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Invested in America

asset management group

November 23, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
200 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (Release No. IC-29776, File No. S7-33-11)

Dear Ms. Murphy:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "**SEC**" or the "**Commission**") regarding the Commission's August 31, 2011 Concept Release relating to the Use of Derivatives by Investment Companies Under the Investment Company Act of 1940.[2] The Concept Release requests public comment on various issues relevant to the use of derivatives by investment companies registered under the Investment Company Act of 1940 (the "**Investment Company Act**") and companies that have elected to be treated as business development companies under the Investment Company Act (collectively, "**Funds**").

Specifically, the Concept Release seeks public comment on several issues relating to Funds' use of derivatives, including: (i) the application of the Investment Company Act's prohibitions and restrictions on senior securities and leverage, as well as current SEC guidance on the use of segregated accounts to "cover" senior securities; (ii) the application of the Investment Company Act's limits on investments in securities-related issuers; (iii) the application of the Investment Company Act's provisions concerning portfolio diversification and concentration (including valuation of derivatives for purposes of determining a Fund's diversification classification); and (iv) the application of the Investment Company Act's provisions regarding valuation of Funds' assets.

General Suggestions Relating to Further Assessment of the Concept Release

[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. Many AMG member firms sponsor or advise investment companies registered under the Investment Company Act. These registered investment companies may invest in various types of derivatives as part of their respective investment strategies.

[2] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 Fed. Reg. 55237 (Sept. 7, 2011) (the "**Concept Release**"), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-09-07/pdf/2011-22724.pdf.

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The AMG believes that the critical issues presented by the Concept Release should be addressed by the Commission only after it has had the benefit of considering those issues from the most informed vantage point possible. The vast transformation in the regulatory structure applicable to US derivative markets that is currently in progress is likely to change much of the conventional wisdom about derivatives transactions. Consequently, we recommend that the Commission fully assess at least the fundamental aspects of the new regulatory framework mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") prior to addressing the issues presented by the Concept Release. As the Commission knows, the process of finalizing rules to implement the many mandates of Dodd-Frank is well underway but not yet complete. The new regulatory framework that will emerge once the final rules are adopted and implemented may significantly impact the issues addressed in the Concept Release, fundamentally altering the terms and conditions on which derivatives transactions are conducted. We therefore urge the Commission to refrain from taking action on the Concept Release until it has an opportunity to assess the impact of these regulatory changes on the issues presented.

To the same end of assuring full development of the issues, the AMG encourages the Commission to hold an industry roundtable to foster debate about the issues discussed in the Concept Release by industry experts, academics, market users and other interested parties. We believe that this type of public interaction among a cross-section of market participants will help to assure that the Commission has received all material information and viewpoints and will serve to refine and develop the issues under consideration.

Summary of Our Comments

The AMG's principal comments in response to the Concept Release are the following:

- With regard to derivative transactions under Section 18 of the Act, the Commission should, consistent with its historical approach, treat as senior securities only those transactions that create potential indebtedness leverage, *i.e.*, potential future payment obligations. We suggest methodologies that should be considered by the Commission to improve the current asset segregation approach to compliance with Section 18.

- With regard to diversification and portfolio concentration, we believe that the requirements should be applied to derivative transactions by using the current notional value (*i.e.*, the notional value of the reference asset underlying the derivative reflecting the current mark-to-market value of the reference asset).

- With regard to the Section 12(d)(3) limitations on investments in securities-related issuers, we believe that the Commission should consider a substitute rule that would limit unduly concentrated exposures to counterparties.

- With regard to valuation, in general, the AMG believes that derivatives held by Funds are appropriately valued at their mark-to-market value.

I. The Investment Company Act's Senior Securities Prohibition

In the Concept Release, the Commission has requested comment on a wide range of issues relating to the appropriateness and effectiveness of the Commission's approach toward the senior security prohibition in Section 18 of the Investment Company Act. In this section, we address some of the primary issues raised in the Concept Release.

A. Treatment of Economic Leverage

The Concept Release seeks comment concerning whether derivatives that create economic leverage but do not create potential future payment obligations, such as purchased options or structured notes,[3] raise the same or similar concerns as transactions that create future payment obligations. The AMG believes that the Commission's Release 10666, the core guidance concerning Section 18 for more than 30 years, properly focused upon potential future indebtedness, rather than economic leverage, as the basis for senior security concerns under Section 18.[4] Economic leverage alone should not implicate the senior security prohibition of Section 18, as defined by the Commission in Release 10666, and it would be anomalous to treat instruments in which a Fund assumes no future obligations in the same manner as those that do. For example, application of the concept of asset segregation to purchased options would not protect a Fund against future exposure to any liability and would serve mainly to restrict the Fund's flexibility in deploying its assets for the benefit of investors.

B. Treatment of Indebtedness Leverage

The Concept Release seeks comment on the Commission's current approach toward the treatment of derivatives as senior securities under Section 18, and on possible alternative approaches. Release 10666 permits Funds to comply with Section 18 obligations either by segregating assets[5] or by entering into offsetting transactions. As discussed below, the AMG believes that, in concept, asset segregation and offsetting transactions may continue to be an

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[3] Structured notes may create economic leverage because they may offer a leveraged return (for example, a return based on the performance of a futures index or a multiple of the performance of a securities index), but do not represent indebtedness leverage because a Fund's losses are limited to the value of its investment in the note.

[4] Securities Trading Practices of Registered Investment Companies; General Statement of Policy, Investment Company Act Release No. 10666, 6 Fed. Reg. 25128 (Apr. 18, 1979) ("**Release 10666**").

[5] As noted in the Concept Release, the staff has taken the position that a Fund that segregates assets may do so by designating such assets on its books (or "earmarking"), rather than establishing a segregated account at its custodian. Concept Release, at 25-26, *citing* Dear Chief Financial Officer Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (Nov. 7, 1997), *available at* http://www.sec.gov/divisions/investment/ seniorsecurities-bibliography.htm. References in this letter to asset segregation should be understood to include earmarking of assets, as applicable.

effective approach toward treatment of such derivatives, but if the Commission continues with this approach, the asset segregation method should be modified to permit segregation amounts that more accurately reflect the risk profiles of derivatives.

1. *Value of Assets Required to be Segregated*

Issues concerning the amount of assets required to be segregated under the asset segregation approach are a central focus of the Commission's discussion of senior securities. The Concept Release contrasts the notional value standard with a daily mark-to-market value standard that reflects a Fund's current liability under a derivative. The Commission highlights criticisms of both standards, noting, for example, that the notional amount of a futures contract will likely exceed the maximum potential loss on the contract, while a mark-to-market standard may fail to reflect potential future losses.[6]

The AMG believes that the Commission's current approach to asset segregation should be revised to better achieve the purposes of the current requirement while preserving the ability of Funds to use derivative products that provide important benefits to their investors. To this end, the AMG recommends that the Commission formulate a standard for asset segregation that would be calculated as the sum of (i) the current mark-to-market value of the derivative (representing the indebtedness on the instrument), *plus* (ii) a 'cushion' amount that would reflect potential future indebtedness. Such an approach would provide a methodology for industry-wide use across all current and future product classes and instruments, while reflecting the specific risk profile of any individual instrument.

This approach would require that Funds segregate not just the mark-to-market value, but also an additional amount calculated using a measure of potential future losses. The 'cushion' would address some potential shortcomings of a simple mark-to-market value measure, such as the risk that a Fund's indebtedness under a derivative could increase significantly on an intraday basis, resulting in a gap between the value of a Fund's segregated assets and its actual payment obligations under the derivative. We suggest possible alternatives for determining the appropriate amount of cushion below.

Preferred Approach: Initial Margin Requirements. We believe that the cushion amount generally should be equal to the initial margin that Funds will be required to post under applicable regulation following the implementation of margin requirements under Dodd Frank. Initial margin represents an amount designed to protect against potential future losses, and where regulators or clearinghouses have determined the amount of initial margin that must be posted, they have already made determinations about the level of risk represented by an instrument. For example, pursuant to Dodd-Frank, the Commodity Futures Trading Commission ("**CFTC**") has adopted or proposed rules governing initial margin requirements for both cleared and uncleared swaps. For swaps and security-based swaps that are not cleared, Dodd-Frank requires swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, "**swaps entities**") to collect margin in amounts determined pursuant to rules adopted by the Commission, the

[6] Concept Release, at 27-28.

CFTC, or the prudential federal banking regulators,[7] as applicable (collectively, the "**swaps regulators**").

To date, the initial margin requirements that have been proposed by swaps regulators generally contemplate a standard that would cover at least 99% of price changes over a specified time horizon geared to the anticipated period in which the transaction could be liquidated. Setting the cushion amount by reference to initial margin amounts determined by a derivatives clearing organization ("**DCO**") or swaps entity pursuant to the requirements of a swaps regulator would have important benefits. This approach would provide a single, uniform standard applicable to all products and all Funds. Further, all of the requirements for initial margin amounts will be clearly established, including what type of models are acceptable, what data inputs and risk factors are required to be included in the calculation, and the time and confidence parameters for these calculations. For example, for uncleared swaps, under rules proposed by the CFTC, a swaps entity would be required to collect initial margin from a financial end-user in an amount calculated based on a model that is (i) used by a DCO for cleared swaps, (ii) used by an entity subject to oversight by a prudential regulator or (iii) made available for licensing to any market participant by a vendor, and any such model would be required to set margin at a level that would cover at least 99% of price changes over at least a 10-day measurement horizon.[8] Similarly, under rules proposed by the prudential regulators, a swaps entity would be required to collect margin for uncleared swaps using either a standardized grid-based approach that applies a multiplier to the notional value of the swap, or an internal model that has been approved by a regulator and that would cover at least 99% of price changes over at least a 10-day measurement horizon.[9] For cleared swaps, under final rules adopted by the CFTC, a DCO will be required to use models that generate initial margin requirements that are commensurate with the risks of the relevant product or portfolio, based on an established confidence level of at least 99%, with minimum liquidation times of one day (for all futures and options, and for swaps on agricultural commodities, energy commodities and metals), five days (for all other swaps) or a longer period (to the extent appropriate for a particular product or portfolio). Any model used by a DCO for establishing initial margin requirements is required to be reviewed and validated by

[7] The prudential regulators are the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Authority. The Securities and Exchange Commission has not yet issued initial margin rules for security-based swaps.

[8] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732, 23737 (Apr. 28, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf. A swap dealer or major swap participant not using a permitted model for initial margin calculations on an uncleared swap would look to an economically similar cleared swap and double the initial margin requirement of that cleared swap; if there is no similar cleared swap, the swap entity would multiply by 4.4 the initial margin requirement of a futures contract that is economically similar to the uncleared swap and most likely to be used to hedge such uncleared swap.

[9] Margin and Capital Requirements for Covered Swap Entities (Apr. 12, 2011), *available at* http://fdic.gov/news/board/Apr11no4.pdf.

a qualified, independent third party, and the rules also require ongoing review and testing of models used by the DCO.[10]

In addition, using initial margin as the standard will avoid imposing the significant costs on Funds that would be incurred in creating and implementing their own systems to establish an appropriate risk cushion. This initial margin approach would result in decreased complexity, increased effectiveness, a level playing field, and reduced costs to the Funds and their investors.

Alternative Approach: Determination by Fund. To the extent that the Commission determines that initial margin requirements are not a sufficient measure of potential future risk, or in cases where initial margin is not required to be posted, Funds, together with their boards, should determine the appropriate amount of cushion based upon factors such as volatility, liquidity and complexity of a derivative instrument and its reference asset, and whether the derivative is centrally cleared and/or exchange-traded.[11] Under this approach, segregated amounts would likely range from close to the mark-to-market value of a derivative up to the notional value, depending on the Fund's assessment of the potential for future loss on a particular instrument.[12] For example, for products that reference broad-based financial indices and metrics (such as interest rate swaps), the amount required to be segregated is likely to be substantially lower than the notional value and in some cases would be relatively close to the current mark-to-market value. In contrast, products such as single-name credit default swaps, which individually have the potential for large short-term price movements and jump-to-default characteristics, should in certain cases yield a measure close to the notional value of the swap.

If this approach to calculating the cushion is adopted, Funds and their boards also should be permitted to apply, as an alternative, a portfolio-based analysis to assessing the appropriate cushion amount in certain cases.[13] A portfolio-based option should be available

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[10] CFTC Rule 39.13(g). *See also* Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334 (Nov. 8, 2011), *available at* http://cftc.gov/ucm/groups/public/@newsroom/documents/ file/federalregister101811.pdf.

[11] This approach is similar to the model recommended under the "Risk Adjusted Segregated Amounts" proposal set forth in The Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("**2010 ABA Derivatives Report**"), *available at* http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf.

[12] We recognize that this model and its methodologies would need to be adopted and implemented by Funds. If implemented, we recommend that the Commission provide clarifying guidance for Fund boards regarding the nature of their responsibilities with respect to the establishment by Funds of policies and procedures for selecting and implementing such models.

[13] The AMG does not believe it would be necessary for the Commission to explicitly permit a portfolio-based option if the cushion amount is based on initial margin requirements (as described
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to those Funds that are sophisticated users of derivatives, as determined by the applicable Fund and its board.[14] Such Funds should be subject to heightened disclosure requirements and, in particular, should be required to disclose to investors how they calculate derivatives exposure on a portfolio-wide basis and the measures that they take to manage risk from derivative usage. Methodologies that measure the risk of a portfolio as a whole rather than the exposure created by its individual components are designed to take account of a diversified portfolio of investments where the underlying reference assets are not highly correlated (*e.g.*, a portfolio of single-name credit default swaps referencing different issuers) in determining a Fund's risk of loss. A portfolio that contains multiple derivatives that might warrant high levels of asset segregation, if the amounts to be segregated were considered for each instrument individually and then aggregated, may instead merit a portfolio-based assessment of the risk if the individual derivative positions are not correlated and therefore are unlikely to experience losses in tandem. The AMG, therefore, recommends that a bifurcated approach that includes a portfolio-based alternative, subject to Commission guidance concerning maximum portfolio risk, be available to Funds and their boards in lieu of determining segregation amounts on a derivative-by-derivative basis.[15] In the event that the Commission wishes to consider this approach further, the AMG recommends that it solicit additional input from industry participants, academics, market users and others on the potential benefits and the criteria for determining acceptable levels of portfolio risk.

Based upon the experience of its members, the AMG believes that each of the foregoing approaches would reflect differences in risk levels among instruments and portfolios more accurately than the Commission's current approach.

2. *Offsetting Transactions*

The AMG believes that offsetting transactions should continue to be an acceptable alternative to asset segregation. The use of offsetting transactions for Section 18 compliance purposes should serve the same purposes as segregation of liquid assets – to assure that the

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above) because such requirements are likely in many cases to already contemplate the use of models that calculate initial margin across multiple derivative instruments (*i.e.*, on a sub-portfolio basis).

[14] We note that the use of similar risk measures has been incorporated in the European Union's guidance concerning the treatment of derivatives by Undertakings for Collective Investment in Transferable Securities ("**UCITS**") and that this approach appears to achieve both retail investor protection as well as investment flexibility. *See, e.g.*, CESR's *Guidelines for Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS,* Committee of European Securities Regulators (July 28, 2010).

[15] Similarly, the UCITS regulatory framework recognizes two forms of risk limitations – the commitment approach, which uses a schedule of derivative investments and their corresponding conversion methods in order to calculate a UCITS fund's global exposure, and the portfolio risk measurement approach, which is designed to measure the probability of risk of loss based on all positions in the UCITS fund's portfolio using value-at-risk (VaR) or a comparably sophisticated methodology.

Fund has the ability to meet future payment obligations. In circumstances where an offsetting transaction provides a source of value that satisfies the Fund's obligations under the transaction being covered, the objective of the asset coverage requirement will be met. These circumstances would be present, for example, where offsetting transactions have the same counterparty and contract terms. We believe that the Commission should also provide that other transactions which may not have identical contract terms or counterparties could also be offset, if the economic nature of the transactions is substantively similar and such transactions meet other prudential standards adopted by a Fund's board.

3. *Types of Assets Eligible to be Held in Segregation*

In a 1996 no-action letter, Merrill Lynch Asset Management, L.P., Commission staff permitted a Fund to use any liquid asset, including equity securities and non-investment grade securities, for the segregated amount. The AMG believes that the staff's conclusion in the Merrill Lynch letter that segregating any type of liquid asset would limit both the amount of leverage that a Fund can undertake as well as potential increases in the speculative nature of its outstanding shares was correct, and is supported by the track record of Funds relying upon the 'liquid asset' standard in the decades since the letter was issued.[16] We are unaware of any instance in which the quality of segregated liquid assets has caused any adverse impact upon a Fund, or of any other reason for revisiting the long-standing position of the staff in the Merrill Lynch letter.

If the Commission nonetheless determines that a more restrictive approach to the quality of assets eligible for segregation is desirable, the AMG suggests that it consider requiring Funds to adopt policies applicable to liquid assets that are lower-rated or outside the categories of cash or cash equivalents (which would include government securities, agency securities and money market funds). The AMG agrees that, as the staff recognized in the Merrill Lynch letter, "[u]ltimate oversight responsibility for determining liquidity resides with the Fund's board of directors," and recommends that the responsibility for determining how to treat liquid assets that are lower-rated or outside the categories of cash or cash equivalents be placed with the board, which would be required to approve policies and procedures for such assets, including assessing appropriate "haircuts" to certain securities to be used as segregated assets.[17]

II. Portfolio Diversification and Concentration

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[16] Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) ("**Merrill Lynch**").

[17] We also note that additional restrictions on the liquid assets eligible to be used for segregation could impair the ability of Funds to engage in hedging or risk-reducing strategies, as illustrated in the Merrill Lynch letter. Furthermore, restrictions on the liquid assets eligible to be used for segregation could result in Funds having to invest in asset classes that are outside of their mandates in order to cover exposures created by derivatives, artificially skewing their portfolios and introducing a drag on performance.

The Concept Release raises issues concerning which entity should be considered to be the issuer of a derivative and how a derivative should be valued for purposes of the Act's diversification and portfolio concentration requirements. As noted in the Concept Release, the diversification requirements are designed to preclude a Fund that has classified itself as "diversified" from concentrating its portfolio investments in the securities of one issuer or a few issuers.[18] Similarly, Funds are required to disclose in their registration statements their policy concerning concentrating investments in one or more industries[19] because a Fund that concentrates its investments may be exposed to greater risks than Funds that do not.

A. Apply Test to Reference Assets

In applying the diversification and concentration tests to derivatives, the AMG believes that the diversification and concentration tests should be based on a Fund's exposure to reference assets, rather than exposures to counterparties, in light of the purposes of these requirements.[20] In communicating to shareholders the character of the Fund's portfolio, exposures to reference assets are likely to be far more meaningful than counterparty exposure, because reference assets reflect the Fund's investment strategy and are the intended source of investment return.[21] If the tests were applied to counterparties rather than reference assets, the result for many Funds (such as those that enter into a significant number of derivative transactions with large financial institutions) could be a determination that the Fund is not diversified or that it is concentrated in the financial services industry, even though the Fund has highly diversified market exposure and its investment exposures are not concentrated in financial services.

The AMG believes that the issuer diversification requirements, in particular, are inapposite, and should not apply, to derivatives based on certain types of reference assets that do not have "issuers." Derivatives on broad-based indices, commodities and currencies do not represent exposure to an issuer and, therefore, should not be considered when determining whether a Fund is diversified. Similarly, futures and options on Treasuries should also be excluded from diversification calculations even though Treasuries represent exposure to the U.S. government.[22]

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[18] Concept Release, at 49.

[19] *See* Section 8(b)(1)(E) of the Act; Form N-1A, Items 4, 9 (instruction 4) and 16(c)(1)(iv); and Form N-2, Items 8.2.b(2) and 17.2.e.

[20] The AMG believes that it is appropriate to apply these tests to the reference assets for all derivatives, irrespective of whether or not the derivatives are "securities" for purposes of Section 5(b)(1) of the Act.

[21] *See* 2010 ABA Derivatives Report, at 26.

[22] Derivatives on Treasuries, narrow-based indices, commodities and currencies may implicate portfolio concentration requirements, however, and application of the portfolio concentration standard to these types of products would require a review of the relevant derivative transactions.
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B. Test Exposure Using Current Notional Value

The AMG believes that for purposes of applying diversification and concentration requirements, the current notional value of a derivative – that is, the notional amount of the reference asset marked to current market value – is the appropriate measure. We believe that applying a current notional value standard in the diversification and concentration contexts, where the evident legislative intent is that concentrated exposures be highlighted for investors, will better serve the objectives of the relevant requirements than a mark-to-market measure. Unlike the requirements applicable to senior securities, which are intended to ensure that Funds operate with sufficient assets to meet their obligations, the diversification and portfolio concentration requirements were designed to keep investors properly informed as to the character of a Fund's investments, and we believe that current notional value is a better measure of the Fund's character for this purpose. Such use of a notional value standard in applying diversification and concentration requirements would also require a Fund's "total assets" (*i.e.*, the denominator in the calculation) to be deemed increased by the notional value of the derivative reference assets, based on a current mark-to-market value.

III. Exposure to Securities-Related Issuers

The Concept Release seeks comment concerning whether over-the-counter ("**OTC**") derivatives transactions between Funds and securities-related issuers implicate the purposes of Section 12(d)(3) of the Act. The purposes of Section 12(d)(3) are generally understood to involve protecting Funds from the entrepreneurial risks of securities-related issuers and the potential for reciprocal practices that disadvantage Fund investors.[23] Many Funds test their exposures under Section 12(d)(3) and Rule 12d3-1 thereunder when a security issued by a securities-related issuer is the reference asset for a derivative, or when the counterparty for an OTC derivative is a securities-related issuer. As discussed below, in either case, the AMG believes that applying Section 12(d)(3) will provide little, if any, benefit to Funds and investors. The AMG recommends, however, that the Commission consider adopting, either under Section 12(d)(3) or separately, a rule that would limit unduly concentrated exposures by Funds to individual counterparties. Whether adopted under Section 12(d)(3) or otherwise, we believe that a more general counterparty exposure rule applicable to OTC derivatives would better serve the interests of Fund investors than an approach limited to securities-related issuers.

The AMG believes that the purposes of Section 12(d)(3) have only limited applicability to OTC derivatives that have a reference asset that has been issued by a

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However, derivatives on broad-based indices that are not targeted toward any particular industry should be excluded from determinations relating to portfolio concentrations.

[23] *See* Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses, Investment Company Act Release No. 13725, 29 SEC Docket 793-1 (Jan. 17, 1984) ("**SRI Release**"), at text accompanying notes 5-6.

securities-related issuer. Because derivative instruments generally do not provide for direct connections between the holder of the instrument and the issuer of the reference asset, the relationship between a Fund and a securities-related issuer of the reference asset for a derivative is sufficiently attenuated that application of Section 12(d)(3) is unnecessary to protect against the risk of reciprocal trading practices. The second purpose of Section 12(d)(3) is to limit a Fund's exposure to the entrepreneurial risks of securities-related issuers. However, at the time this provision was adopted, most securities-related issuers were organized as general partnerships, which presented the possibility of unlimited liability for a Fund investing in such an issuer.[24] A Fund entering into an OTC derivative referencing a security issued by a securities-related issuer would assume no comparable risk. Consequently, the applicability of Section 12(d)(3) to OTC derivatives based upon the reference security for the transaction would do little to advance the statutory purposes.

The purposes of Section 12(d)(3) are similarly inapposite in the context of an OTC derivative transaction between a Fund and a securities-related issuer. If the counterparty of a derivative is a securities-related issuer, there would be no apparent incentive for parties to engage in reciprocal practices, nor would the Fund be exposed to the entrepreneurial risks of the counterparty, as discussed above, given the limited nature of counterparty risk as compared to the unlimited liability contemplated when Section 12(d)(3) was enacted. Where the transaction is collateralized, there would be minimal exposure in any event.

The AMG believes that a counterparty exposure rule applicable to all counterparties (rather than only those counterparties that derive 15% or more of their gross revenues from securities-related activities under Rule 12d3-1) to transactions with Funds would have significantly more value in the context of OTC derivatives than the more limited focus of Section 12(d)(3) and Rule 12d3-1. The AMG recommends that the Commission consider adopting a rule that would limit the exposure of a Fund to a given counterparty to a percentage of the Fund's assets. For this purpose, which is to assure that a Fund does not take on an unduly concentrated exposure to a given counterparty, a Fund's exposure would be defined using a method similar to the method proposed above for determining the segregated amount for a senior security, that is, as the sum of the mark-to-market exposure to the counterparty (representing current risk) plus a cushion amount (to measure potential future loss). For this purpose, however, the value of any collateral posted by that counterparty should be subtracted from the exposure to that counterparty. Further, as the exposure is intended to represent the aggregate credit exposure to the counterparty, netting across all derivatives with that counterparty should be permitted in calculating the Fund's exposure.[25]

In the context of Section 12(d)(3) as currently applied or under a new counterparty risk rule, transactions that are cleared by a clearinghouse or central counterparty should not be restricted. Clearing of transactions substantially mitigates the counterparty risk of cleared transactions, and no material benefit would accrue from applying counterparty limitations in

[24] SRI Release, at text accompanying note 7.

[25] *See* 2010 ABA Derivatives Report, at 33.

that context.[26] As most standardized swaps will be required to be centrally cleared after Dodd-Frank is fully implemented, and all futures transactions are cleared, imposing limits on the amount of derivatives that may be transacted through a particular clearinghouse would impair rather than expand Funds' ability to transact in cleared derivatives under the heightened regulatory environment mandated by Dodd-Frank.

IV. Valuation of Fund Assets

In calculating its net asset value ("**NAV**"), a Fund must determine the value of any derivatives it holds. Under the Investment Company Act, Funds generally calculate NAV by using the market values of their portfolio securities when market quotations for those securities are readily available, or fair value, as determined in good faith by the Fund's board of directors, if market quotations are not readily available.[27] The AMG believes that the same requirements should be applied to derivatives.

We appreciate the opportunity to provide these comments. Should you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

[26] Concept Release, at 12. As noted in the Concept Release, the staff has generally not viewed exchange-traded options as an acquisition of a security issued by, or an interest in, a securities-related issuer. Concept Release, at 59, *citing* Institutional Equity Fund, SEC Staff No-Action Letter (Feb. 27, 1984).

[27] Investment Company Act § 2(a)(41)(B), 15 U.S.C. § 2a-41(B) (2011).