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November 7, 2011

Ms. Elizabeth M. Murphy  
Secretary  
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:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's concept release on the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act" or "Act").<sup>2</sup>

We commend the Commission for seeking comment on this topic. Derivatives have become increasingly common, useful, and for some funds, integral portfolio management tools, offering fund managers an expanded set of options to implement investment strategies and manage risks. At the same time, derivatives can involve risks for funds that may not be present in the traditional "cash securities" markets, and the use of derivatives may raise interpretive issues under existing law and regulatory guidance.

Over the past thirty years, the Commission and its staff have addressed these interpretive issues on a case-by-case basis through releases, exemptive orders, no-action letters, speeches, and other public statements. We commend the Commission and its staff for seeking to take a more comprehensive and systematic approach, and for issuing this Concept Release. The responses the Commission receives should help inform its efforts to ensure that the rules and regulatory guidance are working as intended

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.8 trillion and serve over 90 million shareholders.

<sup>2</sup> *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"), available at <http://www.sec.gov/rules/concept/2011/ic-29776.pdf>.

when applied to this dynamic space and serving the best interests of the more than 90 million investors in funds.

## **Executive Summary of ICI Comments on the Concept Release**

The Concept Release seeks input on a very wide range of complex issues. It was not possible, within the comment period, to develop an industry response to each and every question posed by the Commission. Instead, we focus primarily on two broad topics: leverage and the Act's prohibition on funds' issuance of senior securities; and the diversification, concentration, and securities-related issuer tests, particularly as they relate to the regulation of counterparty exposures.<sup>3</sup>

For reasons explained in detail below, our principal recommendations include the following:

- **Clearly define “leverage.”** We recommend that the Commission define “leverage” for purposes of section 18 to include only those transactions that create actual or potential indebtedness. By adopting a definition of “leverage” in the context of section 18 that relates solely to indebtedness leverage and clearly distinguishes it from economic leverage, the Commission could alleviate some of the confusion in this area while appropriately protecting investors and serving the purposes of the Act.
- **Take a principles-based approach to asset segregation.** We recommend that the Commission take a principles-based approach to the practice of segregating or earmarking assets to “cover” for potential indebtedness leverage. Under such an approach, funds would be required to adopt rule 38a-1 policies and procedures concerning asset segregation that would address each type of derivative instrument that they intend to use, subject to Commission guidance that imposes appropriate “guardrails” (discussed below). The policies would establish asset segregation standards in view of the characteristics of particular derivatives and other relevant factors, such as liquidity and volatility, in keeping with other standards used by investment, risk and compliance professionals to manage portfolio risk and exposures. The policies would govern the amount to segregate, the types of assets that can be used for such purposes, and what constitutes an appropriate offsetting exposure. Funds would be required to describe the policies in reasonable detail in their Statement of Additional Information (SAI), and the policies would be subject to approval and oversight by the fund's board. As with other fund policies subject to rule 38a-1, they also would be overseen by the Chief Compliance Officer (CCO) for the fund and adviser and subject to SEC staff inspection and examination.<sup>4</sup>

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<sup>3</sup> While the scope of the Concept Release clearly is ambitious, important issues like disclosure, liquidity, and custody are not addressed. The Commission notes that it may consider these issues at a later date. Concept Release at n.20. We encourage the Commission to do so through industry roundtables and the issuance of additional concept releases like this one, where it can focus in detail on the complex issues involved.

<sup>4</sup> In general, the extent and complexity of a fund's asset segregation policies and procedures should be consistent with the derivatives it anticipates using and its approach to segregated asset coverage. Funds with more complex policies may be likely

- **Issue guidance that creates appropriate “guardrails” to protect investors.** We recommend that the Commission or its staff, while taking a principles-based approach, also issue general guidance that provides “guardrails” to ensure appropriate protections for investors. We suggest that such guidance include:
  - Advisers should design asset segregation policies with the objective of maintaining segregated assets sufficient to meet obligations arising from the fund’s derivatives under extreme but plausible market conditions, as such market conditions are determined on a current basis;<sup>5</sup>
  - When segregating less than the most conservative full notional amount, the segregation policy should require a more in-depth analysis to ensure that the fund has a “cushion” to address the potential loss from derivative contracts that could arise before the next time obligations are marked-to-market (often, the end of the next day), pursuant to which instruments with higher potential for loss or intra-day volatility would warrant a higher level of segregation;
  - A segregation policy should include measures such as back-testing and/or stress-testing in order to help verify the assumptions and models used to determine the amount of assets to be segregated; and
  - Advisers must have internal processes and infrastructure to perform the analysis suggested above and monitor for ongoing compliance.
- **Require funds to “look through” derivatives and apply the diversification, concentration, and securities-related issuer tests to reference assets.** The existing, traditional tests for diversification, concentration, and exposure to securities-related issuers should be applied with respect to the reference assets of derivatives, and not counterparties.

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to take a two-tier approach, where overarching policies are approved by the board and more detailed procedures (sometimes referred to as “desk procedures”) are used for day-to-day implementation purposes.

<sup>5</sup> As discussed in greater detail below, we see this concept as similar to the types of cushions being used or considered in other contexts, such as for initial margin and in the development of swap execution facilities (SEFs) and derivatives clearing organizations (DCOs). “Extreme but plausible market conditions” is a statutory standard used by SEFs and DCOs to determine the minimum amount of financial resources such entities must have to ensure, with a reasonably high degree of certainty, that they will be able to satisfy their obligations. *See, e.g.*, Section 5b(c)(2) of the Commodity Exchange Act, as amended by Section 725(c) of the Dodd-Frank Act. We recognize that this term is new and lacks context under the Investment Company Act, and that upon further consideration the Commission or staff may find that other standards are more appropriate.

- **Deal separately with counterparty exposures, in a rule designed specifically for that purpose.** Such a rulemaking would be complex, but is necessary to address the ways in which counterparty exposures are different from investment exposures. We envision that a counterparty rule would, similar to counterparty-specific rules in Europe and elsewhere:
  - Address the appropriate way to calculate counterparty exposure;
  - Set an appropriate limit on uncollateralized exposure to any one counterparty; and
  - Require additional counterparty risk disclosure in certain contexts.

## **I. Funds' Current Uses of Derivatives**

Derivatives have become an integral tool in modern portfolio management. Derivatives offer fund managers an expanded set of choices, beyond the traditional “cash securities” markets, through which to implement the manager’s investment strategy and manage risk.

Consistent with a fund’s investment mandate and guidelines, portfolio managers may invest in derivatives to, among other things, hedge or target portfolio exposures, with numerous possible combinations depending upon the fund’s investment strategy and current market conditions. Relative to comparable cash securities, derivatives’ potential benefits include the ability to:

- Hedge exposure to a market, sector, security, or other target exposure;
- Gain or reduce exposure to a market, sector, security, or other target exposure more quickly, more precisely, and/or with lower transaction costs and portfolio disruption;
- In some cases, utilize a more liquid alternative to traditional cash securities; and
- Gain access to markets in which transacting in cash securities is difficult, costly, or not possible.

Much of the discussion in the Concept Release focuses on the potential for creating leverage through investments in derivatives. This is appropriate, given the importance of the Investment Company Act restrictions on leverage and senior securities in section 18 to the regulation of funds. But it is essential to recognize that the use of derivatives does not necessarily mean a fund has an aggressive or leveraged investment objective. For example, a U.S.-dollar-denominated international equity fund may find that it is more efficient or cost-effective to use an equity swap to obtain exposure to certain foreign equities, and then a currency swap to adjust that exposure to U.S. dollars, compared to acquiring the same exposure via the foreign equities themselves. Because the fund used two separate instruments to replicate exposure, the notional value of its derivatives exposure would be double its economic exposure

to foreign equities. That fund is not seeking to add economic leverage through those derivatives, however, but rather simply trying to find the most efficient way to implement its investment strategy. Similarly, funds often use derivatives to hedge or otherwise mitigate investment risks, such that even a strategy arguably resulting in greater absolute risk (e.g., increased exposure to a particular non-U.S. currency) may lessen risk relative to corresponding benchmark exposures.<sup>6</sup>

*Do different types of funds use different types of derivatives or use derivatives for different purposes? If so, what are the differences in the types of funds that account for the differences in their use of derivatives?  
[Question from page 18 of the Concept Release]*

As the Concept Release notes, there is no set of complete data concerning the nature of the derivatives activities of funds. A number of recent articles, however, discuss funds' use of derivatives in various ways.<sup>7</sup> Rather than repeat those descriptions, we simply note that the different uses of derivatives by different types of funds is primarily a function of the fund's asset class and overall strategy, rather than whether the fund is a mutual fund, closed-end fund, or ETF. For example, indexed and actively-managed equity and fixed-income funds often use derivatives to gain or reduce exposure to a market, sector, security, or currency. Fixed-income funds frequently use derivatives to structure and control duration, yield curve, sector, and/or credit exposures. Asset allocation funds seeking to move efficiently across asset classes while minimizing disruption of underlying securities holdings may make extensive use of derivatives to control (i.e., maintain, hedge, or shift) their broad asset class exposures. Funds incorporating long-short (e.g., 130/30, market-neutral, or portable alpha) strategies also employ derivatives to maintain their respective target market exposure.

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<sup>6</sup> As the SEC staff has stated, "a fund may have significant exposure to derivatives, but that exposure may not make the fund substantially riskier (e.g., exposure by an international fund to currency forwards, entered into to hedge against the currency risk of securities that trade in those currencies would more likely reduce the fund's overall risk, rather than increase it)." See *Derivatives-Related Disclosures by Investment Companies*, Letter from Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, ICI (July 30, 2010), at n.15, available at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

<sup>7</sup> For more information on the primary fund applications of derivatives, see *Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008), at 7-11, available at [http://www.ici.org/pdf/ppr\\_08\\_derivatives.pdf](http://www.ici.org/pdf/ppr_08_derivatives.pdf); *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) ("ABA Task Force Report"), at 5-10, available at <http://apps.americanbar.org/dch/committee.cfm?com=CL410061>; Robert Helm, et al., *Mutual Funds' Use of Credit Default Swaps—Part I*, *The Investment Lawyer*, Vol. 16, No. 12 (Dec. 2009); Robert Helm, et al., *Mutual Funds' Use of Credit Default Swaps—Part II*, *The Investment Lawyer*, Vol. 17, No. 1 (Jan. 2010); and Cecilia L. Gondor, *Annual Closed-End Fund Leverage Update: Examining Structural Versus Economic Leverage*, *The Investor's Guide to Closed-End Funds* (Oct. 2011). The topic also has been the subject of numerous conference panels. See, e.g., Marco Adelfio, *Derivatives 101 – Introduction to How Funds Use Derivatives*, outline from the 2008 Mutual Funds and Investment Management Conference; and John Miller, CFA, *Derivatives 101: Portfolio Applications*, PowerPoint presentation from the 2008 Mutual Funds and Investment Management Conference.

*How do ETFs use derivatives? Do they use derivatives for the same purposes that other open-end funds use them? Does an ETF's use of derivatives raise unique investor protection concerns under the Investment Company Act? [Question from page 18 of the Concept Release]*

As of September 2011, ETFs registered under the Act held \$841 billion in assets under management. The vast majority of these assets (95.9 percent) are held in so-called “physical” ETFs—funds that seek to track an index by either replicating or sampling the securities in the index. A small portion (0.6 percent) is held in actively-managed ETFs, which also invest primarily in securities but do not seek to track an index. Both index-based and actively managed ETFs may use derivatives such as futures, forwards, options, or swaps, in addition to traditional securities, to meet their investment objectives, subject to the same limitations under the Act that apply to all registered funds.

Leveraged and inverse ETFs, which comprise 3.5 percent of the U.S. ETF market, also seek to track an index, or more specifically a multiple or an inverse of an index, on a daily basis. They rely to varying degrees on derivative instruments to achieve their objectives. Leveraged funds typically invest a sizeable amount of their assets in the securities of the target index. The remaining assets are invested in cash or cash equivalents, against which the funds enter into derivatives transactions to obtain the remaining targeted exposure. Inverse funds invest primarily in cash or cash equivalents and derivatives to achieve their objective.

The Concept Release notes that, since March 2010, the SEC has deferred consideration of exemptive requests by new ETFs that make significant use of derivatives.<sup>8</sup> We believe this protracted moratorium on new ETF applications is unwarranted from a regulatory perspective and should be lifted. While it is true that some ETFs, such as leveraged or inverse ETFs, make substantial use of derivatives, all ETFs must comply with the same regulatory framework as other funds registered under the Investment Company Act. Despite this, the moratorium singles out ETFs, creating an unlevel playing field between them and other types of funds that do not need exemptions to launch. It also creates a competitive imbalance among ETF sponsors, because certain sponsors, prior to the SEC's announcement, received permission to create new funds that make significant use of derivatives. This has given some market participants a substantial advantage as new entrants are prohibited, and has even placed an acquisition premium on those sponsors that have obtained such relief.<sup>9</sup> We believe such an unlevel playing field is inappropriate and unnecessary, and we urge the Commission to decouple the ETF moratorium from its broader review of the issues raised in this Concept Release, as it is likely that it will take considerable time to resolve those issues.

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<sup>8</sup> Concept Release, at n.8.

<sup>9</sup> See, e.g., Ignites, “Grail drawing interest from major institutional managers,” Jan. 12, 2011 (“The asset manager that ultimately buys Grail Advisors’ active ETF business is likely more interested in the firm’s expansive regulatory exemptions than in its existing product lineup.”).

## II. Prohibition on Senior Securities; Concepts of Leverage and Segregated Assets

*Is the definition of leverage articulated by the Commission in Release 10666 – that is, the right to a return on a capital base that exceeds a fund’s investment in the instrument producing the return – sufficiently precise, and appropriate to limit the risks addressed by the senior security prohibition of section 18? [Question from page 38 of the Concept Release]*

For reasons explained below, the articulation of “leverage” in Release 10666<sup>10</sup> is not as clear as it could be. The core purpose of section 18 of the Act is to limit indebtedness – contractual future obligations to pay – and thereby limit volatility caused by indebtedness and the possibility that a fund could lack sufficient assets to pay its obligations.<sup>11</sup> The definition of leverage articulated in Release 10666, however, has caused a fair amount of confusion in the fund industry by straying from this principle. We recommend that the Commission define “leverage” for purposes of section 18 to include only those transactions that create actual or potential indebtedness.

There is no universally accepted definition of “leverage.” As the Concept Release explains, some make a distinction between “indebtedness leverage” and “economic leverage.” Both enable the fund to participate in gains and losses on an amount that exceeds the fund’s initial investment. “Indebtedness leverage” also creates an obligation, or potential indebtedness, to someone other than the fund’s shareholders.<sup>12</sup> Examples include futures contracts, swaps, and written options. “Economic leverage” does not; instruments with purely economic leverage, such as purchased options and structured notes, do not impose a payment obligation on the fund above its initial investment.<sup>13</sup>

Consistent with the distinction between indebtedness and economic leverage, Release 10666 appropriately outlines an asset segregation approach tied to the amount of a fund’s indebtedness leverage, not economic leverage.<sup>14</sup> Some of the phrases used in Release 10666, however, needlessly obscure the distinction between the two types of leverage. For example, it describes leveraged transactions as involving “speculative purposes,” generating “a right to a return on a capital base that exceeds the investment,” “magnifying the potential for gain or loss on monies invested,” and

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<sup>10</sup> *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) (“Release 10666”) [44 FR 25128 (Apr. 27, 1979)].

<sup>11</sup> See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess., at 1025 et seq. (discussing so-called “leveraged investment companies” that had issued some combination of common, preferred stock, and debentures) and 1040 (“The ‘introduction of leverage’ by long-term borrowings was one of the practices of investment companies most severely criticized by investment-company sponsors and managers themselves at the public hearings.”).

<sup>12</sup> See Concept Release at n.31 and accompanying text.

<sup>13</sup> *Id.* at n.32 and accompanying text.

<sup>14</sup> Release 10666 provides for the segregation of amounts equal to the indebtedness incurred by the fund in connection with the senior security (e.g., the purchase price due on the settlement date under a firm commitment agreement).

“result[ing] in an increase in the speculative character of the investment company’s outstanding securities.” These phrases apply to both indebtedness and economic leverage, but only indebtedness leverage raises the issues that the senior security prohibition under the Act was intended to address, and that the asset segregation requirements outlined in Release 10666 actually do address.

There is no question that instruments that involve economic leverage can be volatile. The Act, however, was not designed to regulate or prevent volatility caused solely by economic leverage. Section 1(b) of the Act declares “that the national public interest and the interest of investors are adversely affected—...(7) when investment companies *by excessive borrowing and the issuance of excessive amounts of senior securities* increase unduly the speculative character of their junior securities; or (8) when investment companies operate without adequate assets or reserves.” Section 18 then defines senior securities, in part, as “any bond, debenture, note, or similar obligation or instrument constituting a security *and evidencing indebtedness.*” [Emphasis added.] Thus, in designing the Act, Congress was not concerned in a general sense with the effects of economic leverage—i.e., that it could increase the volatility of fund shares. Rather, it was specifically, and in our view correctly, concerned with excessive borrowing and the issuance of senior securities, and the effect that *those practices* might have on the speculative character of fund shares.

The Act is thus designed to regulate the degree to which a fund issues any form of debt—including contractual obligations that could require a fund to make payments in the future. By adopting a definition of “leverage” in the context of section 18 that relates solely to indebtedness leverage and clearly distinguishes it from economic leverage, the Commission could alleviate some of the confusion in this area while appropriately protecting investors and serving the purposes of the Act.

*Does the segregated account approach adequately address the investor protection purposes and concerns underlying section 18 of the Act? What are the benefits and the shortcomings of the segregated account approach? [Question from page 38 of the Concept Release]*

In our view, the basic theory in Release 10666 underlying the permissible use of segregated accounts remains sound. If properly managed, the segregation of assets<sup>15</sup> is a significant constraint on funds’ ability to engage in transactions that involve indebtedness leverage. And the segregation of assets can help to protect against the possibility that funds will have obligations they are unable to meet. By doing so, the segregated account approach remains an effective way to regulate indebtedness leverage in funds

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<sup>15</sup> The staff has indicated that “segregation” includes the act of designating or “earmarking” assets on a fund’s own books, rather than maintaining a segregated account with a custodian. See “Dear Chief Financial Officer” Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (pub. avail. Nov. 7, 1997).



and protect investors against excessive borrowing and the issuance of senior securities, and the abuses (including excessive volatility) that can arise from those practices.<sup>16</sup>

That said, the SEC staff's approach to date of providing guidance with respect to specific types of instruments has created a patchwork of interpretations that is neither practical nor sustainable. We recommend that the Commission issue a new statement, updating and replacing Release 10666, in which it takes a principles-based approach that requires funds to adopt policies and procedures concerning asset segregation for each type of derivative instrument that they intend to use, subject to Commission guidance that imposes appropriate "guardrails" (discussed below). The policies would establish asset segregation standards in view of the characteristics of particular derivatives and derivatives techniques, such as liquidity and volatility, in keeping with other standards used by investment, risk and compliance professionals to manage portfolio risk and exposures. The policies would govern, in detail, the amount to segregate, the types of assets that can be used for such purposes, and what constitutes an appropriate offsetting exposure. Funds would be required to describe the policies in reasonable detail in their SAI,<sup>17</sup> and the policies would be subject to approval and oversight by the fund's board. As with other fund policies, they also would be overseen by the CCOs for the fund and adviser and subject to SEC staff inspection and examination. As such, the policies would be subject to the same robust system of oversight afforded all policies subject to rule 38a-1 under the Act.

A principles-based approach is necessary because the SEC staff's traditional instrument-by-instrument approach to guidance has created, and would continue to create, regulatory uncertainty. As funds have used new instruments to pursue their investment objectives, they have applied the concepts set forth in Release 10666 and subsequent no-action letters, but interpretive questions frequently arise. For example, no written SEC or staff guidance exists with respect to asset segregation or appropriate offsetting transactions for swaps, some types of which are not easily analogized to futures, forwards, options, or other instruments for which guidance has been given. As the derivatives marketplace continues to evolve, it will continue to be challenging for the SEC or the staff to issue timely guidance addressing segregation and offsetting transactions for each new instrument. A principles-based regime will allow funds and their advisers to be more responsive in this regard, by developing tailored approaches that can be examined by SEC staff. And, of course, to the extent that such examinations suggest that certain policies and procedures should be subject to more specific constraints, the Commission or staff could issue further guidance to that effect.

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<sup>16</sup> In addition to the constraints on *indebtedness* leverage in section 18, the Act's disclosure regime should serve to appraise investors of the risks of *economic* leverage. As the Commission takes up disclosure issues relating to the use of derivatives, we encourage it to address this aspect of fund disclosure to ensure that investors are appropriately protected.

<sup>17</sup> We would expect that this disclosure would be similar, in terms of detail, to funds' disclosure of their proxy voting policies. See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Release No. IC-25922 (Jan. 31, 2003), available at <http://www.sec.gov/rules/final/33-8188.htm>.

*What is the optimal amount of assets that should be segregated for purposes of complying with the leverage limitations of section 18? [Question from page 39 of the Concept Release]*

The decisions on how much to segregate, what to segregate, and what constitutes an acceptable offset in lieu of segregation are all very much intertwined. In part, this is why we favor a principles-based approach, where each fund's policies and procedures would detail what constitutes appropriate cover in each situation.

The guiding principle should be that every fund should segregate enough assets to meet all of its obligations, based on a realistic, reasonable, and current expectation of the potential for loss to the fund under extreme but plausible market conditions. Instead, the existing guidance discusses two approaches to segregation – “notional” and “mark-to-market.” The *Dreyfus* no-action letter, which addressed futures, forwards, options, and short sales, suggested that a fund could cover these transactions by segregating the full value of the potential obligation of the fund under the contract or position.<sup>18</sup> That amount is commonly referred to as the “notional” amount of the contract. More recently, based on informal positions taken by the SEC staff in connection with the disclosure review process, some funds have begun to disclose in their prospectuses that, for long positions in futures and forward contracts that are contractually required to settle in cash, the fund will segregate assets equal to the fund's daily marked-to-market obligation (i.e., the difference between the fund's obligation to its counterparty and the counterparty's obligation to the fund, adjusted daily), rather than the notional amount.<sup>19</sup>

Segregating either the full notional amount or the daily marked-to-market obligation may result in over- or under-collateralization. Segregating “the full value of the potential obligation” ignores, in many cases, the economic reality of a particular instrument or how it functions within the portfolio. Derivatives contracts impose two-sided obligations, so a fund can receive something in return for its obligation (e.g., the strike price or the underlying assets in the case of an option; the cash or assets in the case of futures and forwards; the defaulted bond or its value in the case of written credit default swaps; or the alternate payment in the case of most other swaps). The segregation of the notional amount in most cases ignores this economic reality, and thus calls for the segregation of assets far in excess of a fund's realistic potential obligation, which may not be in the best interest of the fund's shareholders. As derivatives have become more important tools in portfolio management (often cheaper and in some

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<sup>18</sup> *Dreyfus Strategic Investing & Dreyfus Strategic Income*, SEC No-Action Letter, June 22, 1987.

<sup>19</sup> The Concept Release notes that this is an area where some industry participants have argued that the staff's application of the segregated account approach results in differing treatment of arguably equivalent products. We agree. While we believe that the structure of the instrument should be a factor considered in determining the optimal amount of assets to segregate (see page 13 below), we would not expect that whether the instrument is contractually required to settle physically always necessitates a drastically different segregation result from those that must cash settle. Mandatory physical settlement is a feature that often does not meaningfully change the economic reality of the instrument, especially when market participants intend to close their position for cash, prior to the occurrence of any settlement date calling for physical delivery (e.g., Treasury futures).

cases more liquid than cash investments), segregating at full notional can be unduly restrictive, limiting funds' ability to pursue certain investment objectives.

On the other hand, we recognize that calculating a fund's exposure daily based only on its net obligations—the “mark-to-market” approach—may create a risk that market movements could increase a fund's exposure, so that the segregated assets are worth less than the fund's obligation.<sup>20</sup> An additional risk of a pure mark-to-market approach may be present if a fund is segregating liquid assets other than cash or cash equivalents, which may decline in value at the same time the fund's potential obligation is increasing. Hypothetically, in an extreme scenario, a fund that used derivatives heavily and segregated most of its liquid assets to cover its obligation on a pure mark-to-market basis could potentially find itself with insufficient liquid assets to cover its derivative positions.<sup>21</sup>

The optimal amount of cover for many instruments may be somewhere in between full notional and mark-to-market amounts. It should be an amount expected to cover the potential loss to the fund, determined with a reasonably high degree of certainty. This amount—mark-to-market plus a “cushion”—is more akin to the way portfolio managers and risk officers assess the portfolio risks created through the use of derivatives. This is also consistent, conceptually, with the development of initial margin requirements for cleared and uncleared swaps,<sup>22</sup> and the types of cushions mandated for swap execution facilities and derivatives clearing organizations.<sup>23</sup>

While we favor a principles-based policies and procedures approach, we recognize that not all funds may want or need to develop the types of detailed policies described below. In general, the extent and complexity of a fund's asset segregation policies and procedures should be consistent with the derivatives it anticipates using and its approach to segregated asset coverage. We would expect that a fund using derivatives as a principal investment strategy would have detailed policies and procedures, whereas a fund that may only occasionally use derivatives could have a much simpler policy.<sup>24</sup> We also would expect that the need for detailed policies and procedures is a function of the asset segregation

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<sup>20</sup> In that case, the fund would need to segregate additional assets at the end of the trading day or unwind the position.

<sup>21</sup> We are not aware of any case in which this has actually happened.

<sup>22</sup> See, e.g., *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (April 28, 2011), available at <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2011-9598.html>.

<sup>23</sup> See, e.g., *Derivatives Clearing Organization General Provisions and Core Principles*, Commodity Futures Trading Commission, RIN 3038-AC98, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister101811.pdf> (§ 39.11(a)(1) of the final rules will require a DCO to maintain sufficient financial resources to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions).

<sup>24</sup> We would expect that a policy could either 1) establish parameters for each type of instrument, or 2) describe a process, including the considerations to be applied in determining segregation amounts, for how the firm will make such determinations (e.g., by a complex securities review committee comprised of various operational and risk groups), in either event documenting such determinations, and requiring that there is appropriate oversight (e.g., fund's board and/or CCO).

levels employed. For example, given that segregating assets based on full notional value generally overstates the fund's potential exposure, the more detailed and sophisticated analysis recommended below for a fund's asset segregation policy generally would not be necessary when segregating at that level.<sup>25</sup>

For funds that choose to segregate assets at less than the most conservative levels, we recommend that the SEC or its staff set forth general guidance that provides "guardrails" to ensure appropriate protections for investors. We have the following suggestions for inclusion in such guidance:

- **Advisers should design asset segregation policies with the objective of maintaining segregated assets sufficient to meet obligations arising from the fund's derivatives under extreme but plausible market conditions, as such market conditions are determined on a current basis.** Consistent with the Commission's interpretation of Section 18 in Release No. 10666, a fund's asset segregation policies and procedures should be reasonably designed to "function as a practical limit on the amount of [indebtedness] leverage which the investment company may undertake...[and] assure the availability of adequate funds to meet the obligations arising from such activities." We recognize that the standard "extreme but plausible market conditions" is new and lacks context under the Investment Company Act. It has been used in the context of stress testing and in the development of derivatives clearinghouses to determine the minimum amount of financial resources such entities must have to ensure, with a reasonably high degree of certainty, that they will be able to satisfy their obligations.<sup>26</sup> By suggesting that advisers design asset segregation policies with the objective of maintaining sufficient segregated assets under extreme but plausible market conditions, we are not suggesting that advisers take into account every possible outcome. All risk models are necessarily based on historic data, and even consistent with an "extreme but plausible" standard an adviser's methodology may fail to predict a particular portfolio or position outcome. The guidance should recognize that the goal of asset segregation is to *reasonably* assure the availability of adequate funds, and afford advisers appropriate flexibility to interpret what constitutes "extreme but plausible" market conditions. The guidance also could provide examples of "extreme but plausible market conditions" and explain how advisers should take the results of their analysis into account when developing segregation policies.

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<sup>25</sup> Conceptually, this is a similar construct to the bifurcated approach taken in Europe, under which funds choose one of two alternative methods: (i) a highly conservative "commitment" approach that relies on notional values; or (ii) an advanced risk measurement method that measures maximum potential loss through metrics such as value at risk (VaR). See *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, Committee of European Securities Regulators (July 28, 2010), available at <http://www.esma.europa.eu/popup2.php?id=7000> (noting that the "commitment approach should not be applied to UCITS using, to a large extent and in a systematic way, financial derivative instruments as part of complex investment strategies").

<sup>26</sup> See, e.g., Section 5b(c)(2) of the Commodity Exchange Act, as amended by Section 725(c) of the Dodd-Frank Act; CPSS-IOSCO Principles for Financial Market Infrastructures, Consultative Report (March 2011), available at <http://www.bis.org/publ/cpss94.pdf>.

- **When segregating less than the most conservative full notional amount, the segregation policy should require a more in-depth analysis to ensure that the fund has a “cushion” to address the potential loss from derivative contracts that could arise before the next time obligations are marked-to-market (often, the end of the next day).** In setting the level of segregation based on marked-to-market obligations, the adviser should consider the potential for loss of the derivative instrument, and the effect that such loss could have on the fund’s indebtedness before the next mark. Instruments with higher potential for loss would warrant a higher level of segregation. Conversely, instruments with less potential for loss may warrant segregation at or near mark-to-market levels. In any event, the policy should require consideration of the characteristics of the instrument type and other relevant factors when determining the appropriate level of segregation. Such factors may include: (1) the structure of the instrument, (2) the nature of the reference asset, (3) anticipated liquidity (e.g., the ease with which the adviser could sell or terminate the instrument or enter into an offsetting transaction to limit its potential obligation), (4) the settlement terms (e.g., terms that allow the fund to promptly terminate transactions may mitigate risk), (5) the certainty of the settlement amount, and (6) the potential for intra-day volatility.

For each category of derivative instrument used, the fund’s segregation policy should include the rationale for whether or not a cushion is utilized. The fund’s segregation policy should also describe the method the fund will use to determine the amount of cushion for particular instrument categories, if applicable. For the types of instruments subject to initial margin requirements, the initial margin should provide a sufficient amount of cushion. For others, the appropriate amount of cushion would depend upon the type of instrument and the fund’s anticipated use of such instrument. In any case, as described further below, the amount of assets segregated may need to be adjusted depending upon the type of assets used for cover.

- **A segregation policy should include measures such as back-testing and/or stress-testing in order to help verify the assumptions and models used to determine the amount of assets to be segregated.** The scope and level of detail of such testing processes would vary depending on the policies. For example, in the case of a fund that takes the conservative approach of segregating assets equivalent to the full notional amount of its derivative positions, any testing could be limited to the nature of the assets utilized for segregation (and, if the fund limited such assets to cash items and U.S. Treasury securities, even this level of testing might not be necessary). In contrast, a fund that relies on certain risk estimates and assumptions in order to set asset segregation levels should have more sophisticated and frequent testing procedures.
- **Advisers must have the internal processes, infrastructure, and personnel necessary to perform the analysis suggested above and monitor for ongoing compliance.** This is not necessarily a function of the size of the adviser’s organization, but rather its ability to determine asset segregation levels on a more complex basis than the full notional amounts.

*Should the Commission revise its position in Release 10666 to provide expressly for cover methods in addition to asset segregation? If so, should the Commission take the position that a fund may only enter into such non-asset segregation cover methods with the same counterparty to the senior security being covered? If so, what conditions, if any, should be imposed on such cover methods? [Question from pages 41-42 of the Concept Release]*

Entering into offsetting transactions can mitigate the potential for loss and thus the effect of indebtedness leverage. The determination of which transactions actually offset others, however, can be very complicated, and there is no clear guidance on how a fund might offset many different kinds of derivative positions that truly offset one another.

We recommend that, as part of the development of a fund's policies and procedures on segregation, funds using offsetting positions be required to determine appropriate guidelines for determining when positions offset. We also recommend that the Commission or its staff issue further guidance supporting the use of offsetting as an alternative to asset segregation. The *Dreyfus* no-action letter sets forth some examples in which a fund may enter into an offsetting position to a derivative exposure as an alternative to segregating, but given the complexity of how offsetting transactions can operate in practice, the industry would benefit from further guidance in this area.<sup>27</sup>

Specifically, we believe that in certain circumstances funds should be permitted to offset less-than-identical transactions, provided the risk inherent in the altered terms is monitored and addressed on a daily basis. Funds should be required to set forth in their segregation policies the circumstances in which they will deem a position to be offset, and explain how any risks posed by that determination will be addressed. For example:

- **Different counterparties.** In some circumstances, a fund that enters into both sides of an identical contract with different counterparties<sup>28</sup> should be able to deem these contracts to fully or partially offset one another for purposes of asset segregation. Given that using different counterparties may leave the fund exposed to one side of the transaction if the other counterparty defaults, a full offset should only be permitted in cases where the counterparty has fully collateralized the transaction in a bankruptcy-remote manner.<sup>29</sup>

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<sup>27</sup> For example, the *Dreyfus* letter states that a fund may cover a futures or forward contract by purchasing a put option on the same futures or forward contract, with a strike price equal to or higher than the price of the contract held by the fund.

<sup>28</sup> This interpretation appears to be consistent with *Dreyfus* which, in the example of a fund selling a call option on a futures or forward contract, stated that the sale may be offset by holding a long position in the same contract. The letter does not state that the positions must be exchange traded or transacted with the same counterparty.

<sup>29</sup> In practice, funds and their counterparties make allowances for *de minimis* amounts such that the parties are considered "fully collateralized" until additional collateral is called. Like the ABA Task Force, we recommend that the Commission recognize this practice. See ABA Task Force Report, at n.64.

- **Different types of derivatives.** A fund should be permitted to determine that it has offset an exposure by obtaining an opposite exposure through a different instrument, such as offsetting a currency forward with an opposing currency swap.<sup>30</sup> As with the previous example, counterparty risk should be considered if the offsetting transaction is entered into with a different counterparty.

*Should the Commission permit funds to segregate any liquid asset? Or should the Commission further limit the types of assets that may be placed in a segregated account? [Question from pages 40-41 of the Concept Release]*

We believe that funds should be permitted to segregate any liquid assets that may be marked to market daily, consistent with the position taken by the SEC staff in the *Merrill Lynch* no-action letter.<sup>31</sup> As noted above, however, the decision regarding what to segregate is intertwined with decisions about the amount to segregate and what constitutes an acceptable offset. All of these should be addressed in a fund's asset segregation policies and procedures, and should work together to achieve the overarching policy objective of seeking to ensure that the fund maintains segregated assets sufficient to meet its outstanding obligations, as determined on a daily basis.

This approach requires ongoing monitoring of the fund's portfolio to be sure that the fund retains liquid assets to cover its obligations. We recognize that it is theoretically possible that a fund could segregate most of its liquid assets against derivatives positions and yet become unable to meet its obligations due to extraordinary fluctuations in the value of those assets. It is also possible that due to unforeseen market events, previously liquid assets could become temporarily illiquid.

The types of liquid assets discussed in Release 10666—namely cash, U.S. government securities, or other appropriate high grade debt obligations—are the most conservative forms of cover. Given the issues described above with respect to potential changes in the value of other liquid assets, we recommend that advisers electing to segregate such other liquid assets should be required to take additional measures. Specifically, as part of developing the fund's segregation policy, advisers should consider the effects of segregating such other assets, and should take steps to reasonably ensure that single-day market movements do not leave the fund with insufficient assets to meet its obligations. For example, an adviser may elect to restrict the assets that may be segregated to those meeting certain criteria, limit the amount of its liquid assets that may be segregated, apply discounts to some types of segregated assets based on their characteristics, or add a cushion to its basket of segregated assets, among

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<sup>30</sup> This interpretation would also appear to be consistent with *Dreyfus*, which suggested that a fund may offset a short position through several different alternatives that provide long exposure (i.e., holding a long exposure to the same contract, the underlying asset, or a call option on the asset).

<sup>31</sup> *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter, July 2, 1996.

other options.<sup>32</sup> The adviser also should consider how to monitor the liquidity of the markets for the segregated assets and the correlations between those assets and the covered positions. In any event, the fund's segregation policy would set forth how it will treat assets other than cash and cash equivalents, if used, including how it will determine which assets are appropriate for segregation, and what steps it will take to address the possibility of under-segregation.

*Do boards, as currently constituted, have sufficient expertise to oversee an alternative approach to leverage and derivatives management? [Question from page 43 of the Concept Release]*

A board's oversight responsibilities with respect to derivatives are generally the same as for other portfolio investments. The board reviews (and where applicable approves) policies developed by the adviser and asks questions as to why and how the adviser uses particular investment techniques or strategies, what risks those techniques or strategies may entail, and what internal controls exist to monitor such risks and ensure compliance with relevant investment guidelines and regulatory requirements.

As in any context, individual directors will bring different expertise to bear in overseeing the adviser's portfolio management. Some directors may have a portfolio management or similar background that affords a deep understanding of the technical aspects of the adviser's techniques; others may not. This is as true with respect to derivatives as it is with respect to many other types of investments commonly made by funds.

We would expect that boards would approve asset segregation policies and provide robust oversight with respect to their implementation.<sup>33</sup> We do not believe, however, that it is critical to the performance of these functions that directors understand every nuance with respect to sophisticated models such as VaR, or even every element of the decision to segregate a certain amount for a certain type of derivative. It is more important, and more relevant to their oversight role, that the board understands the extent of the adviser's expertise with derivatives, the concepts of indebtedness and economic leverage, the degree to which derivatives in the fund's portfolio create indebtedness leverage, the principles behind the segregated account approach, and the testing and compliance systems utilized by the adviser. Of course, boards also need to understand how derivatives are used by the adviser to implement various investment strategies, and the materiality of such use to those strategies and the overall portfolio.

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<sup>32</sup> We would expect that funds would consider the entire mix of segregated assets in assessing any appropriate adjustments or discounts for certain assets. For example, if a large portion of the segregated assets are high quality, highly liquid instruments, the fund might apply a smaller discount to the remaining assets than it would if the entire basket were not highly liquid.

<sup>33</sup> Moreover, the asset segregation policies will be subject to rule 38a-1, and as such will be subject to the robust oversight provided by fund and adviser CCOs.



### III. Compliance Testing for Diversification, Concentration, and Exposure to Securities-Related Issuers

Several sections of the Concept Release discuss the issues a fund's use of derivatives may raise under the Act's provisions governing diversification, concentration, and investing in certain types of securities-related issuers. As the Concept Release notes, applying these provisions can be complex, in part because derivatives create exposures to multiple variables, such as the credit of a counterparty as well as the reference asset on which the derivative is based.

In this section and Section IV below, we recommend that, with respect to derivatives, the Commission should apply the existing, traditional tests for diversification, concentration, and exposure to securities-related issuers to reference assets, and not counterparties. Counterparties present potential risks that, we believe, could be better addressed through an entirely new rule specifically tailored to those risks.

*Should the issuer of reference assets underlying a derivative entered into by a fund be considered to be the issuer of a security for purposes of the diversification requirements in lieu of, or in addition to, the counterparty? [Question from page 56 of the Concept Release]*

The Concept Release poses this, and several other questions, that seek input on how funds treat reference assets for purposes of complying with the diversification, concentration, and securities-related issuer tests. The Concept Release states that "in general, the 'issuer' of an OTC derivative entered into by a fund would appear to be the fund's counterparty,"<sup>34</sup> and in cases where the reference asset is a security issued by a particular entity (e.g., a total return swap on the common stock of a corporate issuer), "the potential exposure of the fund created by the derivative is to both the counterparty to the contract and the issuer of the reference security."<sup>35</sup> We agree that funds face exposure from both aspects of the transaction. Due to the fact that derivatives entail multiple exposures, it is not always clear whether to apply the diversification, concentration, and securities-related issuer tests to counterparties or reference assets.<sup>36</sup> In addition, for derivative instruments that are not securities, it is not clear whether these tests apply at all.<sup>37</sup>

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<sup>34</sup> See Concept Release, at 53.

<sup>35</sup> Id.

<sup>36</sup> Issues may also arise under section 35(d) of the Act and rule 35d-1, relating to fund names.

<sup>37</sup> Given the purposes of the tests, ideally testing ought to be done with respect to all fund investments. Section 5(b), however, is limited to "securities," whereas section 8(b) applies to all "investments." See, e.g., ABA Task Force Report at 23-24 ("it would be reasonable to conclude that [Section 5(b)] applies to, and the SEC could only enforce, calculations that include securities....The status of other instruments, like swaps and forwards, as securities under Section 5(b) is not clear, although many funds treat some swaps and forwards as securities for [these] purposes..."). We also note that the Dodd-Frank Act amended the Securities Act of 1933 and the Securities Exchange Act of 1934 to include a "security-based swap" within the definition of security for purposes of those acts. Further guidance on the treatment of instruments that may not be securities would be beneficial.

As the Concept Release correctly points out, there is very limited guidance on exactly how these tests should be applied to counterparties. In the absence of guidance, and given the lack of clarity, different funds and their counsel have reached different conclusions on how to apply the tests. As a result, some of the questions posed in the Concept Release as to funds' current practices cannot be answered definitively on an industry-wide basis.<sup>38</sup>

The more important policy question, however, is the one posed above—*should* these tests be applied to reference assets, counterparties, or both? For reasons explained below, we believe the regulatory purposes of the diversification, concentration, and securities-related issuer tests are best served by focusing on the reference asset where it is a security issued by a particular entity,<sup>39</sup> and not counterparties.<sup>40</sup> In our view, counterparty risk could be more effectively handled in a separate rule designed specifically for that purpose.

As the Concept Release notes, the diversification and concentration requirements are intended, at least in part, to inform shareholders of the character of the portfolio of the fund and prevent funds from substantially changing that character without shareholder approval.<sup>41</sup> The reference asset is the most important exposure in determining “the character of the portfolio” because it is the only exposure that could produce positive investment returns and thus contribute to achieving the fund’s objective. After all, fund advisers use derivative instruments in order to obtain exposures to reference assets, not in order to obtain exposures to counterparties. Counterparty exposure has the potential to cause loss, but not gain.

Investors are likely to view “the character” of a fund’s portfolio through the lens of its investment objectives, strategies, and investment risks. Indeed, in evaluating fund portfolios that include derivatives, Morningstar creates a fictitious portfolio, which it calls a “replicating portfolio,” in which the exposures provided by the derivative are replaced by a combination of the reference asset and cash.<sup>42</sup> It does not take counterparty risks into account as part of that analysis. This suggests that Morningstar believes that focusing on the reference assets (and not counterparties) is the primary lens for determining the real economic exposure that the fund has, and thus is more useful to its portfolio

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<sup>38</sup> For a summary of the various approaches funds take to each test, see the ABA Task Force Report, at 21-35.

<sup>39</sup> Interest rate derivatives, Treasury futures and options, commodities and foreign exchange derivatives do not have “issuers” that can be tested for diversification.

<sup>40</sup> We believe that looking at the fund’s exposure to the reference asset also best serves the purposes of rule 35d-1, the fund names rule.

<sup>41</sup> See Concept Release, at n.131 and n.162, citing Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 Wash. U. L. Q. 303, 314 n. 34 (Apr. 1941). In addition to better addressing the substantive aspects of counterparty exposure, a new rule would have the benefit of applying to all funds—not just those that hold themselves out as diversified or non-concentrated.

<sup>42</sup> See Morningstar’s Standardized Global Portfolio Template (December 12, 2006), at 10 (discussing swaps) and 13 (discussing cash offsets for derivatives).

analytics and categorization of funds. The issue of counterparty risk is also important to Morningstar but it is secondary and is regarded as a separate issue.

Although the regulatory purpose of section 12(d)(3) and rule 12d3-1 are somewhat different from diversification and concentration, we believe that focusing on the reference asset is appropriate in this context as well. The Concept Release explains that this section and rule are intended to limit a fund's exposure to the "entrepreneurial risks" of securities-related issuers and limit the possibility of abusive reciprocal practices between funds and securities-related issuers. While we recognize that a fund's counterparty relationships could raise similar concerns, those concerns could be addressed separately in a rule specific to counterparty exposures. A fund's investment in equity or fixed-income securities issued by a securities-related issuer, and derivatives where the reference asset is such an equity or fixed-income security, could continue to be addressed by section 12(d)(3) and rule 12d3-1.

*How should a derivative be valued for purposes of applying the diversification tests?<sup>43</sup> [Question from page 54 of the Concept Release]*

As the Commission clearly recognizes, this is a difficult question. Section 5(b) dictates the use of market values. It requires funds to calculate the "value" of each investment, as a percentage of the fund's "total assets." "Value" is defined in section 2(a)(41) of the Act to mean market values, whether through market quotations (if readily available) or fair values.<sup>44</sup>

There are good arguments in favor of using marked-to-market values for all derivatives for purposes of these compliance tests. First and foremost, it is the value required by the statutory language.<sup>45</sup> The use of market or fair value also is consistent with the calculation of the fund's net asset value, which is based on the same statutory definition of "value" in section 2(a)(41) of the Act. This consistency is beneficial from an auditing and systems perspective, because the figures are easy to confirm and existing accounting systems can be used to perform both types of calculations. Conversely, mandating a different "value" for derivatives for purposes of diversification testing would require new systems to be built, with all of the attendant costs. We recognize, however, that there are limitations on the use of marked-to-market values, because they may not fully reflect the fund's economic exposure to a reference

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<sup>43</sup> In addition to this question, the Concept Release poses similar questions for the concentration and securities-related issuer tests.

<sup>44</sup> With respect to exchange traded derivatives and certain OTC derivatives, such as credit default swaps, the marked-to-market value effectively represents the value at which the derivative could be sold or otherwise transferred. With respect to swaps and similar instruments, the marked-to-market value reflects the extent to which the instrument is either in-the-money or out-of-the-money.

<sup>45</sup> The Concept Release suggests that, with respect to calculating a fund's economic exposure to a derivative's reference asset, the Commission could consider deviating from the definition of "value" in section 2(a)(41) based on section 2(a)'s introductory "unless the context otherwise requires" clause. This would be a significant step, and we strongly recommend that the Commission seek additional input before doing so. These are difficult questions, and the Commission would benefit from focusing on them more intently than in the context of the many issues raised in the current Concept Release.

asset on a derivative, and so may not represent the way in which an investor likely would view the fund's portfolio.<sup>46</sup>

Ultimately, we believe that any potential disparity is best addressed through disclosure. The purpose of the diversification and concentration tests is to inform shareholders of the character of the portfolio. The Commission could clarify that funds that use derivatives may need additional disclosure around the concept of diversification and concentration to appropriately explain the character of the portfolio.

#### IV. Counterparties

*Should counterparties to derivatives investments with funds be considered issuers of securities for purposes of the diversification requirements? [Question from page 55 of the Concept Release]*

By recommending that the diversification, concentration, and securities-related issuer tests focus on reference assets, we are not suggesting that counterparty exposures escape regulatory scrutiny. Rather, we strongly recommend that counterparty risk be dealt with separately, in a rule designed specifically for that purpose.<sup>47</sup> This recommendation stems from a recognition that the nature of counterparty risk is very different from investment risk in a fund's portfolio, and that the diversification, concentration, and securities-related issuer tests may not be the best or most appropriate way to regulate counterparty exposures.

We recognize that a rulemaking on this topic would be complex, and that the Commission would need to consider various options to address the ways in which counterparty exposures are different from investment exposures. Preliminarily, however, we would expect such a rule to address:

- ***The appropriate way to calculate counterparty exposure.***<sup>48</sup> Any counterparty rule would have to address the mitigating effect of collateralization, and the presence of any netting of a fund's exposures with a counterparty. As the ABA Task Force noted, advisers that use derivatives to a large degree increasingly are establishing collateralization protocols that require counterparties to post bankruptcy-remote collateral in respect of their obligations to the fund.<sup>49</sup>

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<sup>46</sup> See, e.g., Morningstar's valuation methodologies for derivatives, *supra* n.42.

<sup>47</sup> The ABA Task Force likewise recommended that the Commission adopt a new counterparty rule. See ABA Task Force Report, at page 33. We agree with the ABA Task Force that a new counterparty rule would likely be promulgated under section 12(d)(3). The vast majority of counterparties used by funds will be broker-dealers or other securities related issuers described in section 12(d)(3), and accordingly the section provides a useful statutory basis for the rulemaking.

<sup>48</sup> In terms of valuation, we believe the marked-to-market value is appropriate when calculating counterparty exposure, because it represents the amount that is owed to the fund on any particular day.

<sup>49</sup> ABA Task Force Report at 33. In the context of swaps and securities-based swaps that are not cleared, ICI has recommended that margin requirements, when imposed, should be bilateral, such that covered swap entities would be

Collateralization protects the fund and significantly reduces (and may, in some cases, practically eliminate) counterparty risks. The counterparty rule should take into account the mitigating effect of collateral on the potential for counterparty risk, particularly if the collateral is held in a bankruptcy-remote manner. It also should take into account the types of assets used for collateral, as the use of liquid assets other than cash, U.S. government securities, or other appropriate high grade debt obligations may warrant a discount in calculating counterparty exposure.<sup>50</sup> Finally, the rule should take account of the degree to which a fund and its counterparty net all of their exposures to one another. For many OTC derivatives, a fund and its counterparty may net their exposures, on a daily basis, with respect to multiple different positions. The rule should recognize this practice and address only a fund's net exposure to its counterparties.

- ***Set an appropriate limit on uncollateralized exposure to any one counterparty.*** Although we do not believe the best way to regulate counterparty exposures is through the diversification, concentration, and securities-related issuer tests, we believe a counterparty rule should establish a maximum limit on uncollateralized exposure to any one counterparty.<sup>51</sup> We would expect the Commission to seek comment on what that limit may be, and how it should be measured. In addition, the Commission could seek comment on the benefits and drawbacks to mandating the use of multiple counterparties in various contexts. In general, the use of multiple counterparties is desirable, although we note that there may be drawbacks to mandated over-diversification of counterparties in certain market environments (e.g., during extreme market conditions, where only a few counterparties may meet a fund's internal credit standards).
- ***Whether additional counterparty risk disclosure is warranted in certain contexts.*** The extent or nature of the derivatives used by certain funds may warrant additional counterparty risk disclosure.

We note that the implementation of Title VII of the Dodd-Frank Act will dramatically change the way swaps are traded, cleared, and settled. Implementing rules under that title would govern, among other things, initial and variation margin requirements for cleared and uncleared swaps and other terms

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required to post margin at the same levels and in the same manner as their counterparties. *See, e.g.*, Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated July 11, 2011, available at <http://www.ici.org/pdf/25344.pdf>. In other contexts, however, we have recognized that a bankruptcy-remote triparty collateral arrangement may not be warranted in every instance. *See, e.g.*, Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated August 8, 2011, available at <http://www.ici.org/pdf/25388.pdf> (supporting the model referred to as "Legal Separation With Commingling" as the most appropriate model for protecting the margin collateral posted by customers of cleared swap transactions).

<sup>50</sup> Funds also should consider the effect actual delivery of collateral may have on their portfolios in the event of a counterparty default.

<sup>51</sup> This was recommended by the ABA Task Force as well. *See* ABA Task Force Report, at n.64 and accompanying text.

central to counterparty and clearinghouse relationships. The Commission should carefully consider the protections provided by the Title VII rulemaking when designing a counterparty rule.

In this regard, we do not believe that central clearinghouses for OTC derivatives should be viewed as counterparties for these purposes. The Concept Release states that, in the case of exchange-traded derivatives that are cleared, the issuer of the derivative typically is the clearinghouse. It notes, however, that the staff did not object to the assertion that, in acquiring an exchange-traded option, a fund generally would not appear to be acquiring securities issued by, or an interest in, a securities-related issuer.<sup>52</sup> Although we recognize that the use of a central clearinghouse does not remove all risk to the fund, the primary purpose of the clearinghouse is to reduce and manage counterparty risk. As a result, the nature of the risks posed by clearinghouses are significantly different than those posed by uncollateralized exposures to other counterparties, and should not be covered by a counterparty-specific rule.

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We strongly commend the Commission for issuing this Concept Release and seeking input on the many complex issues raised by funds' use of derivatives. It is critically important that the Commission's rules and regulatory guidance work as intended when applied to derivatives, and serve the best interests of the more than 90 million investors in funds.

Recognizing the complexity of these issues and their importance, ICI is planning to host a forum in the coming months to discuss these issues in depth. We strongly believe that a wide range of perspectives provides tremendous benefit in this context, and accordingly we will seek to bring together policymakers, regulatory staff, outside counsel, and experts from funds' legal, compliance, risk management, accounting, and portfolio management areas to join that discussion.

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<sup>52</sup> See Concept Release, at 59 (citing *Institutional Equity Fund*, SEC Staff No-Action Letter (Feb. 27, 1984)).

Ms. Elizabeth Murphy

November 7, 2011

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We look forward to working closely with the Commission and its staff on these issues. If you have any questions or need additional information about the views we express in this letter, please contact Bob Grohowski at (202) 371-5430 or me at (202) 326-5815.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan  
General Counsel

cc: The Honorable Mary L. Schapiro  
The Honorable Elisse B. Walter  
The Honorable Luis A. Aguilar  
The Honorable Troy A. Paredes  
The Honorable Daniel M. Gallagher, Jr.

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