

MEMO# 30028

July 8, 2016

ICI Draft Supplemental Comment Letter on SEC's Derivatives Proposal; Feedback Requested by July 15

[30028]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 13-16
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CHIEF RISK OFFICER COMMITTEE No. 16-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 11-16
COMPLIANCE ADVISORY COMMITTEE No. 6-16
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ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 14-16
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SEC RULES COMMITTEE No. 31-16
SMALL FUNDS COMMITTEE No. 19-16
UNIT INVESTMENT TRUST COMMITTEE No. 2-16 RE: ICI DRAFT SUPPLEMENTAL COMMENT
LETTER ON SEC'S DERIVATIVES PROPOSAL; FEEDBACK REQUESTED BY JULY 15

In December 2015, the Securities and Exchange Commission proposed 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. ICI submitted a comment letter in March on the proposed rule that explained, among other things, that there were major aspects of the proposal that would restrict funds far beyond that required for ensuring the stated goal that funds are not

“unduly speculative,” including imposing proposed portfolio limits that are based on notional amounts. [4] To address this concern, one of ICI’s main recommendations was for the SEC to allow funds to adjust the notional amounts attributable to the portfolio limits based on the derivatives’ underlying reference assets. The March letter, however, did not recommend any particular standardized schedule to base these adjustments on. ICI now is supplementing the March letter to recommend a standardized adjustment schedule for these purposes.

ICI’s draft supplemental comment letter is attached for your review. If you have any comments on the letter, please provide them in writing to Jennifer Choi at jennifer.choi@ici.org or Ken Fang at kenneth.fang@ici.org, as soon as possible, but, in any event, no later than end of day on Friday, July 15.

The draft supplemental comment letter reflects the work of ICI’s Risk-Adjusted Notional Sub-Working Group, which derived the proposed adjustment schedule based largely on prudential regulators’ and the Commodity Futures Trading Commission’s initial margin schedule for uncleared swaps. The letter explains how funds would apply the schedule in connection with the proposed portfolio limits and provides the rationale for the provisions in the schedule. [5]

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Assistant General Counsel

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Senior Economist

[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 a limit on the amount of assets a fund can segregate for derivatives (and other senior securities) use is a viable alternative to the proposed portfolio limits; and whether the use of an absolute Value-at-Risk (“VaR”) test with stricter parameters in place of the SEC’s proposed relative VaR test works. The outcomes of those projects, however, are uncertain. Therefore, ICI proposes moving forward with submitting this letter.

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