sifma
Invested in America

asset management group

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

April 21, 2020

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, File No. S7-24-15

Dear Ms. Countryman:

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 re-proposed rule 18f-4 (the "**Proposed Derivatives Rule**") under the Investment Company Act of 1940, as amended (the "**1940 Act**"), proposed amendments to Forms N-PORT, Form N-LIQUID (to be re-titled "**Form N-RN**") and Form N-CEN, under the 1940 Act, proposed changes to rule 6c-11 under the 1940 Act and adoption of proposed rules 15l-2 under the Securities Exchange Act of 1934, as amended and Rule 211h-1 under the Investment Advisers Act of 1940, as amended (rules 15l-2 and 211h-1, the "**Proposed Sales Practices Rules**" and together with the Proposed Derivatives Rule, the "**Proposed Rules**").[2] The Proposed Derivatives Rule would limit the ability of business development companies ("**BDCs**") and registered investment companies (together, "**Funds**" and each a "**Fund**") to enter into derivatives transactions, reverse repurchase transactions ("**Reverse Repos**") and similar transactions, by reference to specified thresholds and would require Funds, other than limited derivatives users and certain other excluded Funds, to establish a comprehensive risk management program.

---

1 SIFMA AMG's members represent U.S. asset management firms whose combined global assets under management exceed $45 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; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles*, 85 Fed. Reg. 4446 (Jan. 24, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf (the "**Proposing Release**").

As fiduciaries to millions of investors and clients and as investment managers to 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 Funds' use of derivatives, Reverse Repos and other similar transactions. As we noted in 2016, when the SEC first proposed rule 18f-4, we agree that the SEC's regulations governing Funds' use of derivatives and similar transactions should ensure that investments comply with the policy objectives of the 1940 Act, including Section 18. At the same time, however, we also believe that it is essential for regulation to provide sufficient flexibility for Funds to enter into derivatives, Reverse Repos and similar transactions. These transactions are critical tools needed by portfolio managers to comply with a Fund's investment objectives, satisfy investor expectations and manage risks.

In submitting our comments, we note that we are doing so in the midst of one of the most volatile markets in the past ninety years and the single most volatile market since 2008. Notwithstanding these extraordinary market conditions, as of the date of this letter, Funds have fared well and continue to satisfy redemption requests and other obligations. We believe that it will be important for the SEC to evaluate the impact that the Proposed Derivatives Rule might be expected to have on Funds during this type of market. For example, one immediate take-away we have drawn from these market conditions is that a longer remediation period is warranted for exceedances. As a result, as noted below, we have recommended that the three (3) day period included in the Proposed Derivatives Rule be extended to five (5) business days. We plan to discuss our data and findings regarding the impact of this market crisis on Funds and its implications for the Proposed Derivatives Rule with the SEC and its staff at the appropriate time and may, as a result, submit additional comment letters in the future. The comments set forth below in large part reflect our views regarding operation of the Proposed Rules during normal market conditions only.

I. EXECUTIVE SUMMARY.

We support the framework underlying the Proposed Derivatives Rule and the SEC's proposal to incorporate sound risk management principles into regulation of Funds' use of derivatives and other transactions. The Proposed Derivatives Rule also provides an updated and more comprehensive approach to the regulation of Funds' use of derivatives and other transactions involving leverage.[3] We believe that if the Proposed Derivatives Rule were revised to provide additional flexibility and legal certainty in the ways we suggest, the Proposed Derivatives Rule would accomplish the SEC's goals while allowing Funds to be efficiently and prudently managed in accordance with their disclosed investment strategies and risk factors. Without the key modifications we suggest, however, we are concerned that the Proposed Derivatives Rule may unreasonably constrain Fund management and indirectly harm investors. As a result, we recommend that the Proposed Derivatives Rule be improved in the ways we discuss below. We also recommend that the SEC adopt the other changes we recommend in respect to the Proposed Rules as a whole.

---

[3] Proposing Release at 4446.

A. Six Key Enhancements.

- *Modification to Risk Limits.* In order to allow Funds to manage their investment strategies and risk manage their portfolios effectively using representative value-at-risk ("**VaR**") measurements, the Proposed Derivatives Rule should: (i) increase the limit for the relative value-at-risk ("**VaR**") test (the "**Relative VaR Test**") to two hundred percent (200%) and the limit for the absolute VaR test (the "**Absolute VaR Test**") to twenty percent (20%); (ii) provide a second group of higher limits for closed-end Funds and BDCs subject to a requirement that the Funds disclose their leverage levels; and (iii) allow Funds to "rescale" the confidence intervals used in their VaR models to a scale ranging from ninety five percent (95%) to ninety nine percent (99%).

- *Acknowledgement and Changes to Application of VaR Tests.* The Proposed Derivatives Rule and related SEC guidance should: (i) recognize that a performance benchmark may not be an appropriate designated reference benchmark for a Fund using the Relative VaR Test based on differences in constituents and risk profiles; (ii) be explicit that the SEC fully expects that, for many Funds, there will be no appropriate designated reference benchmark and these Funds will rightfully select the Absolute VaR Test as the most appropriate risk test; (iii) make clear that selection of the Absolute VaR Test would not subject a Fund to heightened enforcement risk when the derivatives risk manager determines that reliance on the Absolute VaR Test would be most appropriate risk test for the Fund; and (iv) provide that Funds critical additional flexibility of five (5) business days rather than three (3) to remediate exceedances. In addition, the Proposed Derivatives Rule should eliminate a mandatory "time out" period following an unremediated exceedance, and, instead, allow Funds to establish their own policies regarding the consequences of exceedances (beyond reporting to the SEC and to a Fund's board of directors or board of trustees (a "**Fund Board**").

- *Exemption of Delayed Settlement Transactions from the Definition of Senior Security.* The Proposed Derivatives Rule should exclude from the definition of "senior security" delayed settlement transactions such as when-issued securities and bank loans: (i) that are intended to be physically settled; (ii) with respect to which the delivery amount is known; (iii) where the Fund segregates and earmarks liquid assets to deliver at settlement; and (iv) which have a specified settlement cycle that ends within thirty-five (35) days after trade date. This definition should apply, in addition to Funds, to money market mutual funds subject to rule 2a-7 under the 1940 Act ("**Money Market Funds**"), which are not subject to the Proposed Derivatives Rule.

- *Refinement of Treatment of Currency Hedges Under the Limited Derivatives User Exception.* The two separate provisions of the Limited Derivatives User exception that are used to determine whether a Fund is a limited derivatives user (a "**Limited Derivatives User**") should be combined, and the exception should be revised to allow Funds to subtract currency hedges from the Fund's aggregate notional derivatives exposure for purposes of determining whether the Fund's derivatives exposure is less than ten percent (10%) of the Fund's net asset value ("**NAV**"). In addition, instead of providing that the notional amount of the currency derivatives may not exceed the value of the hedged instruments by "more than a negligible amount," the Proposed Derivatives

Rule should provide that the notional amount of such currency forwards may not exceed or be less than the value of the hedged instruments by more than ten percent (10%) of the Fund's NAV.

- *Exempt Reverse Repos and Similar Transactions Based on a Choice of 3x Asset Coverage or Asset Segregation.* The Proposed Derivatives Rule should recognize that leverage under Reverse Repos and similar transactions (including buy-sell transactions, and "with recourse" tender option bond inverse floaters) are appropriately limited either through segregation of liquid assets equal to the notional amount or pursuant to the three (3) times asset coverage test in Section 18 and the Proposed Derivatives Rule. The Proposed Derivatives Rule should allow Funds to choose either approach.

- *Eliminate Unintended Consequences for Money Market Funds.* The Proposed Derivatives Rule should clarify that securities that are eligible investments for Money Market Funds under rule 2a-7 under the 1940 Act, such as tender option bonds issued by a tender option bond trust (a "**TOB Trust**"), would not constitute instruments "similar to" derivatives or Reverse Repos.

B. Additional Recommendations.

- *Select Definitions in the Proposed Derivatives Rule Should be Revised to:*

  - Clarify that cash and cash equivalents into which stock loan collateral may be invested without creating leverage include short-term bond funds and short-term bond ETFs, treasury futures and securities issued or guaranteed by government sponsored entities ("**GSEs**") or the Government National Mortgage Association ("**Ginnie Mae**") (together, "**Other Cash Equivalents**") as well as instruments that are substantially similar to those in which a Money Market Fund may invest, either directly or through a third party investment adviser or pooled investment vehicle;

  - Clarify that the reference to a "leveraged index" (which may not serve as a designated reference index) is intended to exclude indices that provide for a multiplier of returns and not indices comprised of instruments deemed to embed leverage, such as currency forwards included in indices tracked by currency protected Funds; clarify as well that a designated reference index may be developed and maintained by an affiliate of a Fund (without being "widely recognized and used") subject to procedures to ensure the independence of the index team from portfolio managers and a rules-based index structure;

  - Clarify that "with recourse" residual interests in a TOB Trust (but not the tender option bonds issued by a TOB Trust to Money Market Funds or non-recourse residual interests) should be treated as "similar instruments" to Reverse Repos;

  - Classify "to-be-announced transactions" ("**TBAs**") and "to-be-announced dollar rolls" ("**TBA Dollar Rolls**")[4] as "similar transactions to derivatives" subject to the

---

[4] TBAs include forward contracts comprised of mortgage-backed securities issued by GSEs and Ginnie Mae ("**Agency MBS**"). A TBA Dollar Roll is the combination of two TBAs (i.e., forward contracts on Agency

VaR tests for purposes of Section 18 and the Proposed Derivatives Rule and do not classify either TBAs or TBA Dollar Rolls as being similar transactions to Reverse Repos;

- Exclude from the definition of derivatives exposure in the Proposed Derivatives Rules ("**Derivatives Exposure**") Off-Setting Transactions with the same counterparty;

- Exclude from the definition of Derivatives Exposure off-setting transactions required to book monthly rolls of over-the-counter currency forwards and Agency MBS forwards;[5]

- Exclude from the definition of Derivatives Exposures for purposes of the Limited Derivatives User exception fully-paid derivative instruments, such as purchased options, purchased swaptions[6] and structured notes; and

- Expand the type of hedging transactions that may be excluded from Derivatives Exposure to include not only currency forwards but also cleared credit and rate derivatives used to hedge portfolio instruments.

- *The Risk Management Program should be revised to:*

  - Allow a Fund's investment manager, as an entity, as well as any qualified employee of the investment manager (regardless of whether the person is an "officer") to serve as the derivatives risk manager or as a member of the committee serving as derivatives risk manager;

MBS), one of which matures in the front month and one that matures in the future month. The roll seller sells the front-month Agency MBS forward contract and simultaneously buys the forward contract in the Agency MBS for a future-month, both a specified prices. The roll buyer does the opposite. *See* *https://www.frbatlanta.org/-/media/documents/news/conferences/2015/1210-real-estate-finance/zhaogang.pdf* at 2. According to one recent article, approximately half of the trading volume in the entire Agency MBS market is conducted through TBA Dollar Rolls and the trades are an important tool used by the Board of Governors of the Federal Reserve in its quantitative easing operations. *Id.*

5 As explained in more detail below, in order for a Fund to continue or "roll" an over-the-counter currency forward or an Agency MBS forward, on or about the last business day of the month, the Fund must: (i) enter into an equal and off-setting forward for the current month forward and (ii) enter into a new forward covering the succeeding month period. The two transactions generally settle in two (2) business days, as of which time the Fund will have no exposure on the original forward and will only have exposure under the succeeding month forward.

6 A "swaption" is an option transaction that provides one party with the right (but not the obligation) to enter into a swap transaction on specified terms. In the case of a cash-settled swaption, if exercised, the option buyer will receive a cash payment equal to the difference (if greater than zero) between the mark-to-market value of the referenced swap transaction on the exercise date and the strike price.

- Provide that, in the case of Funds and investment advisers who retain sub-advisers, a derivatives risk manager appointed by the primary investment adviser may delegate day-to-day derivatives risk management to the sub-adviser;
- Allow testing periods (other than with respect to testing compliance with VaR limits) to be defined by the Funds rather than by the Proposed Derivatives Rule, provided that the tests are carried out no less frequently than monthly; and
- Confirm that the responsibility of the Fund Board is that of oversight only, consistent with the role of the Fund Board under rule 22e-4 and rule 38a-1 under the 1940 Act.

- *The Proposed Internal and External Reporting Requirements should be revised to:*
  - Clarify that exceedances of metrics established by the risk guidelines, stress testing results and backtesting results are not required to be reported to the Fund Board unless the information is requested by the Fund Board, a material risk arises from the Fund's derivatives transactions or an issue relating to a material exceedance is unremediated within a five (5) business day period; and
  - Limit public reporting required by a Fund to disclosure of a Fund's derivatives exposure and designated reference index, and provide that a Fund must disclose daily VaR information only in non-public, SEC filings.

- *The Limited Derivatives User Exception should be revised to:*
  - Grant flexibility to Funds to measure continued compliance with the exception within a time period to be determined by the Fund Board, not to be less frequent than once per calendar month.
  - Provide a remediation period for temporary exceedances by a Limited Derivatives User of the parameters set forth under the exception.
  - Provide a sixty (60) day period for a Limited Derivatives User to transition from Limited Derivatives User status to compliance with the VaR test and risk management program requirements under the Proposed Derivatives Rule.

- *Transition Period should be revised to:*
  - Extend the transition period for implementation of the Proposed Derivatives Rule to eighteen (18) months (consistent with the transition period for rule 22e-4 (the "**Liquidity Risk Management Rule**")).

- *General Comments on Sales Practice Rules:*
  - We are concerned that the Proposed Sales Practices Rules represent a departure from the SEC's disclosure-based mandate and do not appear to address the policies stated in the statutory provisions on which they are based. The rules suggest a movement away from a market-based approach that allows investors to vet new products and

encourages innovation. We recommend that the SEC reconsider the Proposed Sales Practices Rules and whether enhanced disclosure requirements would meet the SEC's objectives.

II. DISCUSSION OF SIX KEY ENHANCEMENTS AND POLICY RATIONALE.

We believe that our recommended modifications to the Proposed Derivatives Rule would improve the effectiveness of the Proposed Derivatives Rule and mitigate the potential adverse effects of the Proposed Derivatives Rule on the broad base of investors who rely on Funds as a primary savings and wealth-accumulation tool.[7]

A. Modification to Risk Limits.

We support the SEC's proposal to allow Funds, which are not Limited Derivatives Users or otherwise excepted, to use one of two alternative VaR-based tests to establish limits for derivatives transactions. Derivatives represent an essential portfolio management tool for Funds to risk manage, efficiently obtain investment exposure, equitize cash and enhance returns. In our view, regulated investment vehicles, such as the Funds,[8] should have the same access to these portfolio management tools as alternative investment managers – particularly now that the derivatives market has become subject to comprehensive regulation by the Commodity Futures Trading Commission and the SEC in the United States, pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act,[9] and in Europe and other jurisdictions globally pursuant to comparable regulations.

1. <u>Raise Limits of VaR Tests</u>.

In order to allow Funds to manage their portfolios effectively, the limits under the Relative VaR Test and the Absolute VaR Tests should be raised to two hundred percent (200%) and twenty percent (20%), respectively. As explained by the SEC, the proposed one hundred fifty percent (150%) and fifteen percent (15%) limits under the VaR tests were established after consideration of the borrowing limits of Section 18 under the 1940 Act.[10] The SEC took this approach, in part, to limit the amount of debt that a Fund can take on, consistent with its views regarding the policy purposes underlying Section 18.[11] The Proposed Derivatives Rule treats derivatives as "senior

---

[7] *See, e.g.,* ICI 2019 Investment Company Fact Book at 146, *available at* https://www.ici.org/pdf/2019_factbook.pdf ("At year-end 2018, mutual funds held in [defined contribution] plans and IRAs accounted for $8.2 trillion (30 percent) of the $24.7 trillion U.S. retirement market and 46 percent of total mutual fund assets.").

[8] For a detailed summary of the many ways in which the Funds use derivatives for portfolio management, please see our comment letter to previously proposed rule 18f-4 dated March 26, 2016, pp. 10-13.

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

[10] *See* Proposing Release at 4474.

[11] *Id.* at 4451 (". . . the prohibitions and restrictions under the senior security provisions of section 18 should 'function as a practical limit on the amount of leverage which the investment company may undertake…").

securities" and, in turn, suggests that a "senior security" is similar to debt or preferred stock.[12] We believe there are important distinctions between derivatives and debt or preferred stock. For example, the entry into derivatives transactions generally does not subject Funds to the same payment obligations or risks as issuing preferred stock or bonds. Over-the-counter derivatives typically obligate a Fund to pay interest and a mark-to-market, net payment amount or, in the alternative, receive to a net amount from the counterparty. Publicly cleared and traded derivatives involve the purchase or sale by a Fund of a commodity instrument on an exchange and clearance through a regulated, central clearinghouse. Borrowings, on the other hand, result in a payment by a Fund of both interest and principal equal to the full amount of the borrowings. Similarly, a Fund that issues debt or preferred stock incurs a payment obligation with respect to interest and dividends as well as the full principal amount of the instrument. The bankruptcy treatment of derivatives is different from borrowings and issued debt and preferred stock. Bank lenders and holders and preferred holders are subject to the automatic stay in the bankruptcy of the Fund to which they have lent whereas derivatives counterparties generally are not. Similarly, a Fund that is a derivatives counterparty to a swap dealer that becomes insolvent would have the benefit of the exclusion from the automatic stay provision to close out positions and foreclose on collateral posted by the dealer whereas the Fund would be subject to discretion of the bank administrator (i.e., the FDIC) in respect to a loan upon the bankruptcy of a bank lender. Finally, derivatives are entered into exclusively with large, financial intermediaries, may be bought and sold on exchanges and are subject to substantial regulations, including, for examples, mandatory bi-lateral margin, central clearing and trade reporting. In recognition of these differences and the important role derivatives play for Funds in carrying out risk management, seeking certain types of investment exposures, monetizing cash and enhancing returns, we propose that the VaR limits be raised as described below.

The SEC indicated that a policy purpose it was seeking to address and which informs its views on the Proposed Derivatives is a goal of preventing undue speculation by Funds.[13] The SEC indicates that it believes that Section 18 is intended to restrict "the 'potential increase in the speculative character of [the fund's] outstanding common stock' and [to ensure] that funds [do] not 'operate without adequate assets or reserves.'"[14] In our view, increasing the limits to at least two hundred percent (200%) and twenty percent (20%), respectively, would not materially increase these concerns. Failure to increase the limits, on the other hand, could seriously constrain the ability of Funds to achieve their investment objectives and of Fund managers to efficiently manage Fund portfolios. As noted in the two examples in **Annex A**, the VaR of many unleveraged portfolios can exceed the current proposed limits in non-volatile markets, and the VaR levels should be expected to increase in more volatile markets. In light of market volatility, liquidity of some securities can be temporarily impacted and, in this situation, derivatives can be a more liquid and efficient means of obtaining the desired exposure. By raising limits, we believe

---

12 Section 18(g) defines "senior security" to mean "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends. . ."

13 *Id* at 4451 ("The fundamental statutory policy and purposes underlying the Investment Company Act, as expressed in section 1(b) of the Act, inform our interpretation of the scope of the term ''senior security'' in section 18…").

14 *Id*.

that the SEC would provide important and much needed flexibility to portfolio managers to effectively manage Fund portfolios without undermining the risks of leverage and undue speculation that the limits are intended to mitigate. Failure to raise the limits of the VaR test could have negative implications for Fund investors. Among other reasons, certain Funds whose strategies include operating in parallel to a UCITS fund having the same strategy or investing in securities whose liquidity has been temporarily compromised, may be required to change their strategy or operate using more expensive or less liquid instruments.[15] Accordingly, in our view, raising the VaR test limits as recommended would be consistent with the SEC's investor protection objective.

The VaR limits should also be raised in recognition of the inherently imprecise nature of the VaR methodology. As the SEC notes in the Proposed Derivatives Rule, VaR is an estimate, based on historical observations, of an instrument or portfolio's potential losses that provides an overall indication of market risk. VaR cannot, and was never intended to, provide a precise measurement of the specific risk of a given instrument or portfolio. One of the benefits of VaR, as SEC recognizes, is the fact that it can be tailored to a specific Fund's risk characteristics. In recognition of this fact, the Proposed Derivatives Rule requires Funds to conduct model backtesting, stress tests and other testing in order to analyze and adjust their models-based test results.[16] While this flexibility is a benefit of VaR as a risk management tool, it does lead to some level of variability in the VaR results produced by individual Funds. The fact that VaR is a general estimate that requires tailoring and ongoing adjustments underscores its role as an overall indication of risk rather than a source of precise risk metrics. In light of these considerations, it is important that the VaR limit be set at a reasonable level to account for variability in its risk estimates and to limit the number of times that the model must be adjusted. As we discuss below, in our view, the proposed limits should be raised to at least two hundred percent (200%) for the Relative VaR Test and twenty percent (20%) for the Absolute VaR Test, respectively.

Relative VaR Test. Under the proposed Relative VaR Test, many Funds – particularly actively-managed, fixed income Funds – would be limited in their ability to leverage. The primary reason that fixed income Funds, in particular, are constrained by the proposed limit is that they use benchmarks that often have very low volatility. As a result, the one hundred fifty percent (150%) limit for the Relative VaR Test could significantly constrain the ability of the Fund manager to obtain the necessary investment exposure using derivatives. In our view, efforts to obtain exposure through a more liquid and efficient form using derivatives or to enhance returns by concentrating a fixed income portfolio in particular fixed income securities should not be deemed to constitute "undue speculation." Such investment practices reflect prudent investment management and appropriate use of available investment tools to most efficiently manage the Funds for the benefit of the shareholders. By raising the Relative VaR Test limit from one hundred fifty percent (150%) to at least two hundred percent (200%), the SEC would

---

15 For example, a fixed income fund may sometimes elect to obtain interest from a bond through purchase of a credit default swap which may provide more liquidity than the underlying security.

16 Proposing Release at 4464 (providing the following situation as an example of where a Fund would need to adjust the VaR model "If the fund were consistently to experience backtesting exceptions more (or less) frequently, this could suggest that the fund's VaR model may not be effectively taking into account and incorporating all significant, identifiable market risk factors associated with a fund's investments, as required by the proposed rule.")

significantly enhance the ability of Fund managers to manage Funds more efficiently, more safely (from a liquidity perspective) and with the potential of enhanced returns.

In addition to the need for additional portfolio flexibility, we believe that higher limits are appropriate because Funds often have different investment profiles than that of their benchmarks. First, many Funds are actively-managed and are expressly managed to exceed their benchmarks. To the extent that a Fund has a fully-disclosed strategy that is designed to out-perform the benchmark, then by definition the composition of the Fund's portfolio should be different from the Fund's benchmark. Second, it is often impossible or impracticable for Funds to invest in certain securities included in its benchmark index. Investments may be impossible or impracticable to invest in on a temporary basis, due to, among other factors, imposition of currency controls or trading suspensions. In addition, securities may be impossible or impractical for a Fund to invest in due to non-temporary factors such as denomination size, foreign investor restrictions, liquidity, tax issues or other reasons. To the extent that a benchmark or designated reference index were to include such an instrument, a Fund's portfolio would differ from that of the benchmark, even if the Fund were able to obtain economic exposure to the instrument, such as through entry into a derivative. With respect to these instruments, even a purely index-tracking Fund may not hold the same securities as are contained in the applicable index and would typically invest on an optimized basis. Finally, indices often hold such a large number of securities that it is impractical for even fully-replicating, index-tracking Funds to replicate the index and actively-managed Funds will hold a small sub-set of the index. This paradigm is common with fixed income Funds, and divergence of a Fund's portfolio from the composition of a fixed income total-market index, such as the Barclays Aggregate Bond Index is particularly acute in the case of actively-managed fixed income Funds. A total market fixed income index, such as the Barclays Aggregate Bond Index, has thousands of constituents. Unlike an equity total market index, like the S&P 500, not all of the components of the fixed income indices are easily tradable, liquid, easy to value and available in both small and large denomination size. As a result, Funds cannot easily invest in all of the index components, and there are often important differences between the composition of a Fund's portfolio and those of its benchmark. In light of these differences, the impact of a "tail event" (i.e., an event that is outside the range of which is normally expected)[17] may affect Funds differently from the benchmark index. By allowing for a higher VaR limit, the test would better facilitate differences between a Fund's portfolio and the designated reference index and account for imperfect correlations between the two. The higher limit would also facilitate management of Funds in a manner best designed to achieve the Fund's investment strategy, including, mitigating operational difficulties by obtaining exposure in a customized, more liquid and efficient manner through derivatives.

The constraints imposed by the one hundred fifty percent (150%) limit apply to all classes of assets. As discussed above, in many cases (particularly in the case of actively-managed Funds), designated reference indices will not precisely reflect the actual components of the investment program of a particular Fund. In many cases, for example, the benchmark index that most closely resembles the Fund's investment program may have imperfect correlations with the Fund

[17] *See* Wikipedia, "Tail risk is the risk of an asset or portfolio of assets moving more than three (3) standard deviations from its current price, above the risk of a normal distribution."

and thereby be inherently more risky or less risky (i.e., have inherently more or less VaR) than the Fund itself.

In establishing the one hundred fifty percent (150%) limit, the SEC notes its view that the limit would be consistent with the requirements of Section 18. In the example provided by the SEC, the sample Fund has $100 in assets and borrows $50, which suggests a limit of one hundred fifty percent (150%). The SEC arrives at the one hundred fifty percent (150%) limit because it assumes that a Fund would have a VaR of $150 against an index for purposes of its example. This assumption would be true only for a Fund that replicates its index or uses sampling in a manner that closely tracks the performance of its underlying index. In our experience, the SEC's example would not be accurate with respect to many conservative, actively-managed Funds because the VaR of the Fund could already be sufficiently high (based solely on concentration of the securities held) that the Fund would be prohibited from entering into a derivative at the one hundred fifty percent (150%) limit. In this circumstance, the Fund would not be able to enter into a derivatives transaction but would be authorized borrow from a bank consistent with Section 18. This result occurs because VaR measures exposure and not leverage. This paradoxical result suggests that the proposed limit of one hundred fifty percent (150%) under the Relative VaR Test is too low.

We have included as Example #1 in **Annex A**, a sample actively-managed Fund portfolio comprised of ten (10) stocks taken from the S&P 500 Index. To approximate an actively-managed portfolio that seeks to outperform the S&P 500 Index, we identified a sampling of securities that a portfolio manager might select in order to outperform the index. In particular, we selected securities that have low price-to-book ratios. We then compared the VaR of this sample portfolio to that of the S&P 500 Index, both for the historical time period selected by the SEC ended July 2019 and for a more recent time period ended March 11, 2020. As reflected in the example, the portfolio had a relative VaR of one hundred eighty two percent (182%) for the earlier time period and a relative VaR of one hundred ninety three percent (193%) for the more recent time period, both as measured exclusively on an *unleveraged* basis. Assuming that the sample Fund borrowed to the extent authorized by the Section 18 limits and reinvested those borrowed monies in the ten (10) sample stocks selected in the hypothetical portfolio, the relative VaR would have been two hundred seventy three percent (273%) for the earlier time period and two hundred eighty nine percent (289%) for the more recent time period measured on a 1940 Act-compliant *leveraged* basis.

The proposed one hundred fifty percent (150%) limit is potentially even more constraining in respect to certain types of fixed income Funds portfolios. Based on testing carried out by member firms of existing fixed income Funds that are not leveraged and do not hold derivatives, several of the portfolios held by existing, actively-managed Funds would be in breach of the one hundred fifty percent (150%) limit from time to time notwithstanding that they hold no borrowings or derivatives. The reason for this relates to the fact that the VaR of most fixed income Fund portfolios (and indices) is low. If, for example, the VaR threshold for a portfolio is twenty (20) basis points, one hundred fifty percent (150%) of that level would be only thirty (30) basis points, which is unlikely to allow a Fund the headroom it would need to implement its strategy. The two hundred percent (200%) limit would provide important additional flexibility to Fund portfolio managers while still imposing meaningful limits on the Fund's ability to leverage itself.

In the Proposing Release, the SEC indicated that it based the proposed one hundred fifty percent (150%) limit on the fact that Section 18 currently limits debt leverage to 1.5x rather than on the inherent volatility of the assets. By investing in more or less risky securities and other portfolio assets (excluding leveraged instruments), an *unleveraged* Fund would to expected to establish a VaR of between 1.2x or 1.4x (or, in some cases, more, as shown in the attached examples) relative to the Fund's underlying designated reference index. If the estimated and expected VaR level that a Fund would maintain through its non-leveraged portfolio investments is selected and that VaR level is then compared to the 1.5x threshold, the math would suggest that an appropriate limit for a Relative VaR Test would be at least two hundred percent (200%) of – or 2.0 times – the VaR of the designated reference index and not 1.5 times, i.e., 1.3 x 1.5 = 2.0x.[18]

As an operational matter, there are efficiencies in allowing Funds to use the two hundred percent (200%) limit because it is the same limit used under the European requirements for managers of UCITS. These efficiencies may result in cost savings for shareholders.

Finally, since a 150% VaR limit is not mandated by Section 18, the SEC has the ability to[19] and, in our view, should select the higher level in order to provide Fund managers with the tools they need.

For these reasons, we recommend that the limit be raised to at least two hundred percent (200%) under the Relative VaR Test.

Absolute VaR Test. In the case of the Absolute VaR Test, the SEC selected the fifteen percent (15%) limit by analogy to the historical average VaR of the S&P 500 Index, which SEC indicated is approximately ten percent (10%). The SEC then multiplied the VaR of the S&P 500 Index by one point five (1.5) times the borrowing limit contained in Section 18 to arrive at the fifteen percent (15%) limit.[20] In our view, this approach (like the one hundred fifty percent (150%) limit under the Relative VaR Test) is arbitrary.

We believe that a more appropriate measure of the impact of the proposed Absolute VaR Test limit, by analogy to common benchmarks such as the S&P 500 Index, would be to identify the frequency under which the proposal would be binding on a benchmark, the duration for which it

---

18 Given that appropriate and expected VaR level often are higher, it would also be reasonable to establish a higher limit.

19 In establishing the one hundred fifty percent (150%) limit, the SEC sought to extrapolate from the three (3) times asset coverage test in Section 18 of the 1940 Act. However, the limit was arrived at through analogies and extrapolation and not based on the words in the statute. Section 18 neither provides nor mandates use of a hundred fifty percent (150%) limit.

20 Proposing Release at 4475 ("In proposing an absolute VaR test of 15% of a fund's net assets, we considered the comparison of a fund complying with the absolute VaR test and a fund complying with the relative VaR test. A fund that uses the S&P 500 as its benchmark index, as many funds do, would be permitted to have a VaR equal to 150% of the VaR of the S&P 500 if the fund also used that index as its designated reference index. The Division of Economic and Risk Analysis ("DERA") staff calculated the VaR of the S&P 500, using the parameters specified in this proposed rule over various time periods. DERA staff's calculation of the S&P 500's VaR since inception, for example, produced a mean VaR of approximately 10.4%, although the VaR of the S&P 500 varied over time.").

would be binding, and the magnitude of any breach. As an example, for the S&P 500 Index and for the Russell 2000 Index, a fifteen percent (15%) Absolute VaR Test limit would have been exceeded multiple times over the past two decades by significant amounts. These impacts would have occurred despite the fact that these indices are commonly used benchmarks and generally not considered "unduly speculative." The SEC acknowledges this fact in the Proposing Release when it compares the impact of proposed Absolute VaR Test and the Relative VaR Test on the S&P 500 Index.[21] If a Fund would not be deemed to be over leveraged or unduly speculative if it has a VaR of up to one hundred fifty percent (150%) of the S&P 500 Index, then, logically, the S&P 500 itself (i.e., a VaR of one hundred percent (100%) of the S&P 500 Index) should not be deemed to be over leveraged or unduly speculative. By extension, a limit of at least twenty percent (20%) would still be substantially below the one hundred percent (100%) level that is implied by analogy to the Relative VaR Test.

In addition, selection of a fifteen percent (15%) limit for the Absolute VaR Test appears to us to be inconsistent with VaR levels from a number of well-known equity indices. For example, as shown in Example #2 in **Annex A**, assuming that each of the following indices were to borrow in accordance with the limits authorized in Section 18 and reinvest the proceeds in the stocks comprising the index, all but one of them would exceed the fifteen percent (15%) Absolute VaR Test limit: the BONY Mellon China Select Index (BKTCN) – twenty one point ninety six percent (21.96%) VaR; the Dow Jones U.S. Biotechnology Index (DJUSBT) – nineteen point fifty percent (19.50%); the S&P 500 SmallCap 600/Citigroup Growth Index (SMLG) – eighteen point forty percent (18.40%); the S&P MidCap 400/Citigroup Growth Index (MIDG) – seventeen point thirty percent (17.30%); S&P Financial Select Sector Index (IXM) – sixteen point forty seven percent (16.47%); MSCI Japan Index (MSJP) – fifteen point seventy six percent (15.76%); MSCI Europe Financials Index (NDRUFNCL) – fifteen point fifty two percent (15.52%); and NASDAQ-110 Index – fourteen point forty three percent (14.43%), based on the time periods selected by the SEC, which generally reflected a low volatility period. We have also included updated calculations reflecting the recent market volatility. As the example in **Annex A** demonstrates, exceedances beyond the fifteen percent (15%) level are even more frequent during these volatile periods.

Based on these examples, we believe that the fifteen percent (15%) limit under Absolute VaR Test is significantly lower than is necessary or appropriate to satisfy the SEC's stated policy concerns underlying the Proposed Derivatives Rule. We are concerned that if set at this level, the test could adversely impact a broad variety of Funds that are not leveraged or speculative outliers, such as absolute-return Funds and Funds that target consistent, moderate levels of risk. If the tests are adopted in their current form, we believe that actively- managed, moderate risk Funds will be incented to become index-tracking. This in turn could reduce investors' choice and, depending upon the index, increase riskiness of the Fund. Similarly, to the extent that the Absolute VaR Test limits Funds to the extent suggested by these examples, Funds will be constrained in all of the critical ways that derivatives are used, from risk management, to monetization of cash. For these reasons as well, use of a low threshold level could result in harming Fund shareholders.

---

21 *Id*. at 4519.

From a policy perspective, we do not believe that the purpose of Sections 18 and 61 is to dictate the amount of *risk* that a Fund may offer. Instead, we believe that the statutory provisions are designed to limit the amount of leverage that a Fund may incur. The difficulty in the case of the Proposed Derivatives Rule is that it relies on the VaR model, which is a risk model. We agree that use of a risk model to address leverage can be appropriate and consistent with sound risk management techniques. However, because the VaR model is risk-based and not calibrated to measure leverage, we believe that additional flexibility needs to be built into the Absolute VaR Test to reflect the difference between the VaR model and the leverage concerns that the Proposed Derivatives Rule seeks to address. In our view, the applicable limits needs to account for fluctuations in VaR and provide for additional headroom.

We also think that it is inappropriate for governmental regulation rather than investor choice to dictate investment strategies that are made available in the marketplace. In establishing an appropriate threshold, the SEC must evaluate the impact that a mandatory threshold will have on potential investment strategies. The SEC is charged with ensuring that Funds provide full and fair disclosure regarding their investment strategies and not with selecting Funds that it believes would be suitable. Moreover, as the SEC, other regulatory and self-regulatory authorities and courts of law have recognized, investors can have markedly different investment needs and objectives. Regulation should not prohibit distribution of Funds designed to address particular investor needs; instead, regulation should ensure that the strategy and risks of such Funds are accurately and adequately disclosed. We are concerned that the limits in the Proposed Derivatives Rules will impact particular strategies (for example, fixed income Funds and those that target specific levels or ranges of volatility) and reduce the availability to investors of investment strategies that rely on having additional flexibility than the Proposed Derivatives Rule would allow to use derivatives.

For all of these reasons, we believe that the limit under the Absolute VaR Test should be raised to at least twenty percent (20%), consistent with the requirements for UCITS.

2. Provide a Second Group of Higher VaR Limits for Closed-End Funds and BDCs.

Under Section 18 of the 1940 Act, a closed-end Fund is allowed to issue debt, provided that the Fund maintains three (3) times asset coverage. Similarly, a closed-end Fund is allowed to issue preferred stock, provided that the Fund maintains two (2) times asset coverage. Under Section 61 of the 1940 Act, BDCs may issue debt or preferred stock if they maintain either two (2) times asset coverage or one point five (1.5) times asset coverage. As a statutory matter, closed-end Funds and BDCs can already issue senior securities well beyond the one hundred fifty percent (150%) borrowing limit that the SEC provides for the Relative VaR Test under the Proposed Derivatives Rule. Reliance by a closed-end Fund or BDC on the Proposed Derivatives Rule would penalize these Funds by comparison to their statutory rights. In addition, the Funds would not be able to use Limited Derivatives User exception if they issue debt or preferred stock, as authorized under the 1940 Act. In light of the fact that these Funds are authorized to incur leverage under the terms of the 1940 Act, we believe that the Proposed Derivatives Rule should take account of the statutory framework and establish separate, higher VaR limits for closed-end Funds and BDCs from those applicable to open-end Funds. The multiplier of one point five (1.5) times suggested by the Proposed Derivatives Rule does not take into account leverage permitted by Section 18 or Section 61 of the 1940 Act and, as a result, disproportionately disadvantages closed-end Funds and BDCs. In addition, providing separate treatment of closed-end Funds and BDCs from that governing open-end funds is consistent with the historical approach that the SEC has taken in respect to regulation of transactions that it believes implicate senior security concerns. The SEC's asset segregation framework set forth in SEC's General Statement of Policy in Release No. 10666 ("**Release 10666**")[22] applies only to open-end Funds and not to closed-end Funds or BDCs.

We believe it would be reasonable to establish a higher limit for closed-end Funds and BDCs, which could be accomplished by adding a multiplier, reflecting current disclosed leverage assumed by the Fund, to the usual limit applicable to the open-end Funds. If, for example, a closed-end Fund were to hold leveraged instruments equal to forty percent (40%) of the Fund's NAV, the Fund's limit would be one point four (1.4) times the VaR of its designated reference index (i.e., 1.4 x the one hundred fifty percent (150%) limit). Under our proposal, this closed-end Fund would disclose its forty percent (40%) starting leverage point and multiply that by the one hundred fifty percent (150%) limit under the Relative VaR Test (or two hundred percent (200%) or greater if the limit under the Relative VaR Test is raised as we have recommended) in order to establish the appropriate higher VaR level for closed-end Funds and BDCs. As a condition to reliance on this approach, the Fund would be required to disclose its leverage limit in its public SEC filings and keep such disclosure updated.

Another approach that could be added to the Proposed Derivatives Rule would be to raise the limit applicable to open-end Funds (i.e., as proposed, one hundred fifty percent (150%)) by twenty five percent (25%) in respect to closed-end Funds and BDCs. This approach should appropriately reflect the different treatment under the 1940 Act of closed-end Funds and BDCs as compared to open-end Funds.

3. Refine VaR Model Requirements to Scale Confidence Intervals

The Proposed Derivatives Rule requires that the VaR model used by a Fund's derivatives risk manager, to calculate compliance with the Relative VaR Test or the Absolute VaR Test, must use a ninety nine percent (99%) confidence level although the VaR calculation based on a one-day time horizon may be scaled to a twenty (20) day time horizon.[23] We believe that these requirements should be modified to allow a Fund to rescale the confidence interval from ninety five percent (95%) to ninety nine percent (99%). Rescaling is important because it produces an output that is more stable and representative. As an example, a 3-year VaR calculated with 20 day non-overlapping periods, would be based on less than 1 observation at the 99% confidence interval. This single observation could provide an unstable and imprecise VaR calculation. This measurement would be improved by incorporating additional observations as would occur under the 95% confidence interval, which produces a more reflective and stable measure of risk.

Under our proposal, the default case would still be a one-tailed confidence interval of ninety nine percent (99%). However, a Fund would be allowed to use different confidence intervals, provided that none is below ninety five percent (95%) and the holding period would not exceed twenty (20) days. Similar to the UCITS rules, which allow for such rescaling, the rescaling

[22] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] at 25128.

[23] Proposing Release at 4476 n.230.

would be authorized only under the assumption of a normal distribution with an identical and independent distribution of the risk factor returns by referring to the quantiles of the normal distribution and the square root of time rule.

This modification would ensure that the outputs are appropriately representative and take account of unusual volatility periods. In our view, this modification would ensure greater reliability of the model outputs.

B. Acknowledgement and Changes to Application of VaR Tests.

We support the SEC's reliance on VaR as the basis for setting portfolio limits as well as the recognition contained in the Proposed Derivatives Rule that a Relative VaR Test is not appropriate for all Funds. We also understand the importance of establishing a framework under the Proposed Derivatives Rule regarding exceedances. In both cases, we urge the SEC to strengthen the Proposed Derivatives Rule by providing the guidance and modest changes we propose.

1. <u>Recognize that a Performance Benchmark may not be an Appropriate Designated Reference Index.</u>

We agree that use of a test under which a Fund with a VaR that does not substantially exceed the VaR of an appropriate benchmark should indicate that the Fund is not using derivatives to substantially leverage its portfolio.[24] We also agree that the designated reference index selected by a Fund for purposes of the Relative VaR Test should satisfy the requirements of Item 27 of Form N-1A, which is used for open-end Fund performance benchmarks. We do not believe, however, that a Fund's performance benchmark will always be an appropriate choice for a Fund's designated reference index. An index may appropriately reflect a Fund's investment strategy for performance purposes but not be an appropriate baseline for the Relative VaR Test because its assets are materially less risky or more risky than those held by the Fund. Differences in terms of volatility, the numbers of constituents and the correlation among constituents between a Fund's holdings and those in an index may require a Fund to select an index that is different from its performance benchmark in order to ensure that the riskiness of the Fund's portfolio is accurately measured when applying the Relative VaR Test.

In order to provide legal certainty, the Proposed Derivatives Rule and the related SEC guidance should be clear in recognizing that for some Funds, selection of a designated reference index other than the performance benchmark would be appropriate. In these cases, a designated reference benchmark should be selected that accurately reflects portfolio risk rather than strategy performance goals.

In addition, because an index that seeks to achieve a similar return profile to a Fund and, as a result, may serve as an appropriate performance benchmark, may have material differences from the Fund's constituent holdings and risk profiles, there should be no implicit or explicit presumption that use of a different index by a Fund as its designated reference index reflects any gamesmanship by the Fund. The SEC should make clear – either in the text of the Proposed

---

[24] Proposing Release at 4469.

Derivatives Rule, in the adopting release or both – that a Fund's selection of a different index for its performance benchmark from that selected for the Relative VaR Test is appropriate when the benchmarks are selected based on its representative qualities for the purpose for which the index will be used.

2. Make Clear that Selection of the Absolute VaR Test would not Subject a Fund to Heightened Enforcement Risk when the Derivatives Risk Manager Determines that Such Test would be Most Appropriate.

We also believe that the SEC should make clear – either in the text of the Proposed Derivatives Rule, in the adopting release or both – that a Fund will not be presumed to be seeking to game the portfolio limits if it selects the Absolute VaR Test rather than the Relative VaR Test as the most appropriate portfolio limit test for it.

We expect that for many Funds there will be no appropriate designed reference benchmark and, as a result, the Funds' derivative risk managers will need to select the Absolute VaR Test as the most appropriate risk test. For example, many risk parity Funds have a sixty percent (60%)/forty percent (40%) bond performance benchmark.[25] However, risk parity Funds include multiple asset classes not included in the performance benchmark and, as a result, would need to select an Absolute VaR Test in order to operate. Additionally, these Funds typically target a constant level of risk whereas the performance benchmark risk varies through time. Even a very standard, actively-managed fixed income Fund, which uses as a performance benchmark a broad index, such as the Barclays Aggregate Bond Index, might need to select an Absolute VaR Test because the composition of the Fund is likely to differ significantly from the composition of its performance benchmark. Similarly, an actively-managed, long-short equities Fund that maintains a small market beta would more appropriately be risk managed under an Absolute VaR Test. The Fund's performance benchmark would be expected to be a multiplier of point five (0.5) times the return of the S&P 500 Index. This performance benchmark would not qualify as a designated reference index because it is leveraged and even then, would not accurately represent the portfolio risk of the Fund. Funds such as these should choose the Absolute VaR Test without being subjected to additional compliance or regulatory risk.

Closed-end Funds and BDCs operating in compliance with Section 18 and Section 61 of the 1940 Act, are also likely to be constrained in their ability to manage the Fund if they rely on the Relative VaR Test, which relies on an unleveraged index. These and other Funds that appropriately select the alternative of relying on the Absolute VaR Test should not be subject to greater enforcement risk or second-guessing based on that choice so long as the Funds have a reasonable basis for the selection. As a result, we request that the SEC clarify that a Fund does not subject itself to greater enforcement risk or presumption of gamesmanship if it selects the Absolute VaR Test rather than the Relative VaR Test.

[25] A risk parity Fund follows an investment strategy that seeks to combine stocks, bonds and other financial assets and evenly divide risk among the various asset classes rather than, as many traditional Funds do, concentrate risk primarily in equities or another single asset class.

3. Funds should have Five (5) Business Days to Remediate VaR Test Exceedances and There should be No Pre-Determined "Time Out" Period After an Unremediated VaR Test Exceedance.

The Proposed Derivatives Rule would require a Fund to remediate the exceedance within three (3) business days. In our view, this period of time is too short and could lead to fire-sale close outs of transactions in a manner that would not be in the best interest of Fund shareholders. Having this additional flexibility is particularly important during volatile markets. The recent market volatility has highlighted to us the fact that unwind of derivatives positions often take longer than would be the case in normal markets. In order to provide the additional flexibility needed but still ensure reasonable remediation within the seven (7) day redemption period applicable to open-end Funds, we request that the SEC extend the remediation period to five (5) business days after an exceedance.

In addition, we believe that the final rule should not include a mandatory "time out" period following an exceedance during which a Fund could not enter into derivative transactions. Instead, we propose that each Fund be required to include in its own policies and procedures action steps to be taken following an exceedance that was unremediated within the five (5) business day period. The policies and procedures would be tailored to the particular needs of that Fund. This approach would provide sufficient flexibility to a Fund to re-structure its portfolio, and derivatives positions in a measured way while still requiring expeditious remediation of the exceedance. Because a Fund will be required to report its unremediated VaR Test exceedance on Form N-RN, the SEC will be able to monitor the situation as will the Fund Board. The additional scrutiny should incentivize the Fund that has experienced an exceedance to act in a prudent manner and come back into compliance quickly. However, our modified approach would grant additional flexibility to the derivatives risk manager and to the Fund's investment adviser to continue to manage the Fund in a manner that they determine is in the best interest of the Fund shareholders.

C. Exempt Delayed Settlement Transactions From the Definition of Senior Security.

The Proposed Derivatives Rule should be revised to exclude delayed settlement transactions from being "senior securities." Under this new exclusion, when-issued securities and transactions in instruments, such as bank loans, which in the ordinary course of business have a settlement date that is greater than the trade date plus two (2) business days, would not be deemed to be senior securities for purposes of Sections 18 and 61 of the 1940 Act. In defining how our proposed exclusion would apply, we would propose that it cover only those delayed-delivery transactions: (i) that are intended to be physically settled; (ii) with respect to which the delivery amount is known on the trade date; (iii) where the Fund segregates and earmarks liquid assets equal to its delivery obligation on the settlement date; and (iv) which have a specified settlement cycle that is no more than thirty-five (35) days after trade date. These guardrails would protect Fund shareholders from losses due to leverage.

In our view, there are important policy reasons to treat these transactions as non-leveraged transactions, including the fact that one of the most important "when-issued" trading markets in the world is the market for U.S. treasury securities. This market performs a critical function by "promoting competitive auctions by enhancing market transparency."[26] In connection with the when-issued treasury market, dealers and market participants, such as Funds, begin to trade the new security on a when-issued basis soon after the announcement of an upcoming auction. When-issued transactions settle on the issue date of the security. As noted by the Joint Report on the Government Securities Market prepared by the U.S. Department of the Treasury, the SEC and the Board of Governors of the Federal Reserve System "[when-issued trading] reduces uncertainties surrounding Treasury auctions by serving as a price discovery mechanism. Potential … bidders look to when-issued trading levels as a market gauge of demand in determining how to bid at an auction."[27] Settlement of these transactions is safe because it relies on the credit of the U.S. government. The when-issued market performs a similarly important role for other types of securities' issuances.

We believe that these transactions should not be considered to be senior securities because they are similar to transactions that are treated as non-leveraged transactions under the margin rules.[28] As background, the margin rules generally provide that a broker-dealer is deemed to have extended credit to a customer when a customer purchases a security from or through the broker-dealer but defers payment of all or part of the purchase price beyond the standard settlement cycle.[29] Even though the purchase or sale contract is executory, the extension of credit is deemed to occur because the customer obtains the benefits and bears the risk of the "long" or "short" security position once the contract to purchase or sell is entered into.[30] Regulation T provides exceptions to this general rule in respect to payment-versus-delivery transactions and transactions in foreign securities. In both cases, the provisions recognize that trades for which settlement is delayed are different from marginable transactions because there is a willingness and ability to settle. In the case of the delayed delivery transactions that we recommend excluding from the definition of senior security, the same would be true.

We also do not believe that these transactions should be treated as leveraged because they do not present settlement risks due to the fact that the Fund will be required to hold liquid assets to satisfy delivery or payment requirements. In addition, unlike a futures contract or other leveraged instrument, the delivery amount does not change or grow throughout the delayed settlement period. Finally, the length of the delayed settlement cycle is finite and consistent with

---

[26] K. Garbad and J. Ingber, Federal Reserve Bank of New York, Current Issues in Economics and Finance, "*The Treasury Auction Process: Objectives, Structure, and Recent Adaptations*," Vol. 11, No. 2 (Feb. 2005) at 2 ("**NY Fed Treasury Auctions**").

[27] *Id. citing Joint Report on the Government Securities Market,* (1992) p. A-6 at p. 2.

[28] *See* Regulation T, 12 CFR Part 200.8(b) "(2) *Delivery against payment.* If a creditor purchases for or sells to a customer a security in a delivery against payment transaction, the creditor shall have up to 35 calendar days to obtain payment if delivery of the security is delayed due to the mechanics of the transaction and is not related to the customer's willingness or ability to pay." *See also* Regulation T, 12 CFR Part 200.8(b)(1)(ii), providing that, in the case of the purchase of a foreign security, payment must be obtained within one day after the date on which settlement is required to occur by the rules of the foreign securities market but not beyond 35 days.

[29] *See* Board Interpretation of Mar. 31, 1972, FRRS 5-470(R) (deferred payment in tax shelter programs).

[30] C. Rechlin, E. Lindauer and F. Wertheim, Securities Credit Regulation (2d ed. 2019) at §2.19.

the delayed delivery exemptions under the margin rules. As a result, the exclusion should not be expected to add material risk into the markets or to the Funds and their shareholders.

D. Refinement of Treatment of Currency Hedges under the Limited Derivatives User Test.

We agree that Funds that do not rely significantly on derivatives should not be required to build a comprehensive risk management program and designate a specialized risk manager to oversee the Fund's limited derivatives use. We think that the approach taken in the Proposed Derivatives Rule to exclude Limited Derivatives Users from the enhanced and specific compliance requirements for Funds that are more significant users of derivatives is sound and we strongly support this aspect of the Proposed Derivatives Rule. However, there are two aspects of the proposed provisions that we believe should be modified to appropriately define the subject Funds, as described below.

In our view, the two separate provisions of the Limited Derivatives User test should be combined in a manner where currency hedges of portfolio assets would be subtracted from the Fund's notional derivatives exposure for purposes of determining whether the Fund's derivatives exposure is less than ten percent (10%) of the Fund's NAV.

In addition, instead of providing that the notional amount of the currency derivatives to be deducted may not exceed the value of the hedged instruments by "more than a negligible amount," we recommend that the revised definition provide that the notional amount not exceed or be less than the value of the hedged instruments by more than ten percent (10%) of the Fund's NAV. This language and concrete measurement would provide important legal certainty for Funds relying on the Limited Derivatives User exception.

E. Exempt Reverse Repos and Similar Transactions Based on a Choice of 3x Asset Coverage or Asset Segregation.

The Proposed Derivatives Rule should recognize that leverage under reverse repos and similar transactions (including buy-sell transactions and tender option bond inverse floaters) is appropriately limited through segregation of highly liquid assets equal to the notional amount or, in the alternative, through entry subject to three (3) times asset coverage. The rule should allow Funds to choose either approach. While we agree with the SEC's decision not to subject derivatives and similar transactions to the asset segregation approach provided by Release 10666 generally, in our view, the asset segregation approach continues to be a valid means of limiting leverage in respect to Reverse Repos and transactions similar to Reverse Repos, including buy-sell transactions and full recourse, tender option bond inverse floaters (i.e., the residual interest in a TOB Trust). For purposes of the asset segregation test, we would recommend that the assets to be segregated be limited to cash, cash equivalents and Other Cash Equivalents. So long as the segregated assets are comprised of cash, cash equivalents and Other Cash Equivalents, the transactions should economically limit leverage so that the Fund may take on and guarantee satisfaction of the Fund's obligations.

We believe that it is important to offer Funds a choice regarding how to comply with the requirements of the Proposed Derivatives Rule because the duration of the instruments differ (e.g., Reverse Repos are typically very short-term instruments whereas tender option bond inverse floaters have a longer investment horizon). For example, a corporate bond fund that is fully invested and does not have significant amounts of cash and cash equivalents, would be expected to enter into Reverse Repos under the Section 18 limits of three (3) times asset coverage whereas a short-term bond Fund would be expected to opt to rely on asset segregation (assuming our request to treat high quality, short-term bonds as cash equivalents is accepted).

F. Eliminate Unintended Consequences for Money Market Funds.

We agree with the SEC that Money Market Funds typically do not invest in derivatives or engage in Reverse Repos or transactions that are similar to derivatives or Reverse Repos. As a result, we agree that Money Market Funds should be excluded from the Proposed Derivatives Rule. However, because the Proposed Derivatives Rule would treat financial instruments that are "similar to" derivatives or Reverse Repo as "senior securities" but does not define which instruments would be included in this grouping, we believe that it would be important for the Proposed Derivatives Rule to clarify that securities that are eligible investments for Money Market Funds under rule 2a-7 under the 1940 Act would not be deemed to be "similar to" derivatives or Reverse Repos. This clarification is necessary in order to provide sufficient certainty to allow Money Market Funds and their investment managers to properly structure Money Market Fund portfolios and to allow investors sufficient transparency into the universe of eligible Money Market Fund investments to evaluate which Money Market Funds to invest in.

We also believe that this approach would be consistent with the SEC's policy goals underlying the Proposed Derivatives Rule of addressing investor protection and eliminating inconsistent industry practices. Rule 2a-7 already provides a comprehensive framework for investor protection, including requirements to ensure that Money Market Funds invest in high credit quality instruments and maintain a well-diversified investment portfolio comprised of short-term, highly-liquid instruments. Rule 2a-7 also provides an additional level of protection to investors as well as consistent portfolio reporting and stress testing requirements for Money Market Funds to allow the Funds to maintain a stable NAV as well as weekly liquidity thresholds. In light of this existing framework and the short-term nature of all Money Market Fund investments, we do not believe that additional regulation of Money Market Fund investments is necessary to prevent leverage.

III. DISCUSSION OF ADDITIONAL RECOMMENDATIONS AND POLICY RATIONALE.

A. Proposed Select Revisions to Key Definitions

- <u>Expand the Securities Lending Collateral in which a Fund may Invest without Making the Transaction Similar to a Reverse Repo</u>.

We agree with the SEC that securities lending arrangements are structurally similar to Reverse Repos.[31] We also agree that securities lending transactions where the securities lender holds cash and cash equivalents as collateral would not involve leverage. Neither the Proposing

[31] Proposing Release at 4504.

Release nor the Proposed Derivatives Rule clearly specifies which instruments would qualify as "highly liquid, short-term investments" where the transactions are not viewed by the SEC as leveraging transactions subject to the Proposed Derivatives Rule. Our members typically invest cash collateral held in connection with lending of portfolio securities in a variety of highly-liquid instruments deemed to be "cash equivalents," including not only Money Market Funds but also Other Cash Equivalents. In our experience, these instruments are customarily treated as "cash equivalents" and should qualify as the type of non-leveraging investments that the SEC noted in the Proposing Release would not create a transaction that is "similar to" a Reverse Repo. Similarly, we believe that the Proposed Derivatives Rule should be revised to clarify that reliance by a Fund on a third party to manage cash collateral for it or investing in a pooled vehicle as a way to invest cash collateral generated through securities lending could qualify as an investment in "cash and cash equivalents." So long as such third party investment adviser or the pooled investment vehicle (regardless of whether the pooled vehicle is a registered Money Market Fund) invests the collateral in substantially the same types of investments that a Money Market Fund may invest in under rule 2a-7 under the 1940 Act, we believe that these securities lending transactions should not be deemed to be designed to incur leverage or otherwise "similar to" Reverse Repos.

In order to allow Funds to structure their securities lending programs appropriately, we respectfully request that the SEC confirm – either in the Proposed Derivatives Rule, in the adopting release or both – that securities lending transactions would not be deemed to be "similar to" Reverse Repos so long as the posted collateral is invested in cash, cash equivalents and Other Cash Equivalents or in Money Market Fund type investments through a third party manager or separate pooled investment vehicle. We request that the SEC clarify that this type of securities lending program would be exempt from characterization as a senior security.

- Define "Leveraged Index" to Mean an Index Having a Multiplier and Not One that Includes Derivatives and Authorize Use of a Non-"Widely Recognized and Used" Affiliated Index if Subject to Procedures to Ensure the Independence of the Index Team and a Rules-Based Index Structure.

The Proposed Derivatives Rule should provide a clear definition of the term "leveraged index" that is used to describe the type of index that may not serve as a designated reference index for purposes of the Relative VaR Test. In our view, the definition should focus on indices that provide for a multiplier of returns and not indices that are comprised of instruments that themselves may be deemed to embed leverage, such as currency forwards. Funds that are themselves unleveraged may use as a performance benchmark indices that include one or more derivatives. For example, many of the indices tracked by currency protected index ETFs or Funds incorporate the currency hedge in the actual index. For these Funds, it would be critical to be able to use the tracking index as their designated reference index for purposes of ensuring compliance with the Proposed Derivatives Rule.

The Proposed Derivatives Rule requires that a "designated reference index" not be "administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, . . . unless the index is widely recognized and used." While we agree with the SEC's goal of ensuring that Funds and their affiliated persons not be able to game the regulation by creating an index that allows a Fund to assume substantial amounts of leverage, we believe that this goal can be achieved by requiring the affiliated person administering the index to operate independently of the applicable Fund's portfolio managers and requiring the index to be subject to auditable, rules'-based guidelines and procedures necessary to protect against misuse of material non-public information.

The SEC previously granted a number of exemptive orders to ETFs using affiliated indices, and we believe that many of the requirements set forth in those orders to ensure independent administration of the indices would be equally applicable in regard to use of a "designated reference index" administered by an affiliated person. Most importantly, the index team for an affiliated index should be separate from the portfolio manager team so as to prevent the potential ability of the portfolio personnel to implement discretionary changes in the index. In addition, the index provider should have policies and procedures to ensure that the index is appropriately rules'-based and to prevent personnel from misusing material non-public information.

- <u>Clarify which Interests in a TOB Trust are Leveraged and which are Not and Characterize Their Status Accordingly</u>.

In the Proposing Release, the SEC indicates that it believes that "a fund's obligation with respect to a 'tender option bond' financing may be similar to a Reverse Repo in some circumstances."[32] While we agree with the SEC that this would be the case in respect to one type of security issued by a TOB Trust (i.e., a "with recourse" inverse floater TOB), we also believe that other types of holdings in a TOB Trust should not be treated as senior securities or similar to derivatives or Reverse Repos.

A TOB Trust is a special purpose vehicle into which municipal bonds are deposited (usually by the Fund holding the "inverse floater TOBs," as described below) and which issues two classes of securities. One class of securities, sometimes referred to as "floating rate TOBs" or "floaters," are typically purchased by Money Market Funds. The proceeds from the floaters are used to purchase additional long-term, fixed-rate bonds for the TOB Trust. The expectation is that the purchased long-term bonds will yield more than the borrowing rate paid on the floaters. Floaters pay a short-term interest rate, have a priority claim on the cash flows from the underlying bonds, and are redeemable in part at the option of the holder on a periodic basis (subject to certain conditions). The TOB Trust typically pays a liquidity provider to guarantee weekly liquidity for the floaters. The other class, which is sometimes referred to as the "inverse floating rate security" or the "inverse floater TOB," owns the residual interest in the TOB Trust and benefits from bonds purchased by the TOB Trust with the proceeds of issuance of the floating rate TOBs. Inverse floater TOBs also earn interest. The holder of the inverse floater TOB bears substantially all of the underlying bonds' downside risk and also benefits disproportionately from any appreciation of the underlying bonds' value. The purpose of an investment in the inverse floater TOBs is to provide exposure to a particular bond sector, obtain exposure to part of the bond curve, and/or to create strategic leverage. An investor in the residual interest of a TOB Trust may invest on a recourse basis or a non-recourse basis.

[32] Proposing Release at 4504.

"Floaters" are non-leveraged instruments. The instruments are generally eligible for purchase by Money Market Funds.[33]

Inverse floater TOBs (whether recourse or non-recourse) are distinguishable from floaters because they do not have a first priority interest in the assets of the TOB Trust and they effectively bear the full risk of gain and loss on the underlying bonds. Neither instrument is similar to a derivative because neither is a bi-lateral obligation. Instead, inverse floater TOBs represent a lower priority interest in the assets of a TOB Trust. In our view, a non-recourse, inverse floater TOB should not be treated as a senior security. The maximum amount the holder of a non-recourse, inverse floater TOB could potentially lose would be the holder's investment in the TOB Trust. Unlike the holder of a floater, however, the holder of an inverse floater TOB may be requested to increase its investment in the TOB Trust to provide additional assets to the TOB Trust to either provide an additional cushion to the holder of the floaters or allow the liquidity provider to redeem some or all of the outstanding floaters. Neither the holders of the floaters nor the TOB Trust, however, have recourse against the non-recourse inverse floater TOBs if they fail to provide the increased investments. As a result, their position is distinguishable from that of borrowers. Holders of non-recourse, inverse floater TOBs often obtain tax opinions clarifying that their contributions of bonds to establish that the TOB Trust constituted a sale, which opinions rely in part on the fact that the inverse floater TOBs would not be able to unwind the TOB Trust. Characterization of the interest in this manner would suggest that the interest should not be deemed to be a senior security. For these reasons, we believe that non-recourse inverse floater TOBs should be treated as ordinary course, fixed income investments and not treated as similar to derivatives or to Reverse Repos.

"With recourse" inverse floater TOBs, on the other hand, are fully analogous to Reverse Repos because they generate leverage from the associated floaters and, in some circumstances, may obligate the holder to pay additional amounts to the TOB Trust or to other persons having recourse to the holder.[34] The maximum amount that a holder of "with recourse" inverse floater TOBs could lose includes not only the full amount of the holder's investment in the inverse floater TOBs but also the full amount of the floaters issued by the TOB Trust. The "with recourse" inverse floater TOB holders effectively own the "equity" in the TOB Trust whereas the floaters effectively own the debt. As a result, the "with recourse" inverse floater TOB holder has used debt issued by the TOB Trust (rather than by the inverse floater TOB holder directly) to leverage its interest in the bonds held by the TOB Trust. In light of the economic reality of this structure, we believe that it should appropriately be viewed as a senior security and we would support treatment of these instruments as "similar to" Reverse Repos.

---

33 Certain types of capped floaters are not eligible investments under rule 2a-7.

34 In some structures, the holders of the floaters may have the ability to put their instruments back to the holder of the "with recourse" inverse floater TOBs or to the liquidity provider. This right would have the same effect as if the holder of the floaters had made a loan to the holder of the "with recourse" inverse floater TOBs and collateralized the loan with the securities in the TOB Trust.

- <u>Classify TBAs and TBA Dollar Rolls as "Similar Transactions to Derivatives."</u>

The term TBA typically is used to describe forward purchases and sales of mortgage-backed securities issued by the GSEs as well as Ginnie Mae, where the securities to be delivered by the TBA seller to a TBA buyer are announced 48 hours prior to the settlement date. The TBA market establishes parameters under which mortgage pools can be considered fungible even though the contents of the pool of securities are not known until immediately before closing. TBA Dollar Rolls combine a forward month and a future month TBA transaction and thereby "roll" the maturity date of the forward month TBA forward. The buyer and seller of a TBA and of a TBA Dollar Roll each has a delivery or payment deliverable due at maturity of the transaction.

The Proposing Release describes TBAs as firm commitment agreements or standby commitment agreements and concludes that they are "similar to derivatives" because they have "the same economic characteristics as a forward contract" or an "option contract," respectively.[35] We agree with this characterization and believe that such transactions should be recognized as transactions that are not derivatives but that are similar instruments to derivatives for purposes of the Proposed Derivatives Rule. We believe that TBA Dollar Rolls should also be treated as "similar to derivatives" under the Proposed Derivatives Rule. Although the Proposing Release suggests in one section that TBA Dollar Rolls are "similar to firm or standby commitment agreements" (e.g., TBAs) and, as a result, "may fall within the 'any similar instrument' definitional language" to a derivatives transaction,[36] the Proposing Release also suggests that these transactions may be "similar to" Reverse Repos.[37] We believe that the SEC should provide a single characterization for a TBA Dollar Roll, which characterization would apply in all facts and circumstances. In our view, this characterization should treat these transactions as "similar to derivatives" for purposes of Section 18 and rule 18f-4 under the 1940 Act.

In other contexts, such as under FINRA Rule 4210 regarding margin, TBAs are described as securities and not "derivatives." In recognition of the terminology used in those other contexts, we support the SEC's treatment of the transactions as "similar instruments" rather than derivatives *per se*. This treatment and terminology appears to be consistent with the treatment of TBAs and TBA Dollar Rolls for purposes of the UCITS rules, in connection with which traditional TBAs and TBA Dollar Rolls, appear to constitute "financial instruments similar to derivatives."[38]

We would also recommend that the SEC refer to these transactions as TBAs or TBA Dollar Rolls and not as "firm commitment agreements" or "standby commitment agreements." In our view, those terms are confusing, are not commonly used by Funds and could be confused with the

---

35 *Id*. at 4456.

36 *Id.* at 4457.

37 *See, e.g., id.* at 4455 (asking whether Money Market Funds "engage in reverse repurchase agreement, 'to be announced' dollar rolls, or 'when issued' transactions" and thereby inferring that these transactions are similar).

38 *See* FCA treatment of "forwards" (defined to include FX forwards and rate forwards) as similar to derivatives in https://www.handbook.fca.org.uk/handbook/COLL/5/3.html.

terms “unfunded commitment agreements” or “financial commitment transactions,” neither of which is intended to refer to TBAs or TBA Dollar Rolls.

- <u>Exclude from the definition of Derivatives Exposure Off-Setting Transactions with the same Counterparty</u>.

For the sake of clarity, the SEC should make clear in the adopting release that derivatives exposure may be eliminated through entry of off-setting transactions with the same counterparty. In our experience, the SEC staff from time to time has expressed different views regarding which type of off-sets would be recognized as eliminating a Fund’s exposure. For this reason, we recommend that the SEC provide guidance in connection with adoption of the Proposed Derivatives Rule confirming that, once a derivatives transaction has been off-set, either through an equal and off-setting forward, futures contract, swap or option or through a spot transaction, so long as the off-setting transaction is entered into by the Fund with the same counterparty as the original transaction (which would be the clearinghouse in the case of cleared derivatives), the position would be eliminated for purposes of calculating a Fund’s Derivatives Exposure.

- <u>Exclude from the definition of Derivatives Exposure off-setting transactions required to book monthly rolls of over-the-counter currency forwards and Agency MBS forwards</u>.

If a Fund wishes to “roll” or “continue” an existing currency forward contract or an Agency MBS forward contract, it must enter into two additional transactions, each having the same notional amount as the existing transactions. First, the Fund must enter into an off-setting forward contract to off-set the existing forward. Second, the Fund must enter into a new forward for the next month. The new forward contract and the off-setting contract will each settle on a standard settlement period, i.e., generally two (2) business days. Because the off-setting trade and the net forward contract will be held by the Fund for the two (2) business days between trade date and settlement date, the derivatives exposure of the Fund will be artificially high during that time period. As an economic matter, however, the Fund would not have any delivery obligation due to the off-setting transactions to the extent that it enters into the off-setting forward with the same counterparty as it entered into the original forward transaction under a master netting agreement. As a result, we do not believe that the derivatives exposure calculated for purposes of determining whether a Fund qualifies as a Limited Derivatives User should include the two off-setting transactions. Instead, in this situation, we believe that a Fund’s derivatives exposure should only count the new replacement transaction entered into by a Fund rolling a currency forward or an Agency MBS forward contract at month end.

- <u>Exclude Purchased Options, Purchased Swaptions and Structured Notes from the Definition of Derivatives Exposure</u>.

The Proposed Rule distinguishes between the term “derivatives transactions,” which refers to transactions that are subject to the VaR tests and the requirement that a Fund establish a risk management program, and “derivatives instruments,” which refers to instruments that are included in the definition of “derivatives exposure.” *Derivatives transactions* are derivatives instruments under which a Fund has or may have future payment or delivery obligations whereas a *derivatives instrument* is defined simply as a “swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing or any similar instrument."[39] The definition of derivatives instrument appears to include purchased options as well as structured notes (i.e., as a "similar instrument"). As the SEC notes in the Proposing Release, its regulation of derivatives is intended to address "derivative transactions," which involve a future payment obligation and not fully-paid instruments.[40] This purpose would not appear to include "derivative instruments," for which a Fund has fully paid. In light of the fact that purchased options, structured notes and similar instruments do not involve a future payment or delivery obligation, we request that the SEC exclude these instruments from the definition of "Derivatives Exposure," used to determine eligibility for the Limited Derivatives User exception and which are reportable on Form N-PORT.

- <u>In addition to Currency Swaps, Also Exclude Cleared Credit and Rate Hedges from the Definition of Derivatives Exposure</u>.

We agree that currency hedges tied to specific portfolio investments do not raise the policy concerns of undue speculation and excessive leverage that underlie Section 18 of the 1940 Act. In our view, however, the same policy arguments would support recognition of "true" credit and interest rate hedges. As a result, we recommend treating these transaction in the same manner as currency forwards and allowing Funds to exclude them when calculating Derivatives Exposure. In order to mitigate risk, we recommend that the exception apply only to cleared credit and interest rate hedges.

Credit default swaps ("**CDS**") that purchase credit protection with respect to portfolio holdings should be deemed to have the same characteristics as currency forwards since they relate to a particular issuer and specifically hedge portfolio risk. By requiring that the transactions be cleared, the SEC would mitigate any associated credit risk.

Similarly, as the SEC notes in the Proposing Release, certain interest rate derivatives correspond directly to specific cash instruments.[41] For example, a Fund may enter into a fixed-to-floating interest rate swap to convert a floating rate asset to a fixed rate cash flow. In respect to such a transaction, because the notional amount, the maturity, the applicable currency as well as any amortization schedule would be sized to match the face amount and payoff schedule of a portfolio instrument, it would be easy to identify the transaction as a hedge. These transactions present the same justifications as currency hedges do to be eliminated from the calculation of a Fund's Derivatives Exposure. Hedging transactions do not give rise to leverage since they are fully "covered" by the related portfolio instrument. In addition, they are expressly identifiable and they are expressly risk-reducing since they are linked to a portfolio instrument. By requiring these transactions to be cleared, the SEC would mitigate associated credit and settlement risks.

---

39 *See* 18f-4(a).

40 Proposing Release at 4451 ("As was the case for trading practices that Release 10666 describes, where the fund has entered into a derivatives transaction and has such a future payment obligation, we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18.")

41 Proposing Release at 4488-89.

Although other interest rate hedges may be less immediately identifiable as direct hedges of portfolio instruments, Funds engage in a wide variety of interest rate derivatives in order to mitigate risk in connection with portfolios. Fixed income Funds in particular rely on interest rate derivatives to manage duration, which is a measure of the sensitivity of the value of a fixed income instrument (or portfolio thereof) to changes in interest rates. Interest rate derivatives are able to alter this sensitivity to protect investors in fixed income vehicles against the price-depressing effects of interest rates. For example, if a portfolio has a duration of five (meaning that for every one percent (1%) increase in interest rates the value of the portfolio will decline by five percent (5%)), interest rate derivatives could be used to reduce that sensitivity to a lower rate (for example, two percent (2%) or three percent (3%)). Requiring Funds that engage only in duration management and/or matched-notional interest rate hedging using cleared derivatives would be contrary to the SEC's concerns that the compliance burdens of such trading could be disproportionate to the risk management and other benefits of these highly regulated and extremely liquid transactions. If the SEC is concerned about potential abuses of any flexibility such an approach would offer, we would suggest that Funds be required to implement specific hedging policies and procedures specifying duration management goals and parameters.

B. Proposed Modifications to the Risk Management Program

- <u>Allow a Fund's Investment Manager to Serve as Derivatives Risk Manager and Allow Qualified Employees of the Investment Manager (and Not Simply Officers) to Serve Individually or as Part of a Committee comprising the Derivatives Risk Manager role</u>.

We recommend that the Proposed Derivatives Rule be revised to allow any of the following entities and individuals to serve as derivatives risk manager: (i) a Fund's investment manager as an entity; (ii) employees of the investment adviser who are not officers; and (iii) a committee of individuals comprised entirely of employees of the investment adviser or a combination of both employees and officers. Consistent with the Liquidity Risk Management Rule, the investment manager for a Fund should be allowed to serve as the Fund's derivatives risk manager so long as the responsibilities are carried out by personnel that are not primarily portfolio managers.[42] In addition, qualified employees who are not "officers" should be allowed to serve in the derivatives risk manager role or on a committee that serves as derivatives risk manager. We support the SEC's general requirements that: (i) an individual risk manager not be a portfolio manager of the Fund; (ii) if multiple individuals serve as the derivatives risk manager, there not be a majority composed of portfolio managers; and (iii) the entity or individuals selected to serve as the derivatives risk manager have relevant experience regarding management of derivatives risk.[43] Consistent with those requirements, if an investment management entity were to act as

[42] In that regard, we note that rule 22e-4, like the Proposed Derivatives Rule, limits the extent to which portfolio managers for the subject Fund, may act as risk manager. We believe that the SEC could address the potential conflict of interest relating to inclusion of portfolio managers in risk management in the Proposed Derivatives Rule in the same way the SEC addressed it in rule 22e-4, i.e., by providing that the individuals involved in the activity may not be primarily portfolio managers.

[43] We would recommend that SEC consider reflecting its requirements of separation between the derivatives risk manager role and the portfolio management area more generically. We are concerned that the specificity of the

the derivatives risk manager, the employees within the entity acting in that capacity should include only a minority of portfolio management personnel.

- Special Provisions for Sub-Advised Funds and Funds of Funds.

As was the case with implementation of the Liquidity Risk Management Rule, we anticipate that the Proposed Derivatives Rule will create unique challenges in the case of sub-advisory relationships – in particular, multi-strategy Funds – and Funds of Funds (i.e., a registered Fund that invests in other registered Funds). Based on our experience with implementation of the Liquidity Risk Management Rule, we recommend that the SEC add additional clarity around the fact that a Fund's derivatives risk manager may delegate a variety of derivatives risk management functions to the sub-adviser or officers or employees of the sub-adviser, including the establishment of risk guidelines, stress testing and VaR backtesting.[44] In addition, the Proposed Derivatives Rule should make clear that a Fund's derivatives risk manager may delegate the responsibility to escalate material risks arising from Fund's derivative transactions to portfolio management of the Fund.

With respect to multi-strategy funds having separate, identifiable sleeves managed by a sub-adviser that is not affiliated with the Fund's investment adviser, and in respect to Funds of Funds, we request that Funds be permitted to apply the VaR limits at the sleeve or underlying Fund level. We do not believe that the aggregation of VaRs across sleeves of a Fund that are managed by independent sub-advisers in compliance with the applicable Relative VaR Test or the Absolute VaR Test will create materially greater derivatives risks than would applicable to use of a VaR test at the Fund level.

- Allow Testing Periods (Other than with Respect to Testing Compliance with VaR Limits) to be Defined by the Funds Provided that They are Carried Out No Less Frequently than Monthly.

We recommend that the SEC modify the Proposed Derivatives Rule to provide flexibility to Funds to establish their own testing schedules and frequencies. While we agree that testing for compliance with portfolio limits should be carried out each business day at the same time, we do not agree that daily backtesting or weekly stress testing is necessary for all Funds. As a result, we would recommend that the Proposed Derivatives Rule be revised to allow Funds to establish their own testing schedules provided that testing be required to be conducted no less frequently than once a month.

requirements could hamstring smaller and mid-sized investment managers in particular whose key personnel often carry out multiple responsibilities.

[44] We note that under the Proposed Derivatives Rule, a sub-adviser or personnel of a sub-adviser may serve as the derivatives risk manager for a Fund. *See, e.g.*, Proposing Release at 4458. In our view, allowing a manager and sub-adviser to share these responsibilities would be consistent with the existing proposal. However, in order to provide more clarity, it would be helpful if the SEC were to provide additional guidance.

- Confirm that the Responsibility of the Fund Board is that of Oversight Only, Consistent with the Rule of the Fund Board Under Rules 22e-4 and 38a-1 under the 1940 Act.

In the Proposing Release, the SEC notes that the Fund Board would be responsible for overseeing the Risk Management Program. As part of that responsibility and consistent with rule 22e-4 with respect to the administrator of the Fund's liquidity risk program and with rule 38a-1 with respect to approval of the Fund's chief compliance officer, the Fund Board would be responsible for approving the Derivatives Risk Manager. We are concerned, however, that language in the Proposing Release regarding the role of the Fund Board could be read to require the Fund Board to play a role that goes beyond the ordinary role of the Fund Board. For example, in the Proposing Release the SEC states: "…directors should understand the program and the derivatives risk it is designed to manage as well as participate in determining who should administer the program. They should also ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation."[45] We request that the SEC confirm that the Fund Board's role would be consistent under the Proposed Derivatives Rule and rule 22e-4 and rule 38a-1 and that the Fund Board's oversight of the program would be subject to the same standards as that of a Fund's overall compliance program.

C. Proposed Changes to Internal and External Reporting Requirements

- Require Board Reporting Only for Material Exceedances and Matters.

Section (c)(5)(iii) of the Proposed Derivatives Rule requires the derivatives risk manager to provide to the Fund Board, at such frequency as the Fund Board determines, a written report regarding "any exceedances" relating to the Fund's risk guidelines, as well as all results of stress testing and backtesting since the last report. While we believe that it is appropriate for a Fund Board to ask to hear about "exceedances" and understand testing results, we do not believe that it is appropriate for such reporting to be required unless the exceedances are material and unremediated promptly (e.g., within five (5) business days) and unless the results from such testing show material weaknesses. Fund Boards have a number of both routine and non-routine material matters to consider at each quarterly, in-person meeting, and to co-op even one quarterly meeting in order to provide for a full presentation of test results relating to the derivatives risk management program (particularly when the results do not demonstrate any material failures or risks to the underlying Fund) could undermine the ability of Fund Boards to focus and address issues that are significantly more pressing and material for the Fund. In lieu of the proposed requirement, we would recommend that Section (c)(5)(iii) of the Proposed Derivatives Rule be deleted and that an overview of derivatives risk program test results be covered instead in the annual report described in Proposed Derivatives Rule 18f-4(c)(5)(ii) and materially adverse findings be required to be escalated in a timely manner as required by Proposed Derivatives Rule 18f-4(c)(1)(v). We also believe that the Proposed Derivatives Rule should not include the level of specificity it does regarding reporting and escalation in order to allow investment advisers and Fund Boards to tailor their own programs to the size, sophistication and needs of the particular investment adviser, Funds and Fund Boards.

[45] Proposing Release at 4466.

- Limit Public Reporting to Disclosure of a Fund's Derivatives Exposure and Designated Reference Index and Include Daily VaR Information Only in SEC Filings.

While we agree that it is appropriate to require Funds to report publicly the name of their designated reference index used for the Relative VaR Test, we do not believe that it is useful to investors to require Funds to report publicly on Form N-PORT, as the Proposed Rules would require, the following information: (i) the Fund's highest daily VaR during the reporting period and its corresponding date; (ii) the Fund's median daily VaR for the monthly reporting period; and (iii) the Fund's highest daily VaR ratio during the reporting period and its corresponding date. In our view, specific risk management information, such as VaR levels may be appropriate for review by the SEC but would almost certainly be confusing to shareholders. Similarly, we are concerned that disclosure of a Fund's aggregate derivatives exposure could be misleading unless the Fund also explains which positions are risk-reducing. As a result, we recommend that the SEC amend the proposed new Form N-PORT requirements to exclude the VaR-related information outlined above and either eliminate the requirement that Funds report on the daily VaR information outlined above or include the information as a line item on a filing that is provided to the SEC but not to the public at large. We also recommend that the SEC either eliminate the requirements that a Fund disclose its aggregate derivatives exposure or include additional disclosure in connection with the public disclosure regarding hedge positions.

D. Limited Derivatives User Exception

- Grant Flexibility to Funds to Measure Continued Compliance with the Exception Within a Time Period Determined by the Fund Board, Not to be Less Frequent than Once Per Calendar Month.

We recommend that the SEC provide guidance regarding the policies that Funds should adopt and Fund Boards should approve regarding the frequency with which Funds would be required to test for continued compliance with the Limited Derivatives User exception. In our view, each Fund, with oversight from the Fund Board, should establish policies for testing based on the structure of the particular Fund. In order to avoid an inference of wrongdoing regarding such policies, however, we recommend that the SEC provide guidance regarding a minimum frequency for testing that the SEC and its staff would expect to see. For operational reasons related to the rebalancing times for benchmark indices, we believe that the testing frequency should not be required to be more frequently than monthly. For example, an index-linked, currency-hedged Fund would seek to track the index that embeds the currency forward. If the index were rebalanced monthly (as is the case for many indices), it may be more difficult operationally to test for compliance more frequently. As a result, we request that guidance be provided confirming that a Fund may test for continued compliance with exception at a frequency determined by the Fund, which shall be no less frequent than monthly.

- Provide a Remediation Period for Temporary Exceedances by a Limited Derivatives User of the Parameters under the Exception.

We would expect that a Fund that is a Limited Derivatives User may, from time to time, experience an exceedance of the ten percent (10%) Derivatives Exposure limit included in the

Limited Derivatives User exception. In that regard, we believe that it would be appropriate to have a defined time period within which, if the Fund were to come back into compliance, it would not become ineligible to rely on the exception. By analogy to the five (5) business day exceedance period that we recommend above in connection with compliance with the VaR tests, we recommend setting the remediation period for a Limited Derivatives User to come back into compliance with the exception after an exceedance at five (5) business days.

- Provide a Sixty (60) day Period for a Limited Derivatives User to Transition from Limited Derivatives User Status to Compliance with the VaR Test and Risk Management Program Requirements under the Proposed Derivatives Rule.

The Proposed Derivatives Rule does not provide any time period within which a Fund may transition from a Limited Derivatives User to a full-fledged derivatives user, subject to the Proposed Derivatives Rule. We recommend that the SEC provide such a ramp up period to allow a Fund to fully implement its risk management program. During the ramp up period, the Fund would be required to monitor for compliance with an appropriate VaR test – i.e., either the Relative VaR Test or the Absolute VaR Test – but it would not be required to carry out the comprehensive backtesting and stress testing required by the Proposed Derivatives Rule or adopt and monitor risk guidelines. We believe that a full sixty (60) day period would be required due to the fact that the Fund Board would be required to approve the derivatives risk manager and receive the written report of the derivatives risk manager describing the derivatives risk management program on or before implementation of the program.

E. Proposed Transition Period

- Extend the Transition Period for Funds to Come into Compliance with the Proposed Derivatives Rule to Eighteen (18) Months.

In our view, the proposed implementation period for the Proposed Derivatives Rule of one year is too short. Funds will need at least eighteen (18) months to select the derivatives risk manager, adopt and implement risk guidelines and policies and procedures and put in place the prescribed testing program. We note that eighteen (18) months was the time period adopted for implementation of the Liquidity Risk Management Rule, which we believe presented comparable operational challenges. We respectfully request that the transition period be extended to eighteen (18) months or longer.

F. General Comments on the Proposed Sales Practice Rules

We are concerned that the Proposed Sales Practices Rules represent a departure from the SEC's traditional mandate to oversee a disclosure-based regulatory process. Rather than rely on the premise of clear and comprehensive disclosure to inform investors, the Proposed Sales Practices Rules suggest that the SEC will now seek to impose merit-based restrictions on publicly-traded securities based on its own views (rather than those of investors) regarding the riskiness or suitability of a security.[46]

We are also concerned that the Proposed Sales Practices Rules do not appear to be fully consistent with the statutory provisions under which they are proposed. The provisions were adopted under Sections 15(l) of the Exchange Act and Section 211(h) of the Advisers Act, which are focused on prohibiting and restricting conflicts of interest, compensation schemes and bad sales practices of broker-dealers and investment advisers, respectively, and not on regulation of financial products.[47] Based on a plain reading of the statutory provisions, we do not believe that the Proposed Sales Practices Rules are appropriately tailored for the harms that Congress sought to address by these provisions.

Finally, from a policy perspective, we believe that Proposed Sales Practices Rules could undermine the important role played by investors and the market generally in vetting products by restricting the trading of listed and highly-regulated securities based on the SEC's judgment of the riskiness of the Funds. Investor activity is critical for establishing market pricing and liquidity to facilitate maintenance of orderly markets and to encourage development of innovation. We respectfully ask that the SEC reconsider its Proposed Sales Practices Rules and the potentially harmful precedent we believe that the proposal establishes.

IV. CONCLUSION.

We appreciate the opportunity to comment on the Proposed Rules and to provide input, based on our practical experience. As noted above, our comments primarily reflect the data points we observed during normal market conditions and we continue to collect data, that we would like to share and discuss with the SEC and staff, relating to application of the Proposed Derivatives Rule to Funds during extraordinary market conditions.

In general, we agree with the framework that the SEC has established for the Proposed Derivatives Rule and believe that, with the modifications described in this letter, that rule as well as the other Proposed Rules, modified as we have proposed, should achieve the SEC's goals. We urge the SEC and staff, however, to continue to review the Proposed Derivatives Rule in light of the changes currently unfolding in the market place and evaluate what refinements would be necessary and appropriate to address extraordinary market conditions.

We thank the SEC for considering our views and we hope to have an opportunity to meet with the Commissioners and Staff (in person, by Zoom Conference or by telephone) very soon to discuss our suggestions and the data that we continue to collect. We wish all of you good health.

---

[46] For example, this approach would appear to support other types of sales restrictions on registered Funds, such as a requirement that a Fund investing in risky assets only be sold to persons who are accredited investors. We do not believe that it is appropriate for the SEC to restrict distribution of registered Funds in this manner.

[47] *See, e.g.,* Section 15(l) of the Exchange Act requires the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors. Section 211(h) includes similar language.

Should you have any questions, please feel free to contact Tim Cameron at (202) 962-7447 or tcameron@sifma.org, or Jason Silverstein as (212) 313-1176 or jsilverstein@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

Jason Silverstein, Esq.
Managing Director and Associate General Counsel
SIFMA, Asset Management Group

Cc: The Honorable Jay Clayton, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner

Dalia Blass, Director, Division of Investment Management

ANNEX A

Example #1 – Actively-Managed Fund vs. S&P 500 Index

Assumes an equal weighted portfolio of the following 10 stocks, each of which is in the S&P 500 Index

		3 yr. ending 6/28/19	3 yr. ending 3/11/20
	Filter	Lowest Price to Book	Lowest Price to Book
	As of date	3/11/2020	3/11/20
Stocks	1	LNC	LNC
	2	UNM	UNM
	3	MRO	MRO
	4	PRU	PRU
	5	FANG	FANG
	6	IVZ	IVZ
	7	NBL	NBL
	8	AIG	AIG
	9	M	M
	10	FTI	FTI
	Portfolio Return*	15.09%	59.94%
	S&P 500 Index	48.89%	22.59%
	Portfolio VaR (Hist.)*	15.70%	18.98%
	S&P 500 Index (Hist.) *	8.64%	9.85%
	Unlevered Portfolio - Relative VaR (Historical Method)*	1.82	1.93
	Levered Portfolio - Relative VaR (Historical Method)*	2.73	2.89

* *Negative numbers are reflected in absolute value form.*

Example #2 – Absolute VaR of Eight Indices:

		3 yr. ending 6/28/19		3 yr. ending 3/17/20	
		historical method*	Levered	historical method	Levered
Price Return Indexes	**Index Ticker**	**20-day VaR**	**Portfolio***	**20-day VaR***	**Portfolio***
BONY Mellon China Select	BKTCN Index	14.64%	21.96%	15.64%	23.45%
Dow Jones U.S. Biotechnology Index	DJUSBT Index	13.00%	19.50%	13.96%	20.95%
S&P SmallCap/600 Citigroup Growth Index	SMLG Index	12.27%	18.40%	18.20%	27.30%
S&P MidCap 400/Citigroup Growth Index	MIDG Index	11.53%	17.30%	15.12%	22.67%
S&P Financial Select Sector Index	IXM Index	10.98%	16.47%	22.24%	33.36%
MSCI Japan Index®	MXJP Index	10.51%	15.76%	17.40%	26.10%
MSCI Europe Financials Index	NDRUFNCL Index	10.35%	15.52%	23.57%	35.36%
NASDAQ-100® Index	NDX Index	9.62%	14.43%	12.96%	19.43%
S&P 500® Index	SPX Index	8.76%		14.02%	

* *Negative numbers are reflected in absolute form*