March 28, 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:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced proposed rule (the "Proposed Rule") by the Securities and Exchange Commission (the "Commission" or "SEC"). 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.[1]

As AFR previously commented in our letter to the Financial Stability Oversight Council on regulation of public funds, for many years the SEC did not sufficiently address the ways in which Investment Company Act restrictions can be violated through the use of derivatives.[2] The SEC's basic approach to derivatives risk at funds was set out in a series of releases and no-action letters between 1979 and the late 1980s. The fundamental approach adopted at that time was based on 'offsetting' or 'coverage' – that is, if a fund segregates assets deemed sufficient to 'cover' a derivatives risk, or an offsetting derivatives exposure, then derivatives usage would not violate '40 Act limitations.[3]

These restrictions are far from adequate as a control on excessive derivatives use, including derivatives use that effectively violated the Investment Company Act. As the Commission itself has found in the white paper release that accompanies the Proposed Rule, a subset of funds, particularly those in the 'alternative' space, are now accumulating derivatives exposures that are very large compared to their ownership of real assets, and represent very significant implicit issuance of senior securities. The white paper release does not examine risk management of these

[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Americans for Financial Reform, "Letter to Financial Stability Oversight Council on Regulation of Asset Management", March, 2015. Available at http://ourfinancialsecurity.org/2015/03/letter-to-regulator-afr-comment-to-the-fsoc-on-regulation-of-asset-managers/
[3] American Bar Association, "Report of the Task Force on Investment Company Use of Derivatives and Leverage", Committee on Federal Regulation of Securities, ABA Section on Business Law, July 6, 2010. Available at https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf

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exposures. But the Commission's approach in its no-action letters requiring 'coverage' of derivatives exposures has numerous weaknesses as a method for managing these risks or for reducing effective leverage. Among these weaknesses are asset coverage requirements that are based on mark-to-market derivatives valuation which frequently does not reflect actual future payment risks, a lack of restrictions on the type of assets to be segregated, and a failure to reflect counterparty risks.

The excessive use of derivatives by funds can effectively violate key Investment Company Act requirements regarding leverage, issuance of senior securities, and diversification. For example, derivatives can be used to obtain implicit or embedded leverage without actually borrowing funds, derivatives have senior status in bankruptcy, and derivatives counterparty risk may be quite concentrated even if reference assets appear diversified.

In light of these issues, the Proposed Rule is a significant advance. We strongly support it. We commend the Commission for placing the first hard caps on the use of derivatives by funds, for requiring funds to develop derivatives risk management programs that should properly reflect modern techniques for assessing derivatives risks, and for strengthening requirements concerning the liquidity of assets to be segregated to cover derivatives risks. We also commend the Commission for including various financial commitment transactions, which also commit funds to future contingent payments, within its derivatives risk management requirements.

We believe the new requirements in this rule are likely to substantially increase effective compliance with the 1940 Act. Even more important, they will improve investor protections, as well as protect the stability of the financial system as a whole from the effects of excessive leverage.

It is likely that the requirements in this rule will face substantial opposition from the small minority of funds that hold derivatives commitments in excess of the new limits here. However, many of this set of alternative funds have been found by independent observers to pose major risks to investors. This includes the SEC itself and FINRA which issued an explicit warning concerning the risks of leveraged and inverse ETFs.[4]

AFR believes that complex investment strategies that inherently depend on high levels of leverage do not belong in the registered funds space. Registered funds carry an implicit assurance that funds will comply with the extensive protections mandated in the Investment Company Act, which the SEC is charged with enforcing. Asking investors to 'read the prospectus' is not an adequate protection from the highly complex risks presented by these types of funds. Should investors wish to access high levels of leverage and to experiment with

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[4] U.S. Securities and Exchange Commission, "Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors", Investor Alerts and Bulletins, Available at https://www.sec.gov/investor/pubs/leveragedetfs-alert.htm

derivatives-centric investment strategies, they can use the options market directly or, in many cases, invest in unregistered funds.

Turning to the specifics of the rule, there are several major strengths of the Proposed Rule that must be maintained in order for a final rule to be effective:

The hard caps on derivatives notional exposures must not be lifted higher than the levels in the Proposed Rule, and gross notional derivatives exposure must be maintained as the relevant core metric: As discussed below, we do have some criticisms of the 300% cap level, which we believe is excessively high and overly dependent on a flawed value-at-risk metric. However, we strongly support the general approach of setting a hard cap on derivatives exposures and basing this cap on gross notional exposures. Derivatives risk management is highly complex and model-dependent, and risk management programs are difficult to oversee. Placing a cap on overall exposures ensures that potential flaws in risk management programs will not create excessive derivatives risks.

Further, basing the cap on a transparent metric which is difficult to manipulate, such as gross notional exposures, provides security that the cap will not itself be subject to model-based manipulation based on predictions that derivatives exposures will be offset with claimed hedges. Such hedges are dependent on correlation assumptions that can be highly unreliable during periods of financial stress. The Commission has appropriately varied the measurement of gross notional exposures in certain particular cases where the notional value of derivatives is particularly unrepresentative of risk. However, the Commission must avoid any increase in the caps or any attempt to broadly replace derivatives valuations based on gross notional with hedged or netted valuations as the numerator of the cap formula. The 150% notional value limit is already very generous; the white paper accompanying the Proposed Rule finds that 96 percent of a random sample of regulated funds are already under this level.

Broad categories of funds must not be exempted from the new derivatives limits. The Proposed Rule asks whether particular types of funds, such as for example leveraged ETFs or managed futures funds, should be exempted from the 150% portfolio limit (CFR 80913). We believe that such exemptions would undermine the purpose of passing the derivatives limit and would add to investor confusion concerning the rules operative in the registered fund space. We do not believe that it is conducive to the public interest or the protection of investors to facilitate the use of more complex, more speculative, and higher cost investment strategies, particularly those with a limited track record, in the registered fund space.

An asset coverage amount that sums both a mark-to-market and a risk based coverage amount. We support the asset coverage requirements in this Proposed Rule. Crucially, these requirements incorporate both a mark-to-market risk, based on the current netted value of derivatives within a single contractual netting set, and a risk-based add on amount for coverage. The mark to market amount alone is a point-in-time close out concept that reflects only the current payments due on a derivative and does not include future potential risks. We disagree with some details of the Commission's requirements concerning the determination of the risk based coverage amount. However, we strongly support the idea of including both mark to market and potential future risk-based exposure in the asset coverage amount. Without the inclusion of a risk based add on, full derivatives risks will not be reflected.

The requirement that derivatives coverage requirements be met with only liquid assets. Asset coverage is designed to ensure that assets are available to be sold at short notice to cover possible derivatives liabilities. Permitting funds to hold assets that would be difficult to sell during periods of financial stress, or which would need to be sold at a substantial discount, would clearly defeat this purpose. Such less liquid assets will carry higher returns as a reward for their illiquidity risk, meaning that the Commission is likely to be lobbied to permit them to be held as part of the coverage requirement. The Commission should resist these calls.

Financial commitment transactions must be appropriately limited in the Final Rule. We support the inclusion of financial commitment transactions in the Proposed Rule. These commitments clearly represent leverage, are often legally senior to other fund securities, and represent contingent liabilities that vary greatly based on underlying market conditions and can create unforeseen losses. They should be limited and risk managed in order to properly comply with the risk controls in the Investment Company Act.

At the same time, we have concerns with several aspects of the Proposed Rule:

- First, we believe that it is inappropriate to increase the derivatives exposure limit to 300% of net asset value in cases where the fund value-at-risk is decreased due to the use of derivatives.

- Second, we have concerns regarding the determination of the risk based coverage amount, especially the broad permission for netting derivatives risks in determination of the amount. This is likely to lead to under reserving.

The 300% risk-based limit based on VaR: The Proposed Rule would increase the derivatives cap from 150% to 300% of NAV where the securities Value at Risk (VaR) exceeds the full portfolio VaR. The 300% exposure limit is extremely high. According to the white paper accompanying this rule, less than 5% of funds meet even the lower 150% limit.

The VaR metric used to access the higher limit also appears to be highly manipulable. While it would probably not be usable by a fund which simply used derivatives to multiply returns, it could still be manipulated in numerous ways. Beyond the difficulties in policing VaR modeling generally, the limit could be manipulated in several specific ways. First, value-at-risk does not take tail risk into account beyond the probability limit set for the VaR calculation. This means that a fund which used derivatives in such a way as to provide tail risk insurance to other financial entities could qualify for the 300% cap, even though in fact its derivatives use substantially increased its overall risk. Hedge fund type strategies, such as those migrating into the space of registered funds using 'alternative' strategies, often load on tail risk.[5] This will be missed in using VaR models.

Second, because the VaR test is based on a comparison between fund risks without derivatives (the 'securities VaR') and measured risk with the addition of derivatives, the test could also be passed by a choice to hold riskier securities than the fund would otherwise hold. All else equal, a riskier securities position will tend to permit additional holding of derivatives. The test could therefore have the perverse effect of inducing funds to increase the risks they took in the securities portion of their portfolio (including securities which may contain embedded derivatives).

The same logic would appear to hold with respect to financial commitment transactions, which could also be increased in cases where the full portfolio VaR was less than the securities VaR, providing another incentive to increase securities VaR. We are unclear how all financial commitment transactions would be incorporated into the VaR calculation. If they are not fully included then the VaR test would become even easier to manipulate.

The first issue, concerning tail risks, could be addressed by replacing VaR with an expected loss calculation. This type of modeling is more complex. However, it would include some estimate of tail risks in the VaR calculation, which would be a significant advantage. Bank regulators are currently considering replacing VaR with expected loss models to address the issue of tail risk.

The second issue is more difficult to address, since it is inherent to the methodology of risk comparison the Commission has chosen to use. The most straightforward way to address it would be to remove the 300% cap entirely and replace it with a single 150% cap. This would eliminate any unintended or perverse effects of permitting a higher derivatives cap based on a VaR test, while still leaving in place a cap that would permit the current derivatives strategies at over 95% of registered funds. We would recommend taking this course.

Failing that, use of the VaR method would have to be carefully monitored. The Commission would need to examine and possibly disallow cases where funds appeared to pursue a riskier strategy in their base assets in order to access a higher derivatives cap. We are concerned that given limited oversight resources this type of monitoring may be impractical.

Determination of the risk based coverage amount: We are concerned that the definition of the risk based coverage amount lacks specificity and would allow an inappropriate level of netting in the determination of derivatives exposures. The Proposed Rule defines the risk based coverage

[5] Kelly, Bryan T. and Jiang, Hao, Tail Risk and Hedge Fund Returns (November 1, 2012). Chicago Booth Research Paper No. 12-44; Fama-Miller Working Paper. Available at SSRN: http://ssrn.com/abstract=2019482or http://dx.doi.org/10.2139/ssrn.2019482

amount as "the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions" and goes on to state "The risk-based coverage amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement".

It is our understanding that mandatory netting under a Master Netting Agreement (MNA) is essentially a bankruptcy or insolvency close out concept. While netting of individual derivatives contract payments is permitted in daily payments, such netting is optional. The reduction of payment obligations to a single netted balance is obligatory in case of bankruptcy or failure to perform by one party, but is not required if one party simply chooses to exit a contract. As stated by the International Swaps and Derivatives Association[6]:

> Netting takes mainly two forms in the ISDA MNA:
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> a) Settlement netting (or payment netting) takes place during the normal business of a solvent firm, and involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable; payment netting is essentially the same as set-off. Payment netting is optional.
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> b) Close-out netting is the cancellation of open unperformed contracts between parties with a single net balance owing to one or the other party. Close-out netting is usually applied in the event of default or other termination of transactions outside the normal course of business. If one party becomes insolvent or otherwise defaults on its obligations, closeout-netting provisions permit the non-defaulting party to accelerate and terminate all outstanding transactions and net the transactions' marked-to-market values so that a single sum will be owed by, or owed to, the non-defaulting party.

The Proposed Rule appears to contemplate that under stressed conditions, a counterparty will invariably permit a fund to cancel all derivatives transactions under a Master Netting Agreement on a net basis, in the ordinary course of business, with no failure to perform by either party. We do not believe this is necessarily the case.

Permitting funds to treat all derivatives contracts under an MNA as a single netted contract is also dangerous since it will encourage funds to assume a predictable correlation between these contracts behavior in the future, when such contracts may be completely unrelated and have nothing in common except that they are with the same counterparty. Furthermore, permitting this type of risk management may encourage funds to avoid diversifying their counterparty risk, since larger counterparties can aggregate more derivatives contracts under a single MNA.

If the Commission does choose to permit derivatives offsetting in determination of the risk based coverage amount, it should be limited to model based netting grounded on a clear documentation

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[6] ISDA, "Netting and Offsetting: Reporting Derivatives Under U.S. GAAP and Under IFRS", May, 2012. Available at http://www2.isda.org/attachment/NDQyMA==/Offsetting+under+US+GAAP+and+IFRS+-+May+2012.pdf

of historical correlation between related derivatives contracts in stressed conditions. However, we have significant concerns even regarding this form of model based offsetting, as correlation assumptions tend to break down under stress.

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