



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

September 27, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15)

Dear Mr. Fields:

I am writing on behalf of the Investment Company Institute¹ and our members to provide additional comments on the Securities and Exchange Commission's proposed rule on funds' use of derivatives, focusing on the proposed rule's value-at-risk ("VaR") test that would allow funds to apply the "risk-based" portfolio limit on their use of derivatives.² This letter provides greater detail regarding the recommendation in our March letter to replace the Commission's proposed "comparative VaR" test with an "absolute VaR" test and specifies four criteria that, together, provide rigor to the test.³ The

¹ The Investment Company Institute is a leading, global association of regulated funds, including mutual funds, exchange-traded funds, 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 US fund members manage total assets of \$18.4 trillion and serve more than 90 million US shareholders.

² The proposed rule would require every fund that invests in derivatives transactions to comply either with a 150 percent "exposure-based" limit or a 300 percent "risk-based" limit on the amount of senior securities in which a fund can invest. Under the proposed rule, a fund could apply the risk-based limit only if the fund meets a "comparative VaR" test that compares the VaR of the fund's portfolio with derivatives to the VaR of the fund's portfolio without derivatives to measure whether the fund's aggregate use of derivatives reduces, rather than magnifies, potential risk from market movements. *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf>; proposed Rule 18f-4(c)(11).

³ Our recommendation should be read as a complement to the recommendations in our earlier letters. Those included recommendations to apply a risk adjustment to the notional amount of a derivative instrument that would count toward a fund's exposure-based or risk-based portfolio limit, and to increase the exposure-based limit from 150 percent to 200 percent and the risk-based limit from 300 percent to 350 percent. *See* Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016,

absolute VaR test that we recommend would ensure that the only funds that can rely on the risk-based portfolio limit are those funds that can demonstrate that their expected portfolio risks reasonably are constrained.

Part I of this letter summarizes our recommendations. In Part II, we discuss why an absolute VaR test would be more appropriate than the Commission's comparative VaR test and then explain each of the four elements of the recommended VaR approach and our rationale for proposing them. Throughout that discussion, we explain how our recommendation addresses the Commission's concerns about funds being able to "game or manipulate the VaR test in order to obtain riskier investment exposures."⁴

I. Summary of Recommendation

We recommend replacing the Commission's proposed "comparative VaR" test with an "absolute VaR" test that contains four elements:

- ***Common Parameters for VaR Estimation:*** All funds that wish to rely on the risk-based limit must use common parameters for their VaR model: a 10-day⁵ horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund's net assets ("10-Day VaR"). These common parameters – by requiring a common unit of measurement – would reduce variability and subjectivity of the VaR models. Provided a fund uses the prescribed common parameters, the fund may select any appropriate VaR model, subject to certain conditions, including approval by the fund's derivatives risk manager.⁶
- ***Daily Ex-Ante Testing and Grace Period:*** To use the risk-based limit, a fund's 10-Day VaR must not exceed 10 percent of the fund's net assets. Funds must perform this *ex-ante* test of a fund's 10-Day VaR on a daily basis. If a fund's 10-Day VaR exceeds 10 percent, the fund must report the limit exceedance to the Commission staff on a confidential basis within five business days and take steps to bring the fund's 10-Day VaR to 10 percent or less over a 30-day period following the limit exceedance. If the fund is not able to reduce its 10-Day VaR to 10 percent or less within the 30-day grace period, the fund must bring its

available at <https://www.sec.gov/comments/s7-24-15/s72415-114.pdf>; Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated July 28, 2016, available at <https://www.sec.gov/comments/s7-24-15/s72415-244.pdf>.

⁴ See proposing release at 80923.

⁵ Unless otherwise noted, references herein to "days" are to "trading days."

⁶ In our March letter, we recommended that the Commission permit funds to appoint either an individual, group, or committee to serve as derivatives risk manager. All references herein to "derivatives risk manager," therefore, refer to an individual, group, or committee.

portfolio into compliance with the exposure-based limit during the subsequent 30-day period. The *ex-ante* test would ensure that only funds whose expected portfolio risks are constrained could use the risk-based portfolio limit.

- ***VaR Backtesting and Validation:*** As a key safeguard against “gaming,” funds must backtest their 10-Day VaR model—*i.e.*, validate the VaR model against actual return data—on a daily basis. The backtest would be based on a 1-day horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund’s net assets (“1-Day VaR”), which many industry participants commonly understand to be a valid backtesting methodology.
- ***Recordkeeping and Reporting:*** Funds would be required to retain records and report summary statistics on their 10-Day VaR estimates and data from the required backtest as part of the proposed monthly Form N-PORT filing requirements on a non-public basis. The reporting requirements will promote transparency to Commission staff and facilitate Commission staff oversight of Rule 18f-4.

We explain our recommendation in more detail below.

II. Recommendation for Absolute VaR Test

In our March letter, we urged the Commission to replace the proposed comparative VaR test with an absolute VaR test or other alternatives.⁷ Under an absolute VaR test, a fund limits what it expects to lose of its net assets over a specified timeframe for a specified percentage of times (*e.g.*, it limits its expected cumulative losses to less than or equal to 10 percent of the fund’s net assets over a 10-day period for 95 percent of the time). Because the test would measure expected risk of loss of a portfolio, it forms a rational and robust basis for determining which funds should be permitted to obtain higher notional amounts of derivatives exposure. As with the proposed rule, funds would apply the absolute VaR test only to determine whether a fund could use the risk-based limit on notional exposure. Thus, the rule would continue to impose an upper bound on a fund’s use of derivatives (in

⁷ Under the Commission’s proposed “comparative VaR” test, funds would measure the VaR of two components: (i) the fund’s entire portfolio, including securities, other investments, and derivatives transactions; and (ii) the fund’s portfolio of securities and other investments, excluding any derivatives transactions. A fund would be permitted to apply the risk-based limit only if the full portfolio VaR were lower than the securities VaR. In our March letter, we explained that the comparative VaR test is of little value because many funds could not rely on it for two reasons. First, immediately after exceeding the exposure-based limit, all of the derivatives transactions a fund enters into in the aggregate must be risk reducing. Second, for funds that hold cash and US Treasury securities (rather than other types of investments) in addition to derivatives, the securities VaR generally would be close to zero and the VaR of the full portfolio likely would exceed the securities VaR on every occasion.

the form of the risk-based limit on exposure), in keeping with the Commission's stated goal of limiting undue speculation through funds' use of derivatives.⁸

Moreover, by limiting the risk of the *entire* portfolio, the absolute VaR test avoids any incentive for funds to change the mix of physical and derivatives-based exposures merely to pass the SEC's proposed comparative VaR test to use the risk-based limit.⁹ We therefore believe that the absolute VaR approach is an improvement over the comparative VaR and accomplishes the Commission's goal of limiting portfolio risk and undue speculation in a more effective manner.

One of the potential concerns the SEC expressed with an absolute VaR test is the possibility that the VaR model could be "gamed" to enable a fund to avail itself of the higher risk-based limit. We have developed criteria for the use of absolute VaR specifically aimed at minimizing the possibility of "gaming" the test. We believe each element of our recommendation reinforces the strengths of absolute VaR to constrain portfolio risk while limiting the potential for possible gaming of a model. Specifically, a) common parameters reduce variability and subjectivity of the VaR models by setting a uniform standard of measurement, b) *ex-ante* testing ensures that the risk-based limit is available only to funds that limit expected risks to a specified level, c) backtesting against actual returns validates (and further reduces the potential gaming of) a fund's chosen VaR model, and d) recordkeeping and reporting requirements facilitate appropriate Commission staff oversight.

We now describe each component of our recommendation in greater detail.

A. Common Parameters for VaR Estimation

We recommend that the Commission adopt a set of common parameters for the absolute VaR test to limit the variability and subjectivity of the test. Under these parameters, a fund would be required to use a 10-day horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund's net assets (10-Day VaR).¹⁰ The fund could select any appropriate VaR model, provided that (i) the fund uses the prescribed common parameters, (ii) the fund's derivatives risk manager approves

⁸ See proposing release at 80901 (portfolio limits are designed primarily to address undue speculation concerns).

⁹ For example, a fund may have an incentive to obtain within its investment mandate more of its risk exposure through physical securities to ensure that full portfolio VaR always exceeds its securities VaR and only enter into derivatives transactions that are risk reducing. This outcome has potentially negative consequences if a fund forgoes some of the potential benefits of derivatives, including enhancing liquidity compared to traditional securities, more quickly gaining or reducing investment exposure, managing or equitizing cash, reducing costs and managing portfolios efficiently.

¹⁰ 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 1-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.

the fund's VaR model, and (iii) the basis for the derivatives risk manager's approval is documented as part of a fund's board-approved formal derivatives risk management program.

Our recommendation differs from the SEC's proposed parameters, which would permit funds to use a 10-day or a 20-day time horizon but require funds to use a 99 percent confidence level for the comparative VaR test.¹¹ We, instead, recommend that the Commission specify the time horizon required and use a 95 percent confidence level to establish a common unit of measurement across funds. Establishing these two parameters will provide a level of assurance that two funds with similar portfolio risk have similar VaR values and will enable funds to compare their VaR values objectively to an absolute numeric limit (*e.g.*, a 10 percent maximum absolute VaR over a 10-day window, as discussed below in Section II.B.).

We considered different combinations of parameters, with a corresponding adjustment of the VaR limit, such as a higher 20 percent limit for a VaR model that uses a 20-day horizon with a 99 percent confidence level or a lower 3.2 percent limit for a VaR model that uses a 1-day horizon with a 95 percent confidence level. After extensive discussions, ICI members reached the conclusion that the parameters of 10-day horizon and 95 percent confidence level are the most appropriate for our recommended absolute VaR test for two main reasons.

First, longer horizons and higher confidence levels significantly reduce the amount of data available to estimate the VaR model. For example, a 10-day, 95 percent VaR will have ten times as many data points available for estimation than a 20-day, 99 percent VaR.¹² The number of observations matters because generally models that are estimated with more data are more reliable. ICI members also considered setting limits based on a 1-day horizon VaR model but decided against it. VaR estimates based on a 1-day horizon can vary substantially day-to-day, and we believe that it would not be in the best interest of shareholders for fund managers to be forced to trade in response to short-term volatility.¹³

¹¹ See proposed Rule 18f-4(c)(11)(ii) (setting forth the required parameters that VaR models must include when performing the proposed "comparative VaR" test).

¹² Given there are approximately 250 trading days in a year, a 10-day horizon means there are 125 non-overlapping 10-day periods over five years ($5 \times 250 / 10$). If we use a 95 percent confidence level, we would expect approximately 6 of the 125 observations ($125 \times 0.05 = 6.25$) to have a 10-day cumulative loss that was greater than the other 95 percent of the observations. For a 20-day, 99 percent VaR, there would be 62.5 non-overlapping 20-day periods ($5 \times 250 / 20$), and we would expect only 0.625 ($62.5 \times 0.01 = 0.625$, *i.e.*, less than one) of these periods to have a 20-day cumulative losses in excess of those of the other 99 percent of observations. Consequently, a model that estimates VaR at the 95 percent confidence level has ten times ($6.25 / 0.625 = 10$) more loss events that are used in the estimation process than if the model were estimating 20-day VaR at the 99 percent confidence level.

¹³ For example, a fixed income fund might anticipate a higher risk of loss on a day of a key Federal Reserve Board meeting but may not necessarily expect that same higher risk of loss over the 10-day period that includes the meeting date. Indeed, the

Second, longer horizon (*e.g.*, 20-day) and higher confidence levels (*e.g.*, 99 percent) force the VaR model to focus on estimating more extreme outcomes, which happen infrequently. ICI members believe that looking at losses over a shorter (10-day) period that would be expected to occur more frequently (5 percent of the time) would provide a better “early warning” that an overall risk in a fund’s portfolio is increasing.

We recognize that our proposed parameters are different than those used under the Undertaking for Collective Investments in Transferable Securities (“UCITS”) framework.¹⁴ There are a host of benefits from maintaining consistency with the UCITS framework (including uniformity and familiarity), but we ultimately concluded that the considerations discussed above warrant deviating somewhat from that framework.

Outside of the common parameters of the 10-Day VaR, our proposal would permit funds to choose any VaR model suitable for their own portfolios. The limited flexibility we recommend would allow funds to select a reasonable 10-Day VaR model that would measure properly the risks in the fund’s portfolio. Flexibility in choosing the VaR model is helpful because different risk models are appropriate for different types of funds, strategies, and instruments. For example, funds with instruments having a long history (*e.g.*, a stock or a stock index) might find a historical VaR model to be the most suitable, but funds holding other instruments (*e.g.*, individual instruments with limited history) might find a VaR model based on underlying factors the most suitable.¹⁵ Similarly, options and other non-linear derivatives may require sophisticated and customized approaches.

B. *Ex-Ante* VaR Test and Grace Period

Under our recommendation, a fund would be permitted to use the risk-based limit as long as the fund’s 10-Day VaR, calculated on an *ex-ante* basis, does not exceed 10 percent of the fund’s net assets.¹⁶ The fund’s 10-Day VaR must be calculated on a daily basis, and the fund would be required to record its 10-Day VaR as part of the fund’s recordkeeping program.

A key objective of the *ex-ante* test is to constrain portfolio risk such that derivatives risk managers do not expect losses within a 10-day period beyond 10 percent of the fund’s net assets. The

expected risk of loss over the 10-day horizon could be lower and, as such, the fund’s portfolio manager might be more inclined to hold many of the fund’s positions rather than trade on a potentially volatile day.

¹⁴ As the Commission noted, the UCITS framework sets an absolute limit of 20 percent on a 20-day horizon, 99 percent confidence level VaR. *See* proposing release at nn. 683-684 and surrounding text.

¹⁵ A historical VaR model looks at the historical returns of the actual holdings of the portfolio at the time of measurement. A factor model first maps the holdings onto market factors such as interest rates or FX rates before estimating VaR. For example, suppose that on 12/31/2015 you are estimating the VaR of a three-year note issued on 12/31/2014 and maturing 12/31/2017. First, this security would have prices going back for only a little more than one year. Second, this three-year note is now a (less volatile) two-year note, so a volatility estimate based on historical prices would be misleading. In this example, it may be more accurate to look at a time series of two-year note yields to estimate VaR.

¹⁶ Of course, funds could establish their own internal thresholds of risk that are below this mandated 10 percent limit.

daily *ex-ante* VaR test is designed to both assist risk managers in identifying and correcting heightened risk within a portfolio *before* the fund incurs large losses in a stressed market scenario and to help funds constrain their expected portfolio risks at all times. Only funds that measure and manage these risks would be permitted to use the risk-based portfolio limit.

Additionally, as described in more detail below, we are proposing steps that a fund must take in the case of a limit exceedance (*i.e.*, if a fund's 10-Day VaR exceeds 10 percent). These steps include both an "early warning" system, in the form of a requirement to report the limit exceedance to the Commission staff as well as a series of corrective measures that a fund must implement.

The steps that a fund would be required to take following a limit exceedance are as follows:

- The fund must report the limit exceedance to the Commission staff on a confidential basis within five business days of the limit exceedance.
- The fund will have 30 calendar days from the date of the limit exceedance to reduce the fund's VaR to 10 percent or less (using the same VaR model in place at the time of the exceedance).
- If the fund is unable to reduce its VaR to 10 percent or less during the grace period, the fund would no longer be able to use the risk-based limit and must lower its derivatives exposure to or below the exposure-based limit within the next 30 calendar days following the grace period.¹⁷

The reporting to the SEC staff would allow the staff to ask questions and engage in discussions with the fund regarding the limit exceedance and to monitor the fund during the period of time when the fund implements corrective measures. This early warning system will apply to all funds that are subject to the rule and that rely on the risk-based limit, and accordingly, could enable the staff to identify and monitor systemic problems in the market earlier.

In the event of a limit exceedance, the fund also will be required to take steps to reduce risk in the fund's portfolio. We recommend a grace period to enable funds that experience a limit exceedance to reduce risk in the fund's portfolio in a controlled and measured manner. Allowing the fund to reduce risk in a controlled manner will benefit the fund and the market as a whole, particularly during a time of market stress. A grace period would provide a fund with a reasonable period of time to close out or novate positions carefully to bring the fund back into compliance and to seek to obtain the best pricing and terms for closing out or novating positions. We are concerned that requiring funds to make portfolio changes immediately to correct the limit exceedance could harm funds and their

¹⁷ Given the multitude of reasons that a fund might incur a limit exceedance, we strongly recommend that the SEC provide funds with guidance about their ability to seek exemptive relief to extend this period.

shareholders.¹⁸ Forcing funds to close out large positions quickly on a fire sale basis could compel funds to accept unfavorable terms or prices.

Moreover, we strongly urge the Commission to keep reports of a limit exceedance confidential (along with the Form N-PORT reporting described below). The potential that other market participants would become aware of the fund's need to make a change to its portfolio could result in anticipatory trading and positioning that could harm a fund's shareholders. The purpose of these reports is to facilitate Commission staff oversight, and public disclosure is not necessary to achieve that goal.

C. VaR Backtesting and Validation

We recommend that the derivatives risk management program of a fund require and document specified backtesting of the VaR model used to estimate 10-Day VaR, including maintaining the results of the required backtest.¹⁹ A rigorous backtesting program will enable a fund to confirm the validity of its VaR model and assumptions and to make adjustments to the model as needed. We believe that funds will benefit from regular, daily backtesting and from having the flexibility to adjust or fine-tune a fund's VaR model based on the results of the fund's backtesting.

The required backtest would compare the VaR model's estimate using a 1-day horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund's net assets (1-Day VaR), with the fund's actual performance incurred on that day.²⁰ If the actual loss on any day exceeds the 1-Day VaR, the occurrence would be recorded as a VaR "break." The backtesting requirement would validate a fund's chosen VaR model and prevent a fund from creating an unrealistic model to engage in a higher amount of derivatives transactions.

We recommend using a 1-day horizon for the required backtest rather than the 10-day horizon as specified in the *ex-ante* VaR test. The purpose of the *ex-ante* VaR test is to limit expected portfolio

¹⁸ Additionally, as compared to the SEC's proposed comparative VaR test, an absolute VaR test would allow funds to reduce their risk either through securities or derivatives transactions depending on what was best for the fund and its shareholders.

¹⁹ This recommendation is consistent with the Commission view that "[a]s part of its derivatives risk management program a fund that relies on the risk-based portfolio limit may wish to consider periodic backtesting or other procedures to assess the effectiveness of its VaR model." See proposing release at 80921.

²⁰ The required backtest would supplement any routine backtesting that a derivatives risk manager would undertake. Routine backtesting of VaR already is a standard component of many funds' compliance programs. It allows a fund to compare forecasted losses against the actual value of losses the fund incurs over the specified time period. Backtesting enables the fund's risk management and compliance personnel to monitor and, when necessary, fine-tune the fund's VaR model based on a fund's actual experience. Given that funds would be able to select a suitable VaR model and to make adjustments to the VaR model over time (provided that the fund uses the prescribed common parameters described above), we believe it is appropriate for the derivatives risk manager to oversee backtesting of the fund's VaR model in a manner that is customized to the fund and its VaR model.

risk without forcing fund managers to react to short-term volatility. Hence, the 10-day horizon is better suited for this objective. The purpose of the required backtest is to gauge the validity and accuracy of the model used to estimate the 10-Day VaR. In this case, our members agreed that the 1-day horizon was the best choice for this objective. Using a 1-Day VaR backtest to validate the 10-Day VaR in the *ex-ante* test does not permit a fund to “game” the outcome of the backtest.²¹ Moreover, the 1-day horizon is better for testing the validity of the 10-Day VaR model because it minimizes the difference between the portfolio on which the 10-Day VaR was estimated and the actual portfolio during the backtest horizon.²²

The use of two different time horizons in a VaR context is not uncommon. The UCITS framework, for example, also employs two horizons (a 20-day horizon for its *ex-ante* VaR and a 1-day horizon for backtesting).²³

It is important to note that a VaR break is not a compliance violation or a Rule 18f-4 breach. A properly calibrated VaR model that produces estimates at the 95 percent confidence level would be expected to have VaR breaks (1-day losses in excess of the 1-Day VaR) approximately 5 percent of the time. Additionally, a fund’s model may predict a very low VaR and actual returns may show a small VaR break that is far below the 10 percent VaR limit. Therefore, numerous 1-Day VaR breaks may be a helpful early warning of possible problems with a VaR model, but one should not deem a VaR break as a

²¹ Essentially, the difference between using a 1-day horizon and a 10-day horizon is a matter of scaling. The scaling factor to convert a 10-Day VaR to a 1-Day VaR is equal to the square root of 10, assuming the underlying data are normally distributed. For example, a VaR model estimates that from tomorrow through ten days forward the potential loss to the fund at a 95 percent confidence level is 8 percent (10-Day VaR). The equivalent 1-Day VaR is 2.5 percent ($8/\sqrt{10} = 2.5$ percent). For models that assume the underlying data have non-normal distributions, the scaling factor may be higher or lower than the square root of ten, but is generally of the same magnitude. The 1-Day VaR of 2.5 percent would be compared to the actual gain or loss of the fund for tomorrow. If the loss of the fund is more than the scaled 2.5 percent number, the fund would record this as a VaR break. Each day’s 10-Day VaR estimate would be scaled appropriately to its 1-Day VaR equivalent to perform the required backtest.

²² Under a 10-day horizon for the backtest, the difference in the 10-Day VaR estimated on day T for days T+1 through T+10 and the actual performance of the fund over the same period could be attributable to changes in the portfolio rather than an issue with the VaR model. For example, if on day T+4, a fund investing solely in debt securities and derivatives were to change its portfolio composition to invest solely in equity securities and derivatives, the 10-Day VaR estimated on day T would not reflect this portfolio change. Thus, the backtest could be grossly inaccurate because it is highly likely that any difference between the 10-Day VaR and the actual performance of the fund over the 10-day period would have been in large part due to the change in the portfolio rather than stemming from a problem with the VaR model. Under a 1-day horizon for the required backtest, the 1-Day VaR and the actual performance of the fund would be based on the same portfolio and therefore any difference provides a better indication of the soundness of the VaR model.

²³ See 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”), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_108.pdf at Section 3.6.4 (“The back testing program should provide for each business day a comparison of the one-day value-at-risk measure generated by the UCITS model for the UCITS’ end-of-day positions to the one-day change of the UCITS’ portfolio value by the end of the subsequent business day”).

compliance violation.

D. Recordkeeping and Reporting

Our recommendation includes both recordkeeping and reporting requirements. Specifically, funds using the risk-based limit would be required to maintain written records relating to the fund's daily 10-Day VaR estimates and backtesting results. Funds also would be required to document information about the fund's VaR model and the basis for the derivatives risk manager's approval of the VaR model as part of the fund's derivatives risk-management program.

We also recommend that the Commission amend proposed Form N-PORT to require funds that rely on the risk-based limit to report on a confidential basis the following data points relating to the fund's VaR estimations as part of the fund's monthly report on proposed Form N-PORT: average 10-Day VaR; maximum 10-Day VaR; minimum 10-Day VaR. This will enable the Commission to monitor compliance with the *ex-ante* VaR limit.²⁴

We further recommend that the Commission amend proposed Form N-PORT to require funds to report the number of VaR breaks and dates of the breaks that occurred under the required backtest during the relevant reporting period, also on a confidential basis.²⁵

The data on proposed Form N-PORT would provide the Commission and its staff with extensive information about funds' use of VaR and possible trends in the industry. This information will enable the Commission staff to monitor and track a fund's 10-Day VaR estimations and the number of VaR breaks on a regular basis.

Our recommendations complement key components of the Commission's proposed recordkeeping and reporting requirements. The SEC's proposal would require a description of the fund's VaR model and the basis for the derivatives risk manager's approval of the VaR model to be included in the fund's board-approved formal derivatives risk management program. Our recommendation would require a summary of a fund's backtesting results to be included in the derivatives risk manager's written quarterly report to the fund board. The report also would include information about any material changes or adjustments to the VaR model, the basis for such changes or adjustments, and the approval of the derivatives risk manager of such changes.

²⁴ As described in Section II.B, we strongly urge the Commission to keep the information reported on Form N-PORT confidential (along with the reporting of any limit exceedances) to protect fund shareholders from predatory trading.

²⁵ The proposed requirement to report the number of VaR breaks is similar to the requirements under the UCITS framework. Under this framework, a UCITS is required to report to senior management on a quarterly basis (and, where applicable, to the UCITS' primary regulator on a semi-annual basis) if the number of VaR breaks exceeds a specified threshold. Additionally, if the results reveal a percentage of exceedances that is "too high," the UCITS is encouraged to review and adjust its VaR model. *See* CESR Guidelines, *supra* note 23.

In addition to internal and board reporting and reporting on Form N-PORT, as discussed above in Section II.B, our recommendation includes an early-warning notification to the Commission staff if a fund experiences a limit exceedance of the 10-Day VaR as described above. This notification will enable the staff to monitor a fund's activities following a limit exceedance and also to detect any market-wide issues (*e.g.*, if multiple fund groups report limit exceedances at the same time).

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We appreciate the opportunity to provide further comments on the proposal. If you have any questions regarding ICI's recommendation or would like any additional information, please feel free to contact me at (202) 326-5815; Dorothy Donohue, Deputy General Counsel at (202) 218-3563; Jennifer S. Choi, Associate General Counsel at (202) 326-5876; or Kenneth C. Fang, Assistant General Counsel at (202) 371-5430.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

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

David W. Grim, Director
Diane C. Blizzard, Associate Director
Division of Investment Management