MEMO# 30089

July 28, 2016

ICI Files Supplemental Comment Letter on SEC Derivatives Proposal

[30089]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 16-16
CHIEF COMPLIANCE OFFICER COMMITTEE No. 16-16
CHIEF RISK OFFICER COMMITTEE No. 20-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 14-16
COMPLIANCE ADVISORY COMMITTEE No. 8-16
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 37-16
DERIVATIVES WORKING GROUP
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 16-16
ETF ADVISORY COMMITTEE No. 16-16
END OF DAY PRICING FORUM No. 10-16
FIXED-INCOME ADVISORY COMMITTEE No. 20-16
INVESTMENT ADVISERS COMMITTEE No. 13-16
OPERATIONS COMMITTEE No. 17-16
RESEARCH COMMITTEE No. 11-16
SEC RULES COMMITTEE No. 33-16
SALES AND MARKETING COMMITTEE No. 9-16
SMALL FUNDS COMMITTEE No. 20-16
UNIT INVESTMENT TRUST COMMITTEE No. 3-16 RE: ICI FILES SUPPLEMENTAL COMMENT LETTER ON SEC DERIVATIVES PROPOSAL

ICI filed a supplemental comment letter today on the Securities and Exchange Commission's pending proposal for exemptive Rule 18f-4 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 (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.

The comment letter supplements a March ICI comment letter that argued that major aspects of the proposal were problematic, including imposing proposed portfolio limits on the amount of derivatives transactions funds can engage in based on the gross notional exposures of those instruments. [4] The March ICI comment letter explained that using gross notional exposures overstate a fund's obligation under, and the economic risks associated with, a derivatives transaction.

To address some of the shortcoming of using gross notional exposure to calculate the portfolio limits, the supplemental comment letter recommends that the Commission adopt a simple and effective risk-adjustment schedule to adjust the notional amount of a derivatives contract that would count towards the portfolio limits. ICI's recommended risk-adjustment table would allow funds to adjust the gross notional exposures attributable to the proposed portfolio limits based on the relative risk of a derivative's underlying reference asset. The letter explains how funds would apply the schedule in connection with the proposed portfolio limits and provides the rationale for using the schedule. [5] The supplemental letter also provides examples of how different types of instruments would be categorized within seven main asset classes.

The recommended risk-adjustment schedule, which is based largely on prudential regulators' and the Commodity Futures Trading Commission's initial margin schedule for uncleared swaps, is the work product of ICI's Risk-Adjusted Notional Sub-Working Group and Derivatives Working Group.

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Attachment

endnotes

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf; 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 Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016,

available at https://www.sec.gov/comments/s7-24-15/s72415-114.pdf. See also ICI Memorandum No. 29791, dated March 28, 2016, available at https://www.ici.org/my_ici/memorandum/memo29791.

[5] ICI is continuing to evaluate whether the use of an absolute Value-at-Risk (“VaR”) test in place of the SEC’s proposed relative VaR test works. Therefore, ICI proposes moving forward with submitting this letter and may file an additional supplemental comment letter on the proposal in the near future.
