| asset management group

Via electronic mail (rule-comments@sec.gov)

March 28, 2016

Mr. Brent J. Fields
Secretary
U.S. 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

Dear Mr. Fields:

The Asset Management Group ("**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "**SEC**") on proposed rule 18f-4 (the "**Proposed Rule**")[2] under Section 18 of the Investment Company Act of 1940, as amended (the "**1940 Act**"). The Proposed Rule seeks to regulate the use of derivatives by registered investment companies and business development companies (together, "**Regulated Funds**") by establishing limits on the size of derivatives and other senior security positions ("**Portfolio Limits**"), codifying asset segregation requirements ("**Asset Segregation Requirements**") and requiring Regulated Funds having large positions in derivatives to establish risk management programs.

As fiduciaries to millions of investors and clients and as investment managers to the Regulated Funds used as investment vehicles by retail investors and a significant portion of the nation's pension plans, AMG's members are committed to enhancing customer protections through reasonable regulation. Therefore, we support the SEC's objective of consolidating and updating its guidance regarding the use of

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1 SIFMA AMG's members represent U.S. asset management firms whose combined global assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS, and private funds such as hedge funds and private equity funds.

2 *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 Fed. Reg. 80,883 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf (the "**Proposing Release**").

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derivatives by Regulated Funds. We also agree that the regulation should ensure that the investments by Regulated Funds comply with the framework and policy objectives of the 1940 Act, including Section 18. At the same time, however, we believe it is essential that any regulation provide sufficient flexibility for Regulated Funds to enter into derivatives and financial commitment transactions to comply with their investment objectives, satisfy investor expectations and manage risks associated with their investment portfolios. Any unnecessary constraints on the ability of investment managers to Regulated Funds to use derivatives to gain access to markets, participate in investment opportunities, and risk manage the portfolios of Regulated Funds could have direct adverse impacts on the very retail and institutional investors that the Proposed Rule is intended to protect. In light of this, we believe that changes need to be made to the Proposed Rule – the most important of which are:

- **Eliminate Portfolio Limits, or revise the proposed Portfolio Limits to:**
  - *calculate exposure based on the relative riskiness of the derivative rather than flat notional amount*;
  - *substitute an absolute value at risk ("**VaR**") test for the relative VaR test, when applying the SEC's proposed 300% test; and*
  - *raise the proposed 150% exposure limit to 200%.*

and

- **Allow for segregation of liquid assets beyond cash and cash equivalents.**

I. SUMMARY OF OUR PROPOSAL AND RECOMMENDED CHANGES

We believe that our recommended modifications to the Proposed Rule would improve the effectiveness of the Proposed Rule and mitigate its potential adverse effects on the broad base of investors who rely on Regulated Funds as their primary savings and wealth-accumulation tool.[3] We have summarized our comments below:

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[3] *See, e.g.*, ICI 2015 Investment Company Fact Book at 160, *available at* https://www.ici.org/pdf/2015_factbook.pdf ("At year-end 2014, mutual funds held in [defined contribution] plans and IRAs accounted for $73 trillion, or 29 percent, of the $247 trillion U.S. retirement market. The $73 trillion in mutual fund retirement assets made up 46 percent of all mutual fund assets at year-end 2014. Mutual funds accounted for 55 percent of [defined contribution] plan assets and 48 percent of IRA assets.").

Proposal – Eliminate Portfolio Limits.

Based on the Proposing Release,[4] it appears the SEC has designed its proposed Portfolio Limits to address general policy goals that come from the preamble of the 1940 Act and not Section 18. Reliance on general goals in a statutory preamble is not a sound premise for rulemaking.[5]

Moreover, the proposed Portfolio Limits are not tailored to, and we believe that they are not the best means to address, the policy objectives that the SEC has identified under Section 18 – *i.e.*, ensuring that Regulated Funds can satisfy their obligations under trading practices that may involve the issuance of senior securities, and preventing Regulated Funds from engaging in undue speculation. Indeed, Portfolio Limits could create perverse incentives for portfolio managers of Regulated Funds to invest in riskier, less liquid instruments, and would restrict Regulated Funds from engaging in risk management and portfolio management activity that may be otherwise beneficial for investors.

According to a survey conducted by the Investment Company Institute (the "**ICI**"), Portfolio Limits would have a much greater impact on Regulated Funds than suggested by the SEC in the Proposing Release. Based on the ICI survey, which included eighty percent (80%) of industry-wide assets, 471 Regulated Funds, having $613 billion of assets under management, would fail the 150% Portfolio Limit as proposed and at least 369 Regulated Funds, having $458 billion in assets under management, would have to either deregister or substantially change their investment strategy to continue to operate as registered funds.[6] As a result, if adopted, the proposed Portfolio Limits would force the closure or substantial reworking of a substantial number of Regulated Funds and require the investors who

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[4] *See* Proposing Release at 80,910.

[5] *See*, *e.g.*, *Brown v. Bullock*, 294 F.2d 415, 425 (2d Cir. 1961) ("**Law by preamble is risky business.** The phrases are usually most eloquent and Utopian in character**. If this were they [sic] law, no sections beyond the preamble would ever be required** and every case would be decided on an ad hoc basis, resting firmly upon some praiseworthy concept of justice. Experience, however, teaches that it is the sections that follow that create the rights, duties and liabilities imposed by the legislation upon the persons acting and relying thereon." (emphasis added)).

[6] *See* Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016 (the "**ICI Derivatives Proposal Comment Letter**"). Based on data provided by the ICI, the 369 funds and the $458 billion in affected assets under management are based on the survey responses received by the ICI indicating that a fund exceeded the 300% limit or had notional exposure between 150% and 300% and failed the VaR test or would fail the VaR test.

use those investments to find alternatives – regardless of what the investor desires or what is in the investor's best interest from a portfolio perspective.

For these reasons, we believe the SEC's policy objectives would be best addressed through the Proposed Rule's Asset Segregation Requirements, as well as prospectus disclosure and effective risk management rather than through imposition of Portfolio Limits. At a minimum, given the lack of evidence that Portfolio Limits would accomplish the SEC's stated goals, the lack of market experience with Portfolio Limits and the potential that Portfolio Limits may have a significantly adverse impact on investors and Regulated Funds, we urge the SEC to defer imposition of limits until the SEC has obtained empirical evidence and studied the use of Portfolio Limits further. A more prudent course for the SEC to take would be to implement the Asset Segregation Requirements, with the modifications we suggest, and then, at a later time, reconsider Portfolio Limits after collection of additional data to confirm that the potential costs to investors and Regulated Funds would be outweighed by the benefits. In the event that the SEC nevertheless determines to impose Portfolio Limits, we believe it is critical that the proposed Portfolio Limits be modified in the ways we suggest below.

Alternative Proposal – Make Changes to the Operation of Portfolio Limits.

If the SEC is disinclined to accept our recommendation to eliminate Portfolio Limits, we urge the SEC to revise the Portfolio Limits framework as follows:

Increase the exposure-based limit from 150% to 200% – Provide a higher exposure ceiling for Regulated Funds by increasing the proposed limit to 200%, with exposure calculated on a risk-adjusted basis (see below).

and

Replace the proposed relative VaR test with an absolute VaR test for the 300% risk-based limit – Replace the test comparing two different VaR levels with a single test requiring (i) full portfolio VaR for a Regulated Fund portfolio not to exceed 20% of the Regulated Fund's net asset value ("**NAV**"), and (ii) exposure, calculated on a risk-adjusted basis (see below), not to exceed 300% of the Regulated Fund's NAV.

Calculate exposure using risk-adjusted notional amounts – Revise the definition of "exposure" to provide for risk adjustments to notional amounts of derivatives in calculating both of the SEC's proposed Portfolio Limits.

Expand permissible netting to include risk-mitigating instruments other than those allowed under the Proposed Rule – Allow offsetting instruments, which reduce

exposure, to offset derivatives and other senior securities for purposes of calculating Portfolio Limits.[7]

Exclude currency hedges from the calculation of Portfolio Limits – Exclude currency forwards that are matched against a portfolio asset from Portfolio Limits.

Reduce the notional amount attributed to Eurodollar/Euribor and similar futures contracts and subject such amounts to risk adjustments – Calculate notional amounts for Eurodollar/Euribor futures contracts and similar, short-duration credit futures based on the appropriate divisor (*i.e.*, one quarter of the total for Eurodollar/Euribor futures), and apply appropriate risk adjustments to such reduced notional amounts.[8]

Make additional modifications to the operation of Portfolio Limit testing – Allow Regulated Funds to measure compliance with Portfolio Limits at the end of the trading day or as of the commencement of trading on the next trading day,[9] and provide a seven (7) calendar day period (the "**Compliance Period**") to bring a Regulated Fund's portfolio into compliance with the applicable Portfolio Limit if a Regulated Fund exceeds limits due to entry into a derivatives transaction or other senior security.[10]

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7 Examples of transactions that economically and directly decrease portfolio exposure and should be treated as offsetting for purposes of calculating Portfolio Limits include: (i) offsetting interest rate swaps referencing the same currency and having identical, but offsetting, terms other than *de minimis* maturity mismatches (*e.g.*, March 2020 versus April 2020); (ii) long credit default swap positions that provide protection for a bond held in the portfolio when the portfolio holding has the same seniority and same issuer as the instrument referenced by the swap; (iii) single name credit default swaps that offset constituents of a credit default index swap; (iv) a short or long total return swap when the Regulated Fund holds an opposite short or long position in the underlying referenced asset; and (v) short call options when the Regulated Fund holds the underlying referenced asset. In addition to offsetting economic exposure, such transactions are typically entered into as risk-reducing trades in order to hedge existing portfolio positions rather than to seek investment exposure.

8 This would be achieved by dividing the amount of a 90-day futures contract by four, then applying appropriate risk adjustments to such reduced notional amounts.

9 For sub-advisers, in particular, it will be important to have the flexibility to carry out the calculation on the following trading day because a sub-adviser may not have all of the relevant data until such time.

10 This could happen, for example, if a Regulated Fund has sufficient room within its Portfolio Limit at the beginning of a trading day to enter into a derivative and it does so but, by the end of the day, because of redemptions from holders of the Regulated Fund during the day, the Regulated Fund is over its Portfolio Limit. However a Regulated Fund would have no obligation to come within a Portfolio Limit until it wished to transact in a derivative or other senior security if the sole reason it fell out of compliance was market movement or redemptions, as provided in

Exclude from compliance requirements emergency loans to meet redemption requests[11] and reductions of derivatives positions.

Modify requirements related to selection of Portfolio Limits – Allow Regulated Funds to switch between the Portfolio Limit tests without seeking prior approval of the board of directors or board of trustees of the Regulated Fund (each, a "**Board**"), subject to specific disclosure to investors.

Proposal – Revise the Proposed Asset Segregation Requirements.

Expand the definition of "qualifying coverage assets" for derivatives.

*Provide for segregation of instruments allowed for margin as well as redeemable mutual fund shares and shares of 1940 Act-registered exchange-traded funds ("***ETFs***")* – Allow Regulated Funds to segregate instruments allowed under the U.S. margin rules applicable to uncleared swaps (the "**Swap Margin Rules**"),[12] as well as shares of mutual funds and ETFs, subject to application of haircuts to mitigate price risk.

Clarify mark-to-market coverage amount and netting definitions.

Clarify that netting means close-out netting, expand netting and clarify mark-to-market coverage amount definition – Confirm that netting means "close-out" netting and would apply to all transactions under an enforceable netting agreement, including spot and other non-derivative transactions. Confirm that "the amount that would be payable by the fund if the fund were to exit the derivatives transaction"

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the Proposing Release. *See* Proposing Release at 80,924 ("A fund therefore would not be required to terminate or otherwise unwind a senior securities transaction solely because the fund's exposure subsequently increased beyond the exposure limits included in either of the portfolio limitations.").

[11] For example, as a result of the financial crisis, Regulated Fund complexes put in place emergency credit lines to have available in the event of highly unusual market conditions or unanticipated or unusually large redemption requests.

[12] *Margin and Capital Requirements for Covered Swap Entities: Final Rule*, 80 Fed. Reg. 74,839 (Nov. 30, 2015), and *Interim Final Rule*, 80 Fed. Reg. 74,915 (Nov. 30, 2015) (Prudential Regulators) (the "**Swap Margin Rules Prudential Adopting Release**"); *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016) (adopted by the Commodity Futures Trading Commission (the "**CFTC**")). The effective date for both of the Swap Margin Rules is April 1, 2016, with the requirements being phased in over a four-and-one-half year period. Although the SEC has proposed different margin regulations for security-based swaps, we believe that the Asset Segregation Requirements should track the existing Swap Margin Rules, which are already in the process of being implemented by the industry.

means the "replacement value" reflected on the books and records of the Regulated Fund.[13]

Revise the Asset Segregation Requirements to take account of regulations imposed by other regulators and to be operationally workable.

Allow margin for cleared derivatives to satisfy the Asset Segregation Requirements in full – Clarify that regulatory margin would satisfy Asset Segregation Requirements, and broaden offsets for listed options and listed derivatives.

Treat initial and variation margin together – Allow for deduction of initial margin and variation margin as a combined pool.[14]

Provide a safe harbor methodology for establishing the risk-based coverage amount – Provide a safe harbor methodology for Regulated Funds and for their Boards to rely on in establishing the risk-based coverage amount based on a VaR test or a methodology formulated by a regulated clearinghouse for comparable instruments.

Clarify operation of risk-based coverage amount calculation – Provide that the risk-based coverage amount may be calculated weekly rather than daily by a Regulated Fund.

Clarify limit on qualifying coverage assets – Clarify language in the Proposing Release which suggests that bank borrowings may reduce the amount of qualifying coverage assets available to a Regulated Fund.[15] We do not believe that that result is intended and, accordingly, we request that the SEC clarify that bank borrowings would be

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[13] The process for measuring a party's mark-to-market "exposure" is described in the credit support annex to the Master Agreement published by the International Swaps and Derivatives Association, Inc. ("**ISDA**") by reference to the "replacement value" of the party's net positions. The value is calculated to determine the amount of collateral required to be posted or received by a party, using the midmarket price of each transaction for these purposes, based on the net termination payment due under all of the outstanding transactions between the parties under the netting agreement. This term or similar terms are used in other types of netting agreements. In light of the fact that this term is the one generally used in the industry, we believe it is more precise and more widely understood than the definition of "mark-to-market coverage amount" in the Proposed Rule, which could be misread to mean the "notional amount."

[14] Derivatives counterparties of Regulated Funds often calculate variation margin and initial margin together, on a net basis.

[15] Proposing Release at 80,933 ("Thus, if a fund borrowed from a bank, for example, the aggregate amount of the fund's assets that the fund might otherwise use as qualifying coverage assets for derivatives transactions would be reduced by the amount of the outstanding bank borrowing.").

deducted from a Regulated Fund's total assets and not from the portion of the assets constituting qualifying coverage assets in calculating the limit on qualifying coverage assets relative to the NAV of the Regulated Fund.

Proposal – Make Additional Clarifications and Refinements.

We also recommend the following additional clarifications and refinements:

(i) Allow "to-be-announced" transactions ("**TBAs**") to rely on the Asset Segregation Requirements based on mark-to-market exposure and recognizing offsets with respect to TBAs entered into either under or outside of a netting agreement;

(ii) Clarify application of the Asset Segregation Requirements to interests in tender option bond ("**TOB**") trusts;

(iii) Maintain the SEC's current treatment of securities lending and not view a securities loan as a financial commitment transaction;

(iv) Clarify that qualifying coverage assets for financial commitment transactions could include assets for which short settlement dates have been negotiated or used as part of a course of dealing to the extent included in Board-approved policies;

(v) Provide that all required risk metrics would be determined by the risk management team of a Regulated Fund and not by the Board, that the risk management program should be integrated into a compliance program under Rule 38a-1, to the extent practicable, and that the program provide an option for oversight by risk managers rather than by compliance professionals who may not have the expertise to oversee professional risk personnel running VaR metrics;[16] and

(vi) Clarify other regulatory issues relating to derivatives use by Regulated Funds identified in the 2011 Concept Release,[17] including: (a) issuer diversification and

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[16] Although the Chief Compliance Officer (the "**CCO**") would be responsible for administering the policies and procedures of the Regulated Fund generally, a risk manager would handle the day-to-day compliance with the Portfolio Limit and the Asset Segregation Requirements. The CCO would review these policies and procedures as well as any additional derivatives risk management program as required by the Proposed Rule in connection with the annual review and report to the Board.

[17] *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 76 Fed. Reg. 55,237 (Sept. 7, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-09-07/pdf/2011-22724.pdf (the "**Concept Release**").

industry concentration requirements; (b) application of Section 12(d)(3) of the 1940 Act; (c) application of Rule 35d-1; and (d) valuation of derivatives.

II. SUMMARY OF OUR RATIONALE

Our proposal and recommended modifications would revise the Proposed Rule in a way that not only would protect investors, but also would benefit them. For example, our proposal to allow Regulated Funds to segregate the same assets they are allowed to post as margin under the Swap Margin Rules would leverage the existing collateral management infrastructure that Regulated Funds are required to have to invest in derivatives and thus would avoid raising administrative expenses for investors and would minimize operational risk. In addition, our proposal to allow Regulated Funds to hold those assets recognized under the Swap Margin Rules as highly liquid, but to hold them subject to haircuts that take account of the possibility that the asset may depreciate, would protect investors against the risk that the Regulated Fund might not have sufficient assets to satisfy its obligations due to depreciation of qualifying coverage assets, while at the same time ensuring investors would not be exposed to reduced performance or potential violation of investment guidelines if the Regulated Fund were required to hold cash. Finally, our proposal generally seeks to ensure that the Proposed Rule is clear and workable and takes account of economic realities and existing market conventions.

Our proposal and our additional recommendations are based on: (i) the fact that asset segregation, including segregation based on mark-to-market amounts, has worked effectively for over thirty years to protect investors in Regulated Funds from losses due to the inability of Regulated Funds to meet their obligations under derivatives and financial commitment transactions; (ii) a strong preference to have consistent and uniform rules across different regulatory regimes and thereby create operational efficiencies and keep fund operating costs lower for investors; (iii) a desire to avoid artificial distinctions between products (such as the distinction that currently exists in respect to asset segregation for physically settled and cash-settled instruments) and, instead, create an economically based standard that Regulated Funds will be able to apply as products and delivery methods evolve; (iv) a need to establish a framework that is clear to investors as well as to regulatory examination personnel so that investors will understand the Regulated Fund's use of derivatives and examination personnel will be able to accurately evaluate compliance and apply the rule; (v) a need to grant sufficient flexibility to Regulated Funds to provide retail investors with a wide variety of investment alternatives and to maintain effective risk management tools to preserve the value of those investment alternatives during times of market stress; and (vi) a desire to promote market innovation, which not only will lead to growth in value and investor choice, but also will have broader positive effects on market liquidity and capital formation.

Among other things, as we explain below, Regulated Funds use derivatives to gain exposure to different markets and different asset classes. For example, Regulated Funds utilize derivatives to obtain exposure to foreign markets that may not be otherwise accessible and to provide exposure to commodities. Investors specifically choose to invest in these Regulated Funds based on the investment strategies described in the prospectuses of the funds, and such investment opportunities allow investors to better diversify their portfolios.

To impose regulations that would retroactively deny investors the benefit of the investment strategies they have sought would be an inappropriate means for the SEC to manage derivative risks and appears inconsistent with the SEC's investor protection goals. It also would appear to favor institutional investors over retail investors since institutional investors are able to obtain these exposures through managed accounts and private funds that are subject to SEC regulation through regulation of the advisers, while retail investors would not be able to maintain such exposures. Moreover, non-1940 Act regulated investment vehicles likely would not be available for investment through 401(k) plans and, as a result, investors saving for retirement would not have the benefit of such diversification if the SEC's proposal is adopted. Finally, the Proposed Rule would penalize Regulated Funds that have relied in good faith on SEC guidance and approvals of exemptive orders. The Proposed Rule effectively would force closure or substantial revamping of Regulated Funds that have been built based on disclosure to the SEC in registration statements and other filings and have operated effectively and without incident for a substantial period of time.

III. IMPORTANCE OF DERIVATIVES TO EFFECTIVE PORTFOLIO MANAGEMENT

As recognized by the SEC, a "fund may use derivatives to gain, maintain, or reduce exposure to a market, sector, or security more quickly and/or with lower transaction costs and portfolio disruption than investing directly in the underlying assets."[18] These are important elements of effective portfolio management. Retail investment vehicles should have the same access to these portfolio management tools as institutional investors do – particularly now that the derivatives market has become subject to comprehensive regulation by the CFTC and the SEC in the United States, pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act

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[18] Proposing Release at 80,886-87.

("**Dodd-Frank**"),[19] and in Europe and other jurisdictions globally pursuant to comparable regulation.

First and foremost, derivatives are an essential risk management tool. Hedging credit and price deterioration through derivatives can reduce the probability of losses to investors in Regulated Funds. Risk managers rely on a range of instruments to manage risks ranging from interest rate risk, to currency risk, to operational and liquidity risk, and use derivatives to reduce volatility and stabilize investor returns through managing these and other market risks. Given the evolution of the global market economy and the ability of events in one marketplace to affect those in other markets, it is critical that risk managers be able to act expeditiously to react to and mitigate risks, which they are able to do in a timely, effective manner through the use of derivatives.

Derivatives are an important way for bond funds to hedge duration, credit, and interest rate risk. During periods in which interest rates are rising or falling, derivatives allow portfolio managers to manage interest rate risk in a cost-effective manner and avoid costly and risky alternatives, such as investing in more volatile or longer-dated instruments, turning over the portfolio or failing to mitigate duration or interest rate risk altogether. Use of derivatives to manage interest rate and bond duration risk is an ordinary-course activity for portfolio managers and a well-tested strategy used by the vast majority of bond funds on a daily basis. For Regulated Funds investing in foreign markets, derivatives also provide a critical and cost-effective means of mitigating currency risk. Without the ability to manage risk effectively through the use of derivatives, many Regulated Funds, including ordinary bond funds as well as liquid alternative funds, would be exposed to a multitude of other risks that would ultimately pose greater harm to investors.

Swaps, warrants and other instruments also allow portfolio managers to obtain exposure to foreign markets that may not be otherwise directly or easily accessible to a Regulated Fund, such as India, China, Taiwan and South Korea. In the context of Regulated Funds, the ability to provide exposure to a variety of emerging market securities in this manner has been essential to the ability of funds to offer complete emerging market portfolios. In addition, exposure to different asset classes through Regulated Funds utilizing derivatives, such as Regulated Funds that provide exposure to commodities, can allow investors to better diversify their portfolios. Derivatives also can enhance performance and regularly are used to do so. For example, swaps can provide targeted exposure without in any way increasing leverage.

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[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

Derivatives provide Regulated Funds with the ability to equitize cash and mitigate the potentially adverse impact of holding cash. When Regulated Funds receive new subscriptions or hold a portion of their portfolios in cash to address anticipated redemptions, derivatives provide a means for the Regulated Funds to invest extra cash in futures or swaps that track indices or benchmarks to provide exposure to investors pending use or investment in portfolio assets by the Regulated Fund. Investment in this manner allows Regulated Funds that are ETFs to mitigate the impact to investors of new creations or redemptions. Because the cost to enter into a futures contract or swap is often substantially lower than the cost of purchasing the referenced securities in an index or benchmark, the strategy can enhance portfolio returns.

Investment in derivatives allows Regulated Funds to manage liquidity by investing in highly liquid instruments rather than potentially less liquid cash market instruments. In some cases, for example, a bond fund might elect to invest in a total return swap or a credit default swap rather than a referenced bond to obtain exposure because the liquidity for the swap is substantially higher and the swap can be purchased in a customized tenor. Given the recent regulatory developments surrounding liquidity, it seems counterintuitive that the SEC would propose a rule that would inhibit Regulated Funds from effectively managing liquidity through investment in derivatives. In addition to often being more liquid, these kinds of instruments can often allow a fund to gain exposure more quickly and efficiently than it could by purchasing cash instruments. For example, a Regulated Fund can often obtain exposure more quickly, with a minimal amount of transaction costs, by entering into a total return or credit default swap rather than purchasing the underlying bonds. Quick market access through a credit default swap can be essential for a Regulated Fund in the face of a pending market move.

Derivatives allow Regulated Funds to obtain exposure to instruments more efficiently when the referenced cash security is only traded in large denomination size. Exposure can be provided efficiently and cost effectively through derivatives.

Derivatives markets are substantially more regulated and transparent now that much of Dodd-Frank has been implemented and other jurisdictions have similarly moved forward with addressing the G20 countries' commitments to enact reforms..[20] Derivatives have been subject to materially enhanced capital and margin requirements and greater transparency through central execution and post-trade

[20] We include in our reference to "derivatives" both instruments that are regulated by the CFTC, such as swaps, and instruments that are regulated by the SEC, such as securities options and security-based swaps.

reporting requirements. In addition, swaps with security underliers sometimes offer more favorable pricing and greater transparency and liquidity than the cash securities markets – particularly in the bond market. In light of the benefits to Regulated Funds from using derivatives together with the regulated nature of the market, we do not believe that it is appropriate to prevent Regulated Funds from appropriately using these instruments to benefit investors.

IV. DISCUSSION REGARDING COMMENTS TO THE PROPOSED RULE

A. ***Portfolio Limits*.**

Proposal – Eliminate Portfolio Limits

While we agree that Section 18 of the 1940 Act places limits on the ability of Regulated Funds to incur leverage through the issuance of senior securities, we believe that those concerns are most appropriately addressed through the Asset Segregation Requirements.

In our view, adoption of Portfolio Limits is not consistent with the purpose of Section 18 of the 1940 Act. Based on our reading of the statute as well as the legislative history, we are not certain that the policy goals identified by the SEC are those that Section 18 was designed to address. Our reading suggests that the intent of Section 18 was to limit fund activities that would result in some class of persons holding a senior position in the capital structure of a fund compared to common shareholders, rather than to regulated market exposure.[21]

It is also important to remember that sections 1(b)(7) and 1(b)(8) of the 1940 Act, on which the SEC bases its interpretation of Section 18 and looks to as a basis for the Portfolio Limits, are set forth in the preamble to the 1940 Act. As a general matter,

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[21] *See*, *e.g.*, Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Senate Banking and Currency Comm., 76th Cong. 238-240 (1940) (describing a situation where a controlling owner of common stock of a third party corporation leveraged the stock by having a fund controlled by the owner sell debt to the public to margin the stock holdings; "Of course if you are under water and your margin account is at the broker's, you will get a telephone call to put up margin; but no matter how much [the controlling owner] is under water … nobody can call on him to put up more margin. That is one of the things that motivated us in putting a provision in the bill that somewhere along the line there ought to be an equitable distribution of voting power … [t]he income of the company is not sufficient to meet the interest requirements on debentures. [The controlling owner] is gradually liquidating that company by selling its portfolio securities to meet interest payments, and the debenture holders are really getting their own money back.").

courts have found that it is not appropriate to base regulation on a general statement in the preamble of the relevant statute.[22]

As noted earlier, we are also concerned that the Portfolio Limits would have a significant impact on the industry that would be greater than the impact anticipated by the SEC. Based on a survey conducted by the Investment Company Institute that included results from funds holding 80% of industry-wide assets, Regulated Funds with over $600 billion in assets would exceed the SEC's proposed Portfolio Limits.[23]

Additionally, the ICI data indicates that the Portfolio Limits would have a disproportionate impact on fixed income funds. Even conservative fixed income funds may elect to obtain exposure through derivatives (*i.e.*, investing in a credit default swap and an interest rate swap), rather than through direct investments in the underlying debt instruments (*i.e.*, a corporate bond issuance) because the derivatives market may be larger, more liquid and more operationally efficient than the market of the referenced asset. In addition, fixed income funds rely on derivatives to manage duration risk. Under the proposed Portfolio Limits, management of bond funds could become more difficult and, in some cases, may require significant changes to portfolios that increase costs and risk to investors and decrease liquidity for the Regulated Fund.

We agree with the comments of Commissioner Piwowar in his dissent from the Proposed Rule. It is not clear that Portfolio Limits are necessary or prudent under any circumstances, and no data has been provided to indicate that a separate specified leverage limit is warranted.[24] In addition, the proposed Portfolio Limits would have a significant impact on investors and Regulated Funds they invest in. As a result, we urge the SEC not to adopt this aspect of the Proposed Rule at this time. If the SEC continues to believe that adoption is appropriate, however, we believe that it would be critical for the SEC to first engage in additional studies of the proposal to ensure that Portfolio Limits would benefit investors.

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[22] *See Brown v. Bullock*, 294 F.2d at 425, op. cite n. 5 (finding that the defendant's motion to dismiss should be denied based on the substantive sections of the 1940 Act and dismissing action by the trial court based on the general language of section 1(b) of the 1940 Act).

[23] *See* ICI Derivatives Proposal Comment Letter, *supra*.

[24] Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015).

Alternative Proposal – Make Changes to the Operation of Portfolio Limits

In the event that Portfolio Limits are deemed to be necessary, those limits should be reasonable and risk-sensitive so as not to unduly limit the ability of portfolio managers to risk manage Regulated Funds, drive Regulated Funds to invest in less liquid, more volatile alternatives to obtain exposure[25] or have the effect of causing investors to concentrate their savings and wealth accumulation more heavily in equity-related Regulated Funds, which may be less reliant than fixed income and other funds on using derivatives to risk manage or invest fund holdings.

Why Notional-Based Portfolio Limits Are Inappropriate. We do not believe that the proposed reliance on notional amounts to measure Portfolio Limits, as provided in the Proposed Rule, is appropriate. If the SEC determines to impose Portfolio Limits, we urge the SEC to modify the Proposed Rule to risk-adjust notional amounts used as the measure of exposure.

In our view, adoption of a notional-based leverage limit for Regulated Funds does not reduce risk and, instead, creates incentives to invest based on notional size rather than economic effect. We are concerned that the proposed Portfolio Limits could create perverse incentives for portfolio managers of Regulated Funds to invest in riskier, less liquid instruments. For example, the risk to a Regulated Fund of a listed futures contract on a thirty-year U.S. Treasury bond is substantially greater than the risk to the Regulated Fund of a listed futures contract on a two-year Treasury bond.[26] Under the Proposed Rule, though, each of these derivatives would contribute equally to a Regulated Fund's exposure without distinguishing the risks associated with each instrument. A portfolio manager could be disincentivized from investing in the lower-risk bond futures contracts since these lower-risk contracts would "use up" the same amount of space in the Portfolio Limit calculation as the higher-risk bond futures contracts while the higher-risk contracts would have greater possibility of appreciation. Setting a "limit" on derivatives that relies simply on a summing up of

[25] For example, bond funds will often obtain long exposure to bonds by purchasing a credit default swap or a total return swap on the bonds. These swaps are often significantly more liquid than the underlying cash instrument and can provide access to the size of exposure the portfolio manager of the Regulated Fund considers appropriate, which may also be a significant advantage to the Regulated Fund because bonds are often sold only in large denominations such that a bond fund could be forced to over-invest or under-invest in the cash instrument if it were forced to invest directly.

[26] Exposure to long-maturity bonds is generally more risky per unit of notional value than exposure to shorter duration bonds because the price of longer-dated bonds will tend to fluctuate more than the price of shorter-dated ones for a given change in market interest rates. These risks are priced into the futures contracts that reference the bonds, and the futures contracts tend to exhibit the same or greater price volatility as compared to the referenced bond.

notional values may also prevent Regulated Funds from investing in the less risky, less volatile alternative or the instrument that is most closely tailored to the investment guidelines of the Regulated Fund.

In addition, to the extent that Portfolio Limits apply to a Regulated Fund and the Regulated Fund is at the maximum threshold – even if the Regulated Fund has reached that level due to investor redemptions and market movements – the Regulated Fund would be prohibited under the Proposed Rule from entering into transactions to reduce risk or hedge until the Regulated Fund has liquidated its derivatives holdings to below the Portfolio Limit threshold, regardless of the prevailing market conditions or prices that can be achieved. As a result, the proposed Portfolio Limits – which rely on a fixed, notional measurement that values the riskiest of derivatives equally with the least risky derivatives – appear to us to be inconsistent with the SEC's stated goal of disincentivizing undue speculation.

There is no evidence that imposition of notional-based Portfolio Limits would be effective to limit speculation or ensure that a Regulated Fund has sufficient assets to meet its obligations. The Portfolio Limits would still allow a Regulated Fund to speculate by purchasing risky securities or utilizing the "head room" under the Portfolio Limits to speculate. We believe that the most effective way to deter speculative activity is to focus on reducing risk, not notional exposure, by requiring Regulated Funds to maintain prudent risk management programs and to disclose their investment strategies and risk management policies clearly to investors. This approach relies on transparency of the investment strategy coupled with independent oversight by risk managers that would cover *all investments by the Regulated Fund*. In our view that approach would be significantly more effective than simply limiting Regulated Funds from entering into more than a fixed notional amount of derivatives, which would not prevent speculation by the Regulated Fund but would merely limit the amount of speculation that could be carried out through derivatives.

In terms of ensuring that a Regulated Fund has sufficient assets to satisfy obligations, the Portfolio Limits do not address that requirement at all. Instead, the Asset Segregation Requirements address this goal. As recognized by the SEC, the Asset Segregation Requirements prevent a Regulated Fund from engaging in speculative

trading through the use of derivatives[27] and limits the amount of leverage that a Regulated Fund can incur.[28]

A notional-based Portfolio Limit is an overly blunt instrument to use to regulate a broad variety of Regulated Funds. If the SEC continues to believe that Portfolio Limits are appropriate, we believe that Portfolio Limits should be customized to address the SEC's stated goals, as further described in our proposal below, and, at a minimum, focus on the relative riskiness of each derivatives or senior security position rather than notional amounts applicable to each.

Proposed Revisions to Portfolio Limits and Operation of Tests. If the SEC elects to adopt notional-based Portfolio Limits, we believe it is critical that the rule provide for risk-adjusted weightings of notional values for purposes of calculating exposure, an operationally workable risk-based test, a defined compliance period within which a Regulated Fund would be able to come into compliance after exceeding a limit, and the ability for Regulated Funds to net positions against all materially offsettable transactions and not simply those whose maturity and other terms match precisely. Most importantly, any final rule that incorporates Portfolio Limits should be set at levels that would not impede the ability of a portfolio manager to risk manage the portfolio or employ derivatives to obtain exposure if it would be more economical and efficient to do so.

Revise both of the SEC's proposed Portfolio Limits. We would recommend that the 150% exposure-based Portfolio Limit and the 300% risk-based Portfolio Limit under the Proposed Rule be amended as follows.

(i) Increase the 150% limit to 200%. The 150% limit included in the Proposed Rule's exposure-based Portfolio Limit is arbitrary and not supported by any market studies reflecting that this is an appropriate level. The SEC indicates in the Proposing Release that the level was established by reference to the requirement in Section 18 of the 1940 Act that limits Regulated Funds (other than BDCs) that borrow cash through a loan from incurring indebtedness in excess of 50% of the Regulated Fund's NAV because of the 300% asset coverage requirement in the statute.[29] In our view,

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[27] Proposing Release at 80,925 ("the proposed rule would help to address the undue speculation concern reflected in section 1(b)(7) of the Act to the extent that funds limit their derivatives usage in order to comply with the Asset Segregation Requirements").

[28] *Securities Trading Practices of Registered Investment Companies*, 44 Fed. Reg. 25,128 (Apr. 27, 1979).

[29] Proposing Release at 80,909 ("In determining to propose a 150% exposure limitation, we evaluated a range of considerations. First, we considered the extent to which a fund could borrow in compliance with the requirements of section 18. … [F]unds generally can incur

this is an inapposite comparison. First, investments in derivatives are not the same as entry into a cash loan because the derivative is entered into for and provides specific investment exposure and not cash, as a cash loan would. Second, a derivative does not provide a Regulated Fund with a cache of cash to speculate with as a loan would do. Third, derivatives will, by law, be required to be collateralized in a way that cash loans are not and, as a result, impose inherent constraints on the ability of a Regulated Fund to speculate in a manner that an unsecured cash loan would not. Finally, derivatives, unlike loans, generally do not require repayment of the full principal or notional amount and a Regulated Fund may only receive partial payments on a derivative, whereas with a loan, the Regulated Fund will always owe the full amount borrowed back to the lender. In our view, these differences between the instruments are sufficiently stark that the SEC's approach to establishment of the 150% limit based on analogy to a loan is not appropriate.

In addition, as a practical matter, based on portfolio testing carried out by our member firms, which together represent some of the largest fund families in the industry, we believe that the 150% limit will be constraining for Regulated Funds, particularly under certain stressed market conditions and, particularly so, in the case of ordinary, non-leveraged fixed income funds. As shown in **Annex F**, under the Proposed Rule, the 150% limit would restrict the ability of a portfolio manager to hedge a bond portfolio or shorten the duration of the portfolio through derivatives, such as through highly liquid, low cost, publicly traded and heavily regulated Eurodollar futures contracts. In order to ensure that Regulated Funds have the ability to operate efficiently and to mitigate risk, we believe that the appropriate threshold for an exposure limit should be 200% and not 150% (with adjustments to the definition of "exposure" based on the relative risk weightings and exclusions that are described below).

(ii) Revise the risk-based Portfolio Limit to use an "absolute VaR" test. Instead of using a comparative test as used in the Proposed Rule, the risk-based Portfolio Limit should require a Regulated Fund to ensure that its "full portfolio VaR" (as the SEC has defined this term in the Proposed Rule) is less than twenty percent (20%) of the Regulated Fund's NAV (the "**Absolute VaR Test**") and that exposure does not exceed 300% of the Regulated Fund's NAV (with adjustments to the definition of "exposure" based on the relative risk weightings and exclusions that are described

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indebtedness through senior securities under section 18 subject to the asset coverage requirement specified in that section, which effectively permits a fund to incur indebtedness of up to 50% of the fund's net assets. For example, a mutual fund with $100 in assets and with no liabilities or senior securities outstanding could borrow an additional $50 from a bank." (footnote omitted)).

below). This revised risk-based test would allow for notional exposure up to 300% as long as the overall risk of the portfolio is less than 20% of the Regulated Fund's NAV. The revised test would recognize that Regulated Funds use derivatives for legitimate purposes other than risk reduction, and would allow less risky Regulated Funds to invest in derivatives up to a fixed limit of 300%.

We believe that the risk-based Portfolio Limit, as currently proposed, would be neither appropriate nor viable. In our judgment, very few Regulated Funds, even low-risk Treasury bond funds, would pass the 300% test in the Proposed Rule. We have included an example in **Annex F**.

In addition, a VaR-reducing test, such as that proposed in the Proposed Rule, is operationally very difficult to implement. Not only would it require a Regulated Fund to carry out two VaR calculations, but also it would require the Regulated Fund to make the VaR ex-derivatives calculation using custom tagging or segregation of the Regulated Fund's derivatives from non-derivatives. That requirement would be cumbersome to implement and would require a substantial build out by Regulated Funds in terms of software changes, addition of personnel and changes to operational flows. To the extent that Regulated Funds were to rely on this portfolio limit, the implementation could materially raise costs for investors seeking to invest in those Regulated Funds.

Our proposed Absolute VaR Test not only is substantially easier and less costly to implement but also provides a more accurate means of limiting leverage and overall risk, as demonstrated in the examples and commentary set forth in **Annex F**. Implementation of the Absolute VaR Test is simpler than that for the risk-based limit in the Proposed Rule because the Absolute VaR Test would require use of only one VaR calculation rather than two. The test provides an objective comparison to the general marketplace because the 20% is an approximation of the average VaR of the S&P 500 Index over time, which is typically thought to be representative of the U.S. equity market. We believe that the Absolute VaR Test is appropriate for bond funds as well as equity funds in the same way that the 15% illiquidity limit applies to all Regulated Funds (other than money market funds) by creating a single maximum limit on risk. In addition, because the SEC generally appears to be comfortable with the level of risk presented by the S&P 500 Index, we believe that reliance on that risk level for a historical VaR threshold would be appropriate.

In addition to its simplicity, we believe that VaR is a reasonable tool to use to measure risk because it takes into consideration the combined effect of all of the portfolio's investments, and how they interact with each other, to manage overall portfolio risk. While a pure exposure limit relies simply on evaluating an individual derivative's exposure as a proxy for its corresponding risk, VaR-based models are

able to account for how the derivatives interact both with each other and with the other investments in the portfolio to provide a more precise measure of risk. When coupled with the 300% overall notional limit, the Absolute VaR Test helps to provide a more fine-tuned means of risk management that an evaluation of unmodified exposure alone cannot provide.

For Regulated Fund families that sponsor UCITS, the Absolute VaR Test would leverage existing infrastructure used by those Regulated Funds to satisfy the risk limits applicable to the UCITS because the test would be similar to the UCITS absolute VaR limit. This revised test would also have the benefit of being proven in the UCITS context. Like the UCITS test, our proposed test would limit leverage obtained through derivatives use based on an absolute VaR measure, but unlike the UCITS limit, our proposed Absolute VaR Test would be coupled with a limit on total notional exposure.

The SEC staff has expressed concern from time to time that risk models, such as VaR, are inherently subjective and vulnerable to "gaming." While we understand the concern, we continue to believe that VaR is a reliable risk model. It is embraced by other regulators in respect to regulation of funds, is broadly used in the market and, in our view, is an appropriate model to be used in connection with evaluating risk exposure of Regulated Funds. Instead of rejecting VaR as a risk model, we believe that the SEC could create rules and procedures to prevent the sort of gaming about which it is concerned. In order to do so, the SEC could, for example, establish uniform requirements for Regulated Funds to use in calculating VaR. The SEC examination staff might be able to analyze the subjectivity of a Regulated Fund's VaR model if the SEC were to require Regulated Funds not only to calculate the VaR of their own portfolios but also to calculate the VaR of the S&P 500. In this way, the SEC examination staff would be able to evaluate "outlier" VaR models among the Regulated Fund groups since each Regulated Fund group would have a VaR calculation of the S&P 500 using its model.

(iii) Calculate exposure using risk-adjusted notional amounts. Revisions to the calculation of exposure for both of the proposed Portfolio Limits are appropriate to accurately value derivatives exposure and measure relative risk among all portfolio assets, including non-derivatives. Use of a risk-adjusted exposure would also allow Regulated Funds more freedom to select the most liquid and less costly instruments to mitigate risk. For example, using a listed futures overlay to hedge duration and interest rate risk of a long-term bond portfolio is often more cost-effective than selling the long-dated bonds and replacing them with newly issued instruments when rates change or are anticipated to change. It is both counterintuitive and counterproductive for SEC rules to penalize Regulated Funds for selecting more liquid and more cost-effective investments.

Therefore, we recommend that the SEC adopt a standardized schedule of risk adjustments. The calculation of "exposure" for purposes of the Portfolio Limits should be refined to value derivative instruments based on risk rather than gross notional value. Using gross notional for the test takes an overly simplistic view of the concept of "excessive leverage" and resulting risk, equating, for example, $10 million of notional exposure to U.S. Treasury securities with $10 million notional exposure to emerging market equities. Although the SEC suggests that it would be appropriate to use the sort of "relatively blunt measurement" proposed, we believe that use of pure notionals to calculate Portfolio Limits will have unintended consequences by limiting the ability of portfolio managers to enter into derivatives in order to mitigate risk – particularly in the context of fixed income funds, where the use of derivatives for duration hedging often involves a substantial number of derivatives transactions, all of which are risk-reducing.

In order to standardize valuations and provide regulators with a uniform but intelligent point of comparison, we would recommend differentiating derivatives by risk in reliance on uniform risk adjustments. Uniform risk schedules are currently used by regulators for different purposes and could be effectively adapted for purposes of the Proposed Rule. As regulators have recognized, risk adjustments through application of different valuation "haircuts" reflect differing credit, liquidity and market risk inherent in the instruments.[30] One such schedule is the standard initial margin schedule published by the Bank for International Settlements ("**BIS**"), which we have attached at **Annex A**. We understand that prudential regulators globally rely on this schedule as a framework to risk weight different assets and believe that it could effectively be used by Regulated Funds to determine the relative riskiness of the referenced assets (see **Annex A**). Our analysis of the empirical data suggests that the proposed BIS table would provide a conservative risk adjustment and be an appropriate measure of risk.

In the alternative, the SEC could look to relative risk weightings calculated based on the different margin levels required by the maintenance margin rules of the Financial Industry Regulatory Authority, Inc. ("**FINRA**") (see **Annex B**). Like the BIS schedule,

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[30] *See* Alexandre Chailloux, Simon Gray and Rebecca McCaughrin, *Central Bank Collateral Frameworks: Principles and Policies*, IMF Working Paper WP/08/222 (Sept. 2008) (*available at* https://www.imf.org/external/pubs/ft/wp/2008/wp08222.pdf), at 51, 23 ("In most cases, the [Federal Reserve System] applies 'haircuts' to compensate for credit, liquidity, and market risks." (footnote omitted); "Central banks typically deduct initial margins ('haircuts') in order to protect against credit, interest rate, foreign exchange, and liquidity risk. … [Haircutting] is meant to take into account potential movement in asset prices over the time horizon of the loan. A more volatile…less liquid asset carries a higher haircut.").

this schedule would take advantage of existing rules and operational infrastructure that dealers and market participants already have in place.

Another possible approach would be to calculate risk weightings based on the Swap Margin Rules weightings (see **Annex C**). Or, in the alternative, it may be appropriate to rely on the weights included in the SEC's and CFTC's definition of Major Swap Participant (see **Annex D**).

Reliance on any of these tests would provide a basic framework to differentiate the level of risk associated with different types of derivatives. In addition, selection of one of these tests would be efficient because each is already used in the marketplace and each has a proven track record of appropriately measuring relative risk. In all cases, the calculations are mathematically simple to implement. The following example explains how the calculation would work using the BIS initial margin requirements as set forth in **Annex A**:

As an example, consider a Regulated Fund with $1,000,000 in net assets that: (i) obtains exposure to equities through a total return swap on the S&P 500 with a notional value of $1,000,000, (ii) equitizes its cash by investing in futures on three-year Treasury bills with a total notional value of $300,000 and (iii) enters into credit default swaps on 10-year investment grade bonds with total notional values of $300,000. Under the Proposed Rule, this Regulated Fund would have a total derivatives exposure of $1,600,000, or 160% of the Regulated Fund's NAV, exceeding the 150% threshold for the exposure-based Portfolio Limit. Under our risk-adjusted methodology, the notional value of the Regulated Fund's total return swap on the S&P 500 would be multiplied by 100%, the notional value of the Regulated Fund's futures contract on three-year Treasury bills would be multiplied by 13%, and the notional value of the Regulated Fund's credit default swaps on 10-year investment grade bonds would be multiplied by 67%. Using these risk-adjustment factors, the risk-adjusted notional amount of the Regulated Fund's derivatives positions would be equal to ($1,000,000 x 100%) + ($300,000 x 13%) + ($300,000 x 67%), or $1,240,000, which would not exceed the 150% NAV limit.

Revising the definition of "exposure" for purposes of the Portfolio Limits would more accurately value derivatives exposure and measure relative risk among all portfolio assets, including non-derivatives, and would allow Regulated Funds more freedom to select the most liquid and less costly instruments to mitigate risk. Therefore, we recommend that the SEC adopt a standardized schedule of risk adjustments, using any of the schedules we suggest or another standardized schedule.

Expand permissible netting to include additional risk-mitigating instruments. The Proposed Rule should more expansively define portfolio risk-reducing measures to

recognize a broader range of portfolio instruments that reduce a Regulated Fund's exposure. Limiting netting for Portfolio Limits to positions having identical terms is overly restrictive and ignores the important risk reducing effect of a number of offsetting and hedging transactions. Recognizing risk-reducing transactions would be consistent with the goals of Section 18 identified by the SEC, *i.e.*, to ensure that a Regulated Fund is able to satisfy its obligations and to prevent undue speculation. For example, to the extent that a Regulated Fund holds a bond in its portfolio and purchases a credit default swap on that bond, the exposure and risk position of the Regulated Fund has been eliminated in the same way that different types of portfolio insurance would eliminate risk. This type of investment should not "count against" the Regulated Fund for purposes of evaluating compliance with a Portfolio Limit.

In addition, transactions having a difference in maturity but which otherwise offset each other should be netted to the extent that the two match. The decision to enter into an offsetting transaction having a separate maturity date reflects market availability as well as concerns regarding the cost, liquidity or additional protection achieved through the longer-dated position. In the situation where two derivatives match other than a difference in maturity dates such as an April 2020 long swap matching a March 2020 short swap where all other terms are identical and offsetting, the notional value of the original position should be deemed to be fully eliminated through the offsetting position to the extent offset by second position (*i.e.*, up to the date on which the two maturities match, which in the example would be March 2020).

Unless the Proposed Rule is expanded to include risk-reducing transactions in the concept of netting for purposes of the Portfolio Limits, the Proposed Rule may have the effect of limiting or capping risk-reducing transactions. As a policy matter and based on the goals that the SEC has established, we do not believe that it would be wise for the SEC to adopt a rule that minimizes the ability of a Regulated Fund to reduce risk. In the face of a rapidly changing market, it is the job of a portfolio manager to protect the investors in the Regulated Fund by adjusting exposures and mitigating risks. The restrictiveness of the netting provisions under the proposed Portfolio Limits has the effect of capping or, if the Regulated Fund is already at the stated Portfolio Limit, eliminating that risk management tool – which could be dangerous for Regulated Funds and their investors.

Exclude currency hedges from the calculation of Portfolio Limits. In addition to the adoption of risk adjustments to notional amounts used to calculate exposure, we believe that the Portfolio Limits should exclude instruments that are clearly identifiable as purely hedging instruments. Currency forwards and non-deliverable forwards that are held against a portfolio's securities positions are clearly identifiable as hedges and would therefore satisfy this exclusion standard, provided

the instruments do not include a multiplier.[31] This exclusion would not require an exact matching of the currency position against a specific security, but would permit the net currency exposure to offset a net security exposure. Although there is often no objective way to determine whether a derivative position is a hedging position or a speculative position, delta one forwards[32] and non-deliverable currency forwards that match the currency in which one or more portfolio securities are denominated will result in a direct offset to the currency gain or loss from the security. As a result, the gain or loss in the value of the currency position inherent in the portfolio security will always be offset one-for-one with the derivative, which will ensure that the Regulated Fund always has available assets necessary to meet its obligations under the derivatives position. For this reason, the exposure from these positions should be valued at zero since these positions, by definition, are "covered."

Reduce the notional amount attributable to Eurodollar/Euribor and similar futures contracts and subject such amounts to risk adjustments. We believe that any limit test based on notional amount should provide that the notional amounts for Eurodollar and Euribor futures contracts as well as other futures contracts on extremely high grade, short duration debt instruments should be calculated by dividing the amount of the contract by the applicable divisor (which, in the case of Eurodollar/Euribor futures, would be four in order to reflect the three-month length of the interest rate transaction), as is market practice,[33] and then applying the risk adjustment methodology we describe above that would be applicable to all derivatives to measure relative risk. In our view, this methodology more accurately measures the Regulated Fund's exposure under the derivative in light of the short duration of the instrument. This methodology would incent a Regulated Fund to invest in these

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[31] Many Regulated Funds invest in foreign securities in order to provide exposure to foreign markets for their investors while hedging the currency risk in the securities by entering into currency forwards that offset 100% of the currency risk inherent in the securities. Under the Proposed Rule, these forwards would count against the Portfolio Limits and would not be offsettable against the securities they are hedging.

[32] "Delta" is a financial term used to indicate the sensitivity of a derivative's value to changes in the price of the underlying asset. A delta one derivative refers to an instrument that has no optionality and, as a result, a move in the price of the underlying asset would be expected to result in an identical move in price for the derivative.

[33] *See* Daniel Deli, Paul Hanouna, Christof W. Stahel, Yue Tang and William Yost, *Use of Derivatives by Registered Investment Companies,* SEC Division of Economic and Risk Analysis (Dec. 2015), *available at* http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf. The authors describe the various adjustments made to notional amounts of derivatives, including that, "for short term interest rate futures, such as 90-day Euro-dollar futures, we followed the apparent industry convention to divide the notional amount by the appropriate divisor to adjust any interest rate future having a term shorter than one year. For example, with respect to 90-day Euro-dollar futures, the notional amount is divided by four." *See id.* at 11.

safer, less volatile instruments rather than another derivative on a longer-duration instrument, simply to ensure that the Regulated Fund satisfies the Portfolio Limit.[34] In addition, as would be the case for all derivatives, the reduced notional amount would be subject to risk adjustment.

Make additional modifications to the operation of Portfolio Limit testing:

> *(i) only one Portfolio Limit calculation per day would be required, and the calculation could be performed at end of day or at commencement of the next trading day,*
>
> *(ii) if a Regulated Fund goes over a Portfolio Limit due to a trade in a derivative or other senior security, it would have seven days to come within limits; and*
>
> *(iii) emergency loans to fund redemptions[35] and reductions of positions would be excluded from calculation of Portfolio Limits.*

The Proposed Rule prohibits a Regulated Fund from entering into a new derivatives position (or other senior security position) unless, immediately after entry into the derivative or senior security, the Regulated Fund does not exceed its selected Portfolio Limit. In periods of volatility, this could lead a Regulated Fund to be required to calculate its Portfolio Limits more frequently than would be feasible – *e.g.*, multiple times during a single business day. At each moment throughout the day, the Regulated Fund would need to revise its calculation in light of new redemption and subscription orders, changing market values for proposed derivatives trades and non-senior security trades that are pending, as well as changes in market value affecting the existing portfolio of the Regulated Fund, including the derivatives positions and related margin and collateral. Even during non-stressed market conditions, it is difficult for a portfolio manager to know the status of the Regulated Fund's Portfolio Limit "in real time" through a trading day in light of changes in market prices, subscription and redemption activity and pending trades, some of which are allocated or confirmed out only at the close of trading.

As an operational matter, real-time monitoring of Portfolio Limits is impractical for a primary manager regardless of market conditions and is virtually impossible for a sub-adviser. During the course of a trading day, a sub-adviser is typically focused exclusively on managing the sub-adviser's own sleeve of the Regulated Fund's

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[34] For example, a portfolio manager may elect to obtain its desired interest rate exposure by entering into a long-term interest rate swap rather than a three-month, exchange-traded futures contract because the futures contract would have a notional amount that would typically be four times that of the swap if the Regulated Fund were investing in Eurodollar futures.

[35] These would generally be borrowings under a Regulated Fund's credit facility for temporary and emergency purposes in order to meet unanticipated or unusually large redemption requests.

portfolio in accordance with existing investment guidelines, and therefore would typically not be in a position to check back with the primary manager throughout the day to understand what subscriptions and redemptions have been received and what overlays of derivatives and other portfolio positions the primary manager might seek to implement or, indeed, the impact on the Portfolio Limits of investments by other sub-advisers. By the same token, it is virtually impossible for the primary manager to ensure compliance on a real-time basis with the Portfolio Limits as each sub-adviser executes new transactions on an ongoing basis. Thus, the SEC should allow calculation of Portfolio Limits at the end of the day or as of commencement of trading on the next trading day in order to allow the person calculating the Portfolio Limit to aggregate and update all of the relevant portfolio information. Records relating to the calculation would be required to be maintained with respect to the official daily calculation at the end of the trading day or the commencement of the following trading day rather than "immediately after execution" of a trade.

In addition, in order to ensure that a Regulated Fund is able to accurately and completely calculate the Portfolio Limit despite events over which it has no control, yet retains sufficient flexibility to hedge and trade positions in fast-moving, volatile markets, we urge the SEC to provide a seven (7) business day Compliance Period for a Regulated Fund to come into compliance with its Portfolio Limit after breach due to entry into a new derivatives or senior security position during a trading day which would have been authorized under the applicable Portfolio Limit at the beginning of the day. Our proposed length for the Compliance Period would be consistent with the statutory period for payment of redemption proceeds by open-end funds under Section 22(e) of the 1940 Act, which is the core obligation of a mutual fund. By using the same outside date for the Compliance Period as is used in Section 22(e), our proposal would reflect the importance of bringing the Regulated Fund into compliance with its Portfolio Limit.

Providing for a Compliance Period coupled with an end-of-day or next-trading-day calculation would provide a workable means of complying with the Portfolio Limits as an operational and trading matter, as well as a reasonable time period to trade out of positions and mitigate the risk of forced sales.[36] Forced sales of derivative

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[36] Many types of derivatives are terminated through offset rather than sale of the position to a third party. As a result, if a Regulated Fund were over its Portfolio Limit, without relief, the Regulated Fund would be required to reduce the position that exceeds the Portfolio Limit through a single trade. If the position is a large one or the market in the referenced instrument is highly volatile, a large trade could have an adverse impact on the market for the referenced security if the hedge of the counterparty were to be terminated in a large, forced sale or purchase. In addition, termination through a single transaction might result in adverse pricing for the Regulated Fund. As a result, it will often be in the best interest of the Regulated Fund to trade out of a large derivatives position over a period of time, through a series of offsetting transactions or

positions could not only harm Regulated Funds and their investors by producing below-market prices, but sales could also potentially cause pricing and trading disruptions to the derivatives market generally as well as in the markets for the underlying referenced instruments (because liquidation of derivatives positions should be expected to result in sales of the related hedges).

Inadvertent breaches of a Portfolio Limit are likely to occur for a number of reasons, including, without limitation, difficulties in calculating Portfolio Limits throughout the day on a real-time basis, subscription and redemption orders received throughout the trading day but which are not usually transmitted to the portfolio management or trading desks, and price movements in portfolio value. Because subscription and redemption orders and market movements that occur during the course of a trading day will change the calculation of Portfolio Limits as derivatives are traded throughout the course of a trading day, trades that may be compliant at the open of trading on a trading day may cause Regulated Funds to breach a Portfolio Limit due to intraday changes. Among other things, the impact of same-day redemptions is generally not accessible until the close of business on a trading day and, in some cases, on the following day. Even if a trading desk were to receive notice of a large redemption in the middle of a trading day that would cause a Regulated Fund to exceed a Portfolio Limit if a new derivatives trade were entered into, it would often not be possible for a trader to stop a trade that has been entered with a derivatives dealer (*i.e.*, before the redemption order was received) but not yet settled without breaching the fund's contractual commitment (since derivatives are typically entered into based on oral contracts). Because, as a practical matter, compliance with a Portfolio Limit can only be measured as of the end-of-day or next-trading-day level, Regulated Funds may, from time to time, breach Portfolio Limits and need a reasonable time frame to come back into compliance.

Under our proposal, the Compliance Period and the Regulated Fund's corresponding need to bring a Regulated Fund into compliance with its Portfolio Limit would only apply when a Regulated Fund exceeds a limit as a result of entry into a transaction. The seven-day Compliance Period would not apply if the Regulated Fund breached its Portfolio Limits solely as a result of market movements or redemptions rather than because of entry into a derivatives transaction that causes the Regulated Fund to breach its Portfolio Limit. In that case, the Regulated Fund would not be required

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other types of terminations, so as not to disrupt the market for the referenced instrument through a large, forced sale or purchase by the derivatives counterparty of its hedge. Without the relief we are requesting, a Regulated Fund that exceeded its Portfolio Limit (whether voluntarily or involuntarily) would not be able to come within limits in the less risky manner because each offsetting trade would be counted as a new derivatives position that would violate the Portfolio Limit and, thus, the rule.

to come into compliance with its Portfolio Limit unless the Regulated Fund wished to enter into another derivatives or other senior security transaction.

To the extent that the SEC were concerned that adoption of a Compliance Period would encourage excessive trading and abusive behavior, we note that such use of derivatives would be prohibited by the investment guidelines of substantially all Regulated Funds. Such trading would also be subject to extensive oversight by risk management and by the Board, which should mitigate the possibility of such abuses.

Finally, the SEC should clarify that a Regulated Fund would at all times – regardless of whether the transactions would cause the Regulated Fund to exceed its Portfolio Limit or occur at a time when the Regulated Fund is above its Portfolio Limit – be allowed to borrow to meet redemption requests, to pay distributions or to enter into derivatives or other transactions to offset (*i.e.*, trade out of or reduce the Regulated Fund's obligations under) existing derivatives transactions. Such offset should include not only the offset or elimination of exposure under a derivative but also the offset or elimination of risk under a portfolio security, such as the purchase of a credit default swap protection to offset the risk of a bond held by the Regulated Fund.

Modify requirements related to selection of Portfolio Limits. We do not believe that it is appropriate to require a Regulated Fund to obtain Board approval to follow a particular Portfolio Limit or to limit a Regulated Fund's ability to choose between limit as market conditions change. Although we understand that part of the underlying reason for forcing a Regulated Fund to choose only one limit is to provide more specific disclosure to investors regarding the Regulated Fund's use of derivatives, we think that a Regulated Fund could still provide meaningful disclosure to investors about its use of derivatives if it retains a right to switch between the limits – including the type of market conditions in which it would elect one limit test versus the other. We believe that forcing a Regulated Fund to follow only one test in all market situations until it is able to seek Board approval to switch over to the alternative Portfolio Limit would constrain the risk management ability of the Regulated Fund and the ability of portfolio managers to manage the portfolio. Without this flexibility, we believe that there is a serious risk that Regulated Funds would be unequipped to effectively risk manage fund portfolios during periods of market volatility and stress.

While we agree with the SEC that a Board should understand and approve, at a high level, the approach taken by a Regulated Fund and its investment manager with respect to Portfolio Limits, we do not believe that a Regulated Fund should be required to pre-select only one limit that would be applicable in all market conditions or be prevented from changing the limit until the next Board meeting.

Risk managers and portfolio managers of Regulated Funds must be able to react to changing market conditions on a timely basis.

As appropriate, a Regulated Fund should be able to select and disclose to investors that it is selecting to use the lower Exposure Limit during certain market conditions (which the disclosure would describe) but would switch to the higher, risk-based limit, during other market conditions, such as, for bond funds, periods during which interest rates are rising or falling, or for other Regulated Funds, periods requiring enhanced hedging to mitigate risk. In this situation, the risk management team should be able to change the applicable limit in accordance with the conditions described in the disclosure. Such a Regulated Fund should be subject to the particular Portfolio Limit it selects at the time it is following that Portfolio Limit. For example, if a Regulated Fund wishes to preserve flexibility to use a 300% risk-based limit during particular market conditions that it has disclosed in the prospectus, it should be allowed to follow the 200% (or 150%) exposure-based limit at all other times without having to duplicate and calculate the exposure up to 200% (or 150%) on a VaR basis, and should be solely subject to the exposure-based limit test until the risk-based limit test comes into use (based on the triggering event described in the Regulated Fund's prospectus for the application of, and a switch to, the risk-based limit).

B. ***Asset Segregation Requirements*.**

Expand the definition of "qualifying coverage assets" for derivatives

The SEC should allow Regulated Funds to look to a broader group of portfolio instruments than cash and cash equivalents to satisfy the Asset Segregation Requirements with respect to derivatives. The stated goals of the segregation requirement (*i.e.*, assuring availability of assets to meet obligations as well as helping to address undue speculation)[37] are similar to the goals of the Swap Margin Rules, *i.e.*, to "reduc[e] the uncertainty around the possible exposures arising from non-cleared swaps,"[38] albeit the SEC's proposed segregation requirements are designed to protect Regulated Funds and the Swap Margin Rules are designed to address exposures to both participants to the derivatives transaction. In addition, the grouping of eligible collateral available for posting under the Swap Margin Rules is limited to "high-quality, liquid assets that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based 'haircut' or 'discount,' during a severe economic downturn,"[39] which would appear to address exactly the SEC's stated goal

[37] Proposing Release at 80,925.

[38] Swap Margin Rules Prudential Adopting Release, 80 Fed. Reg. at 74,842.

[39] *Id*. at 74,844-45.

of limiting eligible qualifying coverage assets to those that are liquid and less likely to decline in value in times of stress.[40] We recommend that the SEC confirm that all instruments specified in the Swap Margin Rules (set forth in **Annex E**) as eligible to be posted as margin, including, without limitation, foreign cash if the underlying derivative provides for payment in such foreign currency, would constitute "qualifying coverage assets."

In addition, we believe that qualifying coverage assets should include interests in mutual funds and ETFs. These instruments are subject to mandatory redemption rights which guarantee liquidity within seven days assuming, in the case of an ETF, the Regulated Fund holds the shares in creation unit size and can redeem through an authorized participant.[41] This is consistent with relief granted by the SEC to permit registered open-end investment companies to invest uninvested cash and cash collateral in affiliated funds and to permit funds to invest in ETFs in excess of the limits included in Section 12(d)(1) of the 1940 Act.

Adapting the Swap Margin Rules to define qualifying coverage assets would provide operational efficiencies to Regulated Funds. As a policy matter, the approach provides consistency across regulatory regimes, which was an important objective of Congress for regulations governing derivatives as contemplated by Dodd-Frank.[42] These efficiencies would also allow Regulated Funds to maintain lower cost levels for

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[40] Proposing Release at 80,926 ("With certain exceptions, the proposed rule would define qualifying coverage assets for derivatives transactions to mean cash and cash equivalents because, as further described below, these assets are extremely liquid and may be less likely to experience volatility in price or decline in value in times of stress than other types of assets.").

[41] Both mutual funds and ETFs must stand ready to redeem interests in the funds within seven days; however, in the case of ETFs, redemptions must be submitted in creation unit size through an authorized participant and, in most cases, redemptions must be effected on an in-kind basis.

[42] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra*, § 712 at 1641 ("Before commencing any rulemaking or issuing an order regarding security-based swaps, security-based swap dealers, major security-based swap participants, security-based swap data repositories, clearing agencies with regard to security-based swaps, persons associated with a security-based swap dealer or major security-based swap participant, eligible contract participants with regard to security-based swaps, or security-based swap execution facilities pursuant to subtitle B, the Securities and Exchange Commission shall consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible."). Although this provision relates to rulemaking by the SEC pursuant to Title VII of Dodd-Frank and not under the 1940 Act, we believe that the policy considerations underlying the direction should apply to SEC rulemaking under the 1940 Act as well. We believe that the purpose of the language is to promote overall consistency of regulation and to encourage the SEC, where appropriate (as we believe to be the case here), to take advantage of rulemaking by other U.S. regulators related to the same subject matter.

investors. Having a larger group of liquid assets to select from for purposes of complying with the Asset Segregation Requirements would allow portfolio managers to optimize portfolio holdings and maintain the most efficient type of liquid asset.

Expanding the group of liquid instruments in this way would avoid the need for Regulated Funds to maintain significant cash positions that could adversely affect investors. For example, the attendant "cash drag" imposed on Regulated Funds if they were required to hold cash in order to utilize the derivatives necessary to risk manage the portfolio could reduce fund performance. In addition, the limitation of qualifying coverage assets under the Proposed Rule to cash and cash equivalents could require Regulated Funds to sell out of other portfolio positions quickly at reduced prices if necessary to enter into hedging transactions. These forced sales could result in lower fund performance and higher transaction costs. Investment in significant amounts of cash and cash equivalents may also be inconsistent with the investment goals of the Regulated Fund. For example, investment by a tax-exempt Regulated Fund in cash and cash equivalents may violate the investment objectives of the Regulated Fund and cause the investors, who invested in pursuit of tax-exempt income, to recognize taxable income. In addition, imposition of a requirement that a Regulated Fund hold cash to post against a derivative may impair the performance of hedged fund strategies, such as a currency-hedged ETF, in which the fund typically invests in the underlying securities of another fund that invests in the foreign securities together with a currency forward, by forcing a percentage of the top-tier fund to remain uninvested.

The primary reason cited by the SEC for requiring Regulated Funds to segregate cash and cash equivalents is its view that cash is less likely to depreciate than other assets.[43] The SEC is concerned that such depreciation would result in the Regulated Fund's not holding sufficient assets to meet its obligations. As a threshold matter, we believe it would not always be the case that there is positive correlation between the assets used to cover derivatives transactions and the particular derivative transaction that is being covered. However, in our view, this concern can be appropriately addressed through creation of a risk-based coverage amount (which the Proposed Rule includes) as well as providing a haircut on the value of liquid assets that the SEC deems are more likely to depreciate in value. The haircuts incorporated into the Swap Margin Rules are based on the analysis of the prudential regulators and the CFTC regarding the cash that the assets would generate in an immediate sale under extreme market conditions. As a result, the inclusion of haircuts would appear to ensure that a Regulated Fund would at all times have sufficient assets to meet its obligations. As the GAO recognized in its discussion and analysis of the SEC's net capital rule, "a haircut serves as a safety margin for market

43 Proposing Release at 80,932.

fluctuations and delays encountered in liquidating securities and commodities positions."[44] Because mutual funds and ETFs do not appear to be included in the Swap Margin Rules haircut table, we recommend that they be recognized as qualifying coverage assets but haircut at the same level as equities included in that table, *i.e.*, a 15% level.

Clarify that netting means "close-out netting," expand netting and clarify mark-to-market coverage amount definition

The Proposed Rule would allow Regulated Funds to calculate exposure for purposes of calculating the market-to-market coverage amount and the risk-based coverage amount based on the net amount owed under a "netting agreement." This concept is important and recognizes the benefits provided by entry into netting agreements. Because netting agreements – such as the form of master agreement published by ISDA – provide for different types of netting, we believe that the language should be clarified to confirm that the netting referred to under the Proposed Rule is "close-out" netting. Close-out netting applies to transactions between a defaulting firm and a non-defaulting firm and provides a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable, after which collateral is applied. It is distinguishable from payment netting, which involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable.[45] The distinction is important because payment netting does not measure exposure but simply provides for set-off of payment streams, whereas close-out netting allows Regulated Funds to calculate the net amount owed to a counterparty across transactions under a netting agreement if all transactions were to be terminated upon a default. Close-out netting is the measure generally used by risk managers at Regulated Funds to calculate exposure under enforceable netting agreements and should be used for purposes of the Proposed Rule.

Further, the netting provisions should be clarified to allow derivatives to be offset against non-derivatives, such as spot transactions. The Proposed Rule provides for netting only against other *derivatives* transactions. However, derivatives positions may be and often are closed out by entry into an equal but opposite spot transaction. Netting should also be allowed to the extent that the spot or other transaction closes

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[44] *Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk*, U.S. General Accounting Office (the "**GAO**"), GAO/GGD-98-153 (July 1998) (*available at* http://www.gao.gov/assets/160/156259.pdf), at 132 n. 11.

[45] *See* David Mengle, ISDA Research Notes: The Importance of Close-Out Netting (2010), *available at* http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf.

out or fixes the obligations of the Regulated Fund under the derivatives transaction. For example, in connection with currency forward transactions, Regulated Funds will often close out and effectively cash settle the transaction by off-setting the obligation of the Regulated Fund under such currency transaction with a spot transaction, with the same or different counterparty, resulting in a "mark-to-market" payable or receivable in U.S. dollars. As an economic matter, entry into such an offsetting spot transaction is the usual manner in which counterparties to a currency forward sell or close out the forward. The matching transaction establishes the gain or loss on the transaction and provides a firm close-out date for the forward transaction. As a result, once entered into, the Regulated Fund's obligations are effectively closed out (if the forward is "in the money" to the Regulated Fund or fixed at the mark-to-market amount if the forward is "out of the money" to the Regulated Fund).

Finally, the definition of mark-to-market coverage amount in the Proposed Rule refers to the amount payable by a Regulated Fund if the Regulated Fund were to exit the transaction. In the case of a swap, the plain reading of the language would appear to mean the mark-to-market amount. However, in the case of a physically settled forward transaction, the definition could be read to mean the stated contract amount or the notional amount.[46] In order to clarify the intention of the language as the replacement value of the transaction and not notional amount, we would recommend that the SEC amend the definition. In our view, the definition should utilize the language ordinarily used in the industry and describe such amount as the replacement value as reflected on the books and records of the Regulated Fund[47] rather than describing the amount as "the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time". Our proposed definition is consistent with the calculation of damages used in the ISDA Master Agreement and definition of amount payable by a derivatives counterparty under the ISDA Master Agreement upon the default of a party, referred to in the 2002 ISDA Master Agreement form as "close-out value." In general, the "close-out amount" means the amount of losses or gains that a counterparty would incur or reap under prevailing circumstances in replacing or providing the economic equivalent of (a) the material terms of the transaction or group of netted transactions and (b) the option rights of the parties in respect to that transaction or those transactions. The amount is a net number and not the stated notional or delivery amount under the contract.[48]

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[46] *See*, *e.g.*, Proposing Release at 80,933 ("The proposed rule, however, would not require funds to segregate a derivative's full notional amount, and instead would require the fund to segregate its mark-to-mark [*sic*] and risk-based coverage amounts.").

[47] *See supra* note 13.

[48] The User's Guide to the 2002 ISDA Master Agreement explains the damages calculation as follows: "Under the 2002 Agreement a payment on early termination can be viewed as consisting

In addition, the definition should make clear that the amount may be zero, for example, as would be the case if a Regulated Fund held a short, out-of-the-money listed option.[49]

Revise the Asset Segregation Requirements to take account of regulations imposed by other regulators and to be operationally workable

The need for asset segregation for cleared derivatives should be addressed through pre-existing initial and variation margin requirements, and offsets for listed options and listed derivatives should be broadened to recognize when no cover should be necessary. Cleared derivatives provide certain advantages to derivatives counterparties, including the use of a highly rated clearinghouse holding member capital and, for futures and swaps, the clearinghouse practice of applying margin to settle outstanding exposure on a daily basis. Although cleared derivatives may have embedded leverage, the obligations of a Regulated Fund under the instruments are paid down each trading day through the exchange of variation margin. This mechanism results in a Regulated Fund having a zero obligation to the clearinghouse as of the margin posting time. As a result, the Asset Segregation Requirements for cleared derivatives should be satisfied by existing initial and variation margin requirements.

The segregation regime should also broaden availability of offsets for listed options and listed derivatives for transactions with the same clearinghouse (without a netting agreement, since clearinghouses do not use netting agreements). Offset rights should be allowed for listed option positions and other cleared derivatives. Because listed derivatives are typically traded out of through offset, full offset should be recognized to eliminate the need for asset segregation.

As recognized by FINRA Rule 4210, offsetting positions eliminate or reduce risk and thus result in reduced exposure. The mark-to-market value of listed options

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of the following three components: (i) payments for obligations which became payable or deliverable but which were not paid or delivered prior to the Early Termination Date; (ii) payments for obligations which would have been payable or deliverable prior to the Early Termination Date if all conditions to payment or delivery (such as the absence of any Event of Default) had been satisfied or if the Early Termination Date had not been designated; and (iii) payment for the future value of the Terminated Transactions." *See* User's Guide to the ISDA 2002 Master Agreement, p. 27, *available at* www.ISDA.org.

[49] The Regulated Fund would still be subject to a risk-based coverage amount to account for volatility in the referenced security or index, but based on rules of the OCC, our understanding is that listed options, although exercisable by the holder when out of the money, would be net-settled. As a result, the Regulated Fund would never owe a payment to the OCC on an out-of-the-money listed option.

transactions should be determined in the same manner provided in FINRA Rule 4210, and holdings that serve as "cover" for options positions for regulatory margin purposes should also be deemed to satisfy Asset Segregation Requirements under the Proposed Rule. In addition, offsets provided for under the rules of the Options Clearing Corporation (the "**OCC**") should be allowed to be used by Regulated Funds in their calculation of exposure. FINRA margin rules as well as the margining rules of the OCC are based on the greatest estimated loss for the total portfolio. These valuation concepts, which the SEC approved years ago in the context of brokerage accounts, should also be applied in respect to portfolios of Regulated Funds.

Initial and variation margin should be treated together. The Proposed Rule would require a Regulated Fund to track the margin posted by it to a counterparty under a derivatives transaction (whether cleared or uncleared) differently depending upon whether the margin constituted initial margin and additional "house margin," as required in respect to initial margin, or variation margin and additional "house margin," as required in respect to variation margin. In our view, there is no reason to differentiate between the types of collateral in calculating compliance with the Asset Segregation Requirements. In practice, variation margin and initial margin are often calculated in the aggregate, on a net basis, rather than separately. Regulated Funds should, therefore, be able to get credit for both initial and variation margin posted on a net basis in respect of a Regulated Fund's mark-to-market coverage amount and risk-based coverage amount rather than requiring that only margin that is specifically designated as variation margin count toward the mark-to-market coverage obligations and margin designated as initial margin count toward the risk-based coverage obligations. As a result, we urge the SEC to revise the Proposed Rule to treat initial margin and variation margin and additional house margin as a single amount for deduction against the required mark-to-market coverage amount and the risk-based coverage amount. This approach is consistent with the recognition that initial and variation margin work in tandem to reduce exposure, would be operationally simpler to apply than the current proposal and would be less likely to result in calculation errors. In addition, as part of the guidance, we ask the SEC to confirm our understanding that Regulated Funds may deduct from the required coverage amounts the margin and collateral agreed with the counterparty to the transaction and posted under a tri-party agreement, whether or not such margin is comprised of cash or cash equivalents or is posted in amounts greater than the regulatory minimum (*e.g.*, to meet a dealer's "house margin" requirements).

The SEC should provide a safe harbor methodology for establishing the risk-based coverage amount. The Proposed Rule provides substantial flexibility to the Board in developing policies to establish the risk-based coverage amount. Given the lack of precedent and the breadth of possible approaches noted in the Proposing Release, we are concerned that the standard adopted by a Board for adoption of a risk-based

coverage amount could be second-guessed by regulators or, in the context of litigation, by a court. As a result, we request that the SEC establish a safe harbor methodology for Regulated Funds and their Boards to rely on if desired. The safe harbor standard should be simple and one that could be appropriately applied by both small and large advisers to Regulated Funds. One such method would be a test based on VaR. We would recommend that the Proposed Rule allow Regulated Funds to establish the measure in any reasonable way but clarify that the Regulated Fund would be deemed to be acting reasonably if such amounts are calculated based on VaR, using the parameters described in the Proposing Release for the risk-based Portfolio Limit. In the alternative, the SEC could establish as a safe harbor methodology the initial margin levels established by a regulated clearinghouse for "comparable" instruments.

In addition, the Proposed Rule should clarify that the risk-based coverage amount may be determined on a portfolio basis, rather than on a position-by-position basis, provided that the records maintained by the Regulated Fund support the calculated amount and reflect how it is determined.

The SEC should clarify operation of the risk-based coverage amount calculation. We believe that the Proposed Rule should be revised to provide that the risk-based coverage amount would be established on a weekly or other periodic basis rather than daily. The risk-based coverage amount represents a buffer to cover the Regulated Fund for price movements of the referenced instrument based on historical volatility data. The calculation embeds predictable price movements but is not intended to attempt to predict or address a "black swan event."[50] Although Regulated Funds should revisit their calculations of the risk-based coverage amounts on a periodic basis – such as weekly – the calculations should not be required to be carried out on a daily basis.

The SEC should clarify the limit on qualifying coverage assets. Proposed Rule 18f-4(c)(8) provides that qualifying coverage assets may not exceed the net assets of the Regulated Fund. This limitation is designed to prevent Regulated Funds from borrowing qualifying coverage assets.[51] We agree with this goal and agree with the

[50] As described by the writer Nassim Nicholas Taleb, this type of event is one that has an outsized impact but is rare and difficult to predict. Nassim Nicholas Taleb, The Black Swan: The Impact of the Highly Improbable (2008).

[51] Proposing Release at 80,933 ("This aspect of the proposed rule is designed to require a fund to have sufficient qualifying coverage assets to meet its obligations under its derivatives transactions and also prohibit a fund from entering into a financial commitment transaction or otherwise issuing senior securities pursuant to section 18 or 61 of the Act and then using the additional assets resulting from such leveraging transactions to support an additional layer of leverage through senior securities transactions.").

language in the Proposed Rule that implements the limit. However, language in the Proposing Release that provides an example of how this limit would operate could be read to suggest a broader limit than either the language in the Proposed Rule or the description of the intention of the limit suggests. The Proposing Release states, "Thus, if a fund borrowed from a bank, for example, the aggregate amount of the fund's assets that the fund might otherwise use as qualifying coverage assets for derivatives transactions would be reduced by the amount of the outstanding bank borrowing."[52] We believe that the meaning of this example is to reflect that a Regulated Fund may not have qualifying coverage assets that are greater than the NAV of the fund. As a result, in the example provided, the Regulated Fund would be required to deduct the bank borrowings from the total assets of the Regulated Fund in calculating its NAV and be required to have the mandatory 300% asset coverage required by Section 18 of the 1940 Act in respect to the bank borrowing (or 200% if the Regulated Fund were a BDC), but would not subtract the borrowed amount from its qualifying coverage assets.

C. ***Additional Proposed Clarifications and Refinements*.**

Clarify Asset Segregation Requirements for TBAs

The asset segregation requirements applicable to TBAs should be clarified to allow for coverage based on a mark-to-market coverage amount and a risk-based coverage amount and offset when another transaction closes out or reduces the TBA.[53] As a matter of market practice, TBAs are generally settled through agreed cash settlement or entry into offsetting transactions. Offset and mark-to-market treatment for segregation purposes should apply not only when the Regulated Fund has entered into a master netting agreement with respect to the transaction (such as a Master Securities Forward Transaction Agreement ("**MSFTA**")) but also when the obligations of a Regulated Fund are reduced to a fixed market amount by entry into an enforceable offsetting spot or contra-side forward transaction. For example, if a Regulated Fund has contracted to sell a designated TBA settling April 30, 2016 but, on March 31, 2016, it enters into a purchase transaction of the same TBA which will fix its payment obligation to the difference in prices in the two contracts, the Regulated Fund should be allowed to segregate only such difference between the two

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[52] *Id*.

[53] Clarification with respect to the treatment of TBAs is necessary because the transactions appear to satisfy both the definition of "derivative" (because TBAs have the same economics as forwards) and the definition of financial commitment transaction (because the transactions are referred to in SEC guidance as "firm commitment transactions"). We also believe that it would be important to expand the netting provisions for these instruments to include enforceable offsetting transactions entered into by a Regulated Fund outside of a netting agreement.

payment amounts plus a risk-based coverage amount that reflects the intra-day volatility of the instruments.

The TBA market is one of the largest and most liquid markets for any loan or fixed income security. Institutional investors trade TBAs with dealers, often under MSFTAs. TBAs are often subject to variation margin and, if mandatory margin rules are adopted by FINRA as expected, TBAs held by Regulated Funds may be subject to mandatory margin requirements. The asset segregation requirements for these instruments should allow for deduction by a Regulated Fund of margin posted to a dealer in respect to a TBA in calculating the asset segregation amount.

Clarify Treatment of TOB Inverse Floaters

TOB trusts are created when a Regulated Fund or outside party deposits a municipal bond into a TOB trust and the TOB trust issues floating rate securities (sometimes referred to as "floaters") to money market funds or similar investors. The holder of these floating rate securities receives a short-term, tax-exempt interest rate and has the right to put the floating rate securities to the TOB trust or to a liquidity provider hired by the trust at par plus accrued interest. The Regulated Fund retains the residual interest in the TOB trust, which is typically referred to as the "inverse floater" based on the fact that the value varies inversely with the interest payable by the TOB trust on the floating rate securities. Any increase or decrease in the value of the underlying bond is borne almost entirely by the Regulated Fund. By using a TOB trust, the Regulated Fund obtains market exposure to the full municipal bond, which in part is financed through the issuance of the floating rate securities.

The SEC has previously stated that a TOB trust "involves the issuance of a senior security by a fund unless the fund segregates unencumbered liquid assets (other than the bonds deposited into the TOB trust) with a value at least equal to the amount of the floaters plus accrued interest, if any."[54] However, the status of TOB trusts employed by Regulated Funds is not addressed under the Proposed Rule or in the Proposing Release. We seek confirmation that inverse floaters issued by a TOB trust to a Regulated Fund should be viewed as financial commitment transactions. A Regulated Fund employing a TOB trust has in effect used the underlying bond as collateral to secure a borrowing which the Regulated Fund will ultimately be required, as a practical matter, to repay, and in this sense has many characteristics similar to a reverse repurchase agreement. Thus, ownership by a Regulated Fund of inverse floaters issued by a TOB trust should be treated as a financial commitment

[54] See Investment Management Staff Issues of Interest, Funds Using Tender Option Bond (TOB) Financings (March 29, 2012), *available at* https://www.sec.gov/divisions/investment/issues-of-interest.shtml#tobfinancing.

transaction under the Proposed Rule, with the amount of that financial commitment transaction being the value of the outstanding floating rate securities issued by the TOB trust (plus any accrued and unpaid interest).[55]

The analogy to reverse repurchase agreements is also significant for purposes of determining asset segregation obligations with respect to a Regulated Fund's residual interest in a TOB trust. In a reverse repurchase agreement, assets transferred by a Regulated Fund to a counterparty remain an asset of the Fund and can be used to "cover" the repurchase obligation.[56] In the same way, the underlying bond in a TOB trust remains an asset of the Regulated Fund[57] and should be available

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[55] We note that TOB trusts can be structured in two different ways. Under the first structure – commonly referred to as a "recourse" TOB trust – in the event the holders of the floating rate securities exercise their put rights, the TOB trust or its liquidity provider (which is obligated to purchase tendered floating rate securities at par plus accrued interest) will often require the Regulated Fund that holds the inverse floater to make the TOB trust or liquidity provider whole to the extent that the proceeds from liquidation of the underlying bond are insufficient to meet the obligation to the holders of the floating rate securities. By contrast, in a "non-recourse" TOB trust, the Regulated Fund would have no obligation to make the TOB trust or liquidity provider whole if there were such a shortfall. It could be argued that non-recourse TOB trusts should not be considered senior securities at all under the Proposed Rule or Section 18 because the Regulated Fund is not obligated to make the liquidity provider or the floater holder whole for any shortfall if the liquidation value of the TOB trust's underlying bond is less than the amount required to redeem outstanding floaters at par plus accrued. The SEC may wish to consider whether the differences between recourse and non-recourse TOB trusts merit differences in treatment under Section 18.

[56] *See* Proposing Release at 80,949 ("Assets that a fund has transferred to its counterparty in connection with a reverse repurchase agreement could be regarded as having been pledged by the fund for purposes of paragraph (c)(8)(iii) of the proposed rule. If such assets can be expected to satisfy the fund's obligations under such transaction, the fund could … segregate such assets on its books and records as qualifying coverage assets….").

[57] We note that, for accounting purposes, a "self-deposited" TOB trust (i.e., a TOB trust created by a Regulated Fund depositing a bond it owns into the trust and receiving the inverse floater in return) and an "externally deposited" TOB trust (i.e., a TOB trust created by a third party (typically a bank) depositing a bond it owns into the trust and selling the inverse floater to a Regulated Fund) receive different treatment. For self-deposited TOB trusts, a Regulated Fund's inverse floater is treated for accounting purposes as a "secured borrowing," such that the Fund is deemed to "own" the underlying bond (i.e., it shows the entire underlying bond as an asset on its financial statements) and to have borrowed money from the floater holders (i.e., the amount of floater par outstanding is shown by the Fund as a liability on its financial statements), with the Fund deemed to be paying interest to those floater holders. For externally deposited TOB trusts, the inverse floater is treated as if the Regulated Fund has simply bought the inverse floater (i.e., only the inverse floater (and not the entire underlying bond) is shown as an asset on the Fund's financial statements, and no associated liability is shown on its financial statements). *See* Financial Accounting Standard 140, later re-codified as Accounting Standards Codification Topic 860. Nonetheless, we believe that the asset segregation requirement should be the same for both

to serve as qualifying coverage assets for the floating rate securities if consistent with the Regulated Fund's policies and procedures relating to qualifying coverage assets. We urge the SEC to adopt this position and explicitly acknowledge in the adopting release, in light of the similarities between TOB trusts and reverse repurchase agreements, that the underlying bond in a TOB trust may be used as qualifying coverage assets.

Continue current treatment of securities lending

In the Proposing Release,[58] the SEC asks whether or not securities lending should be treated as a financial commitment transaction under the Proposed Rule rather than continuing to be treated under the current SEC guidance. We believe that it is important to continue to treat securities lending under the existing guidance. The guidance ensures that Regulated Funds are adequately protected by maintaining a minimum of 100% liquid collateral against the securities loan. In addition, the current treatment allows Regulated Funds to avoid sale treatment for tax purposes, which, if modified, could adversely affect the ability of Regulated Funds to earn additional amounts through securities loans.

Clarify that short-settled assets may be used as qualifying coverage assets

Financial commitment transactions may be interpreted to include certain mortgage forwards. These mortgage forwards represent a large and highly liquid market that is already largely regulated.

Mortgage forwards, including TBAs, have fixed settlement dates that apply across the broad market to all purchasers and sellers of the instruments. If these instruments were classified as financial commitment transactions, like repurchase agreements, short sales, standby commitments and other similar kinds of transactions described as such in Release 10666, the "qualifying coverage assets" would be either cash or cash equivalents, or instruments that "will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation."[59] Because this definition of coverage assets would require that the coverage assets be converted to cash by the fixed settlement date for the mortgage forward, Regulated Funds may be incented to seek to

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types of TOB trusts regardless of how they are created, because the inverse floaters are economically identical. We request that the SEC explicitly acknowledge in the adopting release that, notwithstanding the accounting treatment for GAAP purposes, the asset segregation requirements for both types of TOB trusts are the same.

[58] *See* Proposing Release at 80,900.

[59] *See id*. at 80,947.

terminate the mortgage forward early in order to ensure compliance with the Asset Segregation Requirements. To the extent that a significant number of Regulated Funds were all to seek to terminate early their obligations under mortgage forwards and ahead of the fixed settlement date, that practice is likely to cause substantial disruption to the marketplace. In order to address this issue, avoid market disruption and allow the Boards of Regulated Funds to be comfortable that the Regulated Funds they oversee are segregating the appropriate amount of qualifying coverage assets, we ask that the SEC recognize as qualifying coverage assets during the three-day period leading up to the specified settlement date those assets as to which the Regulated Fund has negotiated a shorter settlement of T+1 or T+2, as applicable, or has a course of dealing in doing so. This clarification could be specified in the final rule or in the adopting release, and it could be implemented through the policies and procedures adopted by Regulated Funds, which will then be reviewed and approved by their Boards.

Revise the requirements of the formalized risk management program and corresponding Board oversight

Determinations under the Proposed Rule relating to risk metrics, including but not limited to the selection of Portfolio Limits (if any), the risk-based coverage amount and the instruments that are eligible to be "qualifying coverage assets" for derivative transactions should be determined by the risk management team of the investment adviser of a Regulated Fund and not by the Board of the Regulated Fund. The rule should make clear that this function may be delegated by the Board to the independent risk management team and that such delegation would be reviewed as part of the Regulated Fund's overall compliance program.

In addition, the Proposed Rule and proposed risk management program should generally be integrated into the existing compliance program requirements for the Regulated Fund under Rule 38a-1 so that the Board functions in an oversight, and not a management, role. Oversight of the risk management function to ensure that the group is functioning properly and in accordance with policies and procedures of the Regulated Fund is appropriate to be overseen by the adviser's compliance department and, at a supervisory level, by the Board, using the services of the Regulated Fund's chief compliance officer, as appropriate.

However, although we agree with the need for a Regulated Fund to designate a risk manager(s) and to institute an appropriate supervisory structure with respect to such manager(s) that is independent of the portfolio management team, we do not believe that risk management decisions (as opposed to process) should be overseen by the compliance department or chief compliance officer of a Regulated Fund. We also urge the SEC not to pile on oversight responsibilities to compliance officers in

areas where such compliance professionals, who are responsible for Regulated Funds' day-to-day compliance with Section 18, do not have the required expertise. Risk management functions should be able to be appropriately delegated to individuals who have the expertise to calculate and oversee the risk measures, either in an individual capacity or as members of a risk management committee.

The rule should also take account of sub-advisory arrangements. In lieu of placing responsibility on a single individual or individuals, advisory complexes should be allowed to specify that either the sub-adviser or the primary adviser is primarily responsible for compliance with the Proposed Rule and the applicable risk management function, and should allow the respective risk managers of the sub-adviser and primary adviser to coordinate on a regular basis regarding compliance, with the frequency depending on the extent and nature of derivatives usage.

Clarify other regulatory issues relating to derivatives use by Regulated Funds

In its 2011 Concept Release, the SEC sought public comment on a number of significant interpretive issues that had arisen in connection with the use of derivatives by Registered Funds. The Proposed Rule addresses just one portion of the issues highlighted by the SEC in the Concept Release. We believe that the SEC should take this opportunity to address all of the material issues raised by the Concept Release, in addition to those relating to Section 18, and come up with a comprehensive proposal that addresses the following issues, which the SEC specifically highlighted in the Concept Release: (i) the application of the 1940 Act's limits on investments in securities-related issuers; (ii) the application of the 1940 Act's provisions concerning portfolio diversification and concentration (including valuation of derivatives for purposes of determining a Fund's diversification classification); (iii) the application of the 1940 Act's provisions regarding valuation of Funds' assets; and (iv) the application of Rule 35d-1 under the 1940 Act[60] to derivative investments by Regulated Funds.

In our comment letter on the Concept Release,[61] we addressed these issues other than application of Rule 35d-1. Our comments set forth at that time continue to apply and to be relevant today.

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[60] Rule 35d-1 under the 1940 Act provides that for purposes of Section 35(d) of the 1940 Act, a materially deceptive and misleading name of a fund includes a name suggesting investment in certain investments or industries unless the fund has adopted a policy to invest, under normal circumstances, at least 80% of the value of its assets in the particular investments or in investments in the particular industry or industries suggested by the fund's name.

[61] *See* Letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary,

In respect to application of Rule 35d-1, although the Concept Release mentioned the rule only briefly,[62] over time, the SEC staff has informally provided a variety of sometimes inconsistent views on application of the rule in the prospectus review and exemptive application process. As a result, we believe that it would benefit Regulated Funds and their investors for the SEC to take this opportunity to address the rule's application to derivatives. In our view, a Regulated Fund that invests in derivatives should not be required to include a reference to "derivatives" in the name of Regulated Fund because the reason for the investment is to provide exposure to the referenced asset. In addition, we believe that the 80% analysis under Rule 35d-1 should apply to the exposure provided by derivatives and, thus, derivatives that provide exposure required by the investment policy of the Regulated Fund should be deemed to be part of the 80% basket of compliant assets referenced in Rule 35d-1.

V. CONCLUSION

We appreciate the opportunity to comment on the Proposed Rule and to provide input, based on our practical experience. The real-world examples we have attached as **Annex F** show how the Proposed Rule and the AMG's proposed modifications would impact Regulated Funds, including the constraints that the Proposed Rule (without modification) could impose on risk management of Regulated Funds.

We agree with the goals that the SEC has established for the Proposed Rule and believe that, with the modifications described in this letter, a revised rule could achieve those goals. Without such modifications, however, we think that aspects of the Proposed Rule could enhance both risks to Regulated Funds and systemic risks generally – by leading to forced sales, discouraging hedging and hamstringing ordinary risk management activities. Therefore, we urge the SEC to evaluate our suggestions and incorporate them into a revised rule proposal or final rule. We would be happy to meet with the Commissioners and Staff to discuss our suggestions in person and provide additional examples.

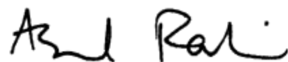
Securities and Exchange Commission, dated November 23, 2011, *available at* https://www.sec.gov/comments/s7-33-11/s73311-51.pdf.

[62] *See* Concept Release, 76 Fed. Reg. at 55,239 n. 16.

Thank you very much for your consideration. Should you have any questions, please feel free to contact Tim Cameron at (202) 962-7447 or tcameron@sifma.org, Aseel Rabie at (202) 962-7388 or arabie@sifma.org, or our counsel, P. Georgia Bullitt at (212) 728-8250 or gbullitt@willkie.com.

Sincerely yours,

Timothy W. Cameron, Esq.
Asset Management Group - Head
Securities Industry and Financial Markets Association



Aseel M. Rabie, Esq.
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association

Cc: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

David Grim, Director, Division of Investment Management
Diane Blizzard, Associate Director, Division of Investment Management

ANNEX A

Proposed Notional Haircuts Derived from BIS Standardised Initial Margin Schedule, as updated by BIS from time to time

BIS Standardised Initial Margin Schedule		SIFMA AMG Proposal
Asset Class	**Initial Margin Requirement (% of Notional Exposure)**	**Multiplier to Calculate "Risk-Adjusted Notional Amount" for Purposes of the "Exposure" Calculation****
Credit: 0–2 year duration	2	13%
Credit: 2–5 year duration	5	33%
Credit 5+ year duration	10	67%
Commodity	15	100%
Equity	15	100%
Foreign exchange	6	40%
Interest rate: 0–2 year duration	1	7%
Interest rate: 2–5 year duration	2	13%
Interest rate: 5+ year duration	4	27%
Other	15	100%

** The multipliers set forth in this column would be used in the "exposure" calculation by multiplying a derivative's gross notional amount by the specified multiplier to equal a "risk-adjusted notional amount" of the derivative. This risk-adjusted notional amount would be used instead of a derivative's gross notional amount for the purposes of calculating exposure and a fund's compliance with the portfolio limitation tests. For example, an interest rate swap with a duration of one year and a notional amount of $100,000 would have a risk-adjusted notional amount of $7,000 ($100,000 x 7%). With this refinement, the portfolio limitation tests would be more appropriately tailored to measure the risks associated with funds' derivatives. The risk-adjusted notional multipliers that we have proposed are derived directly from the BIS schedule by multiplying each number in the BIS schedule by 6 2/3 and rounding to the nearest whole number. We propose scaling the BIS numbers by 6 2/3 because this scaling factor results in the derivatives with the highest relative risk (according to the BIS schedule) being subject to a multiplier of 100% (*i.e.*, no haircut), while preserving the BIS's assessment of the relative riskiness of different derivative asset classes.

ANNEX B

Proposed Notional Haircuts Derived from FINRA Standardized Maintenance Margin Schedule, as updated by FINRA from time to time

FINRA Maintenance Margin Schedule – Summary Version		SIFMA AMG Proposal
Asset Class	**Initial Margin Requirement (% of Market Value, Unless Otherwise Indicated)**	**Multiplier to Calculate "Risk-Adjusted Notional Amount" for Purposes of the "Exposure" Calculation****
Obligations of the US and highly rated foreign sovereign debt securities: 0–1 year duration	1%	3%
Obligations of the US and highly rated foreign sovereign debt securities: 1–3 year duration	2%	7%
Obligations of the US and highly rated foreign sovereign debt securities: 3–5 year duration	3%	10%
Obligations of the US and highly rated foreign sovereign debt securities: 5–10 year duration	4%	13%
Obligations of the US and highly rated foreign sovereign debt securities: 10–20 year duration	5%	17%
Obligations of the US and highly rated foreign sovereign debt securities: 20+ year duration	6%	20%

FINRA Maintenance Margin Schedule – Summary Version		SIFMA AMG Proposal
Asset Class	**Initial Margin Requirement (% of Market Value, Unless Otherwise Indicated)**	**Multiplier to Calculate "Risk-Adjusted Notional Amount" for Purposes of the "Exposure" Calculation****
Long or short positions in exempted securities other than U.S. obligations	7%	23%
Investment grade debt securities	10%	33%
Other non-equity securities	20% of market value or 7% of the principal, whichever is greater	67% 23%
Margin Securities – Long	25%	83%
Margin Securities – Short	30%	100%
Equity Index options (listed)	15%	50%
Single Equity option (listed)	20%	67%
Interest rate contracts (listed options)	10%	33%
U.S. Treasury bill options (95 days or less to Maturity) (listed)	0.35%	1%
Foreign Currency options (listed)	4%	13%
OTC stock and index options	30%	100%

** The multipliers set forth in this column would be used in the "exposure" calculation by multiplying a derivative's gross notional amount by the specified risk adjustment multiplier to equal a "risk-adjusted notional amount" of the derivative. This risk-adjusted notional amount would be used instead of a derivative's gross notional amount for the purposes of calculating exposure and a fund's compliance with the portfolio limitation tests. We propose using FINRA's maintenance margin requirements to calculate this risk adjustment multiplier by scaling each FINRA maintenance margin requirement by a factor of 3 1/3 and rounding to the nearest whole number. We have proposed a scaling factor of 3 1/3 because this scaling factor results in the assets with the highest relative risk (as determined by FINRA) having a multiplier of 100% (*i.e.*, no risk adjustment), while preserving FINRA's assessment of the relative riskiness of different asset classes.

ANNEX C

Initial Margin – Swap Margin Rules of the Prudential Regulators and the CFTC

Asset Class	Gross Initial Margin	Multiplier to Calculate "Risk-Adjusted Notional Amount" for Purposes of the "Exposure" Calculation*
Credit: 0–2 year duration	2%	13.3%
Credit: 2–5 year duration	5%	33.3%
Credit: 5+ year duration	10%	66.7%
Commodity	15%	100.0%
Equity	15%	100.0%
Foreign Exchange/Currency	6%	40.0%
Cross-Currency Swaps: 0–2 year duration	1%	6.7%
Cross-Currency Swaps: 2–5 year duration	2%	13.3%
Cross-Currency Swaps: 5+ year duration	4%	26.7%
Interest Rate: 0–2 year duration	1%	6.7%
Interest Rate: 2–5 year duration	2%	13.3%
Interest Rate: 5+ year duration	4%	26.7%
Other	15%	100.0%

* The multipliers set forth in this column would be used in the "exposure" calculation by multiplying a derivative's gross notional amount by the specified multiplier to equal a "risk-adjusted notional amount" of the derivative. This risk-adjusted notional amount would be used instead of a derivative's gross notional amount for the purposes of calculating exposure and a fund's compliance with the portfolio limitation tests. The risk-adjusted notional multipliers that we have proposed are derived from the Swap Margin Rules schedule by multiplying each number in the Swap Margin Rules schedule by 6 2/3 and rounding to the nearest whole number. We propose scaling the numbers by 6 2/3 because this scaling factor results in the derivatives with the highest relative risk (*i.e.*, 15% according to the Swap Margin Rules schedule) being subject to a multiplier of 100% (*i.e.*, no haircut), while preserving the Swap Margin Rules' assessment of the relative riskiness of different derivative asset classes.

ANNEX D

Derivatives Valuation Measurement Chart from Definition of Major Swap Participant

Asset Class	Discount Factor	Multiplier to Calculate "Risk-Adjusted Notional Amount" for Purposes of the "Exposure" Calculation*	
Security-Based Swaps			
Debt: 1 year or less	10%	66.7%	= 10/15
Debt: 1–5 years	10%	66.7%	= 10/15
Debt: 5+ years	10%	66.7%	= 10/15
Equity & other: 1 year or less	6%	40%	= 6/15
Equity & other: 1–5 years	8%	53.3%	= 8/15
Equity & other: 5+ years	10%	66.7%	= 10/15
Swaps			
Interest rate: 1 year or less	0%	0%	= 0/15
Interest rate: 1–5 years	0.5%	3.3%	= 0.5/15
Interest rate: 5+ years	1.5%	10%	= 2/15
FX & Gold: 1 year or less	1%	6.7%	= 1/15
FX & Gold: 1–5 years	5%	33.3%	=5/15
FX & Gold: 5 + years	7.5%	50%	=7.5/15
Precious Metals: 1 year or less	7%	46.7%	=7/15
Precious Metals: 1–5 years	7%	46.7%	=7/15
Precious Metals: 5 + years	8%	53.3%	=7/15
Other Commodities: 1 year or less	10%	66.7%	=10/15
Other Commodities: 1–5 years	12%	80%	=12/15
Other Commodities: 5 + years	15%	100%	=15/15
Credit: 1 year or less	10%	66.7%	= 10/15
Credit: 1-5 years	10%	66.7%	= 10/15
Credit: 5+ years	10%	66.7%	= 10/15
Equity: 1 year or less	6%	40%	= 6/15
Equity: 1–5 years	8%	53.3%	= 8/15
Equity: 5+ years	10%	66.7%	= 10/15

* The largest percentage serves as the base (15% for other commodities 5+ years) and all other types of derivatives are scaled to that base to determine the risk adjustment factor.

ANNEX E

Margin Values for Eligible Noncash Margin Collateral

Asset Class	Discount (%)
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity less than one-year	0.5
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity between one and five-years	2.0
Eligible government and related (e.g., central bank, multilateral development bank, GSE securities identified in §23.156(a)(1)(iv)) debt[1]: residual maturity greater than five-years	4.0
Eligible GSE debt securities not identified in §23.156(a)(1)(iv): residual maturity less than one year	1.0
Eligible GSE debt securities not identified in §23.156(a)(1)(iv): residual maturity between one and five years	4.0
Eligible GSE debt securities not identified in §23.156(a)(1)(iv): residual maturity greater than five years	8.0
Other eligible publicly traded debt[2]: residual maturity less than one year	1.0
Other eligible publicly traded debt[2]: residual maturity between one and five years	4.0
Other eligible publicly traded debt[2]: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0

[1] This category would include any security that is issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the covered swap entity, or an OECD Country Risk Classification rating of 0-2.

[2] This category would include investment grade corporate and municipal debt securities.

ANNEX F

Impact of the SEC's Proposed Portfolio Limits and of the AMG's Proposed Modifications

SEC's Proposed Rule – Relative VaR Test – Unintended Consequence #1: Disincentivizes Hedging

Asset	Notional	Asset Value
$100m Japanese high yield bond portfolio	$0	$100m
-$100m notional EuroYen futures to hedge duration	-$100m	$0
-$100m Japanese Yen hedge	-$100m	$0
Total:	200%	$100m

- ***Hedging ≠ VaR reduction***
  - 12/31/2015 portfolio – VaR without hedge = 14.4%, VaR with hedge = 16.1%.
    - Hedging would result in non-compliance with the proposed SEC VaR test.
      - Outcome: the proposed SEC VaR test could disincentivize hedging.
      - However, the portfolio would comply with the AMG's proposed 20% absolute VaR test since VaR is less than 20%.
- ***VaR reduction is not a robust test***
  - On 6/30/2015 the hedge reduced VaR, but on 12/31/2015, the hedge increased VaR on the same portfolio.
  - ***The AMG's proposed 20% absolute VaR limit, however, is a robust test and has been tested in other regulatory regimes in which it is used.***

1

SEC's Proposed Rule – Both the Exposure Limit and the Risk-Based Limit – Unintended Consequence #2: Disincentivizes Duration Management

Asset	Notional	Risk-Adjusted Exposure*
$100m bond portfolio (duration is 2.5 years)	$0	$0
-$400m Eurodollar futures (to partially hedge duration: 2.5 years => 1.5 years)	$400m	$7m
Total:	400%	7%

- ***Fails the SEC's proposed Portfolio Limit tests.*** This portfolio would fail both the 150% and the 300% limits as proposed by the SEC.
- Although the portfolio manager ("PM") wants to reduce duration of the bond portfolio (from 2.5 years to 1.5 years), the PM would not be able to do so using Eurodollar futures under the SEC's proposal. Therefore, the PM's alternatives would be 1) not hedge, or 2) hedge with a longer-dated, less-efficient instrument (such as bond futures).
- However, using a risk-adjusted exposure (with adjustments from the BIS schedule) as we propose, the PM would be able to manage duration with Eurodollar futures.
  - As a result, the portfolio could appropriately hedge in a safe but still limited manner under the AMG proposal.

* Calculated by dividing by four to account for the three-month duration, then applying the applicable 7% haircut from the BIS schedule.

Changes Recommended by AMG to SEC's Proposed Rule Would Still Eliminate Leveraged ETFs

Asset	1X	2X	3X
S&P 500 ETF	$100m	$200m	$300m
Notional:	100% notional	200% notional	300% notional
Risk-Adjusted Exposure:	100% exposure	200% exposure	300% exposure
VaR:	12.3%	24.6%	36.9%
Results:	Notional and risk-adjusted exposure are below 150%	Notional and risk-adjusted exposure are below 300%; VaR is risk increasing, with VaR > 20%	Notional and risk-adjusted exposure are at 300%; VaR is risk increasing, with VaR > 20%

Leveraged ETFs would not be allowed under either the SEC's Proposed Rule or AMG's proposed modifications:

1) Fail the SEC's proposed VaR test; 2) fail the risk-adjusted exposure test; 3) fail the AMG's proposed 20% absolute VaR test