Consumer Federation of America

March 28, 2016

Brent Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

**Re: File Number S7-24-15**
**Use of Derivatives by Registered Investment Companies and Business Development Companies**

Dear Secretary Fields,

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our support for the Commission's proposed rules on funds' use of derivatives. These rules would require funds that enter into derivatives transactions to comply with certain conditions, including limiting portfolio leverage to prevent undue speculation, maintaining segregated assets to enable funds to meet their obligations and, for those funds that engage in more than a limited amount of derivatives or that use complex derivatives, establishing a formal derivatives risk management program to ensure that they are using derivatives as intended. These conditions on funds' use of derivatives will better protect investors from derivatives-related risks and fulfill the purposes and concerns underlying the Investment Company Act (Act).

## I. Funds' use of derivatives has grown considerably and is expected to grow even further, despite significant risks involved with the use of derivatives.

Registered investment companies, including mutual funds and ETFs, are the preferred investment vehicles for most investors, and specifically, for most retail investors. Investors routinely use these funds to save for retirement, college, or other important savings goals. However, many of the funds that are marketed and sold to investors today look very different from those that were marketed and sold to investors just twenty years ago. As the derivatives market has grown in volume and complexity over the last two decades, there has also been a growth in registered funds' use of derivatives. Using derivatives has enabled funds to engage in a range of complex and, in some cases, highly leveraged strategies, including managed futures funds, total return funds, long-short funds, unconstrained bond funds, and double and triple leveraged ETFs, among others. Some of these funds, for example have notional exposures

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

exceeding the fund's net assets, with some attaining almost 10 times the fund's net assets. This is in sharp contrast to how funds traditionally operated, with virtually no leverage.

The market for alternative strategy funds in particular has grown considerably in recent years and is expected to grow even further in the near future. For example, in 2010, there were only about 590 alternative strategy funds, with around $320 billion in assets under management. However, by the end of 2014, there were more than 1,100 alternative strategy funds, with total assets under management in excess of $469 billion, according to the DERA white paper on the use of derivatives by registered investment companies.[2] And, according to a recent report by McKinsey & Co., the global market for retail alternative assets has grown by 16 percent annually since 2005 and now stands at almost $900 billion, with "hedge fund-like offerings structured as so-called '40 Act funds hav[ing] experienced particularly robust growth."[3] McKinsey expects that "[r]etail alternatives will be one of the most significant drivers of U.S. retail asset management growth over the next five years, accounting for up to 50 percent of net new assets."[4] PWC expects similar growth in the retail market and has specifically highlighted a 2014 RIA Database survey that finds financial advisors have been, and are likely to continue, allocating more of their clients' portfolios to alternatives.[5]

While non-accredited retail investors are now able to gain exposure to alternative strategies that use derivatives, doing so often comes with considerable risks. This is because the use of derivatives can result in heightened leverage that exposes a fund and its investors to the possibility of magnified and accelerated portfolio losses, illiquidity, counterparty risk, and operational risk. Yet, retail investors can't reasonably be expected to understand the complex risks implicated by various derivatives transactions and make informed decisions whether or not to invest in funds that employ certain derivatives strategies. And, while warnings by regulators may discourage some retail investors from investing in alternative strategy funds,[6] we are not aware of any empirical data that shows investors actually read such warnings or, if investors do read them, that they are effective at informing retail investors' decision-making process. Even if retail investors do consider regulators' warnings, those warnings may be counteracted by the sophisticated marketing campaigns that product providers engage in, which are designed to convey the impression their products are essential for investors' needs.[7]

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[2] Daniel Deli, Paul Hanouna, Christof W. Stahel, Yue Tang and William Yost, *Use of Derivatives by Registered Investment Companies* at Table 2,, SEC DIVISION OF ECONOMICS AND RISK ANALYSIS, December 2015, http://1.usa.gov/1RwtL3I.

[3] Pooneh Baghai, Onur Erzan, and Ju-Hon Kwek, *The $64 trillion question: Convergence in asset management*, MCKINSEY AND CO., February 2015, http://bit.ly/1ogSKzJ.

[4] Pooneh Baghai, Onur Erzan, and Ju-Hon Kwek, *The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments*, MCKINSEY AND CO., August 2014, http://bit.ly/1BBhBlC.

[5] Caitlyn Truong, Carl Drisko, Kimberly Richards, Gbenga Babarinde, *Alternative Investments: It's time to pay attention*, PWC STRATEGY& LLC, http://pwc.to/1LUrBKa.

[6] *See, e.g.*, Investor Alert, Alternative Funds Are Not Your Typical Mutual Funds, FINRA, June 11, 2013, http://bit.ly/1UXh9ag; Investor Alert, Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors, FINRA, August 18, 2009, http://bit.ly/21PfFzm.

[7] *See, e.g.*, Press Release, Invesco, "It's All About How You Say It," June 23, 2015, http://prn.to/25sALIu (finding that the specific words that are associated with alternative strategy funds can profoundly affect investors' perceptions of those funds and strategies. The word "derivatives" was number one on the list of toxic words or phrases to avoid when talking with clients about alternative investments.); Direxion advertises its leveraged ETFs as fit for the "bold, confident investor." http://bit.ly/25sBcT8.

There is evidence that suggests investors are incorrectly using certain alternative investments that use derivatives extensively. For example, despite the fact that double and triple leveraged ETFs are short-term trading vehicles that are not meant to be held longer than one day, a significant number of shares are held for several days, if not weeks.[8] Holding these investments for longer than one day exposes investors to substantial risk as the holding period returns will deviate from the returns of the leveraged or inverse investment in the index or benchmark being tracked. At a certain point, it's a near mathematical certainty that the investor will lose her entire investment.[9]

The profound risks associated with derivatives transactions do not just relate to whether retail investors are capable of understanding and using derivatives appropriately. As we've seen time and time again, even some of the most sophisticated investors have proven incapable of adequately understanding the dangers that derivatives can pose or taking appropriate steps to limit the damage that can ensue when derivatives transactions go awry.[10]

The International Monetary Fund has recently raised specific investor protection and systemic risk concerns about bond funds' use of derivatives.[11] Their data show that the assets of large bond mutual funds that use derivatives have increased significantly since the global financial crisis and that many funds have relatively high leverage and sensitivity to the returns of U.S. fixed-income benchmarks. According to their analysis, this combination of high leverage and sensitivity to U.S. fixed-income benchmarks "raises a risk that losses from highly leveraged derivatives could accelerate in a scenario where market volatility and U.S. bond yields suddenly rise. Investors in leveraged bond mutual funds, when faced with a rapid deterioration in the value of their investments, may rush to cash in, particularly if this results in greater than expected losses relative to benchmarks (and the historical performance of their investments). This could then reinforce a vicious cycle of fire sales by mutual fund managers, further investor losses and redemptions, and more volatility."[12]

## II. The purposes and concerns underlying the Investment Company Act relating to funds' use of derivatives are not being fulfilled.

The Investment Company Act (Act) imposes strict restrictions on funds' activities that are designed to protect investors. Among them, Section 18 of the Act imposes various limitations on the capital structure of funds, including restricting the ability of funds to issue "senior securities." Congress' findings and declaration of policy underlying Section 18 make clear that

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[8] Ilan Guedj, PhD, Guohua Li, PhD, and Craig McCann, PhD, Leveraged ETFs, Holding Periods and Investment Shortfalls, Securities and Litigation Consulting Group, 2010, http://bit.ly/1Uq86ju.
[9] Paul Justice, Warning: Leveraged and Inverse ETFs Kill Portfolios, Morningstar, January 22, 2009, http://bit.ly/1WSQTgz.
[10] *See, e.g.,* Long Term Capital Management (Robert M. Merton and Myron B. Scholes founded Long Term Capital Management and received the Nobel prize in 1997 for their work that expanded on the Black-Scholes options pricing model. Long Term Capital Management collapsed a year later due to derivatives-related losses, and required a private bailout to limit the risk of contagion); *See also* AIG, Lehman Bros., JPMorgan London Whale, to name a few. While none of these examples arose in the registered fund context, they are still relevant to showing the substantial risks derivatives can create for even the most sophisticated investors.
[11] Fabio Cortes, The Specter of Risk in the Derivatives of Bond Mutual Funds, iMFDirect, December 17, 2015, http://bit.ly/1Rwu0Mh.
[12] *Id*.

Congress was concerned with the potential for investment companies, through excessive borrowing, to engage in undue speculation and operate without sufficient assets to cover potential losses.[13] Accordingly, Congress declared it to be in the national public interest and the interest of investors for the Act to be interpreted "to mitigate and, so far as is feasible, to eliminate" these concerns.[14]

However, the purposes and concerns underlying the Act relating to funds' use of derivatives are no longer being fulfilled. The Commission first issued a General Statement of Policy (Release 10666) in 1979 in order to address the possible economic effects and legal implications of trading practices that may create an evidence of indebtedness for the capital structure of investment companies. Since then, however, the Commission, through staff guidance and approximately 30 no action letters, has undertaken a patchwork application of Release 10666 with regard to different derivative transactions. This ad-hoc, instrument-by-instrument approach has created a lack of clarity about how Release 10666 should apply to each particular derivative instrument. Without clear guidance on how to treat the full range of derivatives transactions, different funds have engaged in their own varying interpretations of how they should apply Release 10666 to their particular situation. This has allowed funds to take on substantial leverage without any meaningful constraints, implicating concerns that they are engaging in undue speculation and that they may not have sufficient assets to cover potential losses. When a fund uses derivatives in ways that are unduly speculative or that result in the fund's not having sufficient assets to cover its losses, the fund exposes its investors to sudden and severe losses. The Commission's ad-hoc, instrument-by-instrument approach to applying Release 10666 to different derivatives also makes it difficult for the Commission to effectively examine funds to ensure compliance with Release 10666 and its progeny. These deficiencies have resulted in a lack of adequate regulatory protections for investors of funds that use derivatives.

The current mark-to-market segregation approach that funds use for derivatives is a prime example of funds' use of derivatives that is not consistent with the Act or even with the protections contemplated by Release 10666. This approach allows funds to segregate only the amount equal to their daily mark-to-market losses, which reflects only their current obligations and not the potential obligations that can arise in the future. If there is no mark-to-market loss for the fund on a given day, the fund might not segregate any assets. By not segregating assets in case any future losses occur, a fund may not have a sufficient cushion of segregated assets to cover any sudden losses that may occur.

Moreover, the mark-to-market approach allows funds to segregate any liquid assets, instead of requiring them to segregate high quality assets that are less susceptible to experiencing volatility or declining in value. For example, funds are allowed to segregate volatile stocks and complex debt securities under this approach. But as we witnessed during the financial crisis, assets that are considered liquid during good times can quickly lose value and become illiquid during times of stress. If a fund's derivative position experiences a sudden and severe loss and the fund needs to cover that loss by selling an asset that at the same time has experienced a sudden and severe loss, the fund could easily experience a shortfall. Faced with this shortfall, the fund would need to engage in fire sales of those and possibly other assets to meet its obligations.

[13] Section 1(b)(7) and 1(b)(8) of the Investment Company Act.
[14] *Id*.

As the IMF report discussed above, these fire sales would depress the fund's NAV and deplete fund liquidity, exacerbating stress at the worst possible time.

Allowing funds to combine the segregation approach of only segregating the mark-to market daily liabilities for each derivative transaction and segregating any liquid asset, rather than high quality assets, compounds risks to the funds themselves and to their investors. It means that funds are allowed to take on virtually limitless leverage and operate without any reasonable cushion in case losses occur. This is clearly not what Congress contemplated when it passed Section 18 of the Act. Because the regulatory framework that currently applies to funds' use of derivatives is not addressing the purposes and concerns underlying the Act, a new framework that does address these purposes and concerns is necessary.

## III. The proposed regulatory approach requiring funds that engage in derivatives transactions to comply with certain conditions will better protect investors from derivatives-related risks and fulfill the purposes and concerns underlying the Investment Company Act.

The Commission has proposed a clear and comprehensive framework that puts prudent safeguards in place to ensure funds limit their leverage and, as a result, avoid undue speculation, operate with sufficient assets so they can meet their current and potential obligations and, for those funds that engage in more than a limited amount of derivatives or use complex derivatives, properly manage the associated risks that come with subjecting a fund and its investors to those transactions. These conditions on funds' use of derivatives complement and reinforce one another to effectively address the policies and concerns underlying the Act. They achieve these goals while still allowing funds the flexibility to take on a considerable amount of derivatives exposure through a variety of transactions, which will enable them to accomplish different investment objectives that may be beneficial for portfolios.

### A. Requiring funds to comply with certain defined portfolio exposure limits is critical to prevent funds from taking on excessive leverage and engaging in undue speculation. Moreover, the limits proposed are reasonable.

Under the proposal, a fund using derivatives must comply with one of two alternative portfolio limitations on the amount of notional derivatives exposure it can take on. Under the first alternative, a fund can accumulate a notional exposure of up to 150 percent of net assets. Under the second alternative, a fund can accumulate a notional exposure of up to 300 percent of net assets, provided the fund complies with a value-at-risk-based test showing that the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.

Defined limits on portfolio exposure are a critical component of the proposed rule. Current fund practices suggest that an asset segregation approach alone may not be sufficient to constrain funds from taking on excessive leverage or ensuring funds have adequate assets available to meet potential obligations arising from their derivatives transactions. Therefore, we think it is necessary to establish an outer limit on funds' ability to take on excessive leverage. While we recognize that notional exposure is an imperfect measurement of leverage, we still think that it is useful because it provides a general measure of the fund's economic exposure arising from the transaction. And, while we would be open to alternative approaches to address the concern that notional is an imperfect measurement of leverage, it is difficult to see how such a measure could be better designed so that it does not create undue complexity, require different leverage determinations on an instrument-by-instrument basis, lead to inconsistent applications by different funds, or result in difficulties for regulators to inspect for compliance.

Moreover, the proposed alternative limits on portfolio exposure reasonably account for the fact that notional exposure is an imperfect measure of leverage. Under the first alternative, funds are allowed to take on notional exposure of up to 150 percent of net assets, which is a considerable amount that still allows funds to use a variety of strategies, based on a variety of different derivative arrangements. To the extent that funds want to dedicate their allowed exposure to amplify returns, hedge exposure, or a combination thereof, they will be free to do so. Nonetheless, we expect that industry opponents will likely claim that the 150 percent limit is too low to allow funds to engage in a variety of desired activities and strategies. However, if funds are permitted to use derivatives to gain notional exposures beyond the 150 percent without having to prove that they are doing so in a way that mitigates risk to the portfolio, it would implicates the same concerns about funds' engaging in undue speculation as the rule is intended to address.

As DERA's analysis indicates, the vast majority of funds are already complying with this condition and therefore would not have to modify their activities under the rule, which suggests it is not unreasonably constraining. It appears based on the DERA analysis that only a small percentage of funds, predominantly alternative strategy funds and certain leveraged ETFs, use derivatives to a much greater extent and would therefore be at risk of breaching the 150 percent threshold. Even within the sampled alternative strategy funds, approximately 73 percent of the funds had aggregate notional exposures that were under 150 percent of net assets.

The minority of sampled alternative strategy funds that would be above the limit engage in more exotic strategies, including absolute return, managed futures, unconstrained bond, and currency strategies. The fact that some managed futures funds have notional exposures of almost 10 times (950 percent) the funds' net assets explains, at least in part, why these investments are so risky and expose retail investors to such inordinate harm.[15] It also demonstrates how the status quo does not impose any meaningful constraints on funds' derivatives activities. And, the minority of sampled ETFs that would be above the limit seek to deliver two or three times the multiple of, or inverse multiples of, the performance of an index or benchmark. These ETFs engage in pure leverage strategies, magnifying gains and losses.

Certainly, Section 18 was intended to prevent registered funds from taking on such high degrees of leverage and being offered to less sophisticated investors who aren't capable of withstanding the losses that can accompany such highly leveraged vehicles. In order to restore the purposes and policies underlying Section 18, the Commission should not hesitate to prohibit

[15] *See, e.g.*, David Evans, "How Investors Lose 89 Percent of Gains from Futures Funds," BLOOMBERG MARKETS MAGAZINE, Oct. 7, 2013, http://bloom.bg/1JbuuHh (chronicling how retail investors routinely lose money when investing in these funds, in part, because of leverage. In the article, Gerald Corcoran, CEO of Chicago-based R.J. O'Brien & Associates LLC and a director of the Futures Industry Association is quoted as saying, "You're going to lose money in managed futures over the course of a period of time. There's no question."); *See also* Lawrence C. Strauss, "Managed-Futures Funds' Misery Continues," BARRON'S, July 26, 2014, http://bit.ly/22HM1lj (highlighting persistent underperformance and a high degree of volatility in these funds).

registered funds from engaging in such highly leveraged strategies. If funds can't stay under the proposed 150 percent threshold, and they can't demonstrate that their increased exposure beyond 150 percent results in a portfolio that has a lower value-at-risk, they should be required to either change their activities to comply with the proposed conditions or deregister and operate as private funds for investors who are, at least in theory, more sophisticated and capable of withstanding the losses that can accompany such highly leveraged vehicles.

Under the second alternative, a fund can accumulate a notional exposure in excess of the 150 percent of net assets but under 300 percent of net assets, provided it complies with a value-at-risk-based test showing that the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives. We strongly agree with the Commission that funds should only be allowed to take on notional exposures beyond the 150 percent limit if they can prove that they are using those derivatives in ways that mitigate and reduce risk for the portfolio, thus rendering the portfolio less speculative than it would be if the fund did not use derivatives.

Even then, we have concerns that a value-at-risk (VAR) test may not provide sufficient protections against funds' engaging in undue speculation. VAR, which is intended to measure the potential loss on an instrument or portfolio over a specified time horizon and at a given confidence level, is typically based on varying economic models. These models are calculated using different inputs and assumptions, which can materially affect the resulting VAR calculations.[16] As a result, VAR calculations have been shown time and time again to be prone to error and susceptible to manipulation.[17] In some cases, VAR calculations have shown the use of derivatives to be risk-reducing even in circumstances where they increased risk significantly.[18]

Given VAR's inherent shortcomings, any VAR-based exposure test must meet minimum standards so as to limit the potential for VAR to be used in ways that result in less reliable calculations. These include meeting minimum procedural standards requiring funds to document

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[16] Two of VAR's most prominent deficiencies, for example, are that it doesn't reflect tail risk, which is an unexpected event leading to a significant loss, and that it is based on recent historical data, which may not predict future events.

[17] *See, e.g.,* Aswath Damodaran, VAR, NYU Stern School of Business, http://bit.ly/1VQ6or1 ("While Value at Risk has acquired a strong following in the risk management community, there is reason to be skeptical of both its accuracy as a risk management tool and its use in decision making."); Joe Nocera, "Risk Mismanagement," New York Times Magazine, January 2, 2009, http://nyti.ms/1MN901K (Marc Groz, a risk consultant, referred to VAR inputs by saying, "The old adage, 'garbage in, garbage out' certainly applies."); Philippe Jorion, Risk Management Lessons From Long Term Capital Management, January 2000, http://bit.ly/1ShfRSW (Long Term Capital Management's failure was largely blamed for its overreliance on VAR. LTCM routinely made statements related to its VAR, including, "LTCM asserts that the portfolio was managed so that its target risk was no larger than the risk of an unleveraged position in the S&P 500."); United States Senate Permanent Subcommittee on Investigations Committee on Homeland Security and Governmental Affairs, JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, March 15, 2013, http://1.usa.gov/1MN9O6I (Chronicling JPMorgan's hasty change in VAR methodology, which allowed the bank to show a 50 percent reduction in risk. This effectively masked the significant changes in JPMorgan's portfolio and allowed the bank to take on more risk. JPMorgan later acknowledged that the internal approval process for the new VAR model was "hurried," that it included flawed and untested components, and that it was "not proud" of the inadequate back-testing undertaken.)

[18] Long Term Capital Management's failure was blamed for overreliance on VAR highly leveraged through derivatives "LTCM asserts that the portfolio was managed so that its target risk was no larger than the risk of an unleveraged position in the S&P 500." *Id*.

the methodology and data underlying their VAR calculations, requiring funds to apply their VAR models consistently when calculating their securities VAR and full portfolio VAR, and requiring funds to document and explain any subsequent changes to their VAR models. These also include meeting minimum substantive standards. By and large, the requirements that the Commission has proposed, including requiring funds to take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments and to use a minimum 99 percent confidence interval, a time horizon of not less than 10 and not more than 20 trading days, and a minimum amount of historical data to estimate historical VAR, appear reasonable.

However, the proposed minimum three years of historical market data appears far too limited to provide any meaningful predictive value of current or future risk. The length of the data observation period may significantly influence the results of a VAR calculation, with a shorter observation period having a smaller data set that has a greater influence on the resulting VAR calculation, as compared to a longer observation period having a larger and richer data set that has a moderating influence on the resulting VAR calculation. A shorter observation period may also reflect the growth of a recent bubble and thus fail to take into account relevant risks or appropriately indicate future events. As the risk consultant Marc Groz put it best, "The years 2005-2006, which were the culmination of the housing bubble, aren't a very good universe for predicting what happened in 2007-2008."[19] While we acknowledge the fact that even a longer observation period would still not appropriately factor in tail-risk, and therefore likely would not have predicted the financial crisis, we still urge the Commission to expand the minimum observation period. We believe a period of at least five, but preferably seven to ten years is appropriate, so that any historical data set isn't solely reliant on potentially atypical and misleading information, such as the growth and height of a recent bubble.

We also encourage the Commission to consider requiring funds to comply with a stressed VAR test in addition to complying with the proposed VAR test. Such a test would require funds to take into account the impact of reasonably foreseeable stress events on their securities portfolio and full portfolio. Doing so would help protect against the risk that a fund could engage in undue speculation by taking on derivatives exposure that appears to be risk-reducing based on recent but unrealistic assumptions, but which would actually be risk-increasing under reasonably foreseeable circumstances.

While we think these minimum standards are necessary to ensuring that the VAR test is the most reliable and meaningful that it can be, we do not believe that even a well-designed VAR test is sufficient on its own to prevent funds from engaging in undue speculation. Thus, it is imperative that the Commission preserve the 300 percent outer limit coupled with the VAR test to ensure that, if and when a fund's VAR turns out to be wrong, it is not excessively exposed. Without such a ceiling, funds could obtain vast amounts of derivatives exposure that comply with the VAR test during certain periods, but which are nonetheless unduly speculative and ultimately experience devastating losses during periods of unexpected market stress.

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[19] Joe Nocera, "Risk Mismanagement," New York Times Magazine, January 2, 2009, http://nyti.ms/1MN901K (Groz also said, "When you realize that VaR is using tame historical data to model a wildly different environment, the total losses of Bear Stearns' hedge funds become easier to understand. It's like the historic data only has rainstorms and then a tornado hits.")

In sum, both proposed alternatives ensure that funds do not engage in undue speculation, while still accommodating the fund industry by permitting them to take on a considerable amount of exposure and engage in a diversity of strategies and derivative arrangements that exist now or that may be created in the future.

**B. Requiring funds to comply with asset segregation standards that take into account reasonable estimates of future liabilities and that segregate cash or cash-equivalents is critical to ensure funds operate with sufficient assets to meet their obligations.**

In addition to the proposed alternative portfolio exposure limits, which are necessary to prevent funds from engaging in undue speculation, funds must also be required to have a sufficient cushion of segregated assets to cover any losses that occur from their derivatives transactions.

As discussed above, the current mark-to-market segregation approach that funds use for derivatives transactions is not consistent with the Act or the protections contemplated by Release 10666. Funds are allowed to segregate the amount equal to their daily mark-to-market losses, which reflects only current obligations, not potential obligations that may arise in the future. Thus, this approach could result in a shortfall if a derivative transaction experiences sudden and severe losses. In addition, funds are allowed to segregate any liquid assets, including those that may quickly lose considerable value, which could also lead the fund to experience a shortfall if a derivative transaction undergoes sudden and severe losses.

The proposed asset segregation approach restores the asset sufficiency protections envisioned in the Act. For each derivative transaction, a fund would be required to maintain qualifying coverage assets with a value equal to: 1) the mark-to-market amount, representing a reasonably current estimate of the amount the fund would owe if it were to exit the position, determined daily; and 2) an additional risk-based coverage amount reflecting a reasonable estimate of potential future liabilities if the fund were to exit the derivatives transaction under stressed conditions, also determined daily. Requiring an additional risk-based amount appropriately addresses the concern that a shortfall may arise between the mark-to-market amount of a transaction and any future payment obligation that may arise under a transaction. Whereas the current mark-to-market approach is reactive to covering current liabilities, the proposed approach is forward-looking and allows funds to stay ahead of any potential liabilities.

The additional risk-based coverage amount would be determined in accordance with policies and procedures approved by a fund's board of directors. Because each fund will have different policies and procedures based on their unique circumstances, it is critical that each board adequately document its policies and procedures. We note that if a fund is applying a stressed VAR model for this aspect of the rule, it should not be significantly more burdensome to apply a similar model in addition to the VAR-based exposure test, discussed above.

The proposed asset segregation requirement would also require the coverage assets for derivatives transactions to consist of cash and cash-equivalents, which are extremely liquid and less likely to experience volatility or to decline in value in times of stress. By requiring coverage assets to consist of cash and cash-equivalents, the proposed rule would protect funds and their investors against the risk that a fund will need to cover sudden and significant derivatives liabilities by engaging in fire sales of coverage and other assets. Thus, this requirement will protect against the risk that inadequate asset segregation practices will ultimately lead to the exacerbation of stress on funds at the worst possible time.

These proposed asset segregation standards that take into account reasonable estimates of future liabilities and that segregate cash or cash-equivalents will better ensure funds operate with sufficient assets to meet their obligations.

**C. Requiring funds that take on more than a limited amount of derivatives exposure or that use complex derivatives to establish a formalized derivatives risk management program will help to ensure that they are using derivatives as intended.**

Given that the use of derivatives often comes with considerable risks that can expose funds and their investors to the possibility of magnified and accelerated portfolio losses, and that those risks are especially pronounced if funds takes on more than a limited amount of exposure or uses particularly complex derivatives, it is critical that those funds take affirmative steps to ensure they are engaging in prudent risk management. Requiring funds that have more than a limited amount of exposure or use complex derivatives to establish a formalized risk management program that meets minimum standards and is overseen by a risk manager and the fund’s board would help achieve those goals, as well as complement and reinforce the other requirements of the rule.

However, the proposed threshold, whereby a fund’s notional exposure is considered “a limited amount of exposure” if it falls below 50 percent, appears misguided. For example, we don’t think it’s appropriate that a fund with 40 or 45 percent notional exposure should be viewed as having a limited amount of exposure obviating the requirement for that fund to implement a formal risk management program. Moreover, we do not agree with the Commission’s reasoning for establishing the 50 percent threshold. The Commission analogizes the threshold to the statutorily defined threshold for senior securities under section 18, which limits the amount of senior security transactions that funds may achieve through bank borrowing to one-third of the fund’s total assets, or 50 percent of the fund’s net assets. However, as the Commission rightly recognizes, Section 18’s limit reflects a congressional determination on the level of exposure funds may not exceed; it does not reflect the level of exposure at which funds should begin to establish formal risk management practices.

We think that a threshold based on a fund’s notional exposure falling below one-third of net assets is more appropriate, as it would better reflect what should be considered “a limited amount of exposure.” Coupling a lower threshold with a tailored approach that requires funds to undertake increasing rigor based on their increased exposure and risk profiles would achieve an appropriate balance to ensure that minimum risk management safeguards are in place and that funds with lower amounts of derivatives exposure and risk profiles are not faced with undue compliance burdens.

Furthermore, under the proposal, a fund's formal risk management program must meet certain minimum standards. We strongly support requiring a fund to have policies and procedures reasonably designed to:

- assess the risks associated with the fund's derivatives transactions;
- manage the risks of the fund's derivatives transactions;
- reasonably segregate the functions associated with the risk management program from the portfolio management of the fund;
- and periodically review and update the program.

Establishing a baseline of minimum standards will help to ensure acceptable risk management safeguards are in place. It will give firms guidance on the policies and procedures they are expected to have in place and the types of administrative and oversight functions that should drive those policies and procedures. As discussed above, we think that each fund should tailor its policies and procedures to reflect its particular derivatives use and that funds with higher amounts of exposure or more exposure to complex derivatives should adopt much more rigorous policies and procedures than those with lower amounts of exposure or less exposure to complex derivatives.

**Conclusion**

We've unfortunately reached a point where an unsound regulatory framework has allowed registered funds to engage in incredibly exotic strategies and use leverage extensively, despite the fact that Congress specifically intended for those activities not to occur within the registered fund context. It should mean something to be a registered fund, and retail investors who purchase these investment vehicles should have certain protections and assurances that their funds aren't suddenly going to blow up. Not every fund or strategy will be able to fit within this rubric. However, that should not dissuade the Commission from moving forward. If a particular fund wants to pursue activities that are inconsistent with what Congress envisioned in the Investment Company Act, it is entirely appropriate that that fund operate outside the registered fund context.

This proposal reflects a thoughtful, modernized regulatory framework for funds' use of derivatives. It will better protect fund investors from derivatives-related risks and better fulfill the policies and purposes underlying the Investment Company Act. We urge the Commission to finalize it, along with our suggested adjustments, expeditiously.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
Financial Services Counsel