AFR Americans for Financial Reform

December 15, 2016

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: RIN 3235-AL60; Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

In March, Americans for Financial Reform ("AFR") commented on the above-referenced proposed rule (the "Proposed Rule") issued by the Securities and Exchange Commission (the "Commission" or "SEC").[1] We are submitting this supplementary letter as a comment on the July 28th letter submitted by the Investment Company Institute ("ICI Letter") and the SEC staff memorandum of November 1st ("Staff Memorandum") that appears to respond to issues raised in the ICI letter.[2]

We are deeply concerned that the ICI Letter lays out a set of changes to the Proposed Rule which would effectively negate the derivatives exposure limits in the rule and render them useless as a tool for controlling speculative leverage at registered funds, as is required by the 1940 Act.

The Staff Memorandum is mostly analytic and does not address many of the most objectionable elements of the plan laid out in the ICI Letter. But we are also concerned that the discussion in the Staff Memorandum ignores the flaws in the ICI Letter and does not make note of highly relevant distinctions between regulated banks and registered funds.

The ICI Letter correctly points out that different types of derivatives differ in their average levels of risk, in ways that are not reflected in total notional value. In our March comment letter, AFR endorsed limitations on derivatives use by funds that are based on notional value as preferable to limits based on hedged exposure, as total notional value is the least model dependent and least

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[1] AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. .A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/. AFR's March letter is available at https://www.sec.gov/comments/s7-24-15/s72415-183.pdf

[2] Blass, David, "Investment Company Institute Letter On Use of Derivatives By Registered Investment Companies", July 28, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-244.pdf ; SEC Division of Economic and Risk Analysis, "Memorandum Re Risk Adjustment and Haircut Schedules", November 1, 2016, available at https://www.sec.gov/comments/s7-24-15/s72415-183.pdf

manipulable metric of derivatives exposure. While we still hold this view, we do not dispute the ICI's claim that different classes of derivatives tend to have different levels of risk relative to their notional value.

However, the ICI letter goes on to lay out an alternative plan for measuring derivatives exposures relative to exposure limits which would go far beyond simple risk adjustment to strike at the heart of the SEC's Proposed Rule. Specifically, the ICI suggests that the Commission modify the rule to perform radical downward adjustments on notional exposures in all classes of derivatives except equity, commodity, and "other" derivatives, without at the same time adjusting the overall derivatives exposure limit.

This change would not simply modify the *relative* weighting of derivatives exposures, but would result in a massive increase in the *absolute* limit on derivatives risk exposure. For example, under the ICI proposal a fund using only interest rate and cross currency swaps of less than five years duration would be permitted derivatives exposure of between seven and a half and fifteen times more than that permitted under the Commission's original proposal.[3]

This would be a massive increase in overall derivatives exposures permitted under the rule, an increase for which the ICI provides no justification whatsoever. Their substantive arguments are focused only on the relative risks of different types of derivatives, not the absolute level of derivatives risk exposure that should be permitted. Yet their proposal would result in an effective absolute increase in permitted derivatives exposure that would render the derivatives exposure limit useless as a meaningful limit on speculative leverage.

The ICI proposal is also flawed in that it ignores the distinctions between the existing bank regulatory framework and the regulatory framework that applies to registered funds. Both the risk adjustments and collateral requirements used by ICI in their proposal are drawn from regulations designed for banks and other institutional swap dealers. However, both the regulatory and statutory requirements already applying to banks are very different from those applying to registered funds. Here are important distinctions that we urge the Commission to bear in mind:

- **Banks (and swap dealers) are subject to capital requirements, registered funds are not.** Banks must hold capital against their derivatives exposures, giving them two layered forms of protection against derivatives losses – margin and capital. In contrast, the Commission's regulatory framework for funds does not include any capital requirements.

- **Banks (and swap dealers) are subject to detailed variation margin requirements, registered funds are not.** The ICI's risk adjustments are drawn from prudential

[3] This refers to notional exposures. The 7.5 multiplier is the result of downweighting using the ICI's proposed 13.3% adjustment for swaps in these categories between 2 and 5 years duration, while the 15 multiplier is the result of using the 6.7% adjustment.

> regulators' standardized tables governing initial margin requirements for bank and swap dealers. In addition to these initial margin requirements, regulators of these entities also enforce detailed variation margin requirements. Since variation margin is based directly on market valuations they are not calculated using the kind of crude relative risk multipliers recommended in the ICI report, and provide a critical additional risk control beyond to initial margin. Furthermore, variation margin between significant prudentially regulated entities is strictly limited to cash collateral, which differs from the ICI Letter recommendations concerning fund collateral.
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> It is true that in many transactions, particularly those with swaps dealers, registered funds will also be posting variation margin.[4] But unlike banks there is no guarantee that this will be the case, and any variation margin with non-dealer counterparties will not be governed by strong rules.

Even more broadly than the specific points above, **the business model and statutory regulatory framework for banks and registered funds are significantly different, which motivates a derivatives exposure limit for funds that has no counterpart in bank regulation.** Banks are entities that perform critical financial intermediary functions for customers in a manner that has traditionally relied on very large amounts of debt funding, and have large volumes of government-insured liabilities. Bank regulation focuses on ensuring solvency to avoid a customer run or the exploitation of public insurance, while at the same time permitting extensive debt liabilities that are traditionally connected to financial intermediation.

In contrast, investment funds are structures designed to responsibly manage third party capital for investors, and must abide by securities law restrictions to ensure that such investment management does not involve excessive speculative leverage or deception of investors. The 1940 Act shows that speculative leverage was a matter of deep concern to the framers of the law. The senior securities limit in the 1940 Act, which requires 300 percent asset coverage, implicitly sets a far stricter statutory leverage limit on funds than has ever existed in banking law. The leverage requirement on bank holding companies under current prudential regulation, which is a regulatory and not a statutory requirement, stands at just 5 percent. The statutory 300 percent asset coverage ratio in the 1940 Act would correspond to approximately a 75 percent leverage ratio under the banking definition.

The absolute derivatives exposure limit advanced by the Commission in the Proposed Rule represents an effort to put in place a limit on derivatives exposures that would ensure that the strict limitations on speculative leverage in the 1940 Act have meaningful application to derivatives. The derivatives exposure limit has no counterpart in bank regulation, as bank

[4] In cases where registered funds do post initial margin, the Proposed Rule already provides that such margin is deducted from derivatives exposures.

regulation relies on limiting leverage through capital requirements, a concept that is not directly applicable to funds managing third party capital. As discussed above, were some counterpart to capital requirements used in the fund context, the 1940 Act statutory limit on asset coverage implies that they should be far higher than current prudential regulatory requirements.

We also have concerns regarding the Commission's Staff Memorandum. We realize that this Staff Memorandum is an analytic and not a policy document. Its appears limited to replicating some of the analytical claims in the ICI Letter concerning relative risks of different derivatives classes as they are reflected in the initial margin schedules used by prudential regulators.

However, it is still striking that the Memorandum does not take note of any of the fundamental distinctions between banking regulation and fund regulation. The Staff Memorandum also does not mention or address the way in which the ICI proposal endangers the derivatives exposure limit as a meaningful control on speculative leverage. In enforcing the 1940 Act as it applies to derivatives, the Commission cannot simply draw on one discrete element of banking regulation, relative risk schedules for initial margin, and transplant it into the very different context of fund regulation.

We are further concerned that the Staff Memorandum does not reflect the priority of limiting total absolute derivatives risk. This is particularly important since the derivatives exposure limit in the Proposed Rule is an absolute risk limit. The Staff Memorandum is limited to discussing risk ratios between different classes of derivatives, and provides an Appendix demonstrating that during the period of market stress from 2008 to 2010 such risk ratios remained similar to observed ratios at other times. Yet the Appendix also shows that absolute risks, as measured by the standard deviation of returns, increased sharply during the 2008 to 2010 stress period.

In considering speculative leverage and asset coverage, the Commission must act to limit absolute risk. It is absolute changes in fund valuation that create the difficulty in meeting redemption demands. Relative risks are one input in determining the level of absolute risk that may exist, but both the need to protect investors and the clear mandate in the 1940 Act require the Commission to place its primary focus on limiting absolute risks emerging from derivatives. This will not happen if the effective limit on derivatives exposure is increased as recommended by the ICI.

Thank you for the opportunity to comment on this Proposed Rule. Should you have questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform