INVESTMENT COMPANY INSTITUTE
The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

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ICI Files Second Supplemental Comment Letter on SEC's Derivatives Proposal

[30277]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 26-16
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SMALL FUNDS MEMBERS No. 42-16
UNIT INVESTMENT TRUST MEMBERS No. 8-16 RE: ICI FILES SECOND SUPPLEMENTAL COMMENT LETTER ON SEC'S DERIVATIVES PROPOSAL

ICI filed a second supplemental comment letter 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 require every fund that invests in derivatives transactions[2] to comply with one of two portfolio limits designed to restrict a fund's aggregate exposure to senior securities transactions.[3] Funds would be required to either comply with: 1) a 150 percent exposure-based limit; or 2) a 300 percent risk-based limit, if they meet a value-at-risk ("VaR") test designed to measure whether the fund's aggregate use of derivatives reduces, rather than magnifies, potential risk from market movements.[4] ICI submitted a comment letter in March recommending, among other things, that the SEC replace the proposed "comparative VaR" test with an "absolute VaR" test that would permit funds that can demonstrate that their expected portfolio risks are constrained to apply the risk-based limit.[5] The attached supplemental comment letter provides greater detail regarding that recommendation and sets forth four specific criteria with which funds must comply when using the recommended absolute VaR test.[6]

Summary of the Supplemental Comment Letter

The letter reflects the work of ICI's Derivatives Working Group and VaR Test Sub-Working Group, which developed the criteria over the course of the last several months, using the framework for the Undertaking for Collective Investments in Transferable Securities as the initial starting point. The letter emphasizes that the absolute VaR approach would apply only to determine whether a fund could use the risk-based limit and, thus, the risk-based limit serves as an upper bound on the fund's use of derivatives. The letter explains why the absolute VaR approach is preferable to the Commission's proposed comparative VaR approach, noting that permitting funds that constrain expected portfolio risk to obtain higher notional amounts of derivatives exposure forms a rationale and robust basis for applying the risk-based limit and avoids issues with "gaming" the comparative VaR test.[7]

After explaining the rationale for applying the absolute VaR approach, the letter then explains each of the four criteria of the recommended approach and their rationale. These criteria are:

- ***Common Parameters for VaR Estimation***: All funds that wish to rely on the risk-based limit must use common parameters for their VaR model: a 10-day[8] horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund's net assets ("10-Day VaR"). These common parameters – by requiring a common unit of measurement – would reduce variability and subjectivity of the VaR models. Provided a fund uses the prescribed common parameters, the fund may select any appropriate VaR model, subject to certain conditions, including approval by the fund's derivatives risk manager or committee.

- ***Daily Ex-Ante Testing and Grace Period***: To use the risk-based limit, a fund's 10-Day VaR must not exceed 10 percent of the fund's net assets. Funds must perform this *ex-ante* test of a fund's 10-Day VaR on a daily basis. If a fund's 10-Day VaR exceeds 10 percent, the fund must report the limit exceedance to the Commission staff on a confidential basis within five business days and take steps to bring the fund's 10-Day VaR to 10 percent or less over a 30-day period following the limit exceedance. If the fund is not able to reduce its 10-Day VaR to 10 percent or less within the 30-day grace period, the fund must bring its portfolio into compliance with the exposure-based limit during the subsequent 30-day period. The *ex-ante* test would ensure that only funds whose expected portfolio risks are constrained could use the risk-based portfolio limit.

- ***VaR Backtesting and Validation***: As a key safeguard against "gaming," funds must backtest their 10-Day VaR model — *i.e.*, validate the VaR model against actual return data — on a daily basis. The backtest would be based on a 1-day horizon, 95 percent confidence level VaR estimate measured as a percentage of the fund's net assets, which many industry participants commonly understand to be a valid backtesting methodology.

- ***Recordkeeping and Reporting***: Funds would be required to retain records and report summary statistics on their 10-Day VaR estimates and data from the required backtest as part of the proposed monthly Form N-PORT filing requirements on a nonpublic basis. The reporting requirements would promote transparency to Commission staff and facilitate Commission staff oversight of Rule 18f-4.

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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 "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). 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] Specifically, under the Commission's proposed "comparative VaR" test, funds would measure the VaR of two components: (i) the fund's entire portfolio, including securities, other investments, and derivatives transactions; and (ii) the fund's portfolio of securities and other investments, excluding any derivatives transactions. A fund would be permitted to apply the risk-based limit only if the full portfolio VaR were lower than the securities VaR.

[5] *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. The March letter explained that the proposed risk-based limit and VaR test was of little value for two reasons: 1) the proposed VaR test would require all derivatives entered into by such fund in the aggregate to be risk-

reducing; and 2) funds that hold only cash items and derivatives would not be able to rely on the risk-based limit because it would be difficult for the full portfolio VaR, including the derivatives and cash items, to be lower than the securities VaR.

[6] This second supplemental comment letter should be read as a complement to the recommendations in the March letter and in a July ICI supplemental comment letter on the proposal. Those letters included recommendations to apply a risk adjustment to the notional amount of a derivative instrument that would count toward a fund's exposure-based or risk-based portfolio limit, and to increase the exposure-based limit from 150 percent to 200 percent and the risk-based limit from 300 percent to 350 percent. *See* March letter; Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated July 28, 2016, *available at* https://www.sec.gov/comments/s7-24-15/s72415-244.pdf. *See also* ICI Memorandum No. 30089, dated July 28, 2016, *available at* https://www.ici.org/my_ici/memorandum/memo30089.

[7] For example, a fund may have an incentive to obtain within its investment mandate more of its risk exposure through physical securities to ensure that full portfolio VaR always exceeds securities VaR and only enter into derivatives transactions that are risk reducing. This outcome has potentially negative consequences if a fund foregoes some of the potential benefits of derivatives.

[8] References herein to "days" are to "trading days."
