

**MEMO# 30197**

September 1, 2016

# **ICI Draft Second Supplemental Comment Letter on SEC's Derivatives Proposal; Feedback Requested by September 12, 2016**

[30197]

September 1, 2016

TO: ACCOUNTING/TREASURERS COMMITTEE No. 18-16  
CHIEF COMPLIANCE OFFICER COMMITTEE No. 17-16  
CHIEF RISK OFFICER COMMITTEE No. 25-16  
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 18-16  
COMPLIANCE ADVISORY COMMITTEE No. 10-16  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 45-16  
DERIVATIVES WORKING GROUP  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 19-16  
ETF ADVISORY COMMITTEE No. 18-16  
END OF DAY PRICING FORUM No. 11-16  
FIXED-INCOME ADVISORY COMMITTEE No. 26-16  
INVESTMENT ADVISERS COMMITTEE No. 15-16  
OPERATIONS COMMITTEE No. 21-16  
RESEARCH COMMITTEE No. 13-16  
SALES AND MARKETING COMMITTEE No. 11-16  
SEC RULES COMMITTEE No. 40-16  
SMALL FUNDS COMMITTEE No. 26-16  
UNIT INVESTMENT TRUST COMMITTEE No. 4-16 RE: ICI DRAFT SECOND SUPPLEMENTAL COMMENT LETTER ON SEC'S DERIVATIVES PROPOSAL; FEEDBACK REQUESTED BY SEPTEMBER 12, 2016

In December, 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 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 risks are constrained to apply the higher risk based limit. [5]; The attached draft supplemental comment letter provides greater detail regarding that recommendation and sets forth four specific criteria with which funds must comply when using the absolute VaR test.

ICI’s draft 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](mailto:jennifer.choi@ici.org) or Ken Fang at [kenneth.fang@ici.org](mailto:kenneth.fang@ici.org), as soon as possible, but, in any event, no later than 12:00 noon (Eastern Time) on Monday, September 12, 2016.

### **Brief Summary of the Draft Supplemental Comment Letter**

The draft 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 (“UCITS”) as the initial starting point. The draft letter emphasizes that the absolute VaR approach would apply only to determine whether a fund could use the higher risk based limit and, thus, the risk based limit serves as an outer limit on the fund’s use of derivatives. The draft letter explains why the absolute VaR approach is preferable to the Commission’s proposed comparative VaR approach, noting that permitting funds that constrain risk to obtain higher notional amounts of derivatives exposure is rational and avoids issues with “gaming” the comparative VaR test. [6] It also adds that the use of an absolute VaR measure is consistent with the UCITS framework with which many funds have familiarity and experience, so many funds could administer the test more easily than the proposed comparative VaR test.

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:** All funds that wish to rely on the higher risk based limit must use a 10-day horizon, 95 percent confidence level VaR test (“10-Day VaR”) measured as a percentage of the fund’s total net assets. A fund may select any appropriate 10-Day VaR model (provided the fund uses the prescribed common parameters), subject to certain conditions, including approval by the fund’s derivatives risk manager or committee.;
- **Daily Ex-Ante Testing:** To use the higher risk based limit, a fund’s 10-Day VaR must not exceed 10 percent of the fund’s total net assets pursuant to an ex-ante test conducted on a daily basis. If a fund’s 10-Day VaR exceeds 10 percent, the fund must report the 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 or below 10 percent over a 30-day period following the exceedance. If the fund does not reduce its 10-Day VaR to or below 10 percent within the 30-day cure period, the fund must bring its portfolio into compliance with the lower exposure based limit during the following 30-day period.
- **Backtesting:** Funds must backtest their VaR model on a daily basis using a statistically

equivalent 1-day horizon, 95 percent confidence level VaR measure. This required backtesting would be in addition to any backtesting of the 10-Day VaR that a fund's derivatives risk manager would deem necessary.

- **Reporting and Recordkeeping:** Funds must disclose specific information about their VaR model and report any limit exceedances to the Commission staff to promote transparency and facilitate Commission staff and fund board oversight of Rule 18f-4. In addition, funds would be required to report periodically VaR portfolio data as part of the proposed monthly Form N-PORT filing requirements on a non-public basis. These would include a fund's: average VaR; maximum VaR; minimum VaR; and the total number and dates of backtesting exceedances during the relevant reporting period.

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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](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 ("full portfolio VaR"); and (ii) the fund's portfolio of securities and other investments, excluding any derivatives transactions ("securities VaR"). A fund would be permitted to apply the higher 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](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 a 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 funds' full portfolio VaR, including the derivatives and cash items, to be lower than the securities VaR.

[6] For example, a fund may seek to obtain all of its risk exposure through physical securities and only enter into derivatives transactions that are risk reducing. This could have negative implications if the physical securities trade in markets that are less liquid and more costly than the markets for the derivatives a fund would use to obtain the same exposure.