BETTER MARKETS

March 24, 2020

By Electronic Submission

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles: File Number S7–24–15 (RIN 3235–AL60).

Ladies and gentlemen,

Better Markets, Inc.[1] ("Better Markets") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") re-proposal of Proposed SEC § 270.18f–4[2] under the Investment Company Act of 1940 ("ICA"). Proposed SEC § 270.18f–4 sets forth a number of sensible risk management, governance, and leverage requirements designed to mitigate risks associated with the use of derivatives by funds. We therefore commend the SEC for taking steps to finalize a derivatives-related leverage framework, which would have a disciplining effect on fund governance and risk management and codify a more comprehensive risk management, disclosure, and reporting framework than exists under current law and guidance. Better Markets agrees that, on balance, the re-proposal would progress an ICA section 18 framework that initially addresses statutory concerns relating to derivatives-related leverage and the potential for it to affect the speculative character of fund shares, which raises investor protection and systemic risk concerns.

Nevertheless, after nine years of consideration commencing shortly after the Dodd-Frank Wall Street Reform and Consumer Protection Act's adoption,[3] we question the need for the SEC's introduction of new elements to replace others in the previously proposed, well-considered, and bi-partisan 2015

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446 (Jan. 24, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf.

3 Public Law 111–203, 124 Stat. 1376 (2010).

framework.[4] Although we agree with numerous aspects of the re-proposal, we focus our comments on the most consequential new element of the release—the abandonment of the asset segregation framework overseen by the SEC and its staff since the 1970s and its replacement with the relative and absolute value-at-risk-based leverage limits.

I. The SEC must promptly finalize its re-proposal in a manner that addresses ICA section 18's investor protection and financial stability concerns relating to the use of derivatives-related leverage by funds.

The use of leverage by "funds,"[5] including so-called "synthetic" leverage obtained through derivatives, can present significant risks to U.S. financial stability and investors.[6] Although derivatives-related leverage can amplify positive returns for investors and be risk reducing, it also can exacerbate risks arising from asset price or risk attribute movements not only to the fund itself and its investors but also to other market participants. These risks are likely to be most pronounced in adverse market conditions requiring funds to de-leverage, resulting in correlated "fire" sales of securities with other leveraged firms and often, requiring sales of already de-valued assets to meet redemption requests and other liquidity needs, including margin calls.[7] Furthermore, these stresses may occur as funds experience other market and liquidity stresses, which, in turn, can be expected to affect availability and costs of short-term funding for fund investment activities. These stresses may affect the ability or willingness of funds to transact in funding markets critical to other financial intermediaries, presenting additional contagion and systemic risk concerns.

Financial stability concerns contextualize the "national public interest"[8] reflected in the ICA's mandate that the SEC protect fund investor interests that may be "adversely affected" by "excessive borrowing."[9] The ICA finds that such leverage "increase[s] unduly the speculative character" of securities

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4 The SEC issued a concept release seeking public comment on use of derivatives by funds in 2011. See SEC, Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 Fed. Reg. 55237 (Sept. 7, 2011), available at https://www.govinfo.gov/content/pkg/FR-2011-09-07/pdf/2011-22724.pdf. It followed that initial release with a proposed regulatory framework for use of derivatives by funds in 2015. See SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-12-28/pdf/2015-31704.pdf.

5 Proposed § 270.18f–4(a) would define "fund" to mean "a registered open-end or closed-end company or a business development company, including any separate series thereof, but does not include a registered open-end fund company that is regulated as a money market fund under § 270.2a–7."

6 There are numerous leverage measures that may be relevant to ICA section 18's concerns about increasing the speculative character of fund shares. Leverage restrictions, to be effective, must apply to the use of any financial instrument, including a derivatives contract, that can be used to increase a fund's investment exposure beyond such fund's net asset value. Conversely, though, leverage restrictions, by their nature, cannot be tied solely to funds' uses of derivatives. One of the virtues that balances drawbacks of the proposed value-at-risk framework is that it contemplates implicit leverage across financial instruments in fund portfolios. Yet, the re-proposal addresses derivatives-related leverage risks as part of the broader ICA section 18 leverage framework.

7 See, e.g., Financial Stability Board ("FSB"), Policy Recommendations to Address Vulnerabilities from Asset Management Activities (Jan. 2017) (noting that "[m]easures that are taken to address risk transmission through the counterparty channel, such as margin requirements, may exacerbate procyclicality through the asset sales channel by, for example, necessitating asset sales to meet margin calls"), available at https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

8 See 15 U.S.C. § 80a–1(a) (finding that funds are "affected with a national public interest in that, among other things . . . such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets").

9 15 U.S.C. § 80a–1(b)(7).

held by fund shareholders and presents concerns about whether funds operate with "adequate assets or reserves."[10] In this regard, the ICA commands the following to ensure investors can knowledgeably accept the nature, extent, and magnitude of investment risks associated with fund investments, including those involving derivatives-related leverage:

- That investors be given "adequate, accurate, and explicit information, fairly presented, concerning the character of [fund] securities"[11] involving derivatives-related leverage and the "circumstances, policies, and financial responsibility of such [funds] and their management"[12] relating to such activities; and

- That investors participate in funds with confidence that the ICA provides outer boundaries on the use of leverage and thereby reasonably limits the speculative character of fund investments, reflecting the ICA's concern that disclosure alone does not adequately protect investors from "excessive leverage."[13]

The SEC's re-proposed derivatives-related leverage framework serves these statutory directives better than current law and guidance. Although we have reservations about certain elements of the re-proposal and in particular, the new proposed derivatives-related leverage limitations (the relative and absolute value-at-risk ("VaR")[14] approach), we appreciate the balance of views presented in the re-proposed rulemaking and the SEC and its staff for taking initial steps to implement a comprehensive regulatory framework for funds using derivatives-related leverage and posing derivatives-related risks to the U.S. financial system and investors.

II. Since 1979, the SEC has correctly emphasized substance over form in interpreting the "senior security" limitations in ICA section 18. It must codify a construction of ICA section 18 that applies relevant restrictions and limitations on senior securities to derivatives used to achieve leverage tantamount to bank borrowing.

ICA section 18[15] imposes restrictions on a fund's ability to issue and sell "senior securities," including most claims senior to common stock, with an exception for bank borrowing within statutory limits.[16] As mentioned, Congress enacted ICA section 18 to, among other things, "mitigate and, so far as

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10 15 U.S.C. § 80a–1(b)(7)-(8).

11 15 U.S.C. § 80a–1(b)(1).

12 Id.

13 See, e.g., 15 U.S.C. § 80a–18(a)-(f).

14 See Proposed § 270.18f–4(a) (defining "value-at-risk" to mean "an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level," subject to additional conditions that an eligible VaR model must (1) take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable: (i) equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk; (ii) material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and (iii) the sensitivity of the market value of the fund's investments to changes in volatility; (2) use a 99% confidence level and a time horizon of 20 trading days; and (3) be based on at least three years of historical market data.").

15 15 U.S.C. § 80a et seq.

16 15 U.S.C. § 80a–18(a)-(f). ICA section 18(f), for example, provides that it shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security (except that a registered company may borrow from a

is feasible, to eliminate"[17] the potential for "investment companies [to] operate without adequate assets or reserves"[18] or engage in "excessive borrowing . . . [that] increase unduly the speculative character of their junior securities."[19]

Since at least 1979, the SEC has interpreted ICA section 18 restrictions to apply to certain financial instruments affecting the speculative character of fund common stock in a manner that is "functionally" equivalent or similar to the issuance of senior securities. For example, in its General Statement of Policy ("Release 10666"), [20] the SEC interpreted ICA section 18's senior security limitations to apply to non-securities agreements that carry "contractual obligations to pay in the future for consideration presently received" and set forth a statutory construction of ICA section 18 that emphasized the "fundamental economic nature" of agreements and the potential for a "risk of loss to an investment company analogous to the danger caused by leverage, which is discussed throughout the legislative history of the [ICA]."[21] Funds have since applied ICA section 18 to certain derivatives and "notes or other acknowledgments of debt . . . based . . . on the proposition that trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section18."[22]

Forty years after its adoption, Release 10666 remains somewhat ambiguous with respect to ICA section 18's application to all derivatives, many of which (e.g., swaps) were highly bespoke and infrequently executed on non-currency-related commodities in 1979. In that release, however, the SEC emphasized that "the general statement of policy discusses [certain] securities trading practices . . . ***as examples***" and therefore was "intended to address the use by all registered investment companies of ***similar trading practices***."[23] In addition, the SEC emphasized that "because such types of securities trading practices are subject to innumerable variations, th[e] release [wa]s intended to address generally the possible economic effects and legal implications of ***all comparable trading practices which may affect the capital structure of investment companies*** in a manner analogous to the securities trading practices specifically discussed."[24] Thus, the SEC and its staff have for decades interpreted ICA section 18 to apply to various types of non-securities agreements, including certain derivatives contracts, that expose fund investors to leverage-related risks similar or functionally equivalent to statutorily restricted bank liabilities.

Formalizing that view in a less ambiguous manner when finalizing the re-proposal should be uncontroversial.

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bank if the registered company maintains at least 300% asset coverage over all such bank borrowings). 15 U.S.C. § 80a-18(f). ICA section 18(a) similarly limits a closed-end fund's issuance of an evidence of indebtedness, unless the fund has 300% asset coverage, and preferred stock, unless the fund has 200% asset coverage. 15 U.S.C. § 80a-18(a).

17 15 U.S.C. § 80a-1.

18 15 U.S.C. § 80a-1(b)(8).

19 15 U.S.C. § 80a-1(b)(7). ICA section 18 defines "senior security" to mean "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." 15 U.S.C. § 80a-1(g).

20 SEC, Securities Trading Practices of Registered Investment Companies, Investment Company Act, 44 Fed. Reg. 25128, 25131 (Apr. 27, 1979), available at https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

21 Id at 25131.

22 Id.

23 Id (emphasis added).

24 Id at 25129.

The SEC's initial framework to govern the use of derivatives by funds would thereby serve multiple public interest purposes. First, it would establish a regulatory framework that is more transparent, less ambiguous, more legally reliable, and more uniformly implemented than the combination of previous releases and no-action letters explicitly addressing certain types of financial instruments. Second, the framework would set forth a much better developed set of leverage limitations (focused less on the permissible exclusions from leverage) and require funds to establish and maintain governance and risk management policies, procedures, and controls with respect to the use of derivatives-related leverage more generally.

A. The SEC staff has provided longstanding derivatives-related ICA section 18 no-action relief tied to the segregation of high quality, stable assets. The re-proposal would abandon that approach after four decades.

The re-proposal would eliminate the longstanding asset segregation framework applied to funds using derivatives. Since at least 1979, under Release 10666 and related SEC staff guidance, funds have been generally permitted to use certain types of derivatives, provided they "cover" leverage-related obligations with segregated, high quality, and liquid assets. The SEC and its staff have reasoned that the asset segregation framework practically limits leverage, including certain types of derivatives-related leverage, as follows:

> A segregated account freezes certain assets of the investment company and renders such assets unavailable for sale or other disposition. If an investment company continues to engage in the described securities trading practices [involving certain agreements that introduce leverage] and properly segregates assets, **the segregated account will function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock.** Additionally, such accounts will assure the availability of adequate funds to meet the obligations arising from such activities.[25]

That release has been followed by dozens of SEC staff releases extending ICA section 18 to various types of derivatives and fact patterns imposing similar conditions.[26] Thus, for decades, the asset segregation framework has been implemented and well-understood by the industry, though it could usefully be adjusted.

In addition, SEC commissioners from both political parties also have endorsed the general asset segregation framework. In connection with the retention of asset segregation in the 2015 proposal, for example, Commissioner Michael Piwowar provided a concise and compelling case for maintaining but improving the asset segregation approach, even though he dissented from the proposed ICA section 18 framework:

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25 SEC, Securities Trading Practices of Registered Investment Companies, Investment Company Act, 44 Fed. Reg. 25128, 25132 (Apr. 27, 1979).

26 It was also preceded by SEC staff guidance. See, e.g., SEC, Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12790 (June 29, 1972) (explaining SEC staff positions that short sales, certain fund options, and commodity futures contracts implicated ICA section 18's prohibitions against the issuance of senior securities and stating that "[a]lthough commodities and commodity futures contracts themselves may not be securities, the purchase of a commodities futures contract and the ensuring leverage may involve the creation of a senior security"). See also SEC, Registered Investment Company Use of Senior Securities—Select Bibliography, available at https://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

> Asset segregation has long been a part of fund risk management, including with respect to derivatives transaction obligations, and is the current approach the [SEC] uses to regulate funds' derivatives transactions . . . Today's proposal addresses the inadequacies of the current market practices by requiring a fund to segregate only cash and cash equivalents to cover not only mark-to-market liability, but also a reasonable estimate of the potential future liabilities. These potential future liabilities would be determined in accordance with policies and procedures approved by the fund's board (including a majority of the independent directors) to reflect an amount payable by the fund if the fund were to exit each derivatives transaction under stressed conditions. In addition, the rule generally would not permit a fund to cover its derivatives positions with offsetting positions and would limit the total amount of a fund's segregated assets to no more than the fund's net assets.
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> **These new requirements should serve as a functional leverage limit on funds as well as ensure funds' ability to meet their obligations arising from their derivatives usage, consistent with the original intent of the asset segregation approach specified by the [SEC] in Release 10666.** The proposed rule text, in fact, expressly requires a fund to "manage[ ] the risks associated with its derivatives transactions by maintaining qualifying coverage assets." **Thus, it is clear that the segregated asset requirements are designed to address both limits on a fund's use of leverage and a fund's ability to meet its derivative obligations**.[27]

Commissioner's Piwowar's comments were mirrored by the supporting SEC commissioners to the 2015 proposal.[28] In 2015, the Financial Stability Oversight Council essentially endorsed that asset segregation approach as well, noting that it "welcome[d] the SEC's efforts to limit the amount of leverage that registered investment companies such as mutual funds and ETFs may obtain through derivatives transactions, ***strengthen their asset segregation requirements***, and require derivatives risk management programs for certain funds."[29]

B. The SEC must supplement the VaR framework with an asset segregation framework.

The SEC should reinstate its longstanding asset segregation framework, with reasonable adjustments, as a supplemental measure to the proposed VaR-based framework. Although the proposed VaR framework rightly addresses portfolio market risks and accounts for hedging and other derivatives transactions that do not necessarily increase the speculative character of fund shares, the asset segregation framework considers other relevant risks attendant to derivatives-related leverage and could be modified to reflect not only mark-to-market exposures but also potential future exposures (e.g., by calibration to

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27 See Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015) (supporting the SEC's retention of the asset segregation approach and emphasizing that the "mark-to-market segregation approach has strayed far from the Commission's original asset segregation approach and does not provide the investor protections articulated by the Commission in Release 10666"), available at https://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html.

28 See Chair Mary Jo White, Statement at Open Meeting, (Dec. 11, 2015) (outlining improvements to the asset segregation framework), available at https://www.sec.gov/news/statement/chair-white-statement-at-open-meeting.html. See also Commissioner Luis A. Aguilar, Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance (Dec. 11, 2015), available at https://www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html.

29 FSOC, Update on Review of Asset Management Products and Activities, 21 (2015) (emphasis added).

regulatory initial margin requirements and perhaps risk add-ons that account for unmargined positions and distressed market conditions).[30]

This supplemental approach would be similar to the supplemental asset segregation approach in the 2015 proposal, which was complemented by other portfolio limitations on derivatives and similar transactions.[31] The SEC notes that it "considered applying an asset segregation approach to derivatives transactions, similar to asset segregation under Release 10666, as a tool to limit funds' leverage-related risks."[32] We respectfully ask the SEC to reconsider its determination to abandon the asset segregation approach. In this regard, the SEC also states that it considered "[a]llowing funds to segregate a broader range of [eligible] assets, even if subject to haircuts," though it acknowledged that approach could continue to expose funds to other types of trading losses.[33] It may be rational to consider a broader range of potential assets for internal or "earmarked" segregation, with appropriately conservative haircuts and limitations, provided, of course, such measures are complemented by additional, meaningful leverage limitations (e.g., the VaR-based leverage limitations).

The SEC explains that its proposed elimination of the asset segregation framework was motivated largely by its determination to better reflect the risks, not solely leverage, introduced by fund derivatives usage:

> Notional amount segregation, although generally an effective way to limit leverage risk, is a non-risk-sensitive and often more restrictive approach to limiting potential leverage risk as compared to the proposed VaR tests. Notional amount segregation could limit funds' ability to engage in derivatives transactions that may not raise the concerns underlying section 18. For example, if a fund had segregated all available qualifying assets, it would not be permitted to enter into a derivatives transaction that would reduce portfolio risk. The proposed VaR tests would not constrain such a transaction because it would reduce the fund's VaR.[34]

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30 The SEC expresses that such a concern could incentivize the use of futures contracts, rather than swaps, and notes that "[a]n approach that were to allow a fund to have more leverage when trading futures as compared to swaps . . . would not seem consistent with the concern underlying section 18. SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4482 (Jan. 24, 2020). That is not necessarily correct. In fact, there are numerous risk-reducing reasons to incentivize funds to gain economic exposures through standardized, cleared, central limit order book traded, minimally blocked, and fully pre and post-trade transparent futures markets, and differences in initial margin requirements between these financial instruments reflect the differences in the risks of those instruments.

31 See Chair Mary Jo White, Statement at Open Meeting, (Dec. 11, 2015) ("Asset segregation requirements by themselves, however, may not in all instances provide a sufficient limitation on the amount of leverage that a fund could obtain through derivatives . . . As a result, the proposal contains a second critical element that would require funds to comply with one of two alternative portfolio limitations on derivatives and similar transactions. One limitation would be based on a fund's aggregate exposures and the other limitation would be based primarily on a risk-based test. This framework is designed to provide funds the ability to use various types of derivatives in different ways, while curbing a fund's ability to engage in undue speculation, a principal concern underlying the Investment Company Act.").

32 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4481-4482 (Jan. 24, 2020).

33 Id.

34 Id at 4482.

The SEC's analysis is accurate with respect to risk sensitivity of the VaR framework relative to the asset segregation framework. However, a combined VaR and asset segregation framework would maintain relative and absolute VaR within regulatory limits but also "indirectly limit a fund's leverage risk" by requiring "segregation of liquid assets [associated with each derivatives transaction] [to] limit the net assets available for segregation to support additional derivatives."[35] In our view, a combined VaR and asset segregation framework would be more effective than either framework in isolation. Moreover, such a framework would apply leverage limitations that may be differently effective with respect to different fund trading strategies.

With the minimal adjustments for carefully defined, risk-mitigating hedging and similar risk-reducing activities (but not mere "efficiency"), a fund's total segregated amount within the asset segregation framework could be constrained in a manner that is analogous to and commensurate with the statutory asset coverage requirement applicable to bank debt for certain funds under ICA section 18.[36] To be sure, our recommendation introduces some complexity to the SEC's re-proposal. However, in combination, these two frameworks collectively would best capture derivative-related leverage risks and account for shortcomings of the VaR framework (e.g., model risk) or asset segregation (e.g., risk insensitivity) framework alone.

Furthermore, the SEC could rationally consider some combination of the two frameworks that involves asset segregation at least of some fixed percentage of total current exposure, potential future exposure, and residual exposure for net derivatives positions within a fund portfolio.

III. The Relative VaR and Absolute VaR tests have merit, but they do not measure leverage directly and do not fully address ICA section 18 concerns in isolation.

The SEC's re-proposal would require funds relying on Proposed § 270.18f–4 to comply with one of two value-at-risk ("VaR") measures intended to serve as a proxy for derivatives-related fund leverage risks.[37] The default proposed VaR-based limit seeks to detect highly leveraged funds by comparing the VaR of the fund's full portfolio to the VaR of an unleveraged "designated reference index" ("DRI"),[38] which may be an "appropriate broad-based securities market index" or "additional index" as defined in Item 27 of Form N-1A.[39] Under this proposed comparison ("Relative VaR"), the VaR of the fund's

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35 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4482 (Jan. 24, 2020).

36 See 15 U.S.C. § 80a-18(f).

37 See Proposed § 270.18f–4(c)(2) (stating that the fund must comply with the relative VaR test, except that the fund may comply with the absolute VaR test if the derivatives risk manager is unable to identify a designated reference index that is appropriate for the fund's investments, investment objectives, and strategies).

38 Proposed § 270.18f–4(a) would define "designated reference index" to mean an unleveraged index that: (1) is selected by the derivatives risk manager and that reflects the markets or asset classes in which the fund invests; (2) is not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used; and (3) is an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N–1A [17 CFR 274.11A]." See SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4469, 4559 (Jan. 24, 2020).

39 See SEC Form N1-A, OMB No. 3235-0307 (expiring July 31, 2022), available at https://www.sec.gov/about/forms/formn-1a.pdf. For purposes of Item 27, an "appropriate broad-based securities market index" is

portfolio must not exceed 150% of the VaR of an appropriate DRI.[40] However, if the fund's "derivatives risk manager"[41] ("DRM") is "unable" to identify a DRI that is "appropriate for the fund taking into account the fund's investments, investment objectives, and strategy,"[42] that fund would be required to comply with an Absolute VaR limit. The Absolute VaR limit would require that a fund's full portfolio VaR be no more than 15% of the value of net assets.[43]

Unlike the advisable risk management guidelines, policies, and procedures[44] and governance requirements[45] that the re-proposal would require of funds, the relative and absolute value-at-risk ("VaR") leverage limitations are meant to provide bright-line "outer" boundaries for market risks indicative of some level of derivatives-related leverage.[46] That requires special attention to relevant VaR methodologies and standards. It also requires special attention to the <u>actual</u> <u>application</u> and <u>effect</u> of the VaR-based limits and the potential for them to perversely incentivize leverage. For example, the SEC "estimate[s] that there would only be a very small number of funds, **<u>if any</u>**, that would have to adjust their portfolios in order to comply with the VaR-based limit on fund leverage risk," suggesting that the proposed outer limits may not limit the relevant measure of leverage at all.[47] **<u>The re-proposal therefore implicitly reflects an SEC judgment that the fund market's current use of leverage through derivatives is already sufficiently protective of ICA section 18's investor protection and systemic risk reduction concerns and would remain so even in the absence of the asset segregation framework</u>.** We are not so confident in the commercial judgments and risk management practices of funds. Furthermore, establishing leverage minimums that exceed current regulations and guidance and fund practices could perversely encourage additional leverage and risk-taking in time.

"one that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used." In addition, "additional indexes" include "other more narrowly based indexes that reflect the market sectors in which the Fund invests." <u>Id</u>.

40 <u>See</u> Proposed § 270.18f–4(a).

41 Proposed § 270.18f–4(a) would define "derivatives risk manager" to mean "an officer or officers of the fund's investment adviser responsible for administering the program and policies and procedures required by [Proposed § 270.18f–4(c)(1)], provided that the [DRM]: (1) May not be a portfolio manager of the fund, or if multiple officers serve as derivatives risk manager, may not have a majority composed of portfolio managers of the fund; and (2) Must have relevant experience regarding the management of derivatives risk."

42 Proposed § 270.18f–4(c)(2)(i).

43 <u>Id.</u> In either case, the fund must determine its compliance with the applicable VaR test at least once each business day. In addition, "[i]f the fund determines that it is not in compliance with the applicable VaR test, the fund must come back into compliance promptly and within no more three business days after such determination." Proposed § 270.18f–4(c)(2)(ii).

44 <u>See</u> Proposed § 270.18f–4(c) (setting forth "derivatives risk management program" requirements that include adoption and implementation of policies and procedures that are "reasonably designed" to manage the fund's derivatives risks and the "reasonabl[e] segregat[ion] [of] functions associated with the program from portfolio management of the fund").

45 <u>See</u> Proposed § 270.18f–4(c)(1)(v)(A)-(B); Proposed § 270.18f–4(c)(2)(iii); and Proposed § 270.18f–4(c)(5) (requiring board approval of the "derivatives risk manager" and the submission of an annual derivatives risk management report to the board of directors).

46 <u>See, e.g.</u>, SEC, <u>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</u>, 85 Fed. Reg. 4469 (Jan. 24, 2020) ("The proposed rule would also generally require funds relying on the rule when engaging in derivatives transactions to comply with a VaR- based limit on fund leverage risk. This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a 'designated reference index.'").

47 <u>Id</u> at 4519.

A. Relative VaR is an imperfect but reasonable proxy for derivatives-related leverage, but it should not be adopted to the exclusion of supplemental measures that indicate and mitigate excessive derivatives-related leverage.

The SEC's Relative VaR test has merit. The primary advantage of the Relative VaR approach, in essence, is that it would recognize that "leverage and risk are not [necessarily] the same thing."[48] Relative VaR is one measure of the market risk associated with an individual fund portfolio that could facilitate monitoring of an *indication* of derivatives-related leverage. Although it is not a measure derivatives-related leverage or risk per se, Relative VaR usefully enables the SEC and funds to measure market risks against a benchmark "in a reasonably comparable and consistent manner across diverse types of instruments" and "integrates the market risk associated with [these] different instruments into a single number that provides an overall indication of market risk, including the market risk associated with the fund's derivatives transactions."[49] Relative VaR facilitates a comparison of portfolio "riskiness" across funds, because it conceptually distinguishes between speculative and risk-mitigating positions and accounts for differences in the market risks presented by derivatives-related leverage.[50]

There is considerable logic to a derivatives-related leverage test that limits a properly robust measure of market risk relative to a similar measure calculated with respect to an unleveraged,[51] representative benchmark. Relative VaR indirectly detects leverage, including derivatives-related leverage, through a limits approach designed to capture exposures from the types of leveraged financial instruments that result in VaR calculations that deviate substantially from an available and appropriate unleveraged benchmark. In many circumstances, a sufficient deviation in the two VaRs may be highly suggestive of leverage in the nature that ICA section 18 is meant to address. At a minimum, though, "if the [market] risk of the [fund] portfolio, inclusive of all derivatives, remains lower than a reasonable benchmark for its broad asset class, or is significantly higher, this measure can help to place the derivatives use into proper context."[52]

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48 See, e.g., Letter from the Global Association of Risk Professionals to the Financial Stability Board, Re: Consultative Document for Proposed Policy Recommendations to Address Structural Vulnerabilities for Asset Management Activities (Consultative Document), at 2 (Sept. 21, 2016), available at https://www.fsb.org/wp-content/uploads/Global-Association-of-Risk-Professionals-GARP.pdf.

49 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4469 (Jan. 24, 2020).

50 See, e.g., OICU-IOSCO, Recommendations for a Framework Assessing Leverage in Investment Funds, Final Report, 3 (Dec. 2019) (noting that derivatives "do not necessarily create leverage and are also routinely used for other purposes, including . . . hedging risks; decreasing the fund's exposure to certain risk factors such as the portfolio's duration, or sensitivity to changes in credit spreads and/or interest rates term structure; enhancing liquidity in situation where derivatives are more liquid than their underlying reference assets; improving transactional efficiency; gaining exposure to less accessible markets; cash management. The use of derivatives alone—which can increase certain measures of market exposure—should not, therefore, be seen as synonymous with the amplification of risk and returns.").

51 See Proposed § 18f–4(a) (defining the term ''designated reference index''). SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4472 (Jan. 24, 2020) ("Conducting a VaR test on a designated reference index that itself is leveraged would distort the leverage- limiting purpose of the VaR comparison by inflating the volatility of the index that serves as the reference portfolio for the relative VaR test").

52 FSOC, Update on Review of Asset Management Products and Activities, 21 (2015).

B. The SEC's Relative VaR proposal raises critical concerns relating to risk masking through the volatility of the designated benchmarks, model risks, data reliability risks, and other risks.

The SEC proposes a reasonable initial approach to ferreting out leverage in fund portfolios and placing initial, implicit limitations on derivatives-related leverage, even though VaR, by its nature, has significant limitations, generally is not used for that purpose, and would not be tailored to the derivatives-specific leverage or risks. However, in light of the below concerns relating to the use of VaR, we cannot endorse the VaR-based approach as a stand-alone leverage limitation, though we acknowledge its advantages (as well as its disadvantages) and the fact that it would be more protective of investors and systemic risk reduction concerns than a final rule with no asset segregation and no quantitative leverage limitations at all.

Most fundamentally, VaR is a market risk measure—not a leverage measure—that, in essence, estimates a particular portfolio's maximum expected losses under normal market conditions at a given confidence level. By extension, Relative VaR is simply a comparison of two different VaR (market risk) measures for the purpose of detecting whether *some form* of leverage, including but not limited to derivatives-related leverage, in a fund portfolio may influence a measure of market risk relative to a similar measure for an unleveraged benchmark that is representative of the portfolio. Although Relative VaR provides context to blunt, risk-neutral measures of derivatives-enabled leverage, the most comprehensive ICA section 18 leverage framework would couple Relative VaR's risk-based approach with leverage limitations tied to independent measures that are more inclusive of the types of risks that VaR is not designed to address.

The SEC should remain cautious about leverage limitations that anchor a fund's portfolio VaR to an unleveraged reference index. For example, the baseline index's VaR—i.e., the denominator in the SEC's proposed Relative VaR framework—can substantially affect the actual (not relative) risk profile of the anchored fund portfolio due to changes in the volatilities of the underlying benchmark's constituents. Relative VaR—as its name suggests—is a relative market risk measure, meaning that the baseline for any relative calculation can mask risks in the baseline itself, especially in the presence of substantial basis risk between the portfolio and the designated benchmark. If constituents in the benchmark experience unusual volatility—thereby increasing the VaR anchor for the fund portfolio—the fund managing significantly more risk than would exist in less volatile market environments could remain well below the Relative VaR measure.

Again, while Relative VaR as a supplemental measure has merit and would often usefully detect leverage supporting directional positions, the relationship and behavior of the material constituents in both elements of the VaR ratio can obscure important differences in two portfolios, except in stylized examples. That undermines, to some degree, the value and risk sensitivity of Relative VaR as a sole means for preventing excessive leverage.

Furthermore, the SEC's proposed use of a VaR-based leverage framework inherits the model risk associated with VaR calculations more generally. Common model-related risks include invalid specifications and/or statistical assumptions (e.g., distributions). The Long-Term Capital Management episode, while distinguished by the minimal applicable regulatory framework (and in particular, the lack of direct leverage limitations[53]), as well as significant regulatory and market developments since its collapse,

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[53] FSOC, Update on Review of Asset Management Products and Activities, 14-15 (2015) ("Although hedge funds are not subject to direct regulatory restrictions, their use of leverage may be constrained indirectly through requirements on their broker-dealer counterparties, such as Regulation T and FINRA margin rules for securities transactions, and newly adopted requirements under the Dodd-Frank Act, including increased central clearing of derivatives and the introduction of margin requirements for

demonstrate the principle, at least, that overreliance on and overconfidence in supposedly sophisticated—but often just overengineered—risk models can lead to destructive ends.[54] That is why international leverage recommendations for the asset management industry generally seek to "include[] approaches that limit model risk."[55]

A related concern is that the SEC would permit funds to use different models for each VaR calculation in the Relative VaR test. The SEC's proposal in this regard is not irrational. There are conceptual challenges intrinsic to *any* Relative VaR requirement that demands a fund's portfolio of varied financial instruments use the "same" market risk model as is used to perform VaR calculations on an unleveraged index. One obvious concern is the meaning of the word "same" with respect to use of the "same model," in particular where two models measure materially different things, and perhaps with materially different inputs, assumptions, and specifications. This raises yet another concern counseling the SEC to remain cautious about the potential for gamesmanship or manipulation of the Relative VaR calculations, especially where two different models applied to two different portfolios and giving rise to two different ratio calculations are not required to be the "same" in material respects. The most reasonably designed model risk management framework may not fully address such shortcomings. Moreover, repeated use of the VaR model could make leverage limitations too easily navigable by portfolio management.

In addition, VaR is dependent on the availability of reliable time series data, assumptions, and relationships (e.g., correlations) reflected in or teased out of such data. These dependencies may limit the actual application and effect of the Relative VaR proposal. For example, it is not clear the extent to which Relative VaR would appropriately address leverage risks associated with derivatives positions with limited liquidity or pricing data. While a portfolio significantly populated with such instruments may be expected to be subject to the Absolute VaR test (below), data limitations for less liquid constituents of fund portfolios could further limit or obscure the effectiveness of Relative VaR as a standalone measure for entire categories of funds.

The SEC rightly acknowledges that its proposed VaR calculations would not "reflect the size of losses that may occur on the trading days during which the greatest losses occur—sometimes referred to as 'tail risks'"[56] and perhaps may "underestimate the risk of loss under stressed market conditions."[57] We agree. The VaR approach relies on historical volatility as an imperfect proxy for market risks that may breakdown during periods of significant financial distress. For that reason, at a minimum, we encourage the SEC to require five years of reliable historical data (more representative of market conditions but not

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uncleared swaps. Further, rules implementing the Basel III capital standards may limit access to leverage for hedge funds by increasing the costs to some prime brokers of certain trading activities.").

54 Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (April 1999) ("The size, persistence, and pervasiveness of the widening of risk spreads confounded the risk management models employed by LTCM and other participants. Both LTCM and other market participants suffered losses in individual markets that greatly exceeded what conventional risk models, estimated during more stable periods, suggested were probable. Moreover, the simultaneous shocks to many markets confounded expectations of relatively low correlations between market prices and revealed that global trading portfolios like LTCM's were less well diversified than assumed."), available at https://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

55 The Board of the International Organization of Securities Commissions, ("OICU-IOSCO"), Recommendations for a Framework Assessing Leverage in Investment Funds, Final Report, 3 (Dec. 2019), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf.

56 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4470 (Jan. 24, 2020).

57 Id.

so long as to mute the effects of extreme market events), along with reliable historical data from a one-year period that includes the most extreme but plausible market conditions reflected in a period of market distress material to the fund portfolio.[58]

Given the investor protection and systemic risk concerns of ICA section 18, the SEC must ensure that its Relative VaR measure contemplates first and second order risks likely in such uncommon market events and incorporates a tail risk measure, perhaps through risk add-ons. We therefore also recommend that the SEC consider an expected shortfall measure, despite the "inherent difficulty in estimating the expected value of larger losses."[59] Any relative risk measure must be stable across market conditions, including those extreme but plausible market circumstances that are most likely to present investor protection and systemic risk concerns.

In short, Relative VaR is a useful leverage limitation tool, but it is not a satisfactory replacement for the asset segregation approach. Therefore, we recommend that the SEC supplement the VaR-based derivatives-related leverage proxy with a supplemental and blunt regulatory measure—like an adjusted asset segregation framework—that is less susceptible to the above concerns, most particularly the well-understood and longstanding concerns relating to VaR model risk. If not asset segregation, however, some other regulatory approach must be employed to capture leverage-related risks masked by numerous complexities in the VaR-based approach.

Finally, we have concerns about the potential limitations of the risk management program and governance requirements. They are important and well considered, and they would be useful disciplining and contextualizing measures. Yet, the risk management and governance requirements should not substitute a principles-based framework based on "reasonable designed"[60] policies and procedures for bright-line "outer" leverage limits. In the first instance, the reasonableness standard places considerable discretion in the designated risk manager to determine the specifics of the risk management program. Furthermore, anything can be "considered" and de-prioritized relative to commercial objectives often served by more leverage. "Considering" other risks and methodologies as part of the proposed risk management program guideline therefore cannot substitute for actual limitations that account for derivatives-related leverage risks. In this regard, we fundamentally agree that "[m]easures of leverage when reviewed alongside measures of risk provide a more complete picture of the risks associated with a portfolio's use of leverage."[61]

C. The DRI selection process is too ambiguous, is susceptible to tracking error and manipulation, and could result in systematic underestimation of derivatives-related leverage.

The proposed relative VaR test would require funds to calculate the VaR of the fund's portfolio and compare it to the VaR of a "designated reference index," which properly must be "unleveraged" and

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58 The Relative VaR test was proposed to the exclusion of other similar (stressed VaR and expected shortfall) and that it does not "estimate the extent of . . . loss[es]" or account for counterparty credit or liquidity risks. SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4469 (Jan. 24, 2020).

59 Id.

60 See Proposed § 270.18f–4(c).

61 See, e.g., Letter from the Global Association of Risk Professionals to the Financial Stability Board, Re: Consultative Document for Proposed Policy Recommendations to Address Structural Vulnerabilities for Asset Management Activities (Consultative Document), at 3 (Sept. 21, 2016).

also to "reflect the markets or asset classes in which the fund invests," among other requirements.[62] The Relative VaR test, if applicable, would require the entire fund portfolio to remain below a proposed 150% of VaR relative to the chosen benchmark. Here, again, we agree with the SEC's view that "[i]f a fund is using derivatives and its VaR exceeds that of the [appropriate] designated reference index, this difference may be attributable to leverage risk."[63] The SEC's proposal has theoretical appeal but suffers practical challenges.

The usefulness of the Relative VaR test depends on the baseline VaR benchmark being an appropriate match for the trading strategy and asset allocation of the fund. The inevitable bases between reference indices and fund portfolios (tracking error) therefore could mask differences in the market risks and volatilities of fund portfolio and reference index constituents. That is a particular concern in the re-proposal, because funds and their DRMs are not sufficiently legally tethered to a good proxy for the fund's investments. Proposed § 270.18f–4(a) would define "designated reference index" to mean an unleveraged index that meets the following conditions:

- Is selected by the derivatives risk manager and that **reflects the markets or asset classes in which the fund invests**;

- Is not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is **widely recognized and used**; and

- Is an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N–1A [17 CFR 274.11A]."[64]

For purposes of Item 27, however, an "appropriate broad-based securities market index" is merely "one that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, **unless the index is widely recognized and used**." In addition, "additional indexes" include "other more narrowly based indexes that **reflect the market sectors in which the Fund invests**."

Thus, we see little constraint in the proposed standard meant to limit the discretion of the DRM, who apparently could choose almost any index that, in his or her judgment, merely "reflects" the market sectors or even simply the "markets or asset classes" in which a fund invests. That is problematic, in part, because the DRM may have commercial incentives to perversely choose the most volatile indices as the regulatory leverage benchmark, thereby facilitating the very types of leveraged directional investments that affect the speculative character of the fund and that the relative VaR calculation is meant to detect and prevent.[65]

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62 SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4471 (Jan. 24, 2020).

63 Id.

64 Id at 4559. See also SEC Form N1-A, OMB No. 3235-0307 (expiring July 31, 2022), available at https://www.sec.gov/about/forms/formn-1a.pdf.

65 SEC, 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/

None of the SEC's cited provisions potentially ameliorating these concerns are sufficient to eliminate the tracking error concerns. Proposed § 270.18f–4(c)(5)(ii) would require the DRM responsible for choosing the DRI to provide written reports to the fund's board of directors that must include, among other things, the basis for the selection of the DRI or, if applicable, an explanation of why such DRM was unable to identify a DRI appropriate for the fund.[66] Such reports would be reviewable by the SEC pursuant to Proposed § 270.18f–4(c)(i)(6)(B)'s recordkeeping regulations, which serves as some deterrent to avoidance of the Relative VaR approach.[67] Nevertheless, the broad standards applicable to the selection, again, provide little constraint on DRM's judgment and little to empower a board, or even a risk committee, to second-guess that judgment.

In addition, Proposed § 270.18f–4(c)(5)(i) requires that "[a] fund's board of directors, including a majority of directors who are not interested persons of the fund, must approve the designation of the [DRM], taking into account the [DRM]'s relevant experience regarding the management of derivatives risk."[68] More broadly, Proposed § 270.18f–4(c)(1) requires the fund to "reasonably segregate" the functions associated with the derivatives risk management program from the portfolio management of the fund.[69] These are responsible measures. However, as a practical matter, and from industry experience, we note that the risk function is too often pressured in subtle and not-so-subtle ways to approve changes in risk management program elements at the request of management. In this regard, the SEC has not sufficiently ensured independence through measure to insulate and protect the appointment and compensation of the DRM.

D. The SEC's Absolute VaR fallback raises a number of critical concerns as well.

Not all fund portfolios and trading strategies may be amenable to the Relative VaR test. Therefore, if the fund's DRM is unable to identify a DRI that is "appropriate for the fund taking into account the fund's investments, investment objectives, and strategy,"[70] the fund would instead comply with an Absolute VaR limit. The Absolute VaR limit requires that the fund's full portfolio VaR be no more than 15% of the value of net assets.[71]

Like the Relative VaR approach discussed above, the Absolute VaR fallback has merit and would address "asset sufficiency concerns" underlying ICA section 18.[72] Yet, the Absolute VaR test depends on a fund's entire portfolio VaR relative to the net asset value of the fund. As such, it is not a measure of leverage but rather a measure of the sufficiency of fund assets available to meet any financial resources required to support derivatives-related leverage within the risk tolerance of the fund, which would be

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Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4472 (Jan. 24, 2020) ("We recognize the concern that funds could have the incentive to select an inappropriate designated reference index composed of more volatile securities to allow the fund to obtain more leverage risk under the relative VaR test.").

66 Proposed § 18f–4(c)(5)(ii).

67 Proposed § 18f–4(c)(6)(i)(B).

68 Proposed § 18f–4(c)(5)(i).

69 Proposed § 18f–4(c)(1).

70 Proposed § 270.18f–4(c)(2)(i).

71 Id. See SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/ Inverse Investment Vehicles, 85 Fed. Reg. 4446, 4475 (Jan. 24, 2020).

72 Id at 4482.

reflected in the numerator's VaR calculation. That simply does not address leverage, much less derivatives-related leverage, the focus of ICA section 18. For this reason, we again recommend using that financial resource sufficiency test as a supplement to a blunt, risk-neutral (or partially risk-neutral) leverage approach, like the asset segregation approach.

IV. Conclusion

Given exigent circumstances and resource constraints arising from the still developing global pandemic and economic crisis, as well as the SEC's determination not to toll public comment periods for a period of time sufficient to permit meaningful, thoughtful, and comprehensive comment on a rulemaking of the re-proposal's length, complexity, and importance,[73] we focus our comments on the re-proposal's most consequential new elements—the abandonment of the asset segregation framework overseen by the SEC and its staff at least since the 1970s and its replacement with the Relative VaR and Absolute VaR leverage limits.

The risks arising from funds' uses of derivatives-related leverage undoubtedly vary dramatically depending on a fund's derivatives and other trading activities and strategies. Some funds and trade associations may contend therefore that the SEC must delay further action on the re-proposal until a framework can be developed to accommodate an almost endless array of fact patterns and complexities involving specific types of trading strategies and/or the use of derivatives in distinct ways across different funds. The SEC must resist the temptation to amend its proposal based on such requests. Indeed, a significant value of the re-proposal is that it would institute a single, uniform derivatives framework in place of the current bibliography of more than 30 releases, including a 40-year old SEC policy statement,

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[73] The Administrative Procedures Act ("APA") requires the SEC to provide to the public notice and an opportunity to comment on regulatory proposals. In interpreting the APA's notice-and-comment requirements, the courts have repeatedly affirmed that "[t]he opportunity for comment must be a meaningful opportunity," meaning that agencies must provide "enough time with enough information to comment and for the agency to consider and respond to the comments." Prometheus Radio Project v. F.C.C., 652 F.3d 431, 450 (July 7, 2011); See also, e.g., Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (May 13, 1988) (affirming that the APA's notice provisions require agencies "not only [to] give adequate time for comments, but also must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully"). In Prometheus, the court held that the Federal Communications Commission ("FCC") did not provide adequate notice of a rulemaking under the APA and noted that the FCC failed, in relevant part, to provide "sufficient time" for interested parties to submit responsive information to a request for comment by the FCC chairman. Although the court's holding turned on other grounds, its concern about the length of the public comment period is instructive in light of the procedural steps taken by the FCC. The FCC initially permitted a 90-day comment period and extended that period for an additional 60 days. In addition, the FCC commissioned 10 economic studies and held six public hearings before the FCC's chairman published a New York Times Op-Ed bringing attention to the proposal and setting an additional 28-day deadline for responses. See Prometheus, 652 F.3d at 453 (affirming that "[t]he APA requires that the public have a meaningful opportunity to submit data and written analyses regarding a proposed rulemaking" and stating "commenters did not have sufficient time to do so," though there was not a challengeable agency action with respect to elements of the rulemaking's procedural history). The APA's legislative history makes clear, too, that statutory notice requirements are not sufficient as to "[matters] of great import, or those where public submission of facts will be either useful to the agency or a protection to the public," in which case rulemakings must "naturally be accorded more elaborate public procedures." H.R.Rep.No.1980,233,259, Administrative Procedures Act, Report of the Committee on the Judiciary House of Representatives (May 3, 1946). The courts and Congress agree, in other words, that public comment periods must be commensurate with the length, complexity, and significance of rulemakings. In this regard, we note that essentially nine years have elapsed since the SEC issued the 2011 concept release and five years have elapsed since it issued the 2015 proposal. There is no persuasive, much less lawful, rationale for the SEC to close the comment period for a rulemaking of the present re-proposal's length, complexity, importance during a national health and financial crisis, which has almost entirely deviated the public's attention from the re-proposal's merits and issues. See Letter to Board of Governors of the Federal Reserve System et al., Re: Request for 90-Day Tolling (Extension) of Public Comment Periods During the COVID-19 Pandemic (Mar. 20, 2020), available at https://bettermarkets.com/sites/default/files/Request_for_90-Day_Tolling_of_Public_Comment_Periods_During_the_COVID-19_Pandemic.pdf.

dozens of SEC staff no-action letters, and informal guidance based on specific representations and fact-specific, instrument-by-instrument analysis.[74]

The addition of complexities through a host of exceptions and special accommodations would only diminish effective oversight, limit the adaptability of the proposed framework, and ultimately exacerbate, rather than ameliorate, implementation challenges. The SEC must instead remain focused on risks that can increase losses to investors and market fragility, exacerbate panic among distressed market participants and counterparties, disrupt funding markets and credit channels, and frustrate orderly trading and the price discovery and capital allocation process. Much, if not all, of the re-proposal is amenable to application by a wide array of different funds and trading strategies, while retaining this public interest emphasis. Those funds using derivatives-related leverage responsibly and in a manner that benefits and is consistent with the risk appetites of their investors should have few concerns with the SEC's re-proposal; in most cases, they have (or should have) implemented the vast majority of elements.

The re-proposal neither reflects perfectly our ideal derivatives framework for funds nor eliminates derivatives-related leverage risks. However, it does more than current law and guidance to bring discipline and uniformity to market practices, and it is a reasonable initial effort to balance statutory boundaries for derivatives-related leverage and the fact that some derivatives-related "[i]nvestment risk is a normal and necessary part of market functioning."[75] Therefore, we support the SEC's proposal to establish governance and risk management (including stress testing[76]) frameworks reasonably designed to address the full range of derivatives-related risks posed to the fund and related risks and risk exposures (though we encourage the SEC to reinstate the asset segregation framework, make suggested amendments to its VaR framework, and be more attentive to model risk management, valuation and accounting, credit, and liquidity risks and risk exposures).

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[74] See Chair Mary Jo White, Statement at Open Meeting, (Dec. 11, 2015) (outlining improvements to the asset segregation framework in the 2015 proposal), available at https://www.sec.gov/news/statement/chair-white-statement-at-open-meeting.html. See also Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015) (supporting the SEC's retention of the asset segregation approach and emphasizing that the "mark-to-market segregation approach has strayed far from the Commission's original asset segregation approach and does not provide the inventor protections articulated by the Commission in Release 10666"), available at https://www.sec.gov/news/statement/piwowar-dissenting-statement-use-of-derivatives-funds.html.

[75] See Financial Stability Oversight Council ("FSOC"), Update on Review of Asset Management Products and Activities, 3 (2015) ("explor[ing] ways in which the use of leverage by investment vehicles could increase the potential for direct and indirect losses to counterparties and other market participants, and the extent to which these risks may have implications for U.S. financial stability"), available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

[76] We commend the SEC's proposal with respect to multi-factor stress testing of fund portfolios, which must remain part of the risk management program and account for projected losses in extreme but plausible market conditions that could upset usual relationships between modeled variables and pose tail risks to the fund. Proposed § 18f–4(c)(1)(iii) (requiring the derivatives risk management program to include stress testing "to evaluate potential losses to the fund's portfolio in response to extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to counterparties").

Sincerely,

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