INVESTMENT COMPANY INSTITUTE®

Paul Schott Stevens, PRESIDENT AND CEO

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

202/326-5901 FAX: 202/326-5806
paul.stevens@ici.org

April 20, 2020

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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 Investment Company Institute[1] strongly supports the Securities and Exchange Commission's reproposed rule governing registered investment companies' and business development companies' (together "funds") use of derivatives and similar instruments.[2] Proposed Rule 18f-4, which would place risk-based leverage limits and other requirements on funds that use derivatives in more than a minimal amount, is a vast improvement over the Commission's 2015 proposal on the same topic.[3] We applaud the Commission for thoughtfully considering the comments it received on the prior proposal to develop a more effective approach in this rulemaking.

---

[1] The Investment Company Institute ("ICI") is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$24.1 trillion in the United States, serving more than 100 million US shareholders, and US$7.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[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, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (Jan. 24, 2020) ("Proposing Release"), *available at* www.sec.gov/rules/proposed/2019/34-87607.pdf. In addition to the reproposed rule governing derivatives (Proposed Rule 18f-4), the Proposing Release contains other parts that would impose new reporting requirements designed to assist the Commission in overseeing funds' use of derivatives and enhance public disclosure, and new requirements on the purchase and sale of certain leveraged and inverse investment vehicles.

[3] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80884 (Dec. 28, 2015) ("2015 Proposing Release"), *available at* www.sec.gov/rules/proposed/2015/ic-31933.pdf.

Funds increasingly have turned to derivatives as important and practical portfolio management tools that improve efficiency, enhance liquidity, and reduce costs for their shareholders. Funds appropriately use derivatives to, among other things:

- hedge risk;
- manage interest rate risk and duration;
- enhance liquidity compared to other, more traditional securities;
- gain or reduce exposure, including when access by other instruments is difficult, costly, or practically impossible;
- manage or equitize cash; and
- reduce costs or manage portfolios efficiently.[4]

Maintaining the ability to reasonably employ these important tools benefits funds and, more importantly, their shareholders.

Hand-in-hand with this objective, ICI and its members have a keen interest in ensuring that funds have robust safeguards to protect their shareholders. We fully support the Commission's goal of addressing the investor protection concerns underlying Section 18 of the Investment Company Act of 1940,[5] and the reproposed rule is an effective way to achieve that goal. In particular, the leverage limits coupled with elements of the derivatives risk management program, including required stress testing, will restrict the amount of exposure to economic risk that a fund could take when investing in derivatives. Creating leverage limits that confine economic risk is a far better way to addresses Section 18's "undue speculation" concerns than limits based solely on the aggregate gross notional exposure ("GNE") of a fund's derivatives transactions, as proposed in 2015. The Commission has recognized the severe limitations of GNE as a measure of market exposure, and we strongly support the Commission's proposed move away from limits based on that blunt measurement.

The leverage limits and derivatives risk management program also would meet Section 18's other goal—assuring that a fund has sufficient assets to meet its obligations. For example, the requirements that a fund implement a program reasonably designed to manage its derivatives risk and conduct stress testing that must consider a fund's resulting payments to derivatives counterparties will make funds responsible for considering their obligations in different market environments and retaining sufficient assets to meet their obligations.

---

[4] *See*, *e.g.*, Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated March 28, 2016 ("March 2016 ICI Letter"), *available at* www.sec.gov/comments/s7-24-15/s72415-114.pdf.

[5] Specifically, as described in the Proposing Release, the Commission seeks to address two investor protection concerns that are set forth in Sections 1(b)(7) and 1(b)(8) of the Investment Company Act and are implicit in Section 18—*i.e.*, that funds: 1) "by excessive borrowing and the issuance of excessive amounts of senior securities [may] increase unduly the speculative character of securities issued to common shareholders" and 2) may "operate without adequate assets or reserves." *See*, *e.g.*, Proposing Release at 4451.

Finally, we commend the Commission for taking steps to modernize the current regulatory framework regarding funds' derivatives use, the foundation of which it has left untouched for more than 40 years. Combining into one rule the various forms of relief issued to funds to permit them to invest in derivatives and similar instruments will eliminate the patchwork of regulation and guidance that currently governs fund investments in those instruments. A single rule will create a clear framework that will address the differing interpretations and practices that have developed in this area.

We therefore wholly support the general framework of Proposed Rule 18f-4. We have several recommendations to enhance that part of the rulemaking, as well as to the proposed new reporting requirements and the proposed new sales practices requirements for leveraged and inverse investment products. Our recommendations are intended to, among other things, make certain elements more effective, add clarity, and mitigate the risk of market disruption.

- **Section I** is an executive summary of our comments.
- **Section II** describes our recommendations on the reproposed derivatives rule—Proposed Rule 18f-4. This section is divided into subsections covering: A) the scope of the rule; B) the leverage limits; C) the derivatives risk management program; D) the limited derivatives user exceptions; E) reverse repurchase agreements and similar financing transactions; and F) unfunded commitment agreements.
- **Section III** describes our recommendations on the proposed public reporting requirements.
- **Section IV** contains our comments on the proposed new sales practices requirements.
- **Section V** covers our recommendation on the compliance period.

I. Executive Summary

ICI broadly supports the Commission's rulemaking. Below we summarize our key recommendations to Proposed Rule 18f-4, the public reporting requirements, the new sales practices requirements, and the compliance period.

A. Proposed Rule 18f-4

- **Scope of the rule**. The Commission's proposed treatment of firm and standby commitment agreements (and similar instruments) as "derivatives transactions" could cause funds investing solely or primarily in those instruments to unnecessarily implement derivatives risk management programs and leverage limits. Many firm and standby commitment agreements neither have the purpose nor the effect of leverage. Accordingly, we recommend that the Commission clarify that the definitions of *derivatives transaction* and *senior security* exclude certain firm or standby commitment agreements (or similar instruments) that have a forward-settlement feature beyond regular-way settlement. To be excluded, these agreements must have a relatively short settlement period and create a fixed and known obligation for a fund on the trade date. The Commission also should clarify that commitments whose yields are determined on the date of delivery with reference to prevailing market interest rates, which do not create the potential for leverage, are excluded from the definitions.

We agree that firm and standby commitment agreements (and similar instruments) other than those addressed above appear to meet the derivatives transaction definition. We recommend that funds treat them as derivatives transactions under the rule or be permitted to except those agreements from being treated as derivatives transactions so long as the instruments are fully covered by "highly liquid investments" or "moderately liquid investments" under a modified asset segregation regime. These instruments generally create obligations that are fixed and known at the time that a fund enters into the relevant transaction, and the asset segregation regime would address effectively the Commission's concerns about undue speculation and asset sufficiency.

We agree with the Commission's determination that Rule 18f-4 should not extend to money market funds. The Commission, however, should permit money market funds to continue to invest in firm and standby commitment agreements, as those funds already are subject to the requirements and strong investor protections of Rule 2a-7 under the Investment Company Act.

- **Leverage limits.** We support leverage limits based on value at risk ("VaR"). Compared to GNE-based measures, VaR better reflects how funds use derivatives by factoring in offsetting and hedging transactions that otherwise could overstate artificially the impact that derivatives have on a fund. Asset managers widely use VaR as a derivatives risk management tool and have familiarity with adhering to VaR-based limits, including in jurisdictions other than the United States.[6]

  We recommend modifying the proposed relative VaR test that requires that a "designated reference index" reflect the markets or asset classes in which the fund invests to one that requires the index to reflect the fund's investment strategies. Using an investment strategies standard rather than only assets or markets is a superior approach for managing and limiting risk. Such an approach incorporates not only the "what" but the "how"—for example, whether a fund has a strategy tied to an index or has more latitude in how it meets its investment objective. This approach is better aligned with an investor's expectation that a fund will have volatility and risk similar to its designated reference index (which may differ from the volatility and risk profile of the broad-based market index required in the fund prospectus performance table). The standard also is consistent with the well-tested requirements under the Undertakings for Collective Investments in Transferable Securities ("UCITS") Directive in the European Union.

  We strongly recommend increasing the proposed leverage limits to a 200 percent relative VaR limit and a 20 percent absolute VaR limit. The basis for the proposed 150 percent relative VaR limit and 15 percent absolute VaR limit—an analogy to the borrowing limits of Section 18 of

---

[6] *See* Letter from Paul Schott Stevens, President and CEO, ICI, to Dalia Blass, Director, Division of Investment Management, SEC, dated Oct. 8, 2019 ("October 2019 ICI Letter") at 3–4, *available at* www.sec.gov/comments/s7-24-15/s72415-6270349-193190.pdf (noting that 73 percent of respondents to an ICI survey use both some form of VaR testing and some form of stress testing as derivatives risk management tools).

the Investment Company Act—is imprecise and, accordingly, inappropriate. A Section 18 approach isolates and limits the leverage solely attributable to borrowings, while the proposed VaR-based limits do not isolate the leverage solely attributable to derivatives and thus should be modified.

The Commission also has largely underestimated the impact that the proposed VaR-based leverage limits would have on existing funds. Using year-end 2018 data, it estimated that only 0.04 percent of funds that would be subject to the proposed rule would fail the proposed VaR tests—six funds failed the proposed relative VaR test and, of those, only one fund failed the proposed absolute VaR test. We gathered information from a survey of our members that included not only year-end 2019 VaR results but data throughout 2019 and during stressed periods.[7] Our data indicate that the incidences of failure are much higher than the Commission estimated. Based on data for all of 2019, 6.7 percent of respondents (51 funds with $155 billion in assets) would have failed their relevant proposed VaR test over the course of the year. [8] This percentage jumps to 9.3 percent of respondents (50 funds with approximately $52 billion in assets) that would have failed their relevant proposed VaR test during a stressed period.[9] The higher failure rate during stressed periods is concentrated in funds that use absolute VaR—26.4 percent of respondents that use absolute VaR exceeded the proposed 15 percent limit. More recently, during March 2020 in the midst of the COVID-19 crisis, 15.7 percent of respondents in a smaller sample would have exceeded their relevant proposed VaR limit.[10] Unless the Commission modifies its proposal, these funds would each need to deregister as registered investment companies or substantially alter their investment strategies.[11]

Another consequence of the proposal is that during calmer periods for at least three years following a stressed period, funds, particularly those that use absolute VaR, will be constrained, potentially significantly, in their derivatives use. For example, the inclusion of the COVID-19 crisis period in the minimum three-year required historical lookback will increase a fund's VaR

---

[7] For detailed results of our survey, see *infra* Section II.B.2. In completing the survey, respondents used parameters that were as close as possible to those proposed—three-year historical information, 20-day time horizon, and 99 percent confidence interval. For funds that did not qualify as limited derivatives users under the proposed rule and indicated that they had a designated reference index, we compared the fund's relative VaR result to the proposed 150 percent relative VaR limit. For funds that did not qualify as limited derivatives users under the proposed rule and indicated that they did not have a designated reference index, we compared the fund's absolute VaR result to the proposed 15 percent absolute VaR limit.

[8] Because of the data intensive nature of the request, only 59 percent of respondents (762 funds with $1.4 trillion in assets) were able to compute VaR data over the course of 2019 within the requested time frame.

[9] Because of the data intensive nature of the request, only 42 percent of respondents (538 funds with $794 billion in assets) were able to provide VaR data for a stressed period within the requested time frame.

[10] The smaller sample included information from 318 funds with $310 billion in assets. It is important to note that, during this period, fund VaRs, even from funds that did not have derivatives positions, also rose rapidly because of extreme swings in underlying security prices.

[11] We also note that the Commission's analysis did not consider portfolio management practices that set internal thresholds that are more restrictive than the regulatory limits to mitigate the risk of breach.

estimates going forward. To stay below the proposed VaR limits over the next three years, some funds will need to significantly curtail their derivatives use.

Increasing the proposed leverage limits to a 200 percent relative VaR limit and a 20 percent absolute VaR limit would address the Commission's concerns about undue speculation while more appropriately tailoring the limits for VaR (compared to a bank borrowing under Section 18). These limits should be further increased for closed-end funds to reflect the additional leverage those funds could attain through their preferred stock issuance. The increase of the VaR limits would reduce the number of funds that would have to deregister or change their investment strategies. It also would align with fund leverage restrictions in other jurisdictions familiar to investment managers, investors, and others (*e.g.*, those applicable to UCITS in the European Union).

- **Program requirements.** The Commission should adopt the derivatives risk management program requirements with adjustments. In particular, the Commission should clarify certain statements made in the Proposing Release indicating that fund directors should engage more actively in the day-to-day management of the fund's derivatives risk management program. Directors typically provide general oversight with respect to a fund's derivatives use, and the Commission should affirm that it expects directors to continue in this traditional oversight role. The Commission also should expand the entities eligible to serve as derivatives risk manager to include a fund's investment adviser and eliminate the requirement that the board consider the manager's relevant experience regarding the management of derivatives risk. Permitting the fund's investment adviser to serve as derivatives risk manager is consistent with the Commission's approach to the fund liquidity rule and would enable the investment adviser to appropriately designate employees to staff the program's administration functions. Eliminating the "relevant experience" requirement also would be consistent with the Commission's approach to the fund liquidity rule and would alleviate concerns about what "relevant experience" means in the derivatives risk management context.

- **Limited derivatives user exceptions.** In determining whether a fund must implement a derivatives risk management program and adhere to leverage limits, the Commission should combine the "currency hedging exception" with the "exposure-based exception." Doing so would enable funds to exclude the hedging and offsetting transactions permitted in the currency hedging exception from the exposure-based exception calculation. The Commission notes that such transactions do not raise the policy concerns underlying Section 18, so the Commission should exclude those transactions when determining whether a fund should be subject to additional derivatives restrictions. In addition, the Commission should expand the currency hedging exception to exclude additional hedging and offsetting transactions that, like the currency hedging transactions, do not raise the policy concerns underlying Section 18 (*e.g.*, written call options on securities held by the fund).

- **Reverse repurchase agreements and similar financing transactions.** We agree with the Commission's proposed approach to treat reverse repurchase agreements and similar financing transactions as fund borrowings and indebtedness subject to statutory asset coverage requirements. In addition, the Commission should permit funds that engage in those transactions to have the option to comply with the statutory asset coverage requirements or to cover the obligations from those transactions under a modified asset segregation regime. The Commission has permitted funds to fully cover these transactions with known payment obligations using liquid assets for decades without issue.

B. Public Reporting Requirements

We agree with the Commission's proposed reporting requirements. The Commission, however, should not require public disclosure of derivatives exposures and information related to a fund's VaR calculation model, because such information may be misleading and is neither necessary nor appropriate in the public interest. In addition, it could reveal sensitive proprietary information about a fund's risk management model.

C. Sales Practices Requirements

Subjecting certain registered investment companies to different sales practices requirements than any other registered investment company is a novel and untested regulatory approach. Such an approach must be strongly justified with a demonstrated purpose and need, as registered funds already are subject to a robust regulatory regime under the federal securities laws.

D. Compliance Dates

We urge a transition period of at least 24 months before rescinding the Commission and the staff's existing guidance. A 24-month period is necessary to make wholesale changes to the way funds invest in, administer, account for, and treat derivatives and the other instruments covered in the rulemaking.

II. Proposed Rule 18f-4

A. Scope of Proposed Rule 18f-4

We make several recommendations regarding the scope of the proposed rule to address implications from the Commission's determination that firm and standby commitment transactions (and similar instruments) are or may be derivatives transactions. Proposed Rule 18f-4 under the Investment Company Act defines a *derivatives transaction* to include "[a]ny swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, *or any similar instrument...* under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination...."[12] The Proposing Release explains that this definition covers the types of derivatives that funds currently use and that would be restricted under the

[12] *See* Proposed Rule 18f-4(a) (defining *derivatives transaction*).

requirements of Section 18 of the Investment Company Act.[13] While the definition does not explicitly include "firm commitment agreements" and "standby commitment agreements," the Proposing Release explains that the phrase "any similar instrument" includes those types of agreements.[14] This would be a new position, as the Commission historically has not treated firm and standby commitment agreements as derivatives transactions.[15] The Proposing Release also explains that, to the extent that a fund engages in transactions *similar* to firm or standby commitment agreements, they *may* fall within the scope of "any similar instrument," *depending on the facts and circumstances*[16] (emphasis added).

We do not disagree with the Commission's proposed position. The implications of the position, however, could create additional concerns for funds, including money market funds, that invest in securities that could be deemed to be firm or standby commitment agreements (or similar instruments). For example, under the proposal, funds that hold greater than 10 percent of their assets in firm and standby commitment agreements would be required to have a derivatives risk management program and adhere to the leverage limits. Also, if as proposed, money market funds could not rely on Proposed Rule 18f-4 or current Commission or Commission staff positions, they no longer would be able to invest in firm and standby commitment agreements because they would not have relief necessary to invest in those senior securities.

We provide several recommendations to address these concerns. First, we recommend that the Commission exclude certain firm and standby commitment agreements (and similar instruments) from Proposed Rule 18f-4's derivatives transaction definition. These agreements historically have not been treated as senior securities. Second, we recommend that the Commission permit funds the option to treat firm and standby commitment agreements (and similar instruments) as derivatives transactions under the rule or to *not* treat them as such if they segregate assets to cover their obligations under a modified asset segregation approach. Finally, we recommend that the Commission permit money market funds to continue to invest in these instruments subject to the strict requirements of Rule 2a-7 under the Investment Company Act.

---

[13] *See* Proposing Release at 4456. Section 18 generally restricts funds from issuing "senior securities." Section 18(g) defines a *senior security* as 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. *See* Section 18(g) of the Investment Company Act.

[14] *See* Proposing Release at 4456 (explaining that a "firm commitment agreement has the same economic characteristics as a forward contract," and that "a standby commitment agreement has the same economic characteristics as an option contract....").

[15] *See*, *e.g.*, Item C.11 of Form N-PORT (setting forth a list of derivatives transactions that funds must report as part of their portfolio holdings disclosures that does not include firm or standby commitment agreements).

[16] *See* Proposing Release at 4457.

1. Exclude Certain Firm and Standby Commitment Agreements (and Similar Instruments) from the Derivatives Transaction Definition

We recommend that the Commission exclude certain types of firm and standby commitment agreements (and similar instruments) from the derivatives transaction definition consistent with prior positions. The Commission issued a release ("Release 10666") in 1979 that considered the application of Section 18 of the Investment Company Act to, among other transactions, firm and standby commitment agreements, and took the position that these types of transactions fall within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18."[17] The Commission also concluded that certain types of transactions that neither have the purpose nor the effect of leverage are not senior securities subject to Section 18. For example, the Commission acknowledged that the purchase of equity securities often contemplates "a delay of a few days between the purchase of the security, and clearance of settlement," and that these transactions are not subject to Section 18.[18] The Commission also acknowledged that transactions whose yields are determined on the date of delivery with reference to prevailing market interest rates do not have the potential for leverage and are not subject to Section 18, because they do not present an opportunity for a fund to realize gains and losses between the purchase date and settlement date.[19] This approach, and its basis and rationale, has been followed for more than 40 years.

Similar to the rationale and its position in Release 10666, we urge the Commission to clarify that a delayed-delivery or "when-issued" security—or any other security that has a forward-settlement feature beyond regular-way settlement—is excluded from the definition of derivatives transaction. Also, this type of security would not be classified as a senior security, if the security has a relatively short settlement period and creates a fixed and known obligation for a fund to make a payment or delivery of cash or other assets on the trade date. These securities neither have the purpose nor the effect of leverage, and are substantially identical to securities that have standard settlement periods.

One example of securities that would fall within this exclusion is when-issued US Treasury securities.[20] Although US Treasury securities purchased in the secondary market typically settle on the business day

---

[17] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 27, 1979) at 251131.

[18] *See* Release 10666 at 25130 ("The Commission recognizes that, for example, in the ordinary purchase of equity securities there is often a delay of a few days between the purchase of the security, and clearance and settlement. This general statement of policy respecting Section 18 of the [Investment Company] Act is not intended to address arrangements involving the purchase of equity securities where the delay in delivery involves, for example, only the brief period usually required by the selling party and its agent solely to locate appropriate stock certificates and prepare them for submission for clearance and settlement in the customary way.").

[19] *See* Release 10666 at 25130 ("Commitments to purchase securities whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in this general statement of policy. Such commitments neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage.").

[20] The Proposing Release suggests that when-issued securities are derivatives transactions, without regard to their actual trading characteristics or their potential to create leverage. *See* Proposing Release at 4455 ("Do money market funds currently engage in any

after the trade date (*i.e.,* T+1), US Treasury securities also may be purchased on a when-issued basis immediately following the announcement of a US Treasury auction but before the actual auction. These when-issued US Treasury securities typically settle on the third business day after the auction date (*i.e.,* T+3).[21] Moreover, all of the material terms of US Treasury securities purchased on a when-issued basis are known on the trade date (*e.g.,* price, yield, maturity, issuer, CUSIP).

There is no justification for treating when-issued US Treasury securities—or any similar security—like "traditional" derivatives instruments. These securities have relatively short settlement periods and create a fixed and known obligation on the trade date. They neither have the purpose nor the effect of leverage nor implicate the concerns that Section 18 was designed to address or that the Commission is proposing to address and mitigate through this rule.

There are significant benefits to purchasing US Treasury securities on a when-issued basis (rather than at the auctions or in the secondary market), including the potential to secure better pricing and supply. These securities are important to funds and their investors and should not be adversely affected by the rule. Moreover, when-issued trading in US Treasury securities serves as an important price discovery mechanism for US Treasury auctions, and the Commission should exercise extreme caution when implementing changes that could affect this market.

In addition, consistent with Release 10666, the Commission should clarify that commitments whose yields are determined on the date of delivery with reference to prevailing market interest rates do not create the potential for leverage and are not within the definition of derivatives transaction or senior security. These transactions do not raise the undue speculation concerns contemplated under Section 18 because they do not present the opportunity to realize gains or losses between the date of the fund's purchase and the subsequent delivery of the security on the settlement date.

Without further clarification of the types of transactions that could be included within the scope of "any similar instrument" in the derivatives transaction definition, the proposed rule may limit unnecessarily fund investments to the detriment of investors. Moreover, disparate practices likely will develop.

---

transactions that might qualify as derivatives transactions under the rule or any of the other transactions permitted by the rule? For example, do money market funds engage in reverse repurchase agreements, 'to be announced' dollar rolls, or 'when issued' transactions?").

[21] For example, the US Treasury announces auctions for three- and six-month US Treasury bills on Thursdays, and the auctions for these securities are held on the following Mondays (*i.e.,* two business days after the announcement date). US Treasury bills purchased at the auction—as well as US Treasury bills purchased on a when-issued basis before the auction —settle on the following Thursday (*i.e.,* three business days after the auction date). Therefore, if a fund purchases a US Treasury bill on a when-issued basis, the *maximum* settlement period is seven calendar days, although funds typically settle these securities within T+4/T+5.

2. Permit Funds the Option to Treat Firm or Standby Commitment Agreements (and Similar Instruments) as Derivatives Transactions or to Except Them Under a Modified Asset Segregation Regime

We recommend that funds have an alternative asset segregation option to the proposed approach under the rule. Proposed Rule 18f-4 would treat firm or standby commitment agreements and transactions similar to those agreements as derivatives transactions, depending on the facts and circumstances. Each of these were addressed in Release 10666 (collectively, "10666 Instruments")—including to-be-announced securities ("TBAs"), when-issued securities (other than those addressed above), dollar rolls, and bond forwards. Under the proposal, a fund investing in 10666 Instruments would need to comply with the conditions of the limited derivatives user exceptions, or comply with the derivatives risk management program and the VaR-based limits under the proposed rule.

We agree that these instruments (other than those addressed above) appear to be derivatives transactions and funds generally should treat them as derivatives transactions under the rule. Funds, however, also should have the option of excepting them from being treated as derivatives transactions under a modified asset segregation regime.

We believe that funds have appropriately managed, and would continue to appropriately manage, the risks associated with 10666 Instruments under the Commission's current framework in Release 10666, with certain modifications. While we are mindful of the Commission's goal of eliminating the asset segregation regime, the Commission previously stated that these types of transactions—each of which were included under the 2015 Commission rulemaking definition of *financial commitment transactions*—if covered fully, do *not* raise concerns related to compliance with Section 18.[22] The 2015 Proposing Release noted that a "fund's payment obligation may be largely known and fixed at the time the fund enters into many financial commitment transactions, such as reverse repurchase agreements or firm commitment agreements."[23] The 2015 Proposing Release also noted that "requiring a fund to maintain qualifying coverage assets sufficient to cover its full obligations under a financial commitment transaction may effectively address many of the risks that otherwise would be managed through a risk management program."[24] In addition, requiring a fund that invests only in 10666 Instruments to implement a derivatives risk management program and comply with the limits on fund leverage risk would cause some funds unnecessarily to cease using 10666 Instruments when their associated risks can be both effectively and efficiently managed with a well-tested asset segregation approach.

The Proposing Release does not specifically address 10666 Instruments or discuss specific policy reasons for treating such instruments as derivatives transactions under Proposed Rule 18f-4. 10666 Instruments have the same types of characteristics and create the same types of fixed and known payment obligations

---

[22] *See* 2015 Proposing Release at 80937.

[23] *Id.*

[24] *Id.* at 80937–80938.

as the financial commitment transactions described in the 2015 Proposing Release. 10666 Instruments generally create obligations that are fixed and known at the time that a fund enters into the relevant transaction, and do not create the kinds of risks of loss that transactions more commonly known as derivatives may create. Accordingly, when fully covered, we believe that 10666 Instruments should not cause a fund to be subject to the full program and limit on fund leverage risk requirements.

Accordingly, as an alternative approach to that included in Proposed Rule 18f-4, we recommend that funds not be required to treat 10666 Instruments (other than those addressed in Section II.A.1 above) as derivatives transactions so long as the instruments are fully covered by liquid assets (as described below), marked-to-market on a daily basis. To address any potential remaining asset sufficiency concerns, we propose that Proposed Rule 18f-4 modify the current framework to allow only for a limited asset segregation regime for 10666 Instruments, which would allow a fund to cover its obligations under 10666 Instruments with assets classified as "highly liquid investments" or "moderately liquid investments," as defined under Rule 22e-4 under the Investment Company Act, equal to the fund's payment or delivery obligations under the transactions.[25] Highly liquid and moderately liquid investments are inherently the types of securities that a fund could sell quickly to meet any related payment obligations (even during stressed market conditions),[26] and we believe the proposed regime should thus be sufficient to alleviate the Commission's concerns regarding asset segregation.[27]

In addition, the Commission should state affirmatively that including these transactions as derivatives transactions under Proposed Rule 18f-4 should not affect whether they are, or imply that they are, derivatives for any other legal or regulatory purposes.

3. Permit Money Market Funds to Invest in Firm and Standby Commitment Agreements (and Similar Instruments)

The Commission should permit money market funds to continue to invest in firm and standby commitment agreements (and similar instruments), because those funds already are subject to the requirements and strong investor protections of Rule 2a-7 under the Investment Company Act. As currently proposed, money market funds would not be permitted to rely on Proposed Rule 18f-4.[28] Money market funds also would no longer be permitted to rely on Release 10666, which the Commission is proposing to rescind. As the Commission acknowledges, if money market funds are

---

[25] *See* Rule 22e-4(a)(6) and (12) under the Investment Company Act.

[26] *See* Proposing Release at 4453 (describing instances in which a "fund may be forced to sell portfolio securities to meet its derivatives payment obligations" and how such "forced sales could occur during stressed market conditions").

[27] In permitting the modified asset segregation regime, the Commission should allow a fund to designate the segregated assets solely on its records and not on the fund custodian's records, consistent with current Commission staff positions. *See* Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management, SEC, to Chief Financial Officers, dated Nov. 7, 1997. In addition, the Commission should permit funds to offset any amounts required to be segregated with either initial or variation margin posted at a counterparty for the 10666 Instrument.

[28] *See* Proposed Rule 18f-4(a) (defining *fund* to exclude "a registered open-end company that is regulated as a money market fund under [Rule] 2a-7.").

precluded from relying on Proposed Rule 18f-4 and can no longer rely on Release 10666, "money market funds would not be able to enter into transactions covered by [Proposed Rule 18f-4], including derivatives transactions."[29] Although money market funds do not invest in traditional derivatives instruments (*e.g.,* swaps, futures), they routinely invest in delayed-delivery and when-issued securities (and other similar instruments that have a forward-settlement convention), which under the proposed rule's new approach could be viewed as derivatives transactions. Money market funds typically invest in these securities, which include when-issued US Treasury securities, to secure investments that provide advantageous terms (*e.g.,* price, yield, maturity, issuer) at the time of entering into the transaction rather than for speculative purposes. Moreover, these securities are neither inconsistent with Rule 2a-7 nor a money market fund's objective of maintaining a stable net asset value per share or minimizing principal volatility.

Although we support excluding money market funds from the scope of Proposed Rule 18f-4, the Commission should continue to permit them to invest in delayed-delivery and when-issued securities (and other similar instruments that have a forward-settlement convention or are otherwise within the scope of Release 10666), subject to their compliance with Rule 2a-7. These securities provide benefits to money market fund investors that should not be lost due to the new rule. Rule 2a-7 imposes stringent risk-limiting conditions on money market funds, and these conditions have been revised and refined several times since the Commission adopted Rule 2a-7, providing sufficient protections for money market fund shareholders when investing in these securities.

a) Instruments Within the Scope of Release 10666 Are Appropriate Investments for Money Market Funds

In excluding money market funds from Proposed Rule 18f-4, the Commission explains that "money market funds seek to maintain a stable share price or limit principal volatility by limiting their investments to short-term, high-quality debt securities that fluctuate very little in value under normal market conditions."[30] The Commission then states, however, that "[a]s a result of these and other requirements in [R]ule 2a-7, we believe that money market funds currently do not typically engage in derivatives transactions or the other transactions permitted by [Proposed Rule 18f-4]," and that "these transactions would generally be inconsistent with a money market fund maintaining a stable share price or limiting principal volatility, and especially if used to leverage the fund's portfolio."[31] We generally agree that traditional derivatives instruments (*e.g.*, swaps, futures) would not be appropriate for money market funds. As discussed above, however, some securities that money market funds do use could fall within the definition of derivatives transaction.

For example, money market funds (and, in particular, government money market funds) routinely invest in when-issued US Treasury securities, which are discussed in detail in Section II.A.1, above. Under Rule

---

[29] *See* Proposing Release at 4527.

[30] *Id.* at 4455.

[31] *Id.*

2a-7, government money market funds must invest 99.5 percent or more of their total assets in cash, US government securities, and/or repurchase agreements collateralized fully by cash and US government securities.[32] When-issued US Treasury securities are an important source of investments for government money market funds (as well as prime money market funds), and these funds (and their investors) benefit significantly when purchasing US Treasury securities on a when-issued basis (rather than at the auctions or in the secondary market). These benefits include the potential to secure better pricing and supply in advance of auctions.

Money market funds also routinely invest in delayed-delivery securities and other similar instruments that have a forward-settlement convention**.** Money market funds do not invest in these securities for speculative purposes. Rather, money market funds typically invest in these securities to secure investments that are believed to provide advantageous terms (*e.g.,* price, yield, maturity, issuer) at the time of entering into the transaction. Because these securities fluctuate very little in value under normal market conditions, they do not represent the type of investment typically associated with speculative investing and therefore do not materially implicate the undue speculation concerns to which Section 18 was designed to address.[33]

Further, the Commission has implicitly acknowledged that there is nothing inherently problematic with these types of investments for money market funds. Most significantly, in 1991, the Commission amended Rule 2a-7 to extend the maximum allowable maturity for an investment from 12 months to 13 months, *precisely to accommodate securities purchased by money market funds on a when-issued or delayed-delivery basis*.[34] Similarly, in a release proposing amendments to Form N-1A, the Commission recognized that money market fund prospectuses "often" included detailed discussions of particular investments and investment techniques, including discussions of "securities [purchased] on a 'when-

---

[32] *See* Rule 2a-7(a)(14).

[33] We acknowledge that these securities may implicate the asset sufficiency concerns under the Investment Company Act. However, as discussed more fully below, we believe that the risk-limiting conditions under Rule 2a-7 (namely the stringent liquidity and stress testing requirements) sufficiently address these concerns.

[34] *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005, 56 Fed. Reg. 8113 (Feb. 27, 1991) at 8120. The Commission stated that:

With respect to securities other than Government securities, as suggested by several commenters, the rule extends the maximum permitted maturity of individual securities to thirteen months. *This change has been made in order to accommodate funds purchasing annual tender bonds, and securities on a when-issued or delayed delivery basis. These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them.* Since the purchaser must "book" the security on the day it agrees to purchase it, the maturity period begins on that day. The revised rule allows funds to invest in securities with a remaining maturity of no more than thirteen months (397 days) (emphasis added; internal citations omitted).

See also Investment Company Institute, SEC Staff No-Action Letter (pub. avail. Aug. 6, 1991) ("The extension of maximum allowable maturity, although applicable to all securities, was designed to accommodate funds purchasing annual tender bonds and securities on a when-issued or delayed delivery basis, which often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them.").

issued' basis" and the "acquisition of stand-by commitments."[35] These examples make clear that the Commission historically has accepted that these types of investments are not inappropriate for money market funds or inconsistent with the risk-limiting conditions of Rule 2a-7. Therefore, the Commission should continue to permit money market funds to invest in these instruments under their current regulatory framework.

b) Rule 2a-7 Imposes Significant Investor Protections and Addresses Asset Sufficiency Concerns

Rule 2a-7 requires money market funds to comply with stringent risk-limiting conditions. These conditions relate to, among other things: (1) liquidity; (2) maturity; (3) quality; (4) diversification; and (5) board oversight. For example, under Rule 2a-7, a money market fund may not acquire an illiquid security if, immediately after its acquisition, the fund invested more than 5 percent of its total assets in illiquid securities (significantly less than the limitation on illiquid investments for non-money market funds in Rule 22e-4).[36] Rule 2a-7 also generally requires taxable money market funds to hold at least 10 percent of their total assets in "daily liquid assets" and all money market funds to hold at least 30 percent of their total assets in "weekly liquid assets."[37] Money market funds also are required to undergo routine stress testing to test a fund's ability to maintain sufficient liquidity (at least 10 percent of its total assets in weekly liquid assets) and minimize principal volatility (and, for funds that seek to maintain a stable net asset value per share, to maintain a stable price per share), based on certain hypothetical events in combination with increasing shareholder redemptions.[38] These conditions have proven highly effective in addressing the asset sufficiency concerns outlined in Section 1(b) of the Investment Company Act and underlying Section 18.

Consistent with historical practices and the reasons discussed above, the Commission should permit money market funds to invest in delayed-delivery and when-issued securities (and other similar instruments that have a forward-settlement convention or otherwise are within the scope of Release 10666), subject only to their compliance with the conditions of Rule 2a-7. As discussed in Section II.A.2 above, these instruments generally represent less risk than traditional derivatives instruments (*e.g.,* swaps, futures) and create a fixed and known obligation for a fund to make a payment or delivery of cash or other assets on the trade date. The risk-limiting conditions of Rule 2a-7 provide sufficient investor protections for money market funds investing in these instruments.

---

[35] *See* Money Market Fund Prospectuses, Investment Company Act Release No. 21216, 60 Fed. Reg. 38454 (July 26, 1995) at 38456.

[36] *See* Rule 2a-7(d)(4)(i).

[37] *See* Rule 2a-7(d)(4)(ii) and (iii). Money market funds are also subject to a general liquidity requirement to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of their obligations under Section 22(e) and any commitments made to shareholders. *See* Rule 2a-7(d)(4).

[38] *See* Rule 2a-7(g)(8).

B. VaR-Based Leverage Limits

We generally agree with the proposed portfolio leverage limits, but have several recommendations to make the limits more effective and practical. Proposed Rule 18f-4 generally would require a fund investing in derivatives transactions to: (1) adhere to specified portfolio leverage limits; and (2) to implement a derivatives risk management program that a derivatives risk manager administers.[39] The proposed leverage limits would limit a fund's derivatives use based on one of two VaR tests—a relative VaR test or an absolute VaR test.[40] The relative VaR test would compare the fund's VaR to the VaR of a "designated reference index" that the derivatives risk manager chooses. Under this leverage limit, the fund's VaR could not exceed 150 percent of the VaR of the fund's designated reference index. If the derivatives risk manager is unable to identify an appropriate designated reference index, then the fund must use an absolute VaR test and ensure that its VaR does not exceed 15 percent of its net assets.

Although a fund could use any VaR model, the proposed rule requires that a fund's VaR model use a 99 percent confidence level and a time horizon of 20 trading days.[41] In addition, the proposed rule requires the VaR model to be based on at least three years of historical data.

We agree with the Commission's use of VaR tests to limit fund leverage. Fund VaR tests measure portfolio risk in a reasonably comparable manner and provide a good indication of how a fund's derivatives use could affect its portfolio. A VaR test provides helpful information on whether a fund is using derivatives transactions to leverage its portfolio and can be used to analyze whether a fund is using derivatives for other purposes, like hedging its portfolio investments. Using VaR measures, therefore, would better reflect how a fund is using derivatives and would more precisely restrain the economic risk that derivatives pose to a fund than any GNE-based limit. As a result, the proposed approach would better achieve the Commission's core goals under Section 18—preventing undue speculation and ensuring sufficient asset coverage through a fund's use of senior securities.[42]

---

[39] Funds that invest in derivatives but that qualify as limited derivatives users would be excepted from these requirements. *See infra* Section II.D (discussing the limited derivatives user exceptions).

[40] According to the Commission, a VaR test:

estimates an instrument or portfolio's potential losses over a given time horizon and at a specified confidence level. VaR will not provide, and is not intended to provide, an estimate of an instrument or portfolio's maximum loss amount. For example, if a fund's VaR calculated at a 99 percent confidence level was $100, this means the fund's VaR model estimates that, 99 percent of the time, the fund would not be expected to lose more than $100. However, 1 percent of the time, the fund would be expected to lose more than $100, and VaR does not estimate the extent of this loss.

See Proposing Release at 4469.

[41] The time horizon refers to the number of days over which the VaR test would expect a loss to occur. A 20-day VaR considers how much a fund might lose over 20 days, while a one-day VaR considers how much a fund might lose in a single day. The confidence level indicates how frequently the VaR test expects a loss of the specified magnitude to occur. A 95 percent confidence level indicates that the loss level would be expected to be exceeded 5 percent of the time, while a 99 percent level indicates that it would be expected to be exceeded only 1 percent of the time.

[42] As the Proposing Release notes, while there may be shortcomings in relying solely on a VaR test to manage derivatives risk, the proposed VaR tests should not be viewed in isolation. The required derivatives risk management program, including required risk

In addition, the widespread use of VaR tests in the fund industry allows firms to manage globally their leverage risk in a more consistent manner. Many funds already employ VaR tests as derivatives risk management tools,[43] and many global asset managers already comply with VaR tests to meet regulatory requirements in other jurisdictions.[44] For other managers, the prevalence of VaR and third-party service providers' familiarity and learning from using VaR should ease the significant compliance burdens imposed under Proposed Rule 18f-4.[45]

We provide recommendations below to the Commission's proposed VaR-based leverage limits, including recommendations to: (1) enhance the default relative VaR test; (2) increase the proposed leverage limits; (3) permit funds to scale VaR results from a 95 percent confidence level to a 99 percent confidence level, when appropriate; and (4) ease the impact that VaR test breaches have on funds and their shareholders.

1. Enhance the Relative VaR Test

a) Modify the "Designated Reference Index" to Reflect the Fund's Investment Strategies

The Commission should require the designated reference index to reflect the investment strategies of the fund as well as the assets and markets in which the fund invests. Proposed Rule 18f-4 would require a fund to use the relative VaR test unless the derivatives risk manager is "unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives, and strategy."[46] In determining appropriateness, the derivatives risk manager must choose an unlevered designated reference index that "reflects the markets or assets classes in which the fund invests."[47] The Commission favors the relative VaR test as the default means of limiting fund leverage

---

guidelines, stress testing, backtesting, internal reporting and escalation, and periodic review, will work together to achieve the core goals of Section 18.

[43] *See* October 2019 ICI Letter at 3–4 (noting that 73 percent of respondents to an ICI survey use both some form of VaR testing and some form of stress testing as derivatives risk management tools).

[44] *See*, *e.g.*, Committee of European Securities Regulators, CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (July 28, 2010) ("CESR Guidelines").

[45] *See* October 2019 ICI Letter at 4 (noting that 79 percent of respondents indicated that it would be only slightly or moderately burdensome to implement a VaR test using the same parameters as prescribed for UCITS).

[46] *See* Proposed Rule 18f-4(c)(2)(i).

[47] *See* Proposed Rule 18f-4(a) (defining *designated reference index*). In addition: (1) an affiliated person of the fund, its investment adviser, or principal underwriter must not administer the index, and the fund or its adviser must not have requested the index, unless the index is widely recognized and used; and (2) the index must be an "appropriate broad-based index" or "additional index" as defined in Instruction 5 to Item 27 of Form N-1A.

The Proposing Release highlights three provisions that would prevent derivatives risk managers from selecting inappropriate indexes: (1) the derivatives risk manager must select the index and periodically review it; (2) the index would be disclosed relative to the fund's performance in the fund's annual report; and (3) the board of directors would receive a written report providing the derivatives risk manager's basis for selecting the index. *See* Proposing Release at 4744.

risk based on the view that it closely resembles the way that Section 18 limits a fund's leverage risk.[48] In addition, the Commission believes that a relative VaR test may better reflect investors' expectations when a designated reference index is available. It states that an investor "could reasonably expect a fund to exhibit a degree of volatility that is broadly consistent with the volatility of the markets or asset classes in which the fund invests."[49] This is fair but only looks at "what" a fund may hold and does not take into account "how" the fund seeks to meet its investment objectives, which better aligns with investor expectations of their fund.

We urge the Commission to require the designated reference index to reflect the investment strategies of the fund, which would be a more holistic approach reflecting assets, markets, and strategies, and therefore the risks of a fund. Such an approach would work for a fund following an index strategy or a fund with more latitude with respect to assets and investment techniques. An investment strategies standard is superior as it reflects the volatility and risks of a fund's investments and assets. For example, a fund that holds a sliver of the securities of an index could have a much different VaR than that of the full index. Large VaR differences also could occur if the fund holds the same securities of an index in different weightings than the index.

These statements are true even for funds that do not make extensive use of leverage. Figure 1 shows several examples of funds across different asset classes that, despite being limited derivatives users, have VaRs that are substantially higher than what would be their respective designated reference index under the proposed "markets and asset classes" standard. One example is a taxable bond fund that had no derivatives positions and an absolute VaR of 0.1 percent on December 31, 2019. Yet, on that same day, this fund had a VaR of 152 percent relative to the VaR of the Bloomberg Barclays Short-Term Government/Corporate Index (what would be considered its designated reference index under the markets and asset classes standard). During the COVID-19 crisis, the relative VaR of this fund, which still had no derivatives positions, reached 948 percent on March 23, 2020. Retaining the proposed standard thus could force a derivatives risk manager into using a designated reference index with volatilities and risks that are inconsistent with a fund's investment strategies, simply because an index met the markets and asset classes standard.

---

[48] Section 18 limits the extent to which a fund can potentially increase its market exposure through leveraging using senior securities. The proposed relative VaR test is designed to limit the extent to which a fund increases *its market risk* by leveraging its portfolio through derivatives. *See* Proposing Release at 4470–4471.

[49] *Id.* at 4471.

Figure 1: Even Limited Derivatives Users Can Have High Relative VaRs Under "Assets and Markets" Standard
Percent

Fund description	Designated reference index	Relative VaR[1]	Absolute VaR[1]
Municipal short duration	S&P Municipal Bond Short Intermediate Index	129%	0.9%
International equity	MSCI EAFE Index	120	9.5
Domestic large-cap	Russell 1000 Value Index	121	9.6
Taxable bond[2]	BBG Barclays Short-Term Govt/Corp Index	152	0.146

[1] VaR estimated as of December 31, 2019.

[2] On March 23, 2020, in the midst of the COVID-19 crisis, this fund, which had zero derivatives positions, had a relative VaR of 948 percent and an absolute VaR of 4 percent.

Source: Investment Company Institute

Further, the investment strategies approach to selecting a reference index is well-tested and familiar, as it would be similar to the standard in the European Union. A UCITS complying with a relative VaR standard must choose a benchmark that reflects the investment strategies that the UCITS is pursuing.[50] Tying the designated reference index standard to the fund's investment strategies, rather than the more general markets and asset classes of a fund, more closely aligns with an investor's reasonable expectation that the volatility and risk of a fund will be relatively similar to its index.

b) Provide Additional Guidance to Derivatives Risk Managers to Evaluate and Change Designated Reference Indexes

The Commission also should provide additional reassurance to derivatives risk managers with respect to their determinations regarding a designated reference index and whether an appropriate index does not exist. In a recent ICI survey, 26 percent of funds that did not qualify as limited derivatives users (336 out of 1,288 funds) indicated that they either could not select an index or had difficulty selecting a designated reference index.[51] Derivatives risk managers will have difficulty with these determinations, particularly for funds that have investment strategies that could change under different market conditions or that seek target volatilities. Without firmer guidance and clarification, derivatives risk

[50] *See* CESR Guidelines at Section 3.2 (VaR Approaches—Relative VaR and Absolute VaR—The Choice).

[51] ICI conducted a survey of its members to assess the impact on funds from Proposed Rule 18f-4, particularly with respect to aspects of the proposed VaR tests. Fifty-three fund complexes with 5,228 funds and $17.2 trillion in assets under management responded to ICI's survey. These respondents represented 52 percent of the number and 77 percent of the assets of long-term mutual funds (including variable annuities), closed-end funds, and registered ETFs at year-end 2019. For more information regarding industry coverage of ICI's survey, see Appendix A.

managers could be subject to "second-guessing" by Commission examination staff and others. The fund also could become subject to potential liability.

To address these concerns, the Commission should issue guidance in three areas. First, the Commission should clarify instances in which derivatives risk managers reasonably could conclude that there is no designated reference index. The guidance should specifically state that a derivatives risk manager is unable to find a designated reference index when it determines, in its own business judgment, that there is no index that reflects the fund's investment strategies (*i.e.*, how the fund is run and the volatility or risks of the fund). Requiring funds to use a relative VaR test as the default leverage limit indicates the Commission's strong preference for the relative VaR test, and derivatives risk managers may feel pressure to choose an index, however inappropriate or ill-fitting, absent additional guidance. Clarifying when a derivatives risk manager can affirmatively determine that it is unable to choose an index would alleviate some of this pressure.

Second, the Commission should acknowledge affirmatively that there is no presumption that a fund must use its performance benchmark as its designated reference index. The performance benchmark—a broad-market measure—is required by the Commission for a different purpose, *i.e.*, to help an investor understand a fund's performance. All open-end funds compare their performance against a selected broad-based index.[52] The Commission imposed this requirement to help investors understand a fund's performance, not its investment strategies or risk. As with indexes that simply reflect the markets and asset classes in which the fund invests, a selected performance benchmark does not necessarily reflect the volatility or risk characteristics of a fund. For example, an ultrashort bond fund with an investment strategy of producing positive returns and lower volatility over longer periods may choose a performance benchmark of US government short-term Treasury bills. At times, the fund may invest in short-term Treasury bills, but the short-term Treasury bill index always will have a much lower risk and volatility profile than the fund and would not be a reasonable proxy for the fund.[53]

Likewise, the Commission should make clear that it would not expect certain broad categories of funds to have designated reference indexes. These funds would not be able to identify appropriate benchmarks or other indexes that reflect all the asset classes or markets that the fund invests in, or the fund's investment strategies, under different market conditions. For example, a multi-asset class absolute return fund (sometimes referred to as an unconstrained total return fund or a multi-strategy fund) may choose a performance benchmark for the performance table in the prospectus that is a broad-market equity

---

[52] *See* Items 4 and 27(b)(7)(ii) of Form N-1A. New funds, with limited operating history, would be excluded from the requirement. *See* Proposed Rule 18f-4(c)(2)(iv).

[53] The Commission provides an example in which a fund's chosen performance benchmark (S&P 500 index) could not be used as its designated reference index, because the benchmark did not reflect the markets or asset classes in which the fund invests (primarily commodity futures contracts). *See* Proposing Release at 4471. We agree with the Commission's example and believe that the fund in the example more appropriately could use an unlevered index reflecting commodity index futures as its designated reference index. Unlike the Commission's example, however, we highlight a situation in which the fund may at times invest in the same assets as its performance benchmark but otherwise does not share the same volatility or risk.

index. The fund may invest in securities of the benchmark under certain market environments. In other market environments, however, the fund's strategies may cause it to invest in completely different asset classes. With such a broad investment mandate, the fund cannot be expected to select one particular designated reference index, even a blended one, to reflect the markets and asset classes in which the fund invests while also appropriately taking account of the fund's investment strategies.[54]

We appreciate the Commission identifying multi-strategy funds that manage their portfolio based on target volatilities,[55] but the Commission should provide a nonexclusive list of other categories of funds for which it generally would be appropriate to use the absolute VaR test under Proposed Rule 18f-4. These categories could include funds that employ different investment strategies in different market environments and funds that invest in unique asset classes that do not typically have indexes, including market-neutral funds, multi-alternative funds/non-correlated strategy funds, long-short funds, managed futures funds, and funds that invest in unique asset classes that may not have a broad-based index (*e.g.*, insurance-linked securities). In providing the list, the Commission should clarify that there may be other types of funds that are not listed that also typically would use the absolute VaR test.

Third, it is important that the Commission provide guidance explaining circumstances under which a derivatives risk manager could appropriately change a fund's designated reference index if it is no longer appropriate.[56] The Commission should confirm that, during such periods, a derivatives risk manager could proceed with the index change immediately, then reference the change in its next annual or periodic report to the board.[57] The fund then could inform shareholders about the change immediately on its website, and with disclosure in the fund's next annual report. As with changes in the fund's performance benchmarks, the Commission could require the fund to disclose the reason for the change in the annual report and require performance results for both designated reference indexes.[58]

c) Permit an Index Fund That Tracks an Affiliated Index to Select the Index as Its Designated Reference Index

Proposed Rule 18f-4(a) would restrict an affiliated person of the fund, its investment adviser, or principal underwriter from administering the designated reference index, and would restrict the fund or its investment adviser from requesting the creation of the index, unless the index is widely recognized and used. The Commission imposes these restrictions because it believes that they reduce the likelihood

---

[54] We understand that the proposed rule would permit a fund to create a blended index (provided the blended index meets the proposed requirements of a designated reference index). Given the unpredictability of market conditions, as exhibited in the current COVID-19 crisis, however, derivatives risk managers may conclude that a blended index is inappropriate.

[55] *See* Proposing Release at 4475.

[56] These could include periods when there is a fund merger, a subadviser change, a change to the index the fund tracks, or when the derivatives risk manager determines to do so during its annual review of the index.

[57] Under Proposed Rule 18f-4(c)(5), the derivatives risk manager must provide the board a written report that includes its basis for selecting the designated reference, if applicable. In addition, the derivatives risk manager would provide a written report regarding exceedances of the VaR limits, stress testing, and backtesting of a VaR model at a frequency that the board determines.

[58] *See*, *e.g.*, Instruction 7 to Item 27(b)(7)(ii) of Form N-1A.

that an index provider would design an index with the intent of allowing a fund to incur additional leverage-related risk.

The Commission must permit a derivatives risk manager to an index fund that tracks an affiliated index (a "self-indexed fund") to select the affiliated index as its designated reference index. First, any concern that the Commission has that an affiliated index provider might design an index to permit additional leverage-related risk is addressed already or can be mitigated. Second, it would make little sense to restrict a self-indexed fund from using an affiliated index when the affiliated index best reflects the investment objective and strategies of the fund and the assets and markets in which the fund invests.

Although not entirely clear, it is possible that the Commission's concern is with the affiliated index provider creating an index for the VaR-based limit and adding components to the index that increase the VaR of the index. A fund then could invest in more risky instruments that may not necessarily be in the index, so that it has up to 150 percent of the higher VaR of the index to enhance returns. This could be particularly true for actively managed funds, which are not confined by an investment objective or strategies to track the index.

We believe that this gaming concern is addressed for self-indexed funds. Any concern that an index provider could design an index with the intent of allowing the fund to obtain additional leverage-related risk should be offset by the fact that the fund's board initially would need to approve the fund's stated investment objective and strategies to track the index. The board's general role, along with the periodic reports it receives about the designated reference index that are required under Proposed Rule 18f-4 (as generally discussed in more detail herein), also should provide a level of oversight over these types of affiliated relationships.

If the Commission believes further mitigation is necessary, it, for example, could restrict a self-indexed fund that uses an affiliated index as its designated reference index from having any derivatives in its index.[59] Removing the ability to include derivatives could eliminate substantially the Commission's concern that the affiliated index provider could artificially inflate the VaR of the index.

Requiring a self-indexed fund to use an index other than the index that it is required to track as its designated reference index could force the fund to alter its investments and thus incur index tracking errors. In effect, this could cause a fund to track two different indexes—one for its investment objective and strategies and the other for meeting the limits of Proposed Rule 18f-4.[60]

---

[59] Proposed Rule 18f-4(a) already restricts a designated reference index from containing leverage. We do not believe that this restriction typically would preclude a fund from selecting a designated reference index with derivatives in it so long as those derivatives do not create leverage and meet the other requirements of Proposed Rule 18f-4(a) related to designated reference indexes. In this regard, the Commission should affirmatively permit commodity funds to choose broad-based commodities indexes with derivatives components (*e.g.*, futures on commodities).

[60] As described above, a fund using a designated reference index that it is not tracking could raise issues because of the natural differences between the VaR of the fund and the VaR of the designated reference index. If an index fund is unable to use the index it tracks as its designated reference index, it may be required to choose another index with a VaR that is different than the fund's. In

Permitting an index fund to use the affiliated index that it is tracking as its designated reference index also fits squarely within the Commission's goal of having funds use designated reference indexes that match investor expectations of volatility and risk. For an index fund, investors would expect the fund to yield substantially similar performance, volatility, and risk most closely to its underlying index. Given the variations in risk and volatility that funds could have to general benchmarks, as shown above, we believe that index funds always should be permitted to select their underlying index—the most representative benchmark of the fund's strategies—as their designated reference index, even if the index is affiliated. Allowing for this would better align investor expectations.

2. Increase the Proposed Leverage Limits for the Relative VaR Test and the Absolute VaR Test

We strongly recommend moderately increasing the proposed leverage limits. The Commission proposes setting the relative VaR leverage limit at 150 percent of the VaR of its designated reference index and the absolute VaR leverage limit at 15 percent of net assets. The Commission chose the 150 percent relative VaR limit based on the view that it is similar to the way that Section 18 limits an open-end or closed-end fund's ability to borrow from a bank.[61] It provides an example of a mutual fund with $100 of net assets that borrows $50 as permitted under Section 18. The fund then could invest the $50 in borrowings, and the Commission assumes that the fund then would have a VaR of approximately 150 percent of the VaR of the fund's designated reference index.[62] It thus concludes that the proposed 150 percent VaR limit would effectively limit a fund's leverage risk related to derivatives, similar to the way that Section 18 limits bank borrowings.

The Commission chose the 15 percent absolute VaR limit after comparing a fund complying with the absolute VaR test with a fund complying with the relative VaR test.[63] It notes that a fund relying on the relative VaR test that uses the S&P 500 index as its benchmark would be permitted to have a VaR equal to 150 percent the S&P 500 index's mean VaR.[64] The Commission states that the S&P 500 index's VaR since inception is 10.4 percent.[65] It therefore concludes that setting the absolute VaR at 15 percent would

---

these circumstances, the fund would need to closely monitor and confine its VaR to the VaR of the designated reference index to stay within the proposed relative VaR limits, causing the fund to essentially track two indexes—the affiliated index for tracking error and the designated reference index for the relative VaR test. If the VaRs of the two indexes differ, the fund may need to abstain from making certain investments to stay within the VaR confines of the designated reference index, rather than minimizing its tracking error to the affiliated index. This could result in index tracking errors.

[61] *See* Proposing Release at 4474.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

provide comparable treatment for funds that rely on the absolute VaR and use the S&P 500 index as their designated reference index.[66]

We urge the Commission to change the proposed leverage limits, because: (a) the Commission's justification for the thresholds and their comparison to Section 18 are misplaced; (b) the Commission has underestimated the impact that its proposed leverage limits would have on existing funds; and (c) our recommended limits are well-tested and familiar to investment managers, funds, and their investors.

a) Basis for Proposed Limits Is Inapt

The Commission's justification for the thresholds and the comparison to Section 18 are misplaced. The comparison to the Section 18 requirements for purposes of the 150 percent relative VaR limit is not appropriate, because the Section 18 restrictions on bank borrowings isolate the leverage incurred to the bank borrowings and other forms of indebtedness. Under the proposed leverage limits, the VaR test includes the leverage effects from instruments outside of derivatives and potential losses that could arise from non-leverage variables.

We appreciate the Commission's desire to have a "bright-line" limit, and the proposed VaR tests would provide an indication of the impact that derivatives would have on a fund's portfolio. VaR tests, however, are not entirely precise, so the Commission must provide additional comfort to a fund to operate within these confines. As shown above in Figure 1, a fund's VaR, even before factoring in any leverage attributable to derivatives, may exceed the VaR of its designated reference index for a multitude of reasons (*e.g.*, varying active management strategies).[67] If a fund's VaR already exceeds the VaR of its designated reference index before accounting for leverage, the amount of leverage that a fund then could obtain under the proposed leverage limit would be reduced. For a fund whose VaR without derivatives already reflects 120 or 130 percent of the VaR of the designated reference index (as shown in Figure 1), these inherent variations would significantly reduce the amount of leverage that the fund could incur through derivatives—such a fund would start at a significant disadvantage that is not attributable to derivatives or even leverage. This demonstrates how the proposed rule's leverage limits would restrict a fund's ability to use leverage more severely than the Section 18 limits on bank borrowings because the fund's VaR calculation would account for losses created by many different variables other than leverage.

Similarly, the Commission's tie to Section 18 for the absolute VaR limit is unjustified and relies heavily on whether funds invest in large-cap equity securities. While many funds may use the S&P 500 index as a performance benchmark, that index may not reflect the strategies of a fund and is not intended for the same purposes as the designated reference index. In addition, there are funds that use derivatives and invest in asset classes—such as emerging market stocks or technology stocks—which are more volatile than large-cap stocks and have higher VaR measures. For example, as shown in Figure 2, the mean VaR of the MSCI Emerging Markets Index over the past 25 years is 16.7 percent and the Nasdaq Index's mean VaR is 15.1

---

[66] *Id.*

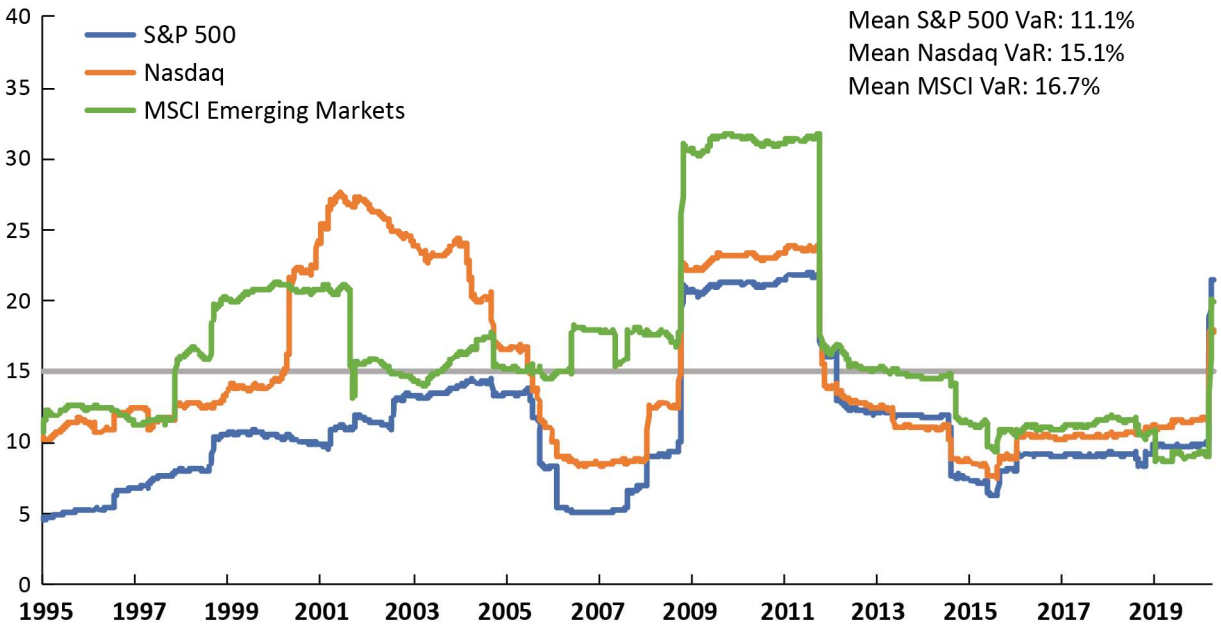
[67] *See supra* Section II.B.1.a.

percent—both substantially higher than the S&P 500 index's mean VaR at 11 percent in the same period. The choice of the S&P 500 index as the basis for the absolute VaR test unfairly and inappropriately constrains funds that may hold securities that are inherently more volatile than the S&P 500 index.

In addition, using the *mean* VaR of the S&P 500 index as the basis for the proposed absolute VaR limit does not take into consideration its wide range of variability. Indeed, as shown in Figure 2, the S&P 500 would not have complied with the proposed absolute VaR test for a three-and-a-half-year period in the aftermath of the global financial crisis. From October 16, 2008, consecutively through March 1, 2012, the VaR of the S&P 500 index exceeded 15 percent—peaking at 22.1 percent in July 2011. More recently, as a result of the crisis in financial markets caused by the COVID-19 pandemic, the VaR of the S&P 500 index reached 15.5 percent on March 19, 2020, and has continued to rise since then, reaching 21.6 percent on April 15, 2020.

Figure 2: Absolute VaR of S&P 500 Index Exceeded 15 Percent for More Than Three Years in Aftermath of the Global Financial Crisis

Percent, January 2, 1995–April 15, 2020



Note: Historical VaR is calculated using three-year historical information, a 20-day time horizon, and a 99 percent confidence level.

Source: Investment Company Institute calculations of Bloomberg data

b) Impact of Proposed Limits Will Be Greater Than SEC Projected

The Commission's proposed limits are too low to serve as "outer bound" limits on funds' use of derivatives. The Commission uses data to justify each of the 150 percent relative VaR and 15 percent absolute VaR limits, citing the minimal impact that the limits would have on existing funds. Using December 2018 year-end information, the Commission's analysis identified six funds that failed the

proposed relative VaR test.[68] Of the six funds that failed the proposed relative VaR test, the Commission stated that only one would fail the proposed absolute VaR test.[69] Citing the minimal impact that the proposed limits would have on existing funds, the Commission states that only "a very small number of funds, if any...would have to adjust their portfolios in order to comply with the VaR-based limit on fund leverage risk."[70]

Our survey results do not support these conclusions and find that the proposed limits would have a greater impact than anticipated. The Commission's analysis used data from one point in time (year-end 2018 information) and failed to factor in market influences throughout the year. The data also did not weigh how the proposed limits would affect funds during stressed periods, such as the one financial markets currently are experiencing from the COVID-19 pandemic. In addition, the Commission does not consider that funds likely will set internal compliance limits that are lower than the regulatory limits, which could affect portfolio management. Each of these additional factors is critical to fully analyzing the economic impact of the proposed limits.

Our survey considered each of these additional factors. Using data for year-end 2019 and VaR models that risk managers believe are the most appropriate for the fund, a total of 28 funds failed the proposed VaR test—27 failed the relative VaR test and one failed the absolute VaR test (Figure 3).[71] These 28 funds, with $58 billion in assets, accounted for 2.5 percent of the 1,138 funds that did not qualify as limited derivatives users and provided year-end 2019 VaR results.

Bond funds, particularly those that are actively managed, are more likely to fail the relative VaR test at the proposed 150 percent limit. Twenty of the 28 funds (71 percent) that failed the proposed VaR test at year-end 2019 were taxable bond funds and represented 92 percent of the $58 billion in taxable bond fund assets (Figure 4). Bond indexes, many of which would be considered as designated reference indexes for purposes of the relative VaR test, generally have low volatilities and low VaRs. For example, the Bloomberg Barclays Short-Term Government/Corporate Index from Figure 1 had an absolute VaR of 0.096 percent at year-end 2019. An actively managed bond fund that is making use of derivatives and has this index as its designated reference index would not need to deviate far from the index's risk profile to fail the proposed relative VaR test at the 150 percent limit. If the proposed relative VaR limit were increased to 200 percent, 11 of the 20 bond funds that exceeded the proposed 150 percent threshold could comply with the limit.

Practically speaking, funds also will set internal compliance limits on their derivatives use to avoid exceeding any regulatory limits. For example, some open-end funds limit their illiquid investments to a

---

[68] *See* Proposing Release at text surrounding notes 515–516.

[69] *Id.* at note 516.

[70] *Id.* at 4519.

[71] VaR tests were conducted as closely as possible to the proposed requirements: three-year historical information, 20-day time horizon, and 99 percent confidence interval.

lower percentage of their net assets (*e.g.*, 10 percent) than the liquidity rule otherwise requires (*i.e.*, 15 percent).[72] For the relative VaR test, these limits may range from 120 to 140 percent of the VaR of the designated reference index. For the absolute VaR test, these limits may range from 12 to 14 percent of the fund's net assets. Based on those parameters, we believe that an additional 12 funds with $85 billion in assets that are in the caution zone (orange shaded region in Figure 3) will need to change their investment strategies to comply with the proposed leverage limits, as such limits would be applied under those funds' standard compliance protocols.

[72] The liquidity rule, Rule 22e-4 under the Investment Company Act, prohibits certain open-end funds from acquiring an illiquid investment, if immediately after the investment, the fund would have invested more than 15 percent of its net assets in illiquid investments. *See* Rule 22e-4(b)(1)(iv) under the Investment Company Act.

Figure 3: More Funds Than SEC Expected Failed Proposed VaR Test at Year-End 2019
Number of funds

Relative VaR test results[1]

Type of fund	< 120%	120% to 140%	140% to 150%	>150%	>200%
Mutual funds	674	51	5	15	6
ETFs	45	1	0	1	2
Closed-end funds	94	7	6	11	1
Total	**813**	**59**	**11**	**27**	**9**
Percentage of respondents	**89.3%**	**6.5%**	**1.2%**	**3.0%**	**1.0%**
Total assets (billions)	**$2,027**	**$93**	**$84**	**$58**	**$38**

Absolute VaR test results[2]

Type of fund	< 12%	12% to 14%	14% to 15%	>15%	>20%
Mutual funds	190	3	1	1	1
ETFs	11	1	0	0	0
Closed-end funds	21	0	0	0	0
Total	**222**	**4**	**1**	**1**	**1**
Percentage of respondents	**97.4%**	**1.8%**	**0.4%**	**0.4%**	**0.4%**
Total assets (billions)	**$452**	**$6**	**<$1**	**<$1**	**<$1**

Combined VaR test results

Total	**1,035**	**63**	**12**	**28**	**10**
Percentage of total respondents	**90.9%**	**5.5%**	**1.1%**	**2.5%**	**0.9%**
Total assets (billions)	**$2,479**	**$99**	**$85**	**$58**	**$38**

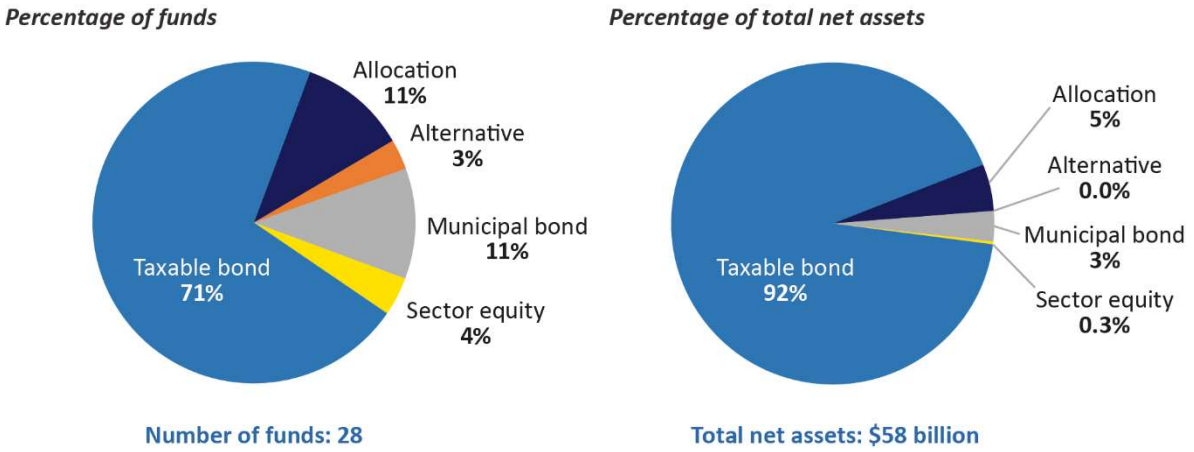
[1] Represents funds from ICI's survey that did not qualify as limited derivatives users and indicated that the fund had an identifiable designated reference index.

[2] Represents funds from ICI's survey that did not qualify as limited derivatives users and did not indicate that the fund had an identifiable designated reference index.

Note: In this figure, funds means all long-term mutual funds (including variable annuities), ETFs registered under the Investment Company Act, and closed-end funds. In ICI's survey, 1,138 out of the 1,288 funds that did not qualify as limited derivatives users (88 percent) provided VaR results for year-end 2019. VaR tests were conducted as closely as possible to the proposed requirements: three-year historical information, 20-day time horizon, and 99 percent confidence interval.

Source: Investment Company Institute

Figure 4: Year-End 2019 Proposed VaR Test Failures Are Predominantly Bond Funds



Source: Investment Company Institute

There are shortcomings to establishing regulatory limits for VaR based on analysis at a single point in time. The primary drawback is that the date chosen for the analysis may not adequately represent the fund's typical portfolio composition. If funds' VaR results at that single point in time generally are lower than normal, the Commission runs the risk of setting the VaR test limits too low and affecting more funds than it anticipated.

To determine whether ICI's survey results on the year-end 2019 VaR test were skewed too low, we asked funds that did not qualify as limited derivatives users to calculate the fund's VaR for each day in 2019 and report the fund's maximum VaR for 2019. As shown in Figure 5, nearly twice as many funds failed the proposed VaR test over the entirety of 2019 than on December 31, 2019. In all, 51 funds with $155 billion in assets failed the proposed VaR test (47 failed the relative VaR test and four failed the absolute VaR test) during 2019.

It is worth noting that the 51 VaR failures should be considered a minimum, as only 59 percent of affected funds in ICI's survey had the resources to complete this analysis. A more informative statistic may be the number of VaR failures relative to the number of respondents. This failure rate may indicate how binding the VaR limits are for the universe of funds over the limited derivatives users threshold. In ICI's survey, when scaled by respondents, 6.7 percent of funds that provided information on their maximum VaR exceeded the proposed VaR limits at least once during 2019. In addition, ICI's survey shows that 2.2 percent of respondents (17 funds with $14 billion in assets) had a maximum VaR over 2019 that was close to the proposed VaR limits (orange shaded region in Figure 5). Similar to the results for year-end 2019, taxable bond funds were the bulk of the VaR failures over the course of 2019 (Figure 6).

Figure 5: More Funds Failed Proposed VaR Test over Course of 2019 Than at Year-End
Number of funds

Relative VaR test results[1]

Type of fund	< 120%	120% to 140%	140% to 150%	>150%	>200%
Mutual funds	365	67	13	31	9
ETFs	29	0	0	3	1
Closed-end funds	70	6	1	13	3
Total	**464**	**73**	**14**	**47**	**13**
Percentage of respondents	**77.6%**	**12.2%**	**2.3%**	**7.9%**	**2.2%**
Total assets (billions)	**$843**	**$122**	**$11**	**$150**	**$40**

Absolute VaR test results[2]

Type of fund	< 12%	12% to 14%	14% to 15%	>15%	>20%
Mutual funds	125	6	2	4	1
ETFs	6	0	0	0	0
Closed-end funds	20	0	1	0	0
Total	**151**	**6**	**3**	**4**	**1**
Percentage of respondents	**92.1%**	**3.7%**	**1.8%**	**2.4%**	**0.6%**
Total assets (billions)	**$301**	**$1**	**$3**	**$5**	**<$1**

Combined VaR test results

Total	**615**	**79**	**17**	**51**	**14**
Percentage of total respondents	**80.7%**	**10.4%**	**2.2%**	**6.7%**	**1.8%**
Total assets (billions)	**$1,144**	**$123**	**$14**	**$155**	**$40**

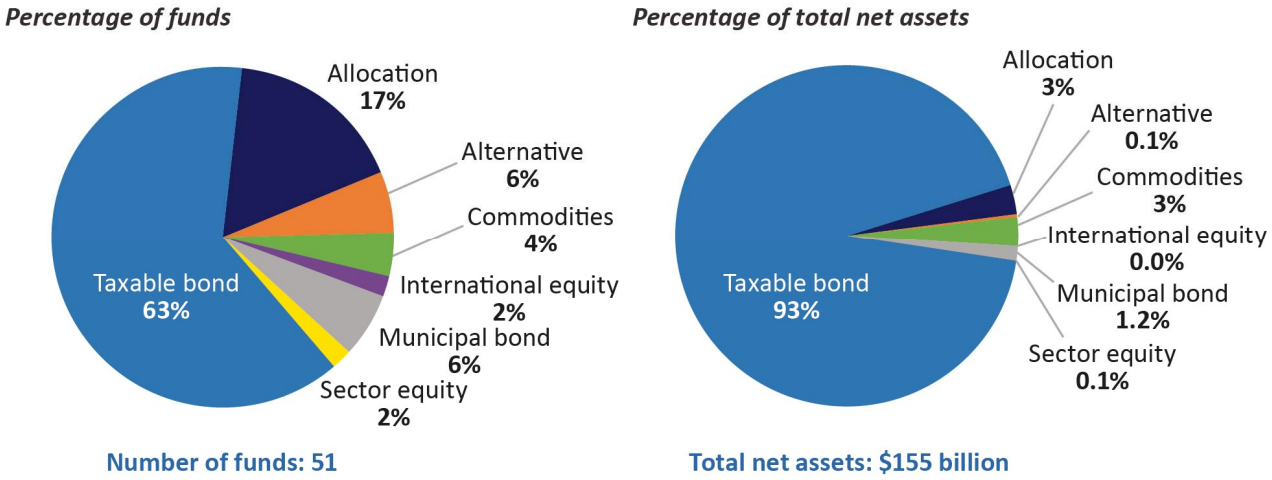
[1] Represents funds from ICI's survey that did not qualify as limited derivatives users and indicated that the fund had an identifiable designated reference index.

[2] Represents funds from ICI's survey that did not qualify as limited derivatives users and did not indicate that the fund had an identifiable designated reference index.

Note: In this figure, *funds* means all long-term mutual funds (including variable annuities), ETFs registered under the Investment Company Act of 1940, and closed-end funds. In ICI's survey, 762 out of the 1,288 funds that did not qualify as limited derivatives users (59 percent) provided the fund's highest value of VaR over 2019. VaR tests were conducted as closely as possible to the proposed requirements: three-year historical information, 20-day time horizon, and 99 percent confidence interval.

Source: Investment Company Institute

Figure 6: Bond Funds Again Were Bulk of Proposed VaR Test Failures over 2019



Source: Investment Company Institute

Another consideration for determining appropriate limits for the VaR test is how funds would fare under stressed market conditions when VaR, even for funds without leverage, can rise to elevated levels rapidly. ICI's survey asked funds that did not qualify as limited derivatives users to calculate VaR over a stressed period and report the fund's maximum VaR. Because this request was extremely data intensive and time-consuming, only 42 percent of affected funds were able to complete the analysis in the requested time frame.

Nevertheless, even with the smaller sample size, 50 funds with $52 billion failed the proposed VaR test during a stressed period (Figure 7).[73] When scaled by respondents, 9.3 percent of funds that provided information on their maximum VaR during a stressed period failed the proposed VaR test during the stressed period.

In contrast to the VaR results for 2019, failures were concentrated in funds that would need to use the absolute VaR test because they do not have a designated reference index. Indeed, 26.4 percent of funds that used the absolute VaR test had VaRs that exceeded 15 percent during a stressed period. This result is not surprising, as many securities markets experienced steep losses during the global financial crisis and well-known and widely used indexes had VaRs that exceeded the proposed 15 percent absolute VaR limit.[74] In addition, Figure 8 shows that the funds that failed the proposed VaR test were not concentrated in a particular asset class, but rather covered a broad range of asset classes and investment strategies.

[73] ICI's survey did not specify a specific stressed period because funds with different strategies or assets may have experienced stressed market conditions at different times. Nevertheless, 64 percent of the funds that failed the VaR test used a period that included the global financial crisis.

[74] *See* Figure 2.

Figure 7: More Than 9 Percent of Funds Failed Proposed VaR Test During Stressed Period
Number of funds

Relative VaR test results[1]

Type of fund	< 120%	120% to 140%	140% to 150%	>150%	>200%
Mutual funds	248	36	7	12	7
ETFs	27	1	0	0	0
Closed-end funds	62	10	2	4	1
Total	**337**	**47**	**9**	**16**	**8**
Percentage of respondents	**82.4%**	**11.5%**	**2.2%**	**3.9%**	**2.0%**
Total assets (billions)	**$521**	**$124**	**$8**	**$26**	**$11**

Absolute VaR test results[2]

Type of fund	< 12%	12% to 14%	14% to 15%	>15%	>20%
Mutual funds	71	4	3	26	12
ETFs	3	0	0	3	1
Closed-end funds	13	0	1	5	0
Total	**87**	**4**	**4**	**34**	**13**
Percentage of respondents	**67.4%**	**3.1%**	**3.1%**	**26.4%**	**10.1%**
Total assets (billions)	**$268**	**$1**	**$1**	**$25**	**$8**

Combined VaR test results

Total	**424**	**51**	**13**	**50**	**21**
Percentage of total respondents	**78.8%**	**9.5%**	**2.4%**	**9.3%**	**3.9%**
Total assets (billions)	**$608**	**$125**	**$9**	**$52**	**$19**

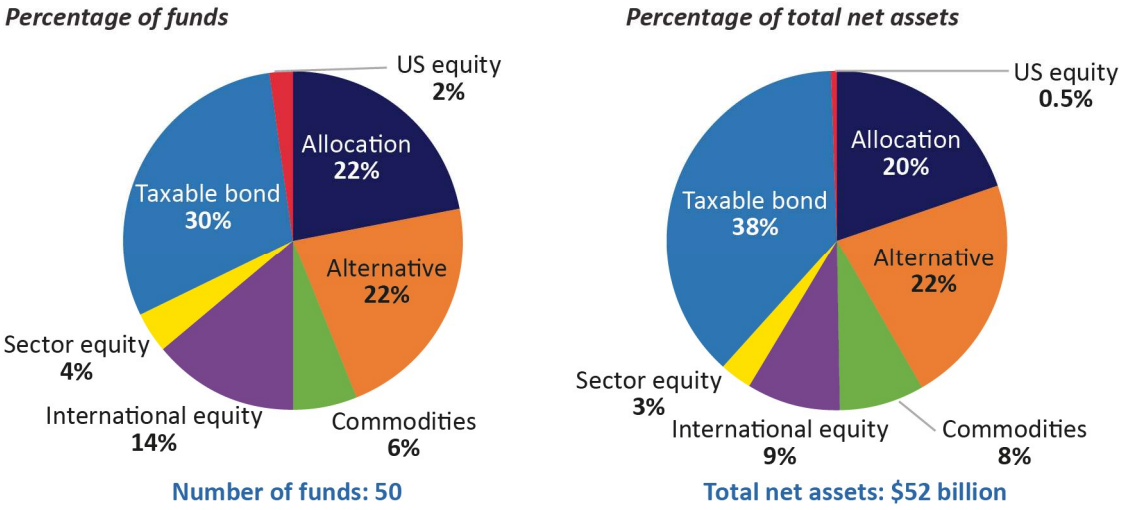
[1] Represents funds from ICI's survey that did not qualify as limited derivatives users and indicated that the fund had an identifiable designated reference index.

[2] Represents funds from ICI's survey that did not qualify as limited derivatives users and did not indicate that the fund had an identifiable designated reference index.

Note: In this figure, *funds* means all long-term mutual funds (including variable annuities), ETFs registered under the Investment Company Act of 1940, and closed-end funds. In ICI's survey, 538 out of the 1,288 funds that did not qualify as limited derivatives users (42 percent) provided VaR results during a stressed period. VaR tests were conducted as closely as possible to the proposed requirements: three-year historical information, 20-day time horizon, and 99 percent confidence interval.

Source: Investment Company Institute

Figure 8: Failures of Proposed VaR Test Spread Across Asset Classes During Stressed Period



Source: Investment Company Institute

To understand how the current COVID-19 crisis would affect fund VaR estimates, we conducted an informal request for information from our members for VaR estimates during March 2020. We received VaR estimates at various points in March for 318 funds that would be subject to a proposed VaR test. [75] Collectively, these funds had $310 billion in assets as of year-end 2019. In addition, on December 31, 2019, all of these funds' VaR estimates were below the proposed VaR limits.

During stressed periods, VaR estimates can increase substantially in a short amount of time. The current crisis is no exception, as VaR estimates for the funds in the sample spiked from their year-end 2019 values. The median percentage increase in VaR across all 318 funds was 25 percent—meaning that in March more than half the funds in the sample saw their VaR estimates increase by more than 25 percent from their year-end 2019 value. In addition, nearly a quarter of the funds (73 funds) had VaR estimates that more than doubled from their year-end 2019 values. The average percentage increase in VaR was 125 percent across all 318 funds.

Consequently, significantly more funds than the Commission expected based on its analysis would have exceeded the proposed VaR limits in March 2020. Of the 318 funds that were below the proposed VaR limits at year-end 2019, 50 funds, or 15.7 percent of the sample, with $81 billion in assets would have exceeded their relevant proposed VaR limit at some point in March—17 funds with $56 billion in assets would have exceeded the proposed 150 percent relative VaR limit and 33 funds with $25 billion in assets would have exceeded the proposed 15 percent absolute VaR limit. If the proposed limits were 200 percent for the relative VaR test and 20 percent for the absolute VaR test, only about half as many funds

[75] The VaR estimates across the 318 funds are not all as of the same date in March. The dates are March 11, 12, 19, 24, 25, and 27 of 2020.

would have failed—26 funds, or 8 percent, with $52 billion in assets. Seven funds with $39 billion would have exceeded the 200 percent limit on the relative VaR test, and 19 funds with $13 billion would have exceeded the 20 percent limit on the absolute VaR test.

Although the Commission likely would want funds to reduce their leverage during stressed periods, one consequence of the proposal is that during calmer periods for at least three years following a stressed period, funds, particularly those that use absolute VaR, will be constrained, potentially significantly, in their derivatives use. At any level of derivatives use, for example, the inclusion of the COVID-19 crisis period in the minimum three-year required historical lookback will increase a fund's VaR estimates going forward. To stay below the proposed VaR limits over the next three years, some funds, such as target volatility funds, will need to significantly curtail their derivatives use.

Setting limits that would force several funds to change their strategies or deregister as investment companies is contrary to the Commission's finding that only a very small number of funds would need to adjust their portfolios to comply with the proposed VaR-based limits on fund leverage. The limits thus appear to be inconsistent with a reasonable outer bound limit on undue speculation. Rather than using the derivatives risk management program as the cornerstone of a multifaceted oversight approach, many funds instead would need to manage to the proposed leverage limits, which would become the primary source of risk control. This result would too narrowly restrict a fund and would be unnecessary for the Commission to achieve its goal of limiting undue speculation and ensuring asset sufficiency.

c) Harmonize the Limits to a Global Standard

The Commission has flexibility to determine what leverage level is appropriate under Section 18 and the Investment Company Act. As discussed above, employing a limit based on one for bank borrowings is inappropriate for VaR and will have a greater adverse impact on funds than the Commission estimates.

Raising the limits as we recommend is not only supported by the data and other analysis described above, but also would be consistent with standards in other jurisdictions for regulated funds.[76] This means that our recommended limits are not only familiar to investment managers, funds, and their investors but also well-tested, thus providing the Commission with further evidence of their appropriateness for serving to meet the investor protection goals of Section 18 and the Investment Company Act. Compliance and other systems already exist, making such an approach cost-effective and able to be implemented with existing expertise and less disruption. Even for managers and funds that have less experience with these limits and methodologies, the fact that the experience exists in the market will be highly valuable to funds, their managers, and boards.

[76] As noted above, the European Union employs similar but higher leverage limits with a relative VaR limit of 200 percent of a UCITS benchmark VaR and an absolute VaR limit of 20 percent of net assets. *See* CESR Guidelines at Section 3.6.1 (Calculation Standards).

d) Increase the Limits for Closed-End Funds to Reflect the Increased Leverage They Can Obtain

Consistent with legislative intent, the Commission should permit closed-end funds to have higher leverage limits than open-end funds. The Commission considered permitting closed-end funds to have higher leverage limits, but it declined to do so.[77] It stated that it did not believe that a registered closed-end fund's ability to issue preferred stock suggested that registered closed-end funds should be permitted to obtain additional indebtedness leverage through derivatives transactions.[78]

We disagree with the Commission's decision to hold closed-end funds to the same leverage limits as open-end funds. Congress clearly intended to allow closed-end funds to obtain more leverage than open-end funds, and the proposed approach fails to take account of that intent reflected in the statute. As the Commission points out, both closed-end funds and open-end funds are subject to 300 percent asset coverage for their senior securities representing indebtedness. Closed-end funds also are able to issue preferred stock that is subject to 200 percent asset coverage for their senior securities representing indebtedness and preferred stock. With the addition of preferred stock, closed-end funds therefore are permitted to incur two times more leverage than open-end funds.[79] This is an important distinguishing feature for investors and managers as well as under the statute.

Congressional intent to provide additional leverage to closed-end funds is important because, under the proposed VaR leverage limits, closed-end funds would not be able to attain additional leverage as compared to open-end funds. VaR is measured at the portfolio level. The proposed VaR limits would not isolate a closed-end fund's portfolio leverage arising from its indebtedness from the portfolio leverage arising from its preferred stock. Instead, the proposed leverage limits would impose one limit (under either the relative VaR or absolute VaR tests) that restricts both indebtedness and preferred stock leverage. A closed-end fund that issues preferred stock, therefore, would be more limited in its ability to invest in derivatives, because it would start out with a higher VaR, attributable to the leverage from its preferred stock, than a fund that does not issue preferred stock.

---

[77] *See* Proposing Release at 4474.

[78] A closed-end fund can issue senior securities that represent indebtedness if it has at least 300 percent asset coverage. A closed-end fund can issue senior securities that represent stock if it has at least 200 percent asset coverage. *See* Sections 18(a)(1) and (2) of the Investment Company Act. "Asset coverage" means, for senior securities representing indebtedness, the ratio by which the value of the issuer's total assets, less all liabilities and debt not represented by senior securities, bears to the aggregate senior securities representing debt of such issuer. *See* Section 18(h). "Asset coverage" means, for senior securities representing preferred stock, the ratio by which the value of the issuer's total assets, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer plus the aggregate of the involuntary liquidation preference of such class of senior security which is a stock. *See* Section 18(h).

[79] For example, an open-end fund that has $100 in net assets could borrow up to $50 consistent with its requirement to have 300 percent asset coverage ($150 in total assets/$50 in borrowings). A closed-end fund that has $100 in net assets could obtain $100 in leverage from issuing preferred stock or from other debt consistent with its requirement to have 200 percent asset coverage ($200 in total assets/$100 in preferred stock and other borrowings).

To meet congressional intent under the statute, the Commission should increase a closed-end fund's leverage limit based on the maximum amount of structural leverage the closed-end fund intends to attain from its preferred stock issuance ("preferred stock leverage factor").[80] In these instances, a closed-end fund should be permitted to multiply, as applicable, either the maximum relative VaR or absolute VaR that open-end funds could attain by the preferred stock leverage factor.[81] For example, a closed-end fund with $100 in assets could issue $25 in preferred stock and use the proceeds from the issuance for investment. The proceeds from the stock issuance could be used to create leverage and, if invested in similar instruments to the designated reference index, one could expect the fund's relative VaR to be approximately 1.25 percent higher than the VaR of its designated reference index. Likewise, if invested in similar instruments to the fund's portfolio prior to the preferred stock issuance, one would expect the fund's absolute VaR to be approximately 1.25 percent higher. In each case, the funds' higher VaR would be attributable to the issuance of the preferred stock. If the fund then were to invest in derivatives, it would reach any leverage limit sooner than if it had not issued preferred stock, and the fund's VaR would be penalized unfairly for having issued the preferred stock. Multiplying the leverage limits by the preferred stock leverage factor (1.25x in the example, assuming that is the fund's maximum intended structural leverage attributable to preferred stock) appropriately should account for any increases to VaR attributable to the preferred stock. Accordingly, we urge the Commission to provide closed-end funds with higher leverage limits.

3. Clarify That a Fund Can Scale Its VaR Results from a 95 Percent Confidence Level to a 99 Percent Confidence Level When Appropriate

The Commission proposes to require funds to use a VaR model that generally is consistent with the VaR model requirements under the UCITS regime, including requiring a 99 percent confidence interval.[82] We agree with the Commission's proposed requirement entailing a 99 percent confidence interval for VaR models.[83] As we previously wrote, common parameters using standard measurements reduces

---

[80] The amount of leverage arising from a closed-end fund's preferred stock issuance could vary on a daily basis depending on fluctuations in the closed-end fund's net assets. The preferred stock leverage factor reflects the fund's maximum intended structural leverage attributable to preferred stock to avoid constantly changing leverage limits. The Commission could require closed-end funds to report this amount in their shareholder reports.

[81] Another way to reflect the additional leverage that Congress intended for closed-end funds is to permit them to use leverage in their benchmark in an amount that offsets the leveraging effect of their preferred shares.

[82] The proposed VaR model, as under the UCITS framework, must include a time horizon of 20 days. It also must be based on at least three years of historical market data. In addition, the proposed model must account for several common market risk factors (*i.e.*, equity price risk, interest rate risk, credit spread risk, foreign currency risk, and commodity price risk), material risks arising from the nonlinear price characteristics of the fund's investments, and the sensitivity of the portfolio investments to changes in volatility. In Europe, funds are required to calculate VaR based on an effective observation period (history) of risk factors of at least one year (250 business days) unless a shorter observation period is justified by a significant increase in price volatility (for instance extreme market conditions). *See* CESR Guidelines at Section 3.6.1 (Calculation Standards). In addition, funds must consider, as a minimum, general market risk, and, if applicable, idiosyncratic risk. *See* CESR Guidelines at Section 3.6.2 (Risk Coverage).

[83] We also do not object to the Commission's requirements that the VaR model use a 20-day time horizon, at least three years of historic market data, and factor in specific risks, which generally are in line with UCITS requirements. We note that, as permitted

variability and subjectivity of the VaR models and, accordingly, the possibility that the VaR model could be gamed.[84]

The Commission states that requiring a 99 percent confidence level and 20-day time horizon would cause the VaR model to measure and seek to limit the severity of less frequent but larger losses.[85] The Commission considered whether the higher confidence interval and longer horizon would result in fewer data points in comparison to lower confidence levels and shorter time horizons. It concluded that funds that use historical simulations could measure those historical losses using overlapping periods, which would increase the sample size considerably.[86] While this is mathematically true, it is unclear whether these added data points from using overlapping periods provide additional useful information in the statistical analysis.[87] To avoid statistical biases associated with using overlapping periods, risk professionals often calculate VaR on a one-day horizon and scale it to a multiday horizon.[88] The Commission acknowledges that this time-scaling approach is common practice and appears to allow risk professionals to continue to employ it, when appropriate, in the VaR calculations under the proposed rule.[89]

The Commission should clarify that it permits confidence scaling as well. Scaling confidence levels is another technique that risk professionals often use to circumvent using overlapping periods and to avoid small sample bias in estimating VaR at higher confidence levels. For example, a risk professional will calculate VaR at a 95 percent confidence level and then scale the VaR to a 99 percent confidence level.[90]

---

for UCITS, certain funds may use exponential weighting when applying historical market data. Doing so would permit funds to more heavily weigh recent market data over data from earlier periods.

[84] *See* Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated September 27, 2016, *available at* www.sec.gov/comments/s7-24-15/s72415-255.pdf.

[85] *See* Proposing Release at 4477.

[86] The Commission states that a fund measuring nonoverlapping periods would only expect 12 or 13 data points, but if it used overlapping periods, the fund could have as many as 250 data points over the trailing 20 days. *Id.*

[87] Overlapping periods adds dependency among the data points and can induce biases in the statistical analysis. Danielson and Zhou (2015) shows that use of overlapping periods in smaller sample sizes reduces the estimation accuracy of the VaR model. *See* Jon Danielson and Chen Zhou, Why Risk Is So Hard to Measure, SRC Discussion Paper No. 36 (April 2015), *available at* http://eprints.lse.ac.uk/62002/1/dp-36.pdf.

[88] *Id.* Danielson and Zhou (2015) shows that the overlapping approach produces less accurate VaR estimates than the time-scaling approach.

[89] *See* Proposing Release at footnote 230.

[90] When fund returns are normal and independent and identically distributed ("iid"), a VaR calculation based on a 95 percent confidence level can be scaled to a 99 percent confidence level by multiplying the 95 percent confidence level VaR by the product of 1.41 and the standard error of the VaR model. The constant 1.41 comes from taking the Z-statistic for a one-tailed test at the 99 percent level (2.33) and dividing it by the Z-statistic for a one-tailed test at the 95 percent level (1.65) (*i.e.*, 2.33 divided by 1.65 = 1.41). When fund returns are not iid normal, but follow another distribution, this scaling factor will be incorrect but may be able to be adjusted. For example, if returns follow a *t* distribution with 3 degrees of freedom, a distribution that describes the returns of the S&P 500 well (*See*, for example, Jianqing Fan and Qiwei Yao, *The Elements of Financial Econometrics*, Science Press, Beijing, 2015) the scaling factor increases to 1.93 but is known.

This allows the risk professional to include a somewhat wider set of negative outcomes in the VaR calculation instead of being limited to the most extreme and unlikely losses. One example of when a risk professional may prefer to scale a VaR model's confidence level arises from the extreme outcomes the financial markets have experienced during the current COVID-19 crisis. The recent large negative returns in asset prices certainly will fall in the far left tail of the distribution and would unduly inflate funds' VaR estimates going forward (at least three years) if a risk professional is not permitted to scale from a 95 percent confidence level to a 99 percent confidence level.

The Proposing Release does not explicitly prohibit risk professionals from using confidence level scaling. The Commission, however, should clarify that funds may use confidence scaling when calculating VaR, when appropriate, much like it clarified that funds may use time scaling when calculating VaR, when appropriate.[91]

We also note that this is already a market practice. For UCITS, managers must use a VaR model with a 99 percent confidence level but are permitted flexibility to scale VaR outputs from models using 95 percent confidence levels.[92] Again, leveraging practices already in place and tested will support the Commission's goals in this rulemaking and enable funds to use existing global compliance mechanisms and expertise.[93] Variations from such an approach will not allow the Commission or industry and fund investors to fully realize the efficiencies and benefits of being able to draw on and leverage the existing systems and expertise.

4. Ease the Impact of VaR Test Breaches

a) Extend the Period During Which a Fund Could Be in Noncompliance with Its VaR Test

We urge the Commission to extend the three-business-day noncompliance period with its applicable VaR test to five business days or, at the very least, seven calendar days.[94] A longer period is necessary to provide a sufficient indication of a fund's inability to comply with its VaR test or that a fund bears too much leverage risk from its derivatives holdings. Under Proposed Rule 18f-4, if a fund determines that it is not in compliance with its daily VaR test, it must return to compliance within three business days.[95] If, after the three business days, the fund remains noncompliant, then requirements regarding board reporting, program (as defined herein) analysis and updating, and restrictions on entering into certain

---

[91] By "when appropriate," we mean that when returns follow an empirically identified parametric distribution that defines the corresponding quantiles.

[92] *See* CESR Guidelines at Section 3.6.1 (Calculation Standards).

[93] *See*, *e.g.*, October 2019 ICI Letter at 3–4 (In response to a member survey, 45 percent of respondent ICI members said that it would be only slightly burdensome to implement a UCITS VaR test that used the same parameters as the UCITS VaR. An additional 34 percent reported that it would be moderately burdensome.)

[94] The Commission could consider extending this to seven business days or 10 calendar days in the event that there is a marketwide disruption that affects the liquidity of funds' underlying holdings.

[95] *See* Proposed Rule 18f-4(c)(2)(ii).

derivatives transactions would apply.[96] The Proposing Release states that the three-business-day period before a fund is required to take specific remedial actions is similar to the remediation approach for open-end funds' asset coverage compliance with respect to bank borrowings under Section 18(f) of the Investment Company Act.[97]

We urge the Commission to provide funds with five business days or, at the very least, seven calendar days to return to compliance. This longer period—at least five business days—is needed to allow for a sufficient indication of a fund's inability to comply with its VaR test or that a fund bears too much leverage risk from its derivatives holdings. The proposed three-day period is insufficient for many funds to adjust their portfolios in a reasoned and thoughtful manner to come back into compliance with a VaR test. Potential harm to a fund from being required to come back into compliance so quickly could be greatly exacerbated if a fund receives large redemption requests during the same period.

Further, basing the period on the remediation period for bank borrowings is an inappropriate point of comparison, as credit facilities generally contemplate and allow for a reduction in the outstanding amount of borrowings on an immediate basis. From a practical perspective, assuming this would reduce VaR, a fund may not be able to terminate or unwind its derivatives transactions within this time frame. For example, under Rule 22e-4, a fund merely needs to reasonably expect to be able to sell or dispose of an investment in seven calendar days or less in order for the investment not to be considered an "illiquid investment."[98] Funds often negotiate early termination rights in their over-the-counter derivatives agreements with that time frame as a guideline, or may have to agree to a negotiated price for termination at the time of termination if they do not have agreed-upon early termination rights, which can be a time-consuming process. Accordingly, funds may need additional time (beyond three business days) to terminate existing derivatives trades to come back into compliance with the applicable VaR test. Increasing the number of days is more consistent with market practice and existing regulatory standards, and still provides strong investor protection.

b) Allow Funds to Enter into Certain New Derivatives Transactions After VaR Test Breaches

Funds should be permitted to enter into new derivatives transactions after VaR test breaches. The Commission's related concern about new derivatives transactions creating impermissible leverage risk already is addressed, and such transactions are important to managing a fund consistent with its investment objective and protecting investors. Under Proposed Rule 18f-4, if a fund does not come back into compliance with the applicable VaR test within three business days (or longer, as recommended above), the fund could not enter into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been

---

[96] *See* Proposed Rule 18f-4(c)(2)(iii).

[97] *See* Proposing Release at 4479.

[98] *See* Rule 22e-4(a)(8) under the Investment Company Act.

back in compliance with its VaR test for three consecutive business days.[99] The Commission proposes this standard to address the concern that funds could return to compliance and immediately increase their market risk, which "could potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test."[100]

The Commission should eliminate this "time-out." The Commission's concern about new derivatives positions leading to funds "having persistently high levels of leverage risk beyond that permitted" already is addressed through the proposal's other requirements and is unnecessary. In particular, the proposal requires a fund to report to the Commission each time the fund experiences a VaR test breach and when it comes back into compliance.[101] The proposed requirement to report VaR test breaches to the SEC on multiple occasions will serve as a deterrent for funds that invest in new derivatives from again breaching permitted leverage limits. Further, Proposed Rule 18f-4 requires the derivatives risk manager to notify the board of each breach, to analyze the circumstances that caused the fund to be out of compliance with the leverage limits, and to update program elements to appropriately address those circumstances. Combined, these proposed new requirements already address the Commission's concern that a fund in breach will add new derivatives positions that cause another breach. The proposed additional restriction on new derivatives investments is unnecessary.

Moreover, the "reducing VaR" standard is vague, and the time-out could harm shareholders. The standard is vague because it implies that a fund must engage in pre-trade monitoring or testing during the time-out period or risk being "second-guessed." Without pre-trade VaR testing, it is unclear how a portfolio manager or derivatives risk manager would demonstrate with certainty that a new derivatives position, individually or in the aggregate, is "designed to reduce the fund's VaR." Pre-trade VaR testing, however, is impractical on a real-time basis because the fund's portfolio is not necessarily static during the trading day. Funds may enter into multiple buy or sell transactions or have shareholder flows throughout the day that could affect the fund's VaR. In addition, the new derivatives transactions may interact with the rest of a fund's portfolio in ways that are not so straightforward. For example, a fund may enter into a derivatives transaction for the purpose of reducing the fund's VaR, but later in the day could determine that such transaction actually had the effect of increasing the fund's VaR, possibly due to other portfolio holdings, changes in market conditions or other general, industrywide trends.

Further, restricting the ability of a fund to enter into certain derivatives transactions for at least three consecutive business days could disrupt a fund's investment strategies. This could be particularly applicable if the fund obtains significant investment exposure through derivatives transactions or, for example, if the fund was prevented from using derivatives to react to changing asset liquidity or market dislocations during the relevant period. In particular, funds should not be unduly restricted from (1) rolling current holdings, (2) meeting liquidity and redemption needs, (3) mitigating risks within the

---

[99] It also should satisfy certain board reporting and program analysis and update requirements. *See* Proposed Rule 18f-4(c)(2)(iii).

[100] *See* Proposing Release at 4479–4480.

[101] *See* Proposed Parts E, F, and G of Proposed Form N-RN.

fund's portfolio more generally, and (4) responding to abnormal market conditions or events. These transactions are important for funds to avoid disruptions, and restrictions on these practices could harm the fund's shareholders and adversely affect a fund's performance.

Instead, a fund—guided and constrained by reporting requirements under Rule 18f-4—will be in the best position to determine what actions to take to address VaR test breaches and prudently manage derivatives risk at that time in light of the fund's portfolio holdings and current market conditions.

C. Program Requirements

We support the proposed requirement that funds investing in derivatives develop and maintain a formalized derivatives risk management program, but have some recommended modifications. Under Proposed Rule 18f-4, a fund (other than a limited derivatives user) could enter into derivatives transactions, if among other things, it adopts and implements a written derivatives risk management program. The program must include policies and procedures reasonably designed to manage the fund's derivatives risks[102] and must reasonably segregate the functions associated with the program from the portfolio management of the fund.[103] It also must include the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing, (4) backtesting, (5) internal reporting and escalation, and (6) periodic review of the program by the derivatives risk manager and the fund's board.[104]

We agree that a formalized program, coupled with board oversight and reporting, should ensure that such funds have sufficient assets to meet their obligations under their derivatives transactions and address concerns about the potential for undue speculation. This approach also will facilitate better design and implementation of a program by each fund, as a fund's program can be appropriately customized to manage the risks posed by the fund's use of particular types of derivatives in light of the fund's investment portfolio and strategies.

We recommend, however, modifications to certain other specific elements of the program related to stress testing, backtesting, the derivatives risk manager, and the role of the board of directors. Our recommended changes will still stay true to the Commission's regulatory objectives but would ease

---

[102] These risks include leverage risk, market risk, counterparty risk, liquidity risk, operational risk, and legal risk, as applicable, and any other derivatives risks that a fund's derivatives risk manager deems material. *See* Proposed Rule 18f-4(a) (defining *derivatives risks*).

[103] *See* Proposed Rule 18f-4(c)(1). The Proposing Release characterized this condition as "critical to appropriate derivatives-risk management" and "foundational to providing exemptive relief under Section 18." *See* Proposing Release at 4453.

[104] *See* Proposed Rule 18f-4(c)(1). The derivatives risk manager would have to review the program at least annually to evaluate the program's effectiveness and to reflect changes in risk over time. The periodic review must include a review of the VaR calculation model (including the backtesting requirement) and any designated reference index to evaluate whether it remains appropriate. *See* Proposed Rule 18f-4(c)(1)(vi).

some of the associated burdens. With respect to the responsibilities of a fund board, we support the detailed comments from the Independent Directors Council[105] and highlight a few key points.

We believe these modifications are important. Proposed Rule 18f-4's costs and additional burdens have the potential to create a *de facto* barrier to the use of derivatives transactions in more than a *de minimis* amount for some funds. Absent changes, some may view the potential regulatory costs and compliance burdens associated with the program as outweighing the benefits that a fund could achieve through derivatives use. As a consequence, a fund may need to change and reduce the ways it uses derivatives transactions to implement its investment objective and strategies and manage risk to meet the conditions of the limited derivatives user exceptions. Such a decision would not seem consistent with the Commission's intentions in this proposal as it would, due to regulatory burdens and costs, unduly limit access to the benefits that a fund could otherwise obtain for investors through the use of derivatives.

1. Stress Testing Requirement Recommendations

We support the Commission's proposed stress testing requirement, but we have recommendations related to some of the details of the stress testing requirements. Under the proposal, a fund's derivatives risk management program must provide for, among other things, stress testing to evaluate potential losses to the fund's portfolio in extreme but plausible market changes or changes in market risk factors that would significantly and adversely affect a fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties.[106] The Commission notes that market risk factors commonly considered for this purpose include liquidity, volatility, yield curve shifts, sector movements, or changes in the underlying instrument's price.[107] Proposed Rule 18f-4 also permits a fund to determine the frequency with which stress tests are conducted, if the fund conducts stress testing at least weekly.[108] In determining testing frequency, a fund must take into account the fund's strategies and investments and current market conditions.[109] The weekly testing minimum is intended to balance the benefits and burdens of frequent stress testing.[110]

We recommend a clarification related to stress testing correlations and a reduction to the frequency of testing.

---

[105] *See* Letter from Thomas T. Kim, Managing Director, Independent Directors Council, to Vanessa A. Countryman, Secretary, SEC, dated April 20, 2020.

[106] *See* Proposed Rule 18f-4(c)(1)(iii).

[107] *See* Proposing Release at 4462.

[108] *See* Proposed Rule 18f-4(c)(1)(iii).

[109] *Id.*

[110] *See* Proposing Release at 4462–4463.

a) Clarify the Scope of Stress Testing Correlations

We urge the Commission to clarify the scope of Proposed Rule 18f-4's requirement that a fund's stress testing consider "correlations of market risk factors."[111] We also recommend that it acknowledge that a fund's derivatives risk manager may need to make determinations in its reasonable business judgment with respect to this and all other aspects of the program, which would not be subject to *post hoc* scrutiny by Commission examination staff.[112] While the Proposing Release identifies six market risk factors as "commonly considered," there are many potential market risks that a fund could consider in connection with its stress testing. The vague requirement that a fund take into account "correlations of market risk factors" invites the potential for "second-guessing" by the Commission's examination staff if a derivatives risk manager fails to consider any specified correlation.

b) Reduce the Minimum Frequency of Stress Testing

We recommend that the Commission decrease, from weekly to monthly, the minimum frequency of Proposed Rule 18f-4's stress testing requirement. Weekly stress testing may be too frequent, burdensome, and costly for funds to implement—particularly during periods of low market stress. Such frequency also is generally not necessary for a fund to benefit from an overlay of stress testing to the VaR-based leverage limits. Instead, a monthly minimum stress testing frequency requirement would allow a fund to assess multiple sets of testing results throughout a year and observe trends and changes over time without sacrificing its ability to assess in a timely manner its risk of potential loss. A fund's derivatives risk manager initially could determine that more frequent stress testing is appropriate and always would remain subject to its general obligation to periodically review the fund's program to evaluate the program's effectiveness and to reflect changes in risk. During the course of its review, a derivatives risk manager similarly may determine that more frequent stress testing is necessary in light of market conditions or for other reasons under the guidance provided in the Proposing Release.

2. Reduce the Frequency of VaR Calculation Model Backtesting

We urge the Commission to reduce the backtesting frequency proposed under the new rule, which would require a fund to conduct backtesting of its VaR calculation model daily. We recommend testing be at least monthly, while considering the one-day value change for each trading day in the period.[113] Proposed Rule 18f-4 would require a fund to backtest the results of its VaR calculation model each business day, comparing the fund's gain or loss with the corresponding VaR calculation for that day, estimated over a one-trading day time horizon. The fund must identify as an exception any instance in

---

[111] *See* Proposed Rule 18f-4(c)(1)(iii).

[112] *See also infra* Section II.C.3 (recommending that the Commission provide guidance granting deference to the derivative risk manager's reasonable business judgment).

[113] We note that this approach would align with the CESR Guidelines. The CESR Guidelines require monthly backtesting for UCITS to monitor the accuracy and performance of a UCITS fund's VaR model, with retroactive comparison of the VaR measure generated by the VaR model compared to the UCITS fund's actual VaR for each business day. *See* CESR Guidelines Section 3.6.4 (Back Testing).

which the fund experiences a loss exceeding the corresponding VaR calculation's estimated loss.[114] The proposed requirement "is designed to require a fund to monitor the effectiveness of its VaR model...and help identify when funds should consider model adjustments."[115]

The Commission should reduce the frequency from daily to monthly, while considering the one-day value change for each trading day in the period. Daily backtesting is not necessary for VaR backtesting to be an effective and beneficial tool to monitor the proper functioning of a fund's VaR model. We understand that derivatives risk managers would need to evaluate several days' backtesting results before determining that any exceedance indicates that the fund's VaR model should be changed. In fact, some fund complexes have determined that they must consider at least six months of backtesting history, not just a few days, before determining whether model changes are necessary or appropriate. Further, for those complexes' funds, any VaR model changes would require substantial analysis from its risk teams and approval by its internal VaR model committee. The additional burdens and costs associated with daily VaR backtesting provide little substantive benefit and, in practice, would not likely result in more frequent model changes than monthly backtesting with daily review.

We recommend adopting a monthly backtesting requirement that compares the fund's actual gains and losses with its estimated VaR for each business day during the period. This approach will allow a fund to monitor the accuracy and performance of its VaR calculation model, and make appropriate adjustments over time, without incurring the significant costs of daily testing. Further, if market risk factors or fund investments change, funds can determine to run interim backtesting on an as-needed basis.

3. Permit a Fund's Adviser to Serve as Derivatives Risk Manager and Eliminate the "Relevant Experience" Requirement

We recommend allowing a fund's investment adviser to serve as the derivatives risk manager. In addition, the Commission should remove the requirement that a fund's board consider the derivatives risk manager's "relevant experience" when approving the derivatives risk manager. Proposed Rule 18f-4 requires that the fund's board of directors, including a majority of directors who are not interested persons of the fund, approve the designation of a derivatives risk manager and take account of the derivatives risk manager's relevant experience in the management of derivatives risk.[116] The derivatives risk manager must be an officer or officers of the fund's investment adviser.[117] The derivatives risk manager also may not be the fund's portfolio manager, if a single officer serves in the position, and the

---

[114] *See* Proposed Rule 18f-4(c)(1)(iv).

[115] *See* Proposing Release at 4463. Daily backtesting is required so that the VaR calculation model could more readily and effectively be adjusted, allowing the fund to more effectively manage its derivatives risk. *Id.* at 4464. The Proposing Release further notes that the dynamic nature of market risk factors and fund investments could necessitate frequent changes to the fund's VaR model. *Id*. The Proposing Release suggests that such adjustments likely would be needed if a fund experienced back testing exceptions more or less frequently than expected using the required confidence level. *Id.* at 4463.

[116] *See* Proposed Rule 18f-4(c)(5)(i).

[117] *See* Proposed Rule 18f-4(a) (defining *derivatives risk manager*).

derivatives risk manager may not have a majority composed of portfolio managers, if multiple officers serve as derivatives risk manager.[118] The derivatives risk manager, among other things, is responsible for providing a written report to the board on or before implementation of the derivatives risk management program. The derivatives risk manager thereafter at least annually must provide a representation that the program is "reasonably designed to manage the fund's derivatives risks" and to incorporate the required program elements.[119]

In the Proposing Release, the Commission draws a comparison between Proposed Rule 18f-4's derivatives risk manager position and the corresponding function under Rule 22e-4 under the Investment Company Act.[120] Rule 22e-4 provides that the "person(s) designated to administer the [liquidity risk management] program" (the "liquidity risk manager") would mean the fund's "investment adviser, officer, or officers (which may not be solely portfolio managers of the [fund]) responsible for administering the program and its policies and procedures...."[121] Specifically, the Proposing Release requests comment on whether the Commission should align the final rule with Rule 22e-4,[122] which would allow a fund's investment adviser, as opposed to a specific individual or individuals, to serve as a fund's derivatives risk manager.

We believe that the Commission should permit a fund's investment adviser as an entity to serve as derivatives risk manager.[123] Such an investment adviser could, in turn, designate its employees to staff the investment adviser's program administration function.

The Commission has provided no rationale as to why a fund's investment adviser could not serve as a fund's derivatives risk manager. Under the framework of Rule 22e-4, it has become common practice for a fund's adviser to be designated as the fund's liquidity risk manager with the ability to delegate responsibilities to the adviser's staff. Many funds and their investors have benefited from this flexibility.[124]

---

[118] *Id.*

[119] The derivatives risk manager must provide a report to the board with the basis for the representation and information reasonably necessary for the board to evaluate the adequacy of the fund's program and (after implementation) the effectiveness of program implementation. *See* Proposed Rule 18f-4(c)(5)(ii). The report also must include the basis for the selection of the designated reference index or explain why the derivatives risk manager was unable to identify an appropriate index. *Id.*

[120] *See* Proposing Release at 4459.

[121] *See* Rule 22e-4(a)(14).

[122] *See* Proposing Release at 4459.

[123] As with the Proposing Release, the term *investment adviser* generally refers to any person, including a subadviser, that is an 'investment adviser' of an investment company as that term is defined in Section 2(a)(20) of the Investment Company Act. *See* Proposing Release at 4458.

[124] *See* "Investment Company Liquidity Risk Management Programs Frequently Asked Questions" (Modified April 10, 2019) ("Liquidity Risk Management FAQs"), *available at* www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq. The Liquidity Risk Management FAQs note that "[n]either [Rule 22e-4] nor the [Liquidity Rule Adopting Release

Further, requiring a fund's board to approve a specific person or persons to serve as a fund's derivatives risk manager in lieu of the fund's investment adviser places a unique burden on the board to determine whether a given person is qualified to serve in that role. This would require a fund's board to take on more management-like responsibilities, as opposed to serving in an oversight role. For example, a fund's board may need to reevaluate its previous approval, in the event that the fund's derivatives risk manager needs to be replaced. Instead, it should be appropriate for a board to determine that a fund's investment adviser is in the best position to determine which individuals possess the relevant expertise to staff the investment adviser's program administration function. The program's policies and procedures could be designed in such a way that appointment of the investment adviser as derivatives risk manager would not reduce the effectiveness of the proposed requirement that there be a reasonable segregation of the program and portfolio management functions.

Permitting the board to approve the designation of the fund's investment adviser as the derivatives risk manager also eliminates the concern that individual derivatives risk managers could face personal liability for determinations made under the program. The requirement that derivatives risk managers represent that the derivatives risk management program is reasonably designed to manage risks and incorporate the required elements of the program is a wholly new requirement unlike those under fund compliance and liquidity risk management programs.[125] It raises concerns that a derivatives risk manager's subjective determinations on the design of the program and implementation of the program could be "second-guessed," creating potential liability for the derivatives risk manager's good faith determinations. As we previously commented, we again recommend that the Commission provide guidance that it will grant deference to the reasonable business judgment of the derivatives risk manager in making these determinations.[126]

We similarly urge the Commission to remove the requirement that a fund's board consider the derivatives risk manager's relevant experience when approving the derivatives risk manager. A fund's board is not obligated to take relevant experience into consideration when approving a fund's liquidity risk manager under Rule 22e-4, and there is no discernable rationale for requiring it to do so under

---

(defined below)] prescribes whether or how a program administrator could delegate responsibilities—either for administering the entire [liquidity risk management] program or for handling discrete responsibilities under the fund's [liquidity risk management] program. Therefore, the staff believes that, subject to appropriate oversight, a program administrator has flexibility regarding delegation, provided that each responsibility is delegated to, and assumed and handled by, an appropriate entity." Liquidity Risk Management FAQs at Answer 1.

[125] The Commission does not require chief compliance officers under Rule 38a-1 or liquidity risk managers under Rule 22e-4 to make any similar or broad representations in their reports or records. Under Rule 38a-1, chief compliance officers must provide reports to the board that summarize the operation of the fund's policies and procedures, any material changes to those policies and procedures, and each material compliance matter that has occurred since the last report. *See* Rule 38a-1 under the Investment Company Act. Under Rule 22e-4, liquidity risk managers must provide a report that addresses the operation of the program, assesses the program's adequacy and effectiveness, and describes material changes to the program since the last report. *See* Rule 22e-4 under the Investment Company Act.

[126] *See* March 2016 ICI Letter at Section III.B.2 (recommending that the Commission clarify that good faith decisions do not create liability for derivatives risk managers).

Proposed Rule 18f-4. The Commission does not explain what relevant experience means or the qualifications a derivatives risk manager must have. Requiring a board to consider a derivatives risk manager's relevant experience therefore places additional burdens on a fund's board and could expose the board to potential liability and "second-guessing" by Commission examination staff. Alternatively, the Commission could provide additional guidance as to what types of relevant experience would be appropriate for a derivatives risk manager to possess. In either case, the Commission should acknowledge that a fund's board will be granted deference in the exercise of its reasonable business judgment when approving a derivatives risk manager.[127]

4. Clarify That a Derivatives Risk Manager May Delegate Responsibilities to Subadvisers

To assist derivatives risk managers in executing their responsibilities, the Commission should clarify that a derivatives risk manager could delegate day-to-day management of derivatives risks to a fund's subadviser or subadvisers. This approach would be similar to that allowed under the liquidity rule and would provide important support to the derivatives risk manager.

The delegated responsibilities could include, among other things, reasonable aspects of the derivatives program, such as the identification and assessment of the fund's derivatives risks, the establishment, maintenance and enforcement of certain risk guidelines, and the measures to be taken if they are exceeded. Derivatives risk managers who choose to delegate these functions would need to develop an oversight and reporting program to ensure that they receive the information that they need from subadvisers to appropriately manage their entire program. For example, the derivatives risk manager could couple the delegation of functions with requiring the subadviser to escalate any material issues to the derivatives risk manager. The recommended delegation would be similar to the framework certain liquidity risk managers currently use to operate under their liquidity risk management programs, and funds could base their approach to delegation on that framework.

5. Ensure That the Role of the Board Is One of Oversight

We recommend some clarification on the role of a fund's board of directors in connection with the proposed rule. The Proposing Release notes that the requirements under Rule 38a-1 under the Investment Company Act regarding a board's approval of a fund's compliance policies and procedures "would encompass [a board's responsibilities for overseeing] a fund's compliance obligations" with respect to Proposed Rule 18f-4.[128] The Proposing Release also states that a fund's board should: (1) "understand the program and the derivatives risks it is designed to manage as well as participate in determining who should administer the program;"[129] (2) "ask questions and seek relevant information

---

[127] *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, 81 Fed. Reg. 82142 (Nov. 18, 2016) at 82212 ("Liquidity Rule Adopting Release").

[128] *See* Proposing Release at 4466.

[129] *Id.*

regarding the adequacy of the program and the effectiveness of its implementation;"[130] and (3) view oversight as an iterative process, and therefore should "inquire about material risks arising from the fund's derivatives transactions and follow up regarding the steps the fund has taken to address such risks, including risks that may change over time."[131]

Proposed Rule 18f-4 would not require a fund's board to approve the program. A fund's derivatives risk manager, however, would have a direct reporting line to the fund's board and must directly inform the fund's board of material risks arising from the fund's derivatives transactions, including risks identified through exceedances of guidelines or by stress testing.[132] The derivatives risk manager must provide to the board, at a frequency determined by the board, a written report analyzing any exceedances of risk guidelines, and the results of certain stress testing and backtesting required under the program that occurred since the last report to the board.[133] That report must include information reasonably necessary for the board to evaluate the fund's response to any exceedances and the results of the stress testing and must explain how and when the derivatives risk manager reasonably expects that the fund will come back into compliance.[134]

We support this approach but recommend that the Commission clarify the expected level of involvement that a fund's board must have in the day-to-day aspects of a fund's program. We also recommend that the Commission permit derivatives risk managers to provide summaries of risk guideline exceedances and stress testing and backtesting results.

We are concerned that the Commission's statements in the Proposing Release regarding a fund board's obligations suggest that board members may need to take on a more active role with respect to a fund's program than under the board oversight role as described in Release 10666 and under the corresponding board oversight role under Rule 22e-4.[135] The board obligations contemplated under Proposed Rule 18f-4 would go beyond a board's obligations under Rule 38a-1, which requires that a fund board's approval of a fund's or service provider's policies and procedures be based on a finding that such policies and procedures are reasonably designed to prevent violations of the specified laws and rules. For example, calling the process an "iterative" one suggests a level of board involvement that exceeds its standard role of providing oversight.

---

[130] *Id.*

[131] *Id.*

[132] *See* Proposed Rule 18f-4(c)(1)(v)(B).

[133] *See* Proposed Rule 18f-4(c)(5)(iii).

[134] *Id.*

[135] *See* Liquidity Rule Adopting Release at 82212. The Liquidity Rule Adopting Release further notes that Rule 22e-4 "retains a role for the board in overseeing the fund's liquidity risk management program, but in response to commenters, eliminates certain of the more specific and detailed approval requirements. We believe the role of the board under the rule is one of general oversight, and consistent with that obligation we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors." *Id.*

The Commission's statements and the detailed level of information required to be provided to a fund's board under the reporting requirements could be viewed as assigning fund boards the responsibility to be actively engaged in the derivatives risk management function, a role that is more appropriately handled by the investment adviser or derivatives risk manager. These statements also suggest that board members would need to have a level of substantive knowledge with respect to the derivatives used by funds beyond what should be required in their traditional oversight role. In addition, while there is no explicit requirement in Proposed Rule 18f-4 for a board to approve a fund's program, it is not clear what the board's obligations would be with respect to approval of the program and policies and procedures thereunder. Further, the Proposing Release provides no rationale as to why the board's oversight role should be similar, but be substantively different and more involved, than the board's oversight role under Rule 22e-4.

Thus, in adopting a final rule, the Commission should replace these statements of guidance with guidance affirming that the role of a fund's board is one of general oversight and that the Commission expects that board members will exercise their reasonable business judgment in overseeing the program, similar to the statements of guidance provided in adopted Rule 22e-4.[136] Board members should be able to rely on the derivatives risk manager, and any third parties the derivatives risk manager engages, to assist it in carrying out its function, and should not necessarily have an iterative role with respect to the program.

The Commission also should eliminate certain of the more detailed and specific obligations imposed on fund boards under the reporting framework. Rather than requiring detailed reports, including on exceedances of risk guidelines and the results of certain stress testing and backtesting requirements, we urge the Commission to permit the derivatives risk manager to provide executive summaries of relevant findings, similar to the framework set forth under Rule 22e-4.[137] Fund boards are increasingly inundated with information. A requirement for boards to evaluate extensive reports on a fund's derivatives risk management program will lead to unnecessary involvement of a fund's board in detailed and technical determinations of the type that historically have been left to the discretion of a fund's portfolio management. Alternatively, executive summaries would allow a fund's board to receive only relevant information and allow them to better evaluate actual concerns raised by a fund's use of derivatives. Moreover, a fund's board would remain empowered to ask questions about any report, or portion thereof, that it believes warrants additional consideration.

---

[136] *Id.*

[137] *Id.* at 82212–82213, noting, "directors may satisfy their obligations with respect to this initial approval by reviewing summaries of the liquidity risk management program prepared by the fund's investment adviser, officer, or officers administering the program, legal counsel, or other persons familiar with the liquidity risk management program. The summaries should familiarize directors with the salient features of the program and provide them with an understanding of how the liquidity risk management program addresses the required assessment of the fund's liquidity risk."

D. Limited Derivatives User Exceptions

The Commission should revise its proposed limited derivatives user exceptions to appropriately exclude those funds that need not be subject to heightened derivatives risk management requirements. Under Proposed Rule 18f-4, a fund would not be required to adopt a derivatives risk management program or comply with the limit on fund leverage risk if the fund either limits its derivatives exposure to 10 percent of its net assets (the "exposure-based exception") or uses derivatives transactions solely to hedge certain currency risks (the "hedging exception").[138] Such a fund, however, still must adopt policies and procedures reasonably designed to manage the fund's derivatives risks.[139]

We support the Commission's efforts to provide exceptions for limited derivatives users, and recommend certain changes to make the exceptions more workable and useful to funds.[140] Our recommendations are consistent with the Commission's intent to provide a "principles-based policies and procedures requirement [that] would appropriately address" risks to which limited derivatives users may be subject.[141] In particular, we recommend that the Commission: (1) include additional derivatives transactions used for hedging and offsetting in the hedging exception; (2) clarify that differences of 10 percent or less of the value of hedged instruments are "negligible amounts" under the hedging exception; (3) combine the exposure-based exception with the hedging exception; and (4) include a defined cure period for exceedances or breaches of the limited derivatives user exceptions.

1. Include Additional Derivatives Transactions Used for Hedging and Offsetting in the Hedging Exception

We recommend that the Commission broaden the scope of the hedging exception to include certain additional derivatives transactions that funds use for hedging or offsetting purposes. These limited transactions are consistent with the risk-limiting aims of the hedging exception and present little possibility for leverage. The Proposing Release states that the hedging exception reflects the Commission's view that "using currency derivatives solely to hedge currency risk does not raise the

---

[138] *See* Proposed Rule 18f-4(c)(3)(i)-(ii). The hedging exception would require a fund to limit its use of derivatives transactions to currency derivatives that hedge the currency risks associated with specific foreign currency–denominated equity or fixed-income investments held by the fund. The fund must enter and maintain the currency derivatives for hedging purposes and the notional amounts of such derivatives could not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount. *See* Proposed Rule 18f-4(c)(3)(ii).

[139] *See* Proposed Rule 18f-4(c)(3). The Proposing Release notes the Commission's belief "that the risks and potential impact of these funds' derivatives use may not be as significant, compared to those of funds that do not qualify for the exception, and that a principles-based policies and procedures requirement would appropriately address these risks." *See* Proposing Release at 4484.

[140] In ICI's survey, 75 percent of respondents (3,940 out of 5,228 funds) indicated that, as of December 31, 2019, they would have qualified as limited derivative users. This is fairly consistent with the Commission's analysis, which showed that, as of September 2019, 78 percent of funds had gross notional exposure (adjusted for interest rate derivatives and options) of less than 10 percent of net assets, and less than 1 percent of funds that would be subject to the proposed rule would qualify under the hedging exception. *See* Proposing Release at 4485, 4521.

[141] *Id*. at 4484.

policy concerns underlying [S]ection 18."[142] The Commission acknowledges that most funds do not use derivatives transactions solely to hedge currency risk, but notes that such currency hedging transactions "are not intended to leverage the fund's portfolio" and "could mitigate potential losses."[143] Funds often use other types of derivatives instruments, in addition to currency derivatives, for hedging risks or for offsetting other holdings in their portfolios.

We acknowledge the Commission's assertion in the Proposing Release that "distinguishing most hedging transactions from leveraged or speculative transactions is challenging."[144] Nevertheless, a tailored exception for these additional categories of derivatives transactions entered into for direct hedging or offsetting purposes can be objectively crafted to limit potential concern about distinguishing between a hedging or offsetting transaction and a transaction that increases leverage. Specifically, the hedging exception should be expanded to include, in addition to the currency transactions included under Proposed Rule 18f-4, derivatives transactions that reduce the risk exposure of a portfolio security or group of securities, when the derivatives transaction is directly related to such security or securities and subject to a notional limitation.[145] The hedging exception should include the following additional derivatives transactions:

- a purchased single-name credit default swap (CDS) that provides credit protection on the issuer of a security held by the fund with a notional exposure that does not exceed the principal amount of the security;
- a written call option on securities in a fund's portfolio;
- a written put or call option for which the fund's obligation is fully covered by an offsetting purchased option the fund holds;[146] and
- transactions under which a fund "rolls" derivatives positions from one expiring contract to another that involve the same underlying asset(s) and notional amount with a similar maturity date.

In addition, the hedging exception should allow for the netting of derivatives holdings with identical underlying assets with different counterparties to allow funds to reduce hedging exposure created by a derivatives transaction that is no longer needed but cannot be terminated.

---

[142] *Id.* at 4488.

[143] *Id.*

[144] *See* Proposing Release at 4488.

[145] For example, a fund that invests in a purchased single-name credit default swap ("CDS") that provides credit protection against a security that it holds would not be eligible to rely on the hedging exception. The use of the CDS to hedge against a credit event that affects the security the fund holds, however, would be consistent with the risk-limiting aims of the hedging exception.

[146] These instances could be limited to: 1) the sale of a put option on an asset with a strike price that is equal to or lower than the strike price of a purchased put option on the same asset and of the same style (*e.g.*, American or European); and 2) the sale of a call option on an asset with a strike price that is equal to or higher than the strike price of a purchased call option on the same asset and of the same style (*e.g.*, American or European).

The transactions identified above clearly eliminate economic exposure and associated portfolio risks without creating leverage. A fund's practices with respect to each of these transactions could be formalized under the fund's policies and procedures required for funds that are limited derivatives users to ensure the fund does not enter into such transactions for impermissible purposes.

2. Clarify That Differences of 10 Percent or Less of the Value of the Hedged Instruments Would Qualify as "Negligible Amounts" Under the Hedging Exception

The Commission should clarify "negligible amounts" by specifying that exceedances of 10 percent or less of the value of the hedged instruments would constitute negligible amounts under the hedging exception. Under Proposed Rule 18f-4, the notional amounts of derivatives entered into in reliance on the hedging exception could not exceed the value of the hedged instruments (or the par value thereof, in the case of fixed-income investments) by more than a "negligible amount."[147] The Commission did not explain what it would consider a "negligible amount" for purposes of the hedging exception. The lack of clarity will result in confusion and likely disparate practices. Further, without clarity, there is the real risk that the Commission examination staff will "second-guess" a fund's determination.

Accordingly, the Commission should clarify that exceedances of 10 percent or less of the value of the hedged instruments would constitute negligible amounts under the exception. This aligns well with the Commission's determination that a 10 percent derivatives exposure threshold would be an appropriate measure to use under the exposure-based exception. The Commission uses this standard to determine that a fund's derivatives use is "relatively limited"[148] and would not rise to the level of derivatives use that would trigger the need to establish a risk management program or adhere to limits on leverage.[149]

As a "bright line," it avoids the problems with "second-guessing" and disparate practices. It also is consistent with the Commission's implicit reasoning in the Proposing Release that exposures at 10 percent or lower could be viewed as *de minimis* for certain purposes.

3. Combine the Exposure-Based Exception with the Hedging Exception

We recommend combining the exposure-based exception with the hedging exception because the combination would more appropriately achieve the Commission's goal of efficiently identifying funds that use derivatives in a limited way. The proposed exposure-based exception would except a fund that limits its derivatives exposure to less than 10 percent of net assets from having to implement a derivatives risk management program or adhere to the leverage limits.[150] The Commission proposes two separate

---

[147] *See* Proposed Rule 18f-4(c)(3)(ii).

[148] Proposing Release at 4485.

[149] *Id.*

[150] Proposed Rule 18f-4 generally would define *derivatives exposure* as the sum of the notional amounts of a fund's derivatives instruments and, for short sale borrowings, the value of any asset sold short. In determining derivatives exposure, the Commission

bases for qualifying for a limited derivatives user exception "to preclude a fund that is operating as a limited derivatives user from engaging in a broad range of derivatives transactions that may raise risks" that the Commission believes should be addressed through the program and limit on fund leverage risk requirements.[151] A fund that invests in (1) derivatives for hedging or offsetting purposes (as we have proposed above under the hedging exception) and (2) other types of derivatives only would be eligible to rely on the exposure-based exception, and only would be able to do so if the total notional amount of its derivatives exposure—including hedging or offsetting positions—is below 10 percent of its net assets.

The Commission should reformulate the limited derivatives user exceptions to combine the exposure-based exception and our recommended hedging exception, because the derivatives transactions in our recommended hedging exception do not raise policy concerns under Section 18 and are more appropriately excluded from counting toward the exposure-based exception threshold. This would enable a fund to exclude the derivatives transactions excepted in the hedging exception from counting toward the 10 percent threshold in the exposure-based exception.

Excluding only the limited derivatives transactions in the hedging exception would achieve the Commission's goal of efficiently identifying funds that use derivatives in a limited way but in a more appropriate manner than proposed. We understand that the exposure-based exception is intended to be a simple way to view the extent to which a fund uses derivatives in its investment strategies but, as the Proposing Release notes, "currency hedges are not intended to leverage [a] fund's portfolio" and thus "do not raise the policy concerns underlying Section 18" of the Investment Company Act that Proposed Rule 18f-4 is intended to address.[152] Because the Commission does not believe these transactions raise the concerns that Proposed Rule 18f-4 is intended to address, the Commission should not consider them when determining whether a fund should be required to have a derivatives risk management program or adhere to leverage limits.[153]

Similarly, the principles-based policies and procedures for limited derivatives users should appropriately cover a fund that is engaged in the limited hedging exception transactions (as we propose above) coupled with a limited amount of other derivatives transactions. The Commission highlights its concerns with a combined approach, stating that such an approach potentially raises risks that would

---

would permit funds to adjust the notional amounts of interest rate derivatives to a 10-year bond equivalent and delta adjust the notional amounts for options contracts. *See* Proposed Rule 18f-4(a) (defining *derivatives exposure*).

[151] *Id.* at 4488.

[152] As noted above, the additional hedges and offsetting positions we propose to except are similar to the currency hedges in the proposed hedging exception and align with the Proposing Release's statement that currency hedges are not intended to leverage a fund's portfolio. Like the currency hedges, the hedging or offsetting positions similarly would not raise Section 18 concerns because of the nature of their risk-limiting or risk-reducing functions within a fund's portfolio. *Id.* at 4488.

[153] We note that the Commodity Futures Trading Commission ("CFTC") explicitly permits funds to trade derivatives both for "bona fide hedging" purposes and for speculative purposes, and still qualify under the *de minimis* trading test for an exclusion from the definition of *commodity pool operator*. In evaluating whether a fund qualifies for the exclusion, the CFTC looks solely at whether the fund's speculative positions meets the *de minimis* trading test limit. *See* CFTC Regulation 4.5.

need to be managed under a derivatives risk management program and Proposed Rule 18f-4.[154] It does not explain, however, what additional risks would need to be managed. We do not see why a fund engaging in both hedging and offsetting positions, consistent with the hedging exception, and a limited amount of derivatives transactions, consistent with the exposure-based exception, would raise additional risks that could not be managed under the policies and procedures for limited derivatives users.

The Commission's proposed approach risks creating the incongruous result that a fund that aims to reduce risk through hedging 10 percent or more of its foreign currency exposure would be completely barred from engaging in other derivative transactions, regardless of whether those transactions are limited or do not materially change the risk profile of the fund. Likewise, a fund that generally uses derivatives (other than currency derivatives for hedging purposes) in a limited manner and also needs to engage in risk-reducing hedging or offsetting derivatives transactions could be forced to alter its investment and strategies to avoid the requirement to implement a full-fledged program. Alternatively, such funds and their shareholders would need to incur the costs and bear the compliance burdens of implementing a program and complying with the other conditions of Proposed Rule 18f-4. We do not believe this was the intended outcome. This is inefficient and likely detrimental to a fund's returns and could create more risk for the fund. It also would put funds that engage in currency hedging (and other hedging and offsetting transactions) at a disadvantage compared to funds that do not engage in such activities.

If the Commission does not exclude derivatives transactions used for hedging or offsetting purposes as we strongly urge, the Commission must at least exclude the currency hedging derivatives under the hedging exception from the exposure-based exception calculation for the same reasons described above. Depending on a fund's strategies, the fund may hold an amount of foreign currency–denominated derivatives that constitute more than 10 percent of the fund's net assets and make some limited use of other types of derivatives for other reasons. Such a fund would not be able to comply with either the hedging or exposure-based exceptions even though it may use derivatives in a limited fashion.

4. Include a Defined Cure Period for Exceedances or Breaches of the Limited Derivatives User Exceptions

To remove ambiguity, we recommend that the Commission set a specific cure period for exceedances or breaches of the limited derivatives user exceptions. Proposed Rule 18f-4 does not include a provision addressing exceedances of the 10 percent exposure threshold under the exposure-based exception or failures to comply with the hedging exception, or remediation thereof.[155] Unlike the specificity of the proposed three-business-day remediation provision for breaches of the VaR leverage limit, the Commission stated only that a fund would have to "promptly" reduce its derivatives exposure to the 10 percent threshold or comply with the program and limit on fund leverage risk requirements.[156] This lack

---

[154] *Id.* at 4488.

[155] *Id.* at 4487.

[156] *Id.* at 4486.

of guidance will lead to industry confusion as to whether and when a fund would be deemed to be noncompliant with either prong of the limited derivatives user exception. As a result, there are likely to be divergent policies and procedures to address exceedances of the exposure-based exception or breaches of the hedging exception. Commission examination staff also could question whether the fund's remediation activities were timely during the exam process without a clear understanding of the Commission's views.

To remedy this uncertainty, the Commission should specify a cure period of at least 14 calendar days for breaches of a limited derivatives user exception. Funds may enter into certain derivatives transactions temporarily for various non-leveraging reasons, and consequently exceed or breach a limited derivatives user exception. A 14-calendar day period is a sufficient and reasonable period of time for funds to unwind, close out, or terminate such transactions in order to come back into compliance with the exception. This cure period would be particularly helpful for circumstances under which funds may have little control over the period during which temporary exceedances or breaches of a limited derivatives user exception may occur, such as during foreign market holidays (which may extend over a significant number of days or possibly weeks).

Funds that do not come back into compliance with the limited derivatives user exceptions within 14 calendar days should be required to adopt and implement a derivatives risk management program, comply with the limit on fund leverage risk, and comply with the board oversight and reporting requirements that would apply to funds that do not qualify as limited derivatives users. We urge the Commission to adopt a period of 90 calendar days for a fund to comply with such requirements beginning after the 14-day cure period has ended and the fund has determined it can no longer comply with a limited derivatives user exception. A 90-calendar-day period is especially helpful for a fund whose adviser has not already established a derivatives risk management program and provides the fund with sufficient time to implement the significant operational processes for a full-fledged program.

Funds may unintentionally or passively breach or exceed, on a temporary basis, an applicable prong under a limited derivatives user exception for many reasons and under varying circumstances that are not related to increasing a fund's leverage or unduly speculative activities. For example, a fund may use index futures or swaps to quickly equitize cash held during periods of significant subscriptions or redemptions. Or a new fund may hold significant amounts of cash at the commencement of operations and may use derivatives to gain exposure to various markets until the fund is invested fully in desired stocks and bonds. Upon the replacement of a subadviser to a fund, a fund may need to invest in derivatives to allow the subadvised fund to maintain full exposure to the markets based on the new subadvised fund's investment mandate until the subadvised fund is fully invested in desired equity or fixed-income securities. Similarly, upon the addition or removal of a subadviser to a multi-managed fund, a fund may need to use derivatives to maintain full exposure to the relevant markets based on the investment mandate applicable to the affected assets until those assets are fully invested. Other circumstances under which a fund's derivatives exposure or use may increase temporarily include purchases of CDS or CDS indexes for credit protection (which may not qualify as hedging transactions) over a limited period of time, periodic rebalancing by funds pursuing asset allocation

strategies, periodic repositioning by an index fund, when a fund plans to roll its holdings, when there is increased volatility within the market, and for extended foreign market holidays.

E. Reverse Repurchase Agreements and Similar Financing Transactions

We generally agree with the Commission's approach to reverse repurchase agreements and similar financing transactions, but recommend that the Commission maintain two practices funds currently engage in without issue. Under Proposed Rule 18f-4, a fund could enter into reverse repurchase agreements and similar financing transactions as long as the fund treats such transactions as bank borrowings or other indebtedness, subject to the full asset coverage requirements of Section 18.[157] Funds would be required to combine the aggregate amount of indebtedness associated with reverse repurchase agreements and other similar financing transactions with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio.[158] The Commission proposes this approach based on a belief that "reverse repurchase agreements and other similar financing transactions that have the effect of allowing a fund to obtain additional cash that can be used for investment purposes or to finance fund assets should be treated for [S]ection 18 purposes like a bank borrowing or other borrowing, as they achieve effectively identical results."[159]

The Commission noted that, while securities lending arrangements and reverse repurchase agreements are "structurally similar," Proposed Rule 18f-4 would treat them differently, excluding them from the Section 18 asset coverage requirements under certain circumstances.[160]

We agree with the Commission's approach to reverse repurchase agreements and similar financing transactions and believe they have a similar effect to bank borrowings and other indebtedness. Therefore, they could be subject to the Section 18 asset coverage requirements, as proposed. We recommend, however, that the Commission also permit funds the option of treating reverse repurchase agreements and similar financings like they do today, excluding them from such requirements if they segregate assets to meet their obligations under a modified asset segregation regime. We also agree with the Commission's rationale for treating securities lending arrangements differently from reverse repurchase agreements and similar financings. We recommend, however, that the Commission permit funds treating securities lending arrangements differently to invest proceeds from the arrangements in a broader set of assets than simply cash and cash equivalents. We discuss each recommendation below.

---

[157] *See* Proposed Rule 18f-4(d). This would require, for example at least 300 percent asset coverage for open-end funds. *See* Section 18(f) of the Investment Company Act.

[158] *See* Proposed Rule 18f-4(d).

[159] *See* Proposing Release at 4504.

[160] *Id*. Specifically, to be treated differently, a fund could not "sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio," and the fund must invest "cash collateral solely in cash or cash equivalents." *Id*. *See also infra* Section II.E.2.

1. Permit Funds to Enter Reverse Repurchase Agreements and Similar Financing Transactions Under a Modified Asset Segregation Regime

In addition to permitting a fund to include reverse repurchase agreements and similar financing transactions under the Section 18 asset coverage requirements, the Commission should permit a fund to address the undue speculation and asset sufficiency concerns associated with the additional cash it receives from such transactions through a modified asset segregation framework. As with our recommendation for firm and standby commitment agreements, the framework would be an optional, alternative approach to the proposed treatment under Proposed Rule 18f-4. It would permit a fund to except reverse repurchase agreements and similar financing transactions from being treated like bank borrowings, if the fund segregates liquid assets (as described below) to fully cover the fund's obligations for those instruments, marked-to-market on a daily basis. The Commission recognized that, in contrast to the more-uncertain payment obligations of many derivatives, these types of transactions create a known repayment obligation.[161] The Commission historically has permitted funds to fully cover instruments with known payment obligations with liquid assets for decades without issue.

The Commission could address any asset sufficiency concerns by requiring that funds use only assets that qualify as "highly liquid investments" or "moderately liquid investments" as defined for purposes of Rule 22e-4.[162] Highly liquid and moderately liquid investments are inherently the types of securities that a fund could sell quickly to meet any related payment obligations.[163]

Currently, if a fund complies with the asset segregation conditions of Release 10666,[164] the fund is not required to count the obligation created under a reverse repurchase agreement toward its Section 18 asset coverage ratio for indebtedness. Proposed Rule 18f-4 is a dramatic shift away from this well-established and long-standing framework.

The Commission did not provide any data or analysis addressing the degree to which funds use reverse repurchase agreements or the potential lost efficiency from limiting funds' ability to obtain short-term liquidity or leverage through these transactions under the Section 18 asset coverage framework.[165] Further, the Commission did not identify any reason that the current asset segregation framework does not adequately address the undue speculation and asset sufficiency concerns underlying Section 18 for reverse repurchase agreements or similar transactions. Forcing a fund to treat reverse repurchase

---

[161] *See* Proposing Release at 4504.

[162] *See* Liquidity Rule Adopting Release at 82168.

[163] *See supra* Section II.A.2. In permitting the modified asset segregation regime, the Commission should allow a fund to designate the segregated assets solely on its records and not on the fund custodian's records consistent with current Commission staff positions. *See supra* note 27.

[164] Under Release 10666, a fund is not required to count the obligation created under the transaction for purposes of calculating its asset coverage requirements under Section 18 of the Investment Company Act so long as the fund segregates certain liquid assets equal in value to the proceeds received on the sale plus accrued interest, or the specified repurchase price.

[165] Reverse repurchase agreements are generally less costly and are easier for funds to access and use than bank borrowings.

agreements and similar financing transactions as indebtedness for asset coverage purposes is not the only way to address Section 18 concerns and could cause some funds to unnecessarily cease using such efficient instruments.

2. Permit Funds to Engage in Securities Lending Activities Consistent with Current Guidance

We urge the Commission to continue to treat securities lending arrangements and the collateral thereunder consistent with well-tested and current Commission and staff positions, including exemptive orders and no-action relief. The Proposing Release states that a fund could engage in securities lending arrangements without subjecting those transactions to Section 18's asset coverage regime, so long it does not "sell or otherwise use non-cash collateral received for loaned securities to leverage the fund's portfolio," and the fund invests "cash collateral solely in cash or cash equivalents."[166] The Proposing Release acknowledges that "currently, funds that engage in securities lending typically reinvest cash collateral in highly liquid, short-term investments, such as money market funds or other cash or cash equivalents, and funds generally do not sell or otherwise use non-cash collateral to leverage the fund's portfolio."[167] The Commission did not describe any specific problem that has arisen in the current regulatory regime for securities lending by funds.

Relying on the long-standing Commission and staff positions, funds presently reinvest cash collateral in certain highly liquid, short-term instruments that may not qualify as cash or cash equivalents. This is the framework used by funds and understood by the market for decades. The Proposing Release, however, contemplates treating funds that reinvest cash collateral in these other highly liquid, short-term instruments as reverse repurchase agreements or similar financing transactions. As with cash and cash equivalents, highly liquid, short-term investments similarly should serve, and have been serving, to address concerns associated with securities lending collateral, and effectively limit funds' ability to use securities lending arrangements as a source of leverage.

We believe that the way a fund engages in short-term cash management–type investing is an investment decision subject to the business judgment of the fund's investment adviser and board (along with proper disclosure to investors). It is not necessary or appropriate to eliminate all potential investment risk to avoid a fund's securities lending activities being viewed as having a leveraging effect. Further, experience with the current framework—funds have invested in these instruments for decades with no issue—should guide the regulatory approach and give the Commission confidence that no change is warranted or needed in this area.

---

[166] *See* Proposing Release at 4504.

[167] *Id.*

If the Commission proceeds with its proposal, additional guidance on what the Commission would view as "cash equivalents" must be provided to ensure clarity for funds and the markets.[168] For example, it is unclear whether investments in private funding vehicles, which are similar to Rule 2a-7 money market funds, would constitute cash equivalents under the Proposing Release.

F. Unfunded Commitment Agreements

We agree with Proposed Rule 18f-4's definition of *unfunded commitment agreement* and support the proposed approach under Proposed Rule 18f-4. Proposed Rule 18f-4(a) defines an unfunded commitment agreement as "a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner." It would permit a fund to enter into an unfunded commitment agreement if the fund reasonably believes at the time it enters into such an agreement that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.[169]

III. Public Reporting Requirements

The Commission proposes to require funds that rely on Proposed Rule 18f-4 to report new publicly disclosed information on Forms N-PORT and N-CEN.[170] This information would relate to a fund's investments in the instruments covered under Proposed Rule 18f-4 and information about the fund's VaR model. We do not object to providing this type of information to the Commission, which could help the Commission assess a fund's investments and oversee funds' use of derivatives and compliance. We recommend, however, that the Commission not make certain of the information public, including the derivatives notional amounts and specific information related to a fund's VaR calculation model. In addition, depending on the final rule, we recommend that the Commission make corresponding changes to the liquidity rule, Form N-PORT, and related guidance.

---

[168] The Proposing Release does not define the term *cash equivalents* for these purposes. US GAAP defines cash equivalents as "short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates." *See* FASB Accounting Standards Codification at paragraph 305–10–20. Generally, only investments with original maturities of three months or less qualify under that definition. Rule 2a51-1(b)(7) under the Investment Company Act defines the term *cash and cash equivalents* as including "bank deposits, certificates of deposit, bankers' acceptances and similar bank instruments held for investment purposes; and the net cash surrender value of an insurance policy." However, this definition does not appear to be the definition contemplated in Proposed Rule 18f-4.

[169] Unfunded commitment agreements entered into by a fund in compliance with Proposed Rule 18f-4(e)(1) will not be considered for purposes of computing asset coverage, as defined in Section 18(h) of the Investment Company Act. *See* Proposed Rule 18f-4(e)(1).

[170] Information on Form N-PORT would be made public for the third month of each fund's fiscal quarter upon filing. *See* General Instruction F of Form N-PORT. Funds must file Form N-PORT no later than 60 days after the end of the reporting period. *See* Rule 30b1-9 under the Investment Company Act. Information on Form N-CEN also is made public upon filing. Funds must file Form N-CEN no later than 75 days after the end of the fund's fiscal year. *See* Form N-CEN.

A. Do Not Require Public Disclosure of Derivatives Notional Amounts and VaR Test "Breaks"

The Commission proposes to amend Form N-PORT to include various information items related to a fund's derivatives positions,[171] short sale exposure, and items specific to the required VaR tests, including VaR results over the reporting period, information about the designated reference index chosen (if any), and the number of exceptions that the fund identified from backtesting its VaR model ("VaR Breaks").[172]

The Commission has broad discretion to determine not to publicly disclose information filed in reports required under the Investment Company Act, if it finds that public disclosure of such information is neither necessary nor appropriate in the public interest or for the protection of investors.[173] In making these determinations, it is critical for the Commission to examine the reporting item to determine the information's purpose and the effect of public disclosure. For example, in adopting Form N-PORT, the Commission determined that public disclosure of some information—valuable for regulatory oversight purposes—might not be necessary or appropriate for disclosure to investors.[174]

We generally agree with the proposed reporting requirements, but the disclosure of a fund's derivatives exposure and VaR Breaks are neither necessary nor appropriate for the protection of investors. Public disclosure of a fund's aggregate derivatives exposure based on GNE would not serve investor protection purposes because such information could be misleading and would be unnecessary as individual portfolio holdings data already provide similar but more useful information.

With regard to public disclosure of GNE, many policymakers and regulators have recognized that a fund's GNE does not yield useful information about a fund's economic risk or portfolio leverage and may be misleading and misunderstood.[175] Aggregated GNEs, with no information about direction (long or short) may overstate both the leverage a fund has and the amount of risk it incurs and may mislead an

---

[171] A fund could adjust the derivatives exposure reported for interest rate derivatives to a 10-year bond equivalent and delta adjust the notional amounts for options. *See supra* note 150.

[172] Specifically, the VaR results information would include a fund's highest daily VaR during the reporting period and its corresponding date, and the median daily VaR for the monthly reporting period. *See* Proposing Release at 4525. In addition, for a fund that uses the relative VaR test, the Commission would require the fund to report information about the designated reference index (name and index identifier) and the highest VaR Ratio (fund VaR divided by the designated reference index VaR) during the reporting period and its corresponding date, and the median VaR Ratio during the reporting period. *See* Proposed Items B.10.a through d of Form N-PORT.

[173] *See* Section 45(a) of the Investment Company Act.

[174] *See* General Instruction F of Form N-PORT (identifying specific Form N-PORT information that remains nonpublic). For example, the Commission determined not to require public disclosure of position-level risk metrics because the calculation of those risk metrics could require a number of inputs and assumptions and could convey a false sense to of precision to investors. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32314, 81 Fed. Reg. 81870 (Nov. 18, 2016) ("Reporting Modernization Adopting Release") at 81908–81912 (discussing public disclosure of Form N-PORT information), *available at* www.sec.gov/rules/final/2016/33-10231.pdf.

[175] *See*, *e.g.*, March 2016 ICI Letter.

investor into thinking that a fund has more net exposure to derivatives than it actually does.[176] As a consequence, international securities regulators agree that assessing measures of notional exposure in isolation raises major concerns. In a recent paper recommending a framework for measuring leverage in investment funds, those regulators found several flaws with fund-reported GNE, including for GNEs that are adjusted in the same manner as derivatives exposure would be under Proposed Rule 18f-4.[177] The flaws include that:

- GNE does not reflect the fact that a fund could be using derivatives for hedging or other risk-reduction purposes;
- GNE may overstate a fund's exposure;
- the sheer size of the GNE may be misleading because funds with less leverage on a GNE basis may in fact present greater market risk or may have investments in securities with embedded leverage; and
- GNE does not differentiate between exposures to different asset classes unless it is presented by asset class.[178]

Moreover, public disclosure of aggregated derivatives exposure or aggregated GNE is unnecessary. Form N-PORT provides investors and data collectors with the fund's individual portfolio holdings, including derivatives with information about their asset class types (commodity, credit, equity, foreign exchange, interest rate, or other) and payoff profile (*e.g.*, purchased/written; long/short; or assets to be paid/received for swaps).[179] These individual holdings data, reported on Form N-PORT, provide investors with sufficiently detailed information, including with respect to offsetting and hedged positions.

For VaR Breaks, public disclosure of this information is neither appropriate nor necessary for the protection of investors. In fact, such information could be misleading and reveal proprietary information about a fund's risk management tools. Moreover, many, if not most, investors are unlikely to understand or ascribe appropriate significance to such information. Information on VaR Breaks in

---

[176] For example, a fund that is rolling an expiring $100 million long FX forward contract in the euro that expires in March may enter into an offsetting $100 million short FX forward contract in the euro that expires in March. It may then enter into a new position in a $100 million long FX forward contract in the euro that expires in June. If the fund held each of those contracts at the end of March, the fund would report $300 million in derivatives exposure for those contracts, even though the contracts only represent $100 million in net exposure to the fund. An investor seeing the $300 million could be misled into thinking the fund had more risk attributable to its derivatives than it truly has.

[177] *See* The Board of the International Organization of Securities Commissions, Recommendations for a Framework Assessing Leverage in Investment Funds (Dec. 2019) at 7–10, *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf; *see also supra* note 150 (describing derivatives exposure as permitting adjustments for interest rate derivatives and options). The regulators noted that GNE adjusted for interest rate derivatives and options would limit to some degree the overstatement of a fund's exposure for those interest rate derivatives and options.

[178] *Id.*

[179] *See* Items C.4 (asset class type) and C.3 (payoff profile) of Form N-PORT.

fact may prove misleading concerning whether a fund is complying with its leverage limits. An investor seeing a number of exceptions under backtesting results may be unduly concerned. These concerns, however, would be unwarranted. A VaR Break reflects the backtesting results of a VaR model and shows whether a fund's actual loss exceeds the model's estimated VaR on a given day. Using a VaR model with a 99 percent confidence level, as required under Proposed Rule 18f-4, a fund would *expect to* experience VaR Breaks 1 percent of the time over a particular period (*e.g.*, 2.5 times during a 250-trading-day year).[180] Simply having a VaR Break, therefore, does not indicate that the fund has a problem and, in many cases, the VaR Break is expected. Further, a VaR Break would not necessarily indicate that there is a compliance violation under Proposed Rule 18f-4. A fund's model may predict a very low VaR, and actual returns may show a small VaR Break that may be far below either of the proposed leverage limits.

Another significant concern with the public disclosure is that VaR Break information could yield proprietary information about a fund's risk management model. Funds have some degree of latitude to choose their VaR model and parameters under the proposed rule. VaR Break information will be generated by funds using complex and somewhat divergent VaR models that, by their nature are subjective, forward-looking, and hypothetical. Publicly disclosing the number of VaR Breaks would reveal sensitive information about a fund's unique risk management systems. Finally, VaR Break information is not essential to the protection of investors.

Consequently, for all the reasons above, neither the exposure information nor the information related to VaR Breaks should be publicly available. While the Commission will have this information, it is neither necessary nor appropriate for the public. As we have explained, this information could in fact be misleading and confusing for investors and also disclose proprietary and sensitive information. We do not think the Commission intends such a result and accordingly recommend that this information not be publicly available.

B. Amend Liquidity Rule, Form N-PORT, and Related Guidance Consistent with Final Rules

To ensure consistency with the proposed requirements, we recommend that the Commission amend Rule 22e-4, Form N-PORT, and any related guidance provided thereunder to eliminate references to assets segregated to cover derivatives transactions, which would become unnecessary.[181]

Proposed Rule 18f-4 would eliminate the Commission and staff guidance requiring funds that invest in various derivatives, reverse repurchase agreements and similar financing transactions, and unfunded

---

[180] *See* Proposing Release at 4464.

[181] If, however, the Commission were to accept our recommendations to permit funds to voluntarily segregate assets to cover firm and standby commitment agreements, these recommended amendments would not be necessary. Under our recommendations, firm and standby commitment agreements would continue to qualify as derivatives transactions but would not be treated as derivatives transactions under Rule 18f-4 when a fund fully covers the agreements' fixed and known obligations with highly liquid or moderately liquid investments on a daily basis. *See supra* Section II.A.2. If a fund were to rely on such relief, the references to assets segregated to cover derivatives transactions therefore would continue to be appropriate.

commitment agreements to segregate liquid assets to cover those transactions.[182] The Commission would not replace the guidance with any new asset segregation requirements, because it does not believe that asset segregation is necessary in light of the proposed requirements.[183] The Commission, however, does not propose corresponding amendments to either Rule 22e-4 or Form N-PORT to remove the references to the assets a fund segregates to cover its derivatives transactions.

IV. Proposed Sales Practices Requirements

The Commission proposes subjecting certain registered investment companies to different sales practices requirements than any other registered investment company. This is a novel and untested regulatory approach for registered funds. Under the proposal, a registered broker-dealer or investment adviser[184] only could approve a retail investor's account to trade in leveraged/inverse investment vehicles[185] if it had a reasonable basis to believe the investor has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles.[186] Those firms also would be required to adopt and implement policies and procedures designed to achieve compliance with the rules.[187]

The Commission explains that the proposed sales practices requirements are modeled after the FINRA options account framework for broker-dealers and options. That framework is designed to ensure that investors in those securities are limited to those that are capable of evaluating their characteristics and the unique risks they present. Compared to options, the securities of registered investment companies are subject to a different securities law regime. Under the FINRA options account framework, broker-dealers must conduct due diligence and approve customers before they can accept transactions in options. Current suitability requirements, requiring a finding that a customer is capable of evaluating

---

[182] *See* Proposing Release at 4530.

[183] *Id*.

[184] The proposed sales practices requirements also would cover broker-dealers and investment advisers that are required to be registered. *See* Proposed Rule 15l-2 under the Securities Exchange Act of 1934 and Proposed Rule 211(h)-1 under the Investment Advisers Act of 1940.

[185] A leveraged or inverse investment vehicle would mean "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time." *See* Proposed Rule 15l-2(d) and Proposed Rule 211(h)-1(d) (defining *leveraged/inverse investment vehicle*).

[186] As part of the evaluation, the broker-dealer or adviser must seek to obtain, at a minimum, specific information about an investor's: investment objectives and time horizon; employment status; annual income; net worth and liquid net worth; percent of liquid net worth intended to be invested in leveraged/inverse investment vehicles; and investment experience and knowledge regarding certain financial instruments.

[187] *See* Proposed Rule 15l-2(a) and Proposed Rule 211h-1(a).

the characteristics and unique risks of options, are similar to the proposed sales requirements but, in contrast, only apply when a broker-dealer makes an options recommendation to a client.[188]

We appreciate that the Commission seeks to ensure that both broker-dealers and investment advisers make appropriate recommendations and investments for their clients, including investments in registered funds.[189] This proposed sales practices approach, however, is unprecedented in the context of registered investment companies subject to the robust regulatory regime of the Investment Company Act.[190] The Commission must consider the strong protections of the Investment Company Act and how this extraordinary approach may affect registered funds and their investors, not only in this context, but as precedent it could set for sales of other registered funds.

V. Compliance Dates

The Commission proposes to provide funds with a one-year transition period from the date the adopting release is published in the *Federal Register*. We urge that the Commission extend the transition period from one year to 24 months to allow funds sufficient time to adjust to the "updated, comprehensive approach to regulation of funds' use of derivatives."[191] Funds investing in these instruments may need to make wholesale changes to the way they invest in, administer, account for, and treat derivatives and the other instruments under the proposed rule. The large number of changes will affect almost every facet of a fund sponsor's business, including portfolio management, operations, information technology, compliance, legal, and risk, as each may be responsible for portions of

---

[188] Before a broker-dealer accepts any order to purchase or write an option, including for any self-directed transaction or any transaction from an investment adviser, the broker-dealer must conduct due diligence on the customer and approve the customer's account to trade in options. *See* FINRA Rule 2360(b)(16). The approval is based on specific information that the broker-dealer must request about the investor, including the investor's investment objectives; employment status, annual income; net worth and liquid net worth; and investment experience and knowledge regarding certain financial instruments. *Id*. Unlike the proposed sales requirements, however, the due diligence does not require a determination that the customer has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract. *See* FINRA Rule 2360(b)(19) (requiring a suitability determination on broker-dealer recommended options transactions).

[189] ICI, for example, strongly supported the Commission's Regulation Best Interest rulemaking, which imposed an enhanced standard of conduct on broker-dealers when providing recommendations to retail customers regarding a securities transaction or investment strategies involving securities. *See*, *e.g.*, Letter from Paul Schott Stevens, President and CEO, ICI, to Brent J. Fields, Secretary, SEC, dated Aug. 7, 2018, *available at* www.sec.gov/comments/s7-07-18/s70718-4184208-172550.pdf.

[190] The Investment Company Act, among other things, provides important safeguards requiring regulated funds to: confine their use of leverage; restrict their transactions with affiliates; custody their assets with qualified custodians; diversify their holdings; retain fidelity bonds for their officers and employees to protect against larceny and embezzlement; obtain annual audits of their financial statements from independent accountants registered with the Public Company Accounting Oversight Board; and maintain certain books and records. It also requires that regulated funds value their assets pursuant to board-approved valuation procedures and disclose these values, along with their holdings, periodically. *See*, *e.g.*, Letter from Susan M. Olson, General Counsel, ICI, to Vanessa Countryman, Secretary, SEC, dated Sept. 24, 2019, at 6-7, *available at* www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf.

[191] *See* Proposing Release at 4509.

derivatives risk management. In particular, funds will need time to prepare for specific aspects of the new VaR test requirements and the new derivatives risk management program. Funds that employ manager-of-managers structures will have further systems complications that will take time to identify and address. Further, the proposed one-year period is insufficient time for registered broker-dealers and investment advisers that recommend or have clients that trade in leveraged/inverse investment vehicles to adequately prepare for the new proposed sales practices requirements.

Certain funds may need to implement VaR models for the first time. Those funds must determine whether to conduct the VaR tests internally or hire a third-party administrator or other service provider to provide a VaR platform. This process will entail meeting with vendors to assess capabilities and engaging in due diligence. Whether such a fund handles VaR testing in-house or chooses a vendor, it will need to develop an appropriate VaR model tailored to its portfolio.

Even funds that currently use VaR will need to modify their VaR model parameters to adhere to Proposed Rule 18f-4's conditions. While we previously noted that a number of funds already use VaR for risk management purposes, we believe that those VaR models typically provide absolute VaRs to assess a portfolio's general risk and not relative VaRs, which under the proposed rule would serve as the default leverage limit.[192] All VaR models will need to undertake system updates or technological enhancements to support the VaR calculations, related compliance testing, and reporting under Proposed Rule 18f-4.

In addition, we understand that some funds (or vendors on their behalf) that will use the relative VaR test will need to negotiate with index providers for the ability to obtain information from their designated reference indexes and cite to those indexes in annual report disclosures. These license agreement amendments will take time to negotiate.

Funds also will have to create a derivatives risk management programs with specific elements or, for limited derivatives users, general policies designed to manage the fund's derivatives risk. Even though certain fund groups already have derivatives risk management programs in place, those groups will need to tailor their current programs to the rule requirements. Accordingly, funds will need to update their policies and procedures and seek board approval of those policies.[193]

Funds also will need to update their internal compliance, reporting, and recordkeeping systems for changes under the proposed rule. For example, under Proposed Rule 18f-4, firm and standby commitment agreements now would be treated as derivatives transactions and would be reclassified as such for compliance and reporting purposes. Internal systems will need to be reevaluated and, as with VaR testing, funds may need to determine whether they will outsource or handle internally changes to

---

[192] *See supra* Section II.B.1.

[193] Fund advisers also would need to consider who to designate as the derivatives risk manager and boards would need to approve the designation.

compliance, reporting, and recordkeeping functions. Perhaps the most time will be needed to conduct backtesting to ensure that these functions work appropriately.

We ask that the Commission consider these many items, particularly vendor readiness, in light of its recent experiences with both the liquidity risk management framework and the investment company reporting modernization rules.[194] In both those cases, the initial compliance deadlines were subsequently extended due to the overall complexity of the new requirements (which were not fully appreciated at the time of adoptions) and vender readiness.[195] As with those instances, many fund groups that will need to comply with Proposed Rule 18f-4 will rely heavily on vendors, whose systems must be updated.

Further, the stressed time frames above are magnified when there are multiple subadvisers for a fund, each managing a portion of the fund's assets. Subadvised funds will need additional time to update and upgrade their compliance systems to coordinate their investment determinations with data feeds into the primary investment adviser's systems. Primary advisers will need to stitch data together from different order management systems to provide a view at the composite fund level. This could create issues for larger primary advisers that have several multiples of subadvisers with whom they will need to coordinate systems.[196]

Moreover, if adopted, registered broker-dealers and investment advisers will need time to adhere to the new sales practices requirements. They will need a significant amount of time to create new policies and procedures, to develop their current compliance and monitoring systems, train their employees, and educate investors and intermediaries about the new requirements.

The proposed one-year implementation period would place an enormous stress on organizations and their resources. A 24-month implementation period seems more appropriate for a final derivatives risk management rule that poses a similar level of complexity as the liquidity risk management and investment company reporting modernization rules, including a considerable level of analysis and diligence of third-party capabilities to support compliance.

* * * * *

The Commission's proposal represents a substantial improvement over its prior approach. The proposed move toward risk-based leverage limits more appropriately confines undue speculation and, together

---

[194] *See* Liquidity Rule Adopting Release; Reporting Modernization Adopting Release.

[195] For example, the liquidity risk management framework was adopted in October 2016 with an initial compliance date of December 2018 for larger fund complexes. The Commission later extended the requirements related to liquidity "bucketing" to June 2019, which proved critical for fund complexes and third parties to implement the new requirements and for the Commission staff to provide guidance on important matters that invariably arise following adoption of complex rules.

[196] We note that certain smaller and midsize investment advisers that serve as subadvisers to registered funds would benefit from more time to meet these implementation challenges. *See* Dalia Blass, Keynote Address: ICI Mutual Funds and Investment Management Conference (March 18, 2019), *available at* www.sec.gov/news/speech/speech-blass-031819 (requesting information about regulatory barriers smaller and midsize fund sponsors face).

with the principles-based derivatives risk management program, would provide an effective framework to regulate funds' use of derivatives. We therefore strongly support Proposed Rule 18f-4, as modified by our recommendations, and commend the Commission and staff for their work on this proposal.

ICI and its members appreciate the opportunity to comment on the proposal. If you have any questions or require further information, please feel free to contact me (202-326-5901); Susan M. Olson, General Counsel (202-326-5813); Kenneth C. Fang, Assistant General Counsel (202-371-5430); or Shelly Antoniewicz, Senior Director of Industry and Financial Analysis (202-326-5910).

Sincerely,
/s/ Paul Schott Stevens
Paul Schott Stevens
President and CEO

cc: The Honorable Jay Clayton
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
The Honorable Allison Herren Lee

Dalia O. Blass
Director, Division of Investment Management

Appendix A: ICI Survey Coverage, All Funds

Year-end 2019	ICI survey	Industry	ICI survey as percentage of industry
Total net assets (billions)			
Mutual funds	$15,739	$17,660	89%
ETFs	1,278	4,314	30
Closed-end funds	162	278	59
Total	**17,179**	**22,333**	**77**
Number of funds			
Mutual funds	4,376	7,581	58
ETFs	555	2,028	27
Closed-end funds	297	500	59
Total	**5,228**	**10,177**	**52**

Note: In this figure *funds* means all long-term mutual funds (including variable annuities), ETFs registered under the Investment Company Act of 1940, and closed-end funds.

Source: Investment Company Institute