MEMO# 29791

March 28, 2016

ICI Submits Comment Letter on SEC's Derivatives Proposal

[29791]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 4-16
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VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 5-16 RE: ICI SUBMITS COMMENT LETTER ON SEC'S DERIVATIVES PROPOSAL

As previously reported, the Securities and Exchange Commission ("SEC") proposed exemptive Rule 18f-4 ("Proposed Rule") under the Investment Company Act of 1940 ("1940 Act") regarding the use of derivatives and certain similar instruments by mutual funds, exchange-traded funds, closed-end funds, and business development companies ("BDCs") (collectively, "funds"). [1] The proposal would permit a fund to enter into derivatives transactions [2] and financial commitment transactions [3] notwithstanding the restrictions on the issuance of senior securities under Section 18 of the 1940 Act, provided that the fund complies with the conditions of the Proposed Rule.

ICI submitted a comment letter in response to the proposal. We summarize below a number of the key points in the letter. With respect to board related issues, ICI endorsed the letter submitted by the Independent Directors Council ("IDC"). [4]

I. General Comments

The letter expresses broad support for the proposal's goal of modernizing and rationalizing the rules governing funds' use of derivatives. The letter states that, although ICI supports the proposal's goal of ensuring that funds are not "unduly speculative," there are major aspects of the proposal that would restrict funds far beyond the extent required for that purpose, including the proposed portfolio limits that are based on notional amounts. The letter warns that any rulemaking in this area must preserve the important benefits of derivatives as a portfolio management tool.

The letter points to the fundamental error of using notional amounts as a basis for the portfolio limits, and states that those amounts overstate a fund's obligation under, and the economic risks associated with, a derivatives transaction. The letter notes the harmful effect that the Proposed Rule's portfolio limits would have on the fund industry, citing results from an ICI study showing a larger-than-expected impact on the industry, and a disproportionately large impact on taxable bond funds. The letter urges the SEC to focus on the proposed asset segregation requirements and proposed derivatives risk management program, with some recommended modifications, rather than on the flawed portfolio limits. Nevertheless, if the SEC determines to maintain the portfolio limits requirement, the letter recommends several modifications to address a number of its shortcomings.

II. Asset Segregation

The Proposed Rule would require a fund to manage the risks associated with its derivatives and financial commitment transactions by maintaining an amount of qualifying coverage assets. For derivatives transactions, a fund would be required to maintain qualifying coverage assets to cover the amount of the fund's mark-to-market obligations under a derivatives transaction ("mark-to-market coverage amount"), as well as an additional amount reflecting a reasonable estimate of the potential amount payable by the fund if it were to exit the derivatives transaction under stressed conditions ("risk-based coverage amount"). For financial commitment transactions, funds would be required to cover the full notional amount of the obligation.

The letter recommends that the SEC:

- expand the types of assets eligible as qualifying coverage assets available for derivatives transactions;
- modify the calculation of coverage amounts for derivatives transactions:
    - to net derivatives transactions that provide offsetting exposures;
    - to eliminate the presumption that derivatives contracts without termination rights or that do not trade segregate the full notional exposure for their risk-based coverage amount;
    - to interpret "stressed conditions" consistent with other regulatory standards;
    - to clarify "netting agreements;"
    - to permit margin provided under standard clearing or escrow receipt arrangements to reduce the mark-to-market coverage amount and risk-based coverage amount;

    - to eliminate the distinction between variation margin and initial margin for reducing the coverage amounts;
- permit netting of obligations for financial commitment transactions;
- clarify the types of assets that are convertible to cash or that will generate cash used to cover a financial commitment transaction; and
- confirm that certain transactions (e.g., securities lending transactions) create neither derivatives transactions nor financial commitment transactions.

III. Derivatives Risk Management Program

Under the Proposed Rule, a fund that exceeds a 50% threshold of notional derivatives exposure, or that engages in any complex derivatives transactions as defined in the proposal, would be required to adopt and implement a formalized derivatives risk management program. Further, the Proposed Rule would require that a fund designate, and the board approve, an employee or officer of the fund or its adviser (or sub-adviser) to act as derivatives risk manager and administer its derivatives risk management program. The derivatives risk manager would be required to provide a written report to the fund's board of directors assessing the adequacy and effectiveness of the derivatives risk management program quarterly.

A fund's board would be responsible for general oversight of the program. The Proposed Rule would require board approval of a fund's initial derivatives risk management program and any material changes to the program, board approval of the fund's designation of the derivatives risk manager, and quarterly board review of the derivatives risk manager's written report. In addition, the board would be required to approve one of the two portfolio limits (described below) and policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets.

The letter recommends that the SEC:

- provide assurances that any inadvertent crossing of the 50% notional threshold would not automatically trigger adoption of a derivatives risk management program;
- allow funds to invest in a de minimis amount of complex derivatives before requiring a derivatives risk management program;
- permit funds to appoint either an individual or group as the derivatives risk manager;
- recognize that any good faith decisions made by the derivatives risk manager would not result in liability;
- permit portfolio management personnel to serve as part of a derivatives risk management committee;
- eliminate the requirement that fund boards approve one of the two portfolio limits;
- remove requirement that fund boards approve models and measurements used in any derivatives risk management program; and
- reduce the frequency of delivery of the derivatives risk manager's written report to the board from quarterly to annually.

IV. Portfolio Limits

Under the Proposed Rule, to the extent that a fund invests in derivatives, the fund's board of directors would be required to approve one of two alternative portfolio limits to apply to the fund: an exposure-based portfolio limit or a risk-based portfolio limit. A fund that relies on the exposure-based portfolio limit would be required to operate so that its aggregate exposure under "senior securities transactions," [5] measured immediately after entering into any such transaction, does not exceed 150% of the fund's net assets. A fund's exposure would include the full notional amount of the fund's derivatives transactions. [6]

As an alternative to the exposure-based portfolio limit, the Proposed Rule includes a risk-based portfolio limit that would permit a fund to obtain exposure of up to 300% of the fund's net assets, if the fund meets a value-at-risk ("VaR") test that measures whether the fund's aggregate use of derivatives reduces, rather than magnifies, potential loss from market movements.

If, despite the grave concerns expressed in the letter, the SEC determines to proceed with portfolio limits, the letter makes a number of recommendations:

- adjust the notional amounts for risk based on the underlying asset class;
- exclude certain, direct hedging transactions from portfolio limits;
- exclude financial commitment transactions from portfolio limits;
- permit netting across different instruments for portfolio limits;
- clarify how to compute notional amounts for cross-currency forwards;
- clarify how to compute notional amounts for complex derivatives;
- raise the exposure-based limit to 200%;
- revise the VaR test by either requiring only derivatives above the exposure-based limit to be risk reducing or adopting an absolute VaR test;
- require VaR to be reported as a percentage of assets;
- permit funds to compute portfolio limits once each business day;
- permit funds that exceed the portfolio limits to acquire additional derivatives when the derivatives reduce the notional amount;
- permit funds to satisfy either the exposure-based limit or risk-based limit at any time; and
- permit closed-end funds and BDCs to use higher exposure-based limits.

V. Other Recommendations

In addition to recommendations on the three main conditions of the proposal, the letter makes a number of comments on other aspects of the Proposed Rule.

Interpretive issues. The letter recommends that, if the SEC adopts the proposed portfolio limits, the SEC should:

- confirm that funds need not look through other pooled investment vehicles when computing those limits; and
- exclude derivatives transactions and financial commitment transactions that comply with the Proposed Rule from any statutory asset coverage requirements under Section 18.

Recordkeeping. The letter generally supports the proposed recordkeeping requirements but recommends that the SEC should:

- not require funds to retain records related to a board's approval of a portfolio limit; and
- not require funds to maintain records showing compliance with a particular portfolio limit immediately after entering into each derivatives transaction.

Existing guidance and compliance dates. The letter recommends that the SEC give funds a transition period of at least 30 months before rescinding the existing guidance.

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Attachment

endnotes

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933, available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf; See ICI Memorandum No. 29566, dated December 15, 2015, for a more complete summary of the Proposed Rule, available at: https://www.ici.org/my_ici/memorandum/memo29566.

[2] The Proposed Rule defines a "derivatives transaction" as any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise. Proposed Rule 18f-4(c)(2).

[3] The Proposed Rule defines a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement, or similar agreement. Proposed Rule 18f-4(c)(4).

[4] See ICI Memorandum No. 29794, dated March 28, 2016, available at: https://www.ici.org/my_ici/memorandum/memo29794.

[5] The Proposed Rule defines "senior securities transactions" as any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to Section 18 or 61 of the 1940 Act without regard to the exemption provided by the Proposed Rule. Proposed Rule 18f-4(c)(10).

[6] A fund's exposure would be the sum of (i) the aggregate notional amounts of the fund's derivatives transactions, subject to certain adjustments; (ii) the aggregate obligations of the fund under its financial commitment transactions; and (iii) the aggregate indebtedness (and with respect to any closed-end fund or BDC, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the fund pursuant to Sections 18 or 61 of the 1940 Act.