MEMO# 29765

March 11, 2016

ICI Draft Comment Letter on SEC Derivatives Proposal; Feedback Requested by March 18

[29765]

March 11, 2016

TO: ACCOUNTING/TREASURERS COMMITTEE No. 4-16
CHIEF COMPLIANCE OFFICER COMMITTEE No. 5-16
CHIEF RISK OFFICER COMMITTEE No. 5-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 3-16
COMPLIANCE ADVISORY COMMITTEE No. 2-16
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 6-16
DERIVATIVES WORKING GROUP COMMITTEE
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 6-16
ETF ADVISORY COMMITTEE No. 6-16
END OF DAY PRICING FORUM No. 3-16
FIXED-INCOME ADVISORY COMMITTEE No. 8-16
INVESTMENT ADVISERS COMMITTEE No. 4-16
OPERATIONS COMMITTEE No. 8-16
RESEARCH COMMITTEE No. 4-16
SEC RULES COMMITTEE No. 12-16
SALES AND MARKETING COMMITTEE No. 1-16
SMALL FUNDS COMMITTEE No. 10-16
UNIT INVESTMENT TRUST COMMITTEE No. 1-16 RE: ICI DRAFT COMMENT LETTER ON SEC's DERIVATIVES PROPOSAL; FEEDBACK REQUESTED BY MARCH 18

In December, the Securities and Exchange Commission ("SEC") issued a release proposing 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 Proposed Rule would permit a fund to enter into derivatives transactions [2] and financial commitment transactions [3] notwithstanding the prohibitions and 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 Proposed Rule seeks to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act to ensure that funds are not unduly speculative and have sufficient assets to meet payment obligations, and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and financial commitment transactions. Broadly speaking, the Proposed Rule would require a fund:

- to manage the risks associated with the fund's derivatives and financial commitment transactions by maintaining an amount of certain assets, defined in the Proposed Rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under those transactions;
- to establish a formalized derivatives risk management program if a fund engages in a more than a limited use of derivatives or uses complex derivatives; [4] and
- to comply with one of two alternative portfolio limits designed to restrict the amount of leverage the fund may obtain through derivatives transactions, financial commitment transactions, and other senior securities transactions.

ICI's draft comment letter (the "Letter") on the Proposed Rule is attached for your review. If you have any comments on the draft letter, please send written comments to Jennifer Choi at jennifer.choi@ici.org or Ken Fang at kenneth.fang@ici.org by close of business on Friday, March 18. The Letter is due to the SEC by March 28.

In the Letter, we express broad support for the Proposed Rule's goal of modernizing the patchwork regulation of funds' use of derivatives, and general support for the SEC's proposed requirements regarding asset segregation and the establishment of a risk management program. The Letter states that the SEC should focus on those two aspects of the proposal, with some recommended modifications, rather than on the flawed portfolio limits that are based on notional exposure. We note the impact 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 as a whole, and a disproportionately large impact on taxable bond funds in particular. We also note that using notional amounts to determine the portfolio limits is not appropriate because notional amounts do not adequately reflect economic risk or leverage. Nevertheless, if the SEC determines to maintain the portfolio limits requirement, we recommend several modifications to the requirement. A summary of the Letter is provided below.

I. 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"). Qualifying coverage assets for derivatives transactions generally would be required to consist of cash and cash equivalents. [5] If the fund has entered into a netting agreement that allows it to net its payment obligations with respect to multiple derivatives transactions, the Proposed Rule would allow the fund to calculate each of its mark-to-market and risk-based coverage amounts on a net basis for all derivatives transactions covered by the netting agreement.

For financial commitment transactions, funds would be required to cover the full notional amount of the obligation. Financial commitment transactions may be covered, however, using a broader set of qualifying coverage assets. [6]

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 must increase their risk-based coverage amount;
    - to interpret "stressed conditions" consistent with other regulatory standards;
    - to clarify "netting agreements;"
    - to eliminate the distinction between variation margin and initial margin for reducing the coverage amounts;
- permit netting of obligations under a financial commitment transaction;
- 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 instruments (e.g., tender option bonds and to-be-announced transactions) are financial commitment transactions.

II. Derivatives Risk Management Program

Under the Proposed Rule, a fund that exceeds a 50% threshold of notional derivatives exposure, or that engages at all in complex derivatives transactions, would be required to adopt and implement a formalized derivatives risk management program. A fund's derivatives risk management program must be designed reasonably to assess and manage the risks associated with the fund's derivatives transactions. The Proposed Rule also would require that a fund institute policies and procedures reasonably designed to segregate the fund's derivatives risk management functions from the fund's portfolio management and would require a fund to review and update its derivatives risk management program at least annually. 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.

A fund's board of directors 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 adequacy and effectiveness of the program. In addition, the board would be required to approve one of the two portfolio limits (further 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; and
- eliminate the requirement that fund boards approve specific limits on derivatives transactions or models and measurements used in any derivatives risk management program.

III. 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," [7] 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. [8]

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. A fund's VaR test must measure two components: (i) the VaR of the fund's entire portfolio, including securities, other investments, and derivatives transactions ("full portfolio VaR"); and (ii) the VaR of the fund's portfolio of securities and other investments, excluding any derivatives transactions ("securities VaR"). To satisfy the VaR test, a fund's full portfolio VaR must be less than the fund's securities VaR immediately after entering into any senior securities transaction.

The Letter recommends that the SEC, if it determines to adopt portfolio limits:

- 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 instrument for portfolio limits;
- clarify how to compute notional amounts for cross-currency forwards;
- 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.

Jennifer S. Choi
Associate General Counsel

Kenneth C. Fang
Assistant General Counsel

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 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] "Complex derivatives" are derivatives transactions for which the amount payable by either party upon settlement date, maturity or exercise is either: (a) dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction or (b) a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price. Proposed Rule 18f-4(c)(1).

[5] In limited situations, the proposal also would permit funds to use a particular asset for any transaction under which a fund may satisfy its obligation under the transaction by delivering that asset. Proposed Rule 18f-4(c)(8).

[6] In addition to the types of qualifying coverage assets available for derivatives transactions, funds could use assets that are convertible to cash, or that will generate cash, equal in amount to the obligation under the financial commitment transaction ("financial commitment obligation"), prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation. Proposed Rule 18f-4(c)(8)(iii).

[7] 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).

[8] 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.
