ALPHASIMPLEX

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November 7, 2011

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (File Number S7-33-11)

Dear Ms. Murphy:

AlphaSimplex Group, LLC ("AlphaSimplex") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") concept release on the use of derivatives by management investment companies registered under the Investment Company Act of 1940.[1]

AlphaSimplex is a registered investment adviser that advises more than $2 billion in four different mutual funds distributed by Natixis Distributors, L.P. Each of these funds employs derivatives -- primarily liquid exchange-traded futures and forward currency contracts. The oldest of these mutual funds was launched September 30, 2008 and has operated during what has been the most tumultuous market environment in recent memory. Our experience during this time convinces us that derivatives can be used safely to provide valuable benefits to mutual fund investors.

We commend the Commission on the comprehensiveness of the Concept Release and its request for comment on issues relevant to the use of derivatives by mutual funds. However, the range of issues surrounding the use of derivatives by mutual funds is so wide in scope that AlphaSimplex has elected to focus its comments on the topics that we believe to be most fundamental or most in need of additional regulatory guidance. These topics include:

1) The Benefits of Leverage to Mutual Fund Investors;
2) Whether Economic Leverage or Potential Indebtedness Leverage Defines a "Senior Security;" and
3) A Recommended Approach to Asset Segregation.

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[1] *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Release No. IC-29776 (Aug. 31, 2011), 76 Fed. Reg. 55237 (Sept. 7, 2011) (the "Concept Release").

Our decision to focus our comments on the above topics also reflects our broad agreement with the thoughtful recommendations contained in the 2010 ABA Derivatives Task Force report cited by the Commission in its Concept Release.[2]

Benefits of Leverage to Mutual Fund Investors

We feel it is important to point out that leverage is a tool that can offer both risks and benefits. Certainly, leverage increases the market volatility associated with the asset to which it is applied. In addition, depending on how leverage is achieved, there can be risks above and beyond the magnified potential losses investors might experience.
The potential benefit of leverage in the context of portfolio construction was first documented in 1958 by the Nobel prize-winning economist James Tobin. Tobin showed that a portfolio must employ leverage in order to be on the "efficient frontier." Through the use of leverage, advisers can construct portfolios that have a higher expected return for any given level of volatility (or a lower volatility for any given level of return) than would be possible to construct *without* leverage.

For example, let us compare two portfolios of stocks and bonds – one without leverage and one with leverage. Portfolio 1 employs no leverage and has 60% of its capital in stocks and 40% of its capital in bonds. Portfolio 2 has 60% of its capital in stock and leverages its remaining capital 4:1 to have a notional exposure of 160% to bonds. Portfolio 2 has a significantly higher return than Portfolio 1, even though Portfolio 2's risk (as measured by volatility or maximum peak-to-trough drawdown) is essentially the same or lower as that of Portfolio 1.

Period: Jan 1995 – Sep 2011

	Portfolio 1 **60% Stocks* + 40% Bonds****	**Portfolio 2** **60% Stocks* + 160% Bonds****
Avg. Annualized Volatility	11.81%	11.95%
Maximum One-Year Volatility	26.75%	25.78%
Maximum Drawdown	-35.20%	-27.30%
Annualized Return	6.20%	13.89%

* Standard & Poor's 500 Index ("S&P 500")

** JP Morgan Global Government Bond Index (Hedged)

[2] *The Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010).

Although both volatility and performance may vary significantly from year-to-year, the above example is intended to show that leverage may be used in multi-asset class portfolios with the objective of improving a portfolio's risk/reward profile.

The above example also illustrates another important strategic use of leverage, namely improving portfolio diversification. The portfolios of many investors are dominated by equity risk. One reason for this is that the higher volatility of stock gives it a much greater impact on portfolio values than bonds. Leverage allows investors to increase their exposure to otherwise low volatility, low correlation markets (such as U.S. Treasury bills, notes and bonds) without being forced to hold a portfolio whose volatility is too low to meet their return objectives, thereby allowing access to more effective diversification while maintaining the same desired level of equity exposure.

The capital efficiency (or leverage) of futures also make them a attractive tool for advisers seeking to hedge their clients' market exposure, profit from falling prices, or profit from temporary distortions in market pricing relationships.

Our review of the potential benefits and uses of leverage by investment companies is not meant to minimize or discount the risks and costs that are associated with leverage. For example, the use of leverage to create a larger risk-weighted exposure to fixed income markets, although diversifying, could subject a fund to significantly larger losses in the event of rising interest rates than than if the fund did not use leverage. The point we wish to make is simply that the potential strategic and tactical benefits of leverage provide compelling reasons why an adviser may wish to accept the potential risks and costs that can also accompany the use of leverage.

Whether Economic Leverage or Potential Indebtedness Leverage Defines a "Senior Security"

In Release 10666, the Commission stated that the segregated account functions as "a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock." The language in Release 10666 could be interpreted to mean that economic leverage is to be treated as a risk unto itself that should be limited by requiring segregated assets. In fact, leverage is not a risk unto itself; leverage simply magnifies the price risk already associated with assets to which it is applied in order to create the potential for larger gains or losses in connection with a market price change.

When applied to low risk assets, leverage will make their price more volatile, but in absolute terms, the level of risk may still be much lower than the risk of an unleveraged, higher risk assets commonly held by individual investors. For example, $100,000 invested in 90-day interest rate futures could be leveraged 30:1 and still be significantly less risky than $100,000 invested in S&P 500 stocks. Given this, the amount of leverage employed by a mutual fund is

not, by itself, necessarily relevant to the "speculative character" of a mutual fund. It follows that an increase in the speculative character of a fund can only be determined relative to the original speculative character of that fund.

If the Commission wished to place an upper bound on the permitted speculative character of a mutual fund (which we do not recommend), it might use a risk (i.e., volatility) measure to define and limit the speculative character of a fund as opposed to the less directly-relevant factor of leverage. Even if the Commission wished only to provide a baseline for the speculative character of a fund in order to be able to determine whether its speculative character has increased, we recommend setting risk expectations with the fund board and the fund's shareholders by including a "risk objective" statement in the prospectus. Such a risk objective could specify whether the fund is managed with the objective of maintaining a specified volatility range (e.g., "5–10% annualized volatility"), or whether the fund's risk level is managed relative to the variable volatility over time of a specified broad market index (e.g., "a volatility that attempts to track the S&P 500"). The risk objective section of the prospectus could even include a numeric table with estimates of the expected magnitude and frequency of potential daily losses. The bases for such estimates would need to be reviewed and approved by the fund's board but could include, for example, the past performance of the fund's benchmark or simulation of the fund's investment strategy.

Regardless of whether the Commission decides to clarify the definition of a fund's "speculative character," we urge the Commission to make clear that the critical determinant of whether a derivative constitutes a "senior security" is whether the derivative has the potential to create a future obligation, and not simply the existence of economic leverage.[3] We also urge the Commission to clarify that the language of Release 10666 is not intended to expand the original intent of section 18's restrictions. Segregating assets to cover potential *obligations* seems prudent in order to: 1) protect fund shareholders from increased speculative risk resulting from redemptions or investment losses that may cause an illiquid, leveraged position to become a larger percentage holding of the fund; and 2) assure the availability of adequate assets to meet future obligations arising from leveraged positions. Moreover, segregating assets to cover the full notional exposure of all derivatives, regardless of whether they have any potential to create future obligations, seems unjustifiably restrictive.

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[3] Indeed, a leverage "effect" can be created without the use of derivatives or borrowing. For example, investors seeking to increase the potential gain/loss from an investment in the stock market can build a portfolio comprised exclusively of high beta stocks. Similarly, investors wishing to increase the potential gain or loss from a move in interest rates can buy longer maturity debt obligations. Few think about such investment decisions as creating leverage and they are broadly used within mutual funds without any segregated assets requirement to protect investors from a sudden increase in the speculative character of a fund, even in the event of illiquidity combined with sudden losses or redemptions. This makes sense because, although market sensitivity and volatility for the fund would be magnified, no future obligation or indebtedness would be incurred.

If the Commission were to draw a distinction between the potential to create indebtedness versus simple economic leverage, a purchased option would never require segregated assets because there is no future obligation on the part of the purchaser of the option. Such a clarification would also inform the treatment of futures contracts. For example, at the time a futures position is established, there is no obligation by either party to the other. The only potential future obligation would be any current market loss plus an allowance for some market loss that might reasonably be expected to occur before the position can be offset at the next trade date. In this framework, measuring derivatives exposure for cover purposes by assuming that their potential loss is equal to their notional exposure can only be justified in scenarios of illiquid markets and infrequent valuations where it is difficult to accurately estimate the potential market loss-to-date, let alone what it might reasonably become by the next trade date. Another scenario for which the more conservative exposure calculation methodology might be justified includes physical-settled futures contracts which, unless the fund promises to roll or offset its position before the delivery date, might require the funds to make or take delivery of the physical commodity.

<u>A Recommended Approach to Asset Segregation</u>

Given the broad array of derivative structures, their different levels of liquidity, the differences in their potential for creating indebtedness, and the pace of innovation in the industry, we recommend that the Commission endorse a principles-based approach to segregating assets to "cover" potential indebtedness created by leverage. Under this approach, funds would be required to adopt policies and procedures for asset segregation uniquely appropriate to the derivatives they intend to use and the investment strategies they employ. These policies could address the bases for measuring the potential obligation (or credit exposure) created by each derivative position, the types of assets that can be used to cover these obligations, and any "haircut" that must be applied when calculating the required value of such cover assets. Other requirements could include board approval of such policies (and ongoing periodic board reporting), disclosure of such policies in the fund's registration statement, and regular adviser review and/or testing of the fund's holdings for compliance with these policies.

AlphaSimplex recommends the Commission complement the principles-based approach above with the specific guidelines to ensure appropriate protections for investors. Examples of such guidelines might include:

1) Only derivatives that create potential future obligations require segregated assets.

2) So long as the derivative in question has daily liquidity and daily margin calls (subject to reasonable threshold amounts that, in the case of OTC-traded derivatives, would be set forth in an International Swaps and Derivatives Association, Inc. Master Agreement, or "ISDA Agreement"), a fund may segregate assets equal to the *sum* of the daily marked-to-market obligation of the fund *plus* an allowance for some daily price move that could increase the fund's outstanding obligations (the "Volatility Amount"). A different

Volatility Amount could be determined for each derivative (i.e., at the position level) based on a calculation of the likelihood of some potential daily increase in the fund's obligations that would be conservative and yet not unexpected (e.g., a loss greater than six daily standard deviations)[4] based on a recent short-term volatility estimate.[5] This approach is conceptually similar to how clearing firms determine the initial margin required for exchanged-traded derivatives. Endorsing a similar approach to be used by funds when segregating assets would help ensure that a fund is able to meet a potential margin call rather than having the position potentially closed out by its broker.

3) The amount of assets required to be segregated may be reduced by the amount of any margin a fund has already posted in a margin account at the broker (in the case of a futures contract) or in a tri-party custody account (in the case of OTC-traded derivatives).

4) If the prospectus states the adviser will roll or offset positions in physical-settled futures contracts prior to the delivery date, exposures to physical-settled futures contracts may be calculated identically to cash-settled futures contracts for the purpose of determining the amount of assets required to be segregated.

5) The value of assets to be segregated in connection with derivatives that have the potential to create future obligations but which *do not have daily liquidity or daily margin calls* (subject to reasonable threshold amounts that, in the case of OTC-traded derivatives, would be set forth in an ISDA Agreement) should be the *full (i.e., maximum) value of the potential future obligation.*

AlphaSimplex would like to thank the Commission again for inviting and considering our comments on the Concept Release. If the Commission has any questions on the above comments and recommendations, we would be pleased to discuss them in greater detail or to participate in a roundtable discussion.

Sincerely,

Jerry Chafkin
President

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[4] Though possible, a loss greater than six daily standard deviations may reasonably be expected to occur only once each year, on average, over a long period of time.

[5] The adviser should use a recent short term volatility estimate in recognition that market volatilities are not static.

cc: The Honorable Mary L. Schapiro
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