based model, or that limit themselves to simple derivatives, we believe that a principles-based approach founded on asset segregation is workable.

OppenheimerFunds believes strongly in the role of a fund's board in providing effective oversight of the investment adviser's risk management process. To this end, we believe that a core component in the oversight of the use of derivatives by funds should be the board's awareness of the controls in place, and the effectiveness of the adviser's governance of risk in maintaining this awareness. We believe it is reasonable for the SEC to expect large and sophisticated investment advisers to have in place a well-developed risk governance framework incorporating an independent risk management function, governance structures designed to ensure the comprehensive review by appropriate levels of management of risk issues and reporting to a fund's board designed to facilitate and enhance effective board oversight.

### A. Value At Risk Has the Virtues of Comprehensive Risk Management And Produces An Investor-Friendly Risk Metric

VaR is a tool used to measure the level of risk in a given portfolio based on the past performance of each security and particular type of derivative in the portfolio. Specifically, VaR uses historical analysis and simulations to estimate the potential loss in value of a portfolio over a defined time period at a specified level of statistical confidence. In Europe, UCITS funds use VaR as part of a comprehensive risk management approach to their derivative exposure.[3] The European UCITS approach includes a

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[2] As an initial matter, whatever ideas emerge from the responses to the Concept Release, we believe that rulemaking is premature because the regulatory structure of the derivatives markets remains unsettled. The regulatory requirements of Title VII of the Dodd-Frank Act continue to unfold and are far from complete. For example, it is not yet clear what derivatives traditionally traded OTC and bilaterally will soon be subject to central clearing. For those derivatives that remain OTC and bilateral, it is not yet clear if and to what extent funds will be entitled to receive collateral from their dealer counterparties. As a result, it is challenging to discuss the issue of counterparty risk, one of the central issues raised in the Concept Release, because the contours of the issues are still unknown.

[3] UCITS funds are required to put in place a risk management process ("RMP"). The RMP must provide for the types of derivatives that will be used in the UCITS fund, the risks involved, how those risks will be monitored and controlled and the processes and IT systems to be in place to monitor and control the associated derivative risks. *See CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS,* Committee of European Securities Regulators (July 28, 2010), *available at* http://www.esma.europa.eu/popup2.php?id=7000 ("CESR Guidelines") at 31-33. In addition, UCITS funds must disclose their methods of calculating exposure and expected levels of leverage. The expected level of leverage is calculated based on the sums of the notional amounts of the derivatives. *See* CESR Guidelines at 35.

requirement for risk management and oversight functions with robust initial risk assessments, frequent calculation of risk measures, back-testing of the VaR model, stress-testing and disclosure to investors. We believe that a similar approach would be sensible in the U.S., especially for larger investment management firms, whose portfolio strategies and methodologies include the sophisticated use of derivatives and risk management techniques.

Advisory firms with reasonably educated staff and adequate computing capacity can run the analysis and produce predictions of the likelihood of a specified level of loss in a particular time period. Once the permissible loss limits are established – whether by appropriate regulation, legislation, or by fund disclosure – the portfolio must then be managed to keep the fund within the prescribed limits. Typically, UCITS funds limit a portfolio's VaR to either (1) less than 20% of the net assets of the portfolio over a 20 business day period or (2) less than twice the VaR of a reference portfolio that does not use derivatives. We believe that these same or similar levels are both appropriate and manageable for U.S. registered investment companies, and will keep derivatives from making U.S. mutual funds "unduly speculative."

VaR's key advantage over senior security and asset segregation-based models is that it measures the overall risk profile of a given portfolio, including a quantification of the manner in which different derivatives function differently and pose different levels of risk. VaR provides a clear estimate of risk across a fund's entire portfolio, which allows fund shareholders to assess the probability that the fund's portfolio will go down in value due to derivatives exposure. In contrast, asset segregation varying across divergent types of derivatives would be complex and difficult to disclose in a comprehensible and meaningful way for retail investors. VaR takes the combined effect of all of the fund's investments, which may be collectively designed to manage the risk of the fund's derivatives. In contrast, asset segregation attempts to manage risk without measuring it precisely. Because asset segregation is necessarily done derivative by derivative, and is geared toward "covering" each derivative's exposure, it results in limiting each individual instrument's exposure, but is not fine-tuned enough to account for how the derivatives in a portfolio interact with each other, and with the rest of the investments, to impact the risk profile and performance of the overall investment portfolio.

In addition, adopting VaR affords investment companies the opportunity to enhance the disclosure information provided to shareholders. The disclosure information should include the methods used in calculating VaR, the actual VaR measure of portfolios over historical periods and how the investment company monitors the accuracy and performance of the VaR model through a program of back-testing. Investors would not need to understand VaR methodology in order to compare this information, particularly the VaR measures, between funds with similar objectives. Complementing the VaR disclosure, and since control of VaR does not directly limit leverage, disclosure should also incorporate the forms of leverage that the fund may use from time to time, and how leverage may impact the fund under normal circumstances.[4] In this way, investors would have a high level overview of the risks

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[4] Neither the Commission nor the SEC staff has ever required funds to quantify a fund's risks. Although we are in favor of strong and intelligent fund disclosure, we believe it is fundamentally unsound to require funds to attempt to quantify investment risks (such as leverage or derivative exposure) that may change from day to day or week to week depending on market conditions, or to attempt to predict how investments will behave in all market conditions. It is an unfortunate hallmark of much post-financial crisis litigation that funds failed to foresee and disclose how various elements of their portfolios would behave under unprecedented market conditions. This *post hoc* critique of fund disclosure will prompt funds to attempt to foresee a

associated with their fund's derivative exposure, and be in a position to more readily compare different funds. Investors would also have access to important information on how those risks are monitored and controlled.

B. Principles Based Asset Segregation for Less Sophisticated Users

As mentioned in the Concept Release on page 32, a bifurcated approach has been approved by the Committee of European Securities Regulators ("CESR"). UCITS funds have the responsibility to "select an appropriate methodology to calculate global exposure…which is based on the self-assessment of the UCITS fund of its risk profile resulting from its investment policy." See CESR Guidelines at p. 5. VaR is one of several risk measurement and control methodologies that UCITS funds may use to calculate their exposure. The CESR also allows UCITS funds to use a schedule of derivatives with asset segregation rules that apply to each derivative. Which approach(es) to use is a decision made by each UCITS fund based on general guidelines that ask UCITS funds to consider their level of sophistication with derivatives.

Although OppenheimerFunds recommends VaR for measuring and mitigating derivative exposure, not all firms have the resources, or the need, given their less sophisticated derivative usage, to manage risk with a VaR model. For such organizations, a principles-based approach, relying on cover or asset segregation would be appropriate. Such an approach would involve each fund adopting reasoned policies and procedures to determine the appropriate means and amount to "cover" each derivative in which it invests and application of those policies and procedures to control the risk of derivatives in the portfolio. Under a bifurcated approach, investment advisory firms would have the ability to select one of two methodologies for controlling risk from derivatives based on sophistication, use and resources.

OppenheimerFunds believes that the principles-based leg of the bifurcated approach should require investment companies to segregate enough liquid assets to meet financial obligations reasonably expected to be created by derivatives in which they invest. In its comment letter, the ICI recommends an asset segregation approach, based on a standard that incorporates "extreme but plausible" events. We disagree with that standard because, although "extreme but plausible" is referred to in the Dodd-Frank Act, it has never been defined, would invite uncertainty and would be difficult to implement. OppenheimerFunds also believes that the SEC staff should update Release 10666 to develop an approach which, while conservative, allows for a reduction in segregated amounts for transactions which are demonstrably fully or partially offsetting. For instance, where a fund has undertaken an interest rate swap pursuant to which the fund is obligated to pay a fixed rate of 4%, and subsequently transacts a swap with the same payment dates and notional amount under which the fund will receive a fixed rate of 3%, the amount of "cover" provided is known and can be used to partially offset the first transaction.

variety of unlikely market scenarios and draft disclosure predicting how the fund's investments might behave under such conditions. Inevitably, however, the risks that emerge in the fullness of time are those that could not be, and were not, predicted, making the disclosure and the effort of producing it of little value. OppenheimerFunds favors a disclosure rubric that focuses on the behavior of funds and their investments under "normal" or expected market conditions.

## III. COUNTERPARTY RISK FOR VALUATION, DIVERSIFICATION AND INDUSTRY CONCENTRATION

### A. Counterparties Are Not Issuers For Purposes of Diversification, Industry Concentration and Securities Related Issuer Requirements

OppenheimerFunds believes that for purposes of the diversification, industry concentration and securities related issuer requirements of the 1940 Act, mutual funds should look to the reference asset, not to the counterparty.[5] Instead, counterparty risks incurred through investments in derivatives should be part of continual risk management and oversight processes with robust initial risk assessments, stress-testing and disclosure to investors and should be considered in a new SEC rulemaking that is primarily disclosure based.

We support the ICI's comment letter in that the diversification and industry concentration limits of the 1940 Act were intended to "inform shareholders of the character of the portfolio of the fund and to prevent funds from substantially changing that character without shareholder approval." We note that, in considering whether to look to the reference asset or the counterparty for purposes of these requirements, funds must determine which entity is the "issuer" of the derivative. We disagree with the idea expressed in the Concept Release that the "issuer" with respect to an OTC derivative for all regulatory intents is generally the counterparty.

Although some, but not all, OTC derivatives are now deemed to be securities under certain federal securities laws, our understanding is that most are not securities but rather are bilateral executory contracts between two parties. For example, a mutual fund that enters into a total return swap with a financial institution counterparty is promising to make certain payments to that counterparty depending on the value of a reference asset. The financial institution is also promising to make certain payments to the fund that depend on the value of the reference asset. In this arrangement, the mutual fund is conceivably just as much an "issuer" as the financial institution counterparty. Both parties are taking on similar obligations, therefore, it is difficult to conclude that one is the "issuer" and the other is not, or that either is the "issuer."

In addition, since many derivatives are not securities under the federal securities laws, the diversification, concentration and securities related issuer requirements do not apply to them. Additionally, assuming that management and mitigation of counterparty risk are critical policy goals for all investment companies and assuming further that counterparty risk could even be adequately controlled through the diversification and industry concentration requirements, the fact that certain funds could choose to be non-diversified or to concentrate in financial services industries would be counterproductive to such policy goals. Finally, lawmakers and regulators worldwide are re-shaping the derivative landscape so that an increasing number of derivatives, over time, will be subject to exchange trading and central clearing requirements. To the extent that derivatives are increasingly subject to central clearing with the concomitant reduction in

[5] This view assumes that the reference asset with respect to a derivative is relevant for purposes of these requirements. If the underlying asset is an interest rate, currency or index (or, in the case of the securities related issuer requirement, not a securities related issuer), then the derivative would have no bearing on the relevant requirement.

counterparty risk, the need to analyze and to attempt to reduce counterparty exposure through the diversification, concentration and securities related issuer requirements would seemingly be reduced.

Because of the impracticality of dealing with counterparty risk using the existing regulatory framework, the SEC should (1) issue guidance that the diversification, industry concentration and securities related issuer requirements should only be applied with respect to the reference asset of a derivative, if applicable, including guidance explaining how compliance with Sections 5(b)(1) and 13(a)(3) and Rule 12d3-1(b) of the 1940 Act can be tested given that the derivative does not represent a direct investment in the applicable securities represented by that reference asset and (2) adopt disclosure requirements that necessitate that funds appropriately disclose potential counterparty risk incurred through derivatives. These disclosure requirements could include information about the types and numbers of entities that serve as counterparties in derivatives transactions with an investment company, the risks associated with those counterparties, actions taken to mitigate those risks (such as use of collateral, master netting agreements or central clearing arrangements) and the procedures in place in case a counterparty is unable to fulfill its obligations. Although the ICI recommends that the SEC explore mandating the use of multiple counterparties, we do not believe that such requirements are advisable. Mandating multiple counterparties could be difficult with respect to certain derivatives, such as customized swaps or those on thinly traded market indices, where there are a limited number of potential counterparties. It could also result in increased risk, with funds possibly having to assume the risk of less creditworthy counterparties solely to satisfy counterparty diversification requirements.

B. Counterparty Risk and Valuation Issues

1. Valuation For Purposes of Diversification and Industry Concentration Testing

For purposes of the diversification, industry concentration and securities related issuer requirements, valuation of derivatives should be left up to fund boards, which may adopt procedures delegating day-to-day duties of investment advisers with respect to the investment companies that they advise.[6] OppenheimerFunds believes that using notional amounts for purposes of these requirements provides fund shareholders with the most information about the character of fund portfolios. For example, if a fund purchases $1,000,000 of XYZ Corp. common stock, it would measure its compliance with the diversification and industry concentration requirements based on the full market value of the investment and not based on the unrealized gain (or loss) on the investment over time. If a fund enters into a total return swap that is based on and is the equivalent of the $1,000,000 initial cash investment in the preceding example of XYZ Corp., the notional amount of that total return swap (as it may be adjusted over time) reflects the fund's economic exposure to XYZ Corp.'s shares. If the fund used the mark-to-market value of the swap (which could be positive, negative or zero) for purposes of the diversification and industry concentration requirements it would be understating the investment exposure to XYZ Corp.

[6] With respect to securities related issuers, OppenheimerFunds believes that Section 12(d)(3) of the 1940 Act is rooted in the business structures of the 1930's, and is not only no longer relevant, but imposes unnecessary compliance burdens on funds, limits financial services firms' access to fund investments and should be repealed. The SEC staff has commented on multiple occasions that the considerations of reciprocal practices and exposure to the risks of financial services firms structured as general partnerships are by now outmoded and of little practical import. Until such a repeal, however, the same reasoning that applies to diversification and industry concentration testing with respect to derivatives should apply to investments in securities related issuers.

conveyed through the swap and treating differently how the equivalent cash investment would be viewed for purposes of these requirements.

Because the diversification, industry concentration and securities related issuer requirements are designed to convey information about the total amount of investment exposures and not investment gains and losses, notional amounts, as adjusted pursuant to the terms of the derivative, are more appropriately used to value derivatives. Accordingly, OppenheimerFunds proposes that valuation for purposes of the diversification, industry concentration and securities related issuer requirements should generally be based on adjusted notional amounts for the purposes of these requirements.

2. Counterparty Risk Should Be Part of the Valuation of Portfolio Holdings for Purposes of Determining Net Asset Value

The SEC should also consider whether counterparty risk should be taken into account in the valuation of derivatives. If valuation of a particular instrument that gives rise to counterparty risk were to account for the default risk of the counterparty, the value of the instrument might need to be reduced by an appropriate "haircut." The amount of the haircut would depend on the credit risk of the counterparty. For derivatives that are unfunded, this would require a fund to discount the positive mark-to-market that the derivative might have at a particular moment in time (using some metric of the counterparty's credit risk). However, if the derivative is subject to collateral margining or is subject to central clearing, counterparty risk for purposes of valuation might rightfully be reduced or ignored. In providing guidance on the impact of counterparty risk on valuation models, the SEC should be sensitive to the effect such complexities could have on the fair valuation process.

## IV. REGULATORY AUTHORITY AND THE CONCEPT RELEASE

OppenheimerFunds believes that the Concept Release provides an excellent opportunity to consider the appropriate regulation of the use of derivatives by investment companies from the ground up. We recognize that the limits of the Commission's existing statutory authority and Dodd-Frank mandated rulemaking may impact some of the ideas discussed in this letter. We advance these ideas nonetheless on the theory that they are, in our view, logical approaches to the regulation of mutual fund use of derivatives, unconstrained by regulatory glosses that were designed for investments, risks and abuses that long predate the widespread use of derivatives. Regulation under the 1940 Act should be reassessed with a view toward modernizing the way in which mutual funds measure and mitigate derivative exposure. The Commission and its staff are in the best position to evaluate how modern ideas can be best implemented within the bounds of the Commission's authority.

In the interim, we suggest that the SEC staff update Release 10666 to allow investment companies to use a principles-based asset segregation methodology for "covering" derivatives in the manner suggested above. The instrument-by-instrument asset segregation and cover approach of Release 10666 and subsequent staff no-action letters need to be updated to permit investment companies to reasonably determine their own formulas and methodologies for calculating the appropriate amount to segregate for or otherwise "cover" each type of derivative. We further suggest that the SEC adopt rules or issue guidance to provide investment companies with clear direction on the disclosure of fund counterparty risk and derivatives usage. Such disclosure would help standardize the information fund investors receive about the risks associated with mutual funds' investments in derivatives.

OppenheimerFunds also recommends that the SEC host one or more roundtables to discuss the issues noted in the Concept Release before taking any additional action in this area, including proposing any new rule or release on derivatives. Speaking on these issues in such a forum would help inform the SEC in greater detail on how investment companies and their investment advisers currently use VaR, segregate assets and manage risk in their portfolios. The SEC should invite experts from the industry to provide information to the SEC staff and to discuss these issues from a legal, compliance and risk management perspective.

OppenheimerFunds applauds the Commission's willingness to rethink regulation of investment company use of derivatives, and appreciates the opportunity to provide our views. Should you have any questions, please feel free to call the undersigned, Ari Gabinet ((212) 323-5062) or Geoffrey Craddock ((212) 323-0357).

Sincerely,

Ari Gabinet
General Counsel

Geoffrey Craddock
Chief Risk Officer

cc: Hon. Mary Schapiro
Hon. Elisse Walter
Hon. Troy Paredes
Hon. Luis Aguilar
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