I. General Discussion of Derivatives

1) I take exception to the idea that ETFs should be exempt from whatever changes are required for mutual funds. As another generation of investors, institutional and individual, dies, ETFs will increasingly take over the market. Making rules for an industry that is losing out to a new industry will only hasten its demise. Mutual funds (especially open end funds) as the '40 Act conceived them are a dying instrument.

2) Valuation is key. The fact that classical open end funds must be marked to market at the end of the day (which used to take a while, in the mid-20th century, and now must be done within a half hour or less), along with the requirement that trading cannot occur until that value is determined, has always distinguished funds from issues which are traded on the spot. ETFs (although they are investment companies and thus subject to the '40 Act: http://www.sec.gov/answers/etf.htm) ARE traded on the spot and thus leave wide open spaces for derivative valuations to be off the mark.

3) The concept of valuing an OTC derivative, such as a credit default swap, at its nominal ("notional") value when the issuing organization is in default, then using funds borrowed from the government (TARP) to make the other side (the purchasers) completely whole, as was done in 2008, is ridiculous. As Gretchen Morgenson pointed out at the time, those who purchased the securities from the issuing organization (AIG, which was bankrupt) should have received exactly what the issuing organization could pay. If the issuer had insured its securities, then the insurer should have paid. There is no SIPC for OTC derivatives. If the SEC thinks there should be, then recommend that.

4) The applications of the '40 Act cited on p. 10 seem almost prescient. They should be applied directly to derivatives as if they had been written with derivatives in mind. Funds which use derivatives, including ETFs, should be clearly identified and separated from those which do not. Those instruments which use or ARE derivatives (VIX) should carry a warning like a pack of cigarettes. OTC derivatives should be distinguished, in this cautionary labeling, from traditional exchange-traded derivatives which are easily valued, such as put and call options on equity securities.

5) Buried on p. 16 is the phrase "the risk that…a rating agency will downgrade…." This epitomizes the problem with credit derivatives as a species of OTC derivatives. The recent downgrade of the U.S. government's credit by an agency illustrates the subjective nature of ratings. It also illustrates how very different OTC derivatives are from exchange-traded derivatives.

6) There are some intricate distinctions that must be made, such as that on p. 17 where covered calls and index futures are lumped together. The decision about whether a derivative is OTC or exchange-traded should be made on the basis of whether there is a ready a market for the derivative, making valuation easy. There should be some way for derivatives to change status from OTC to exchange-traded as they "mature."

II. Senior Securities

Segregation of accounts in BDCs, repurchase agreements, ABA Derivitives Report, VaR, etc. –not enough knowledge to have an opinion. HOWEVER, if funds are directed to adopt a sophisticated risk measurement method, they should be restricted to "sophisticated investors" by the definition of such an investor in the tax code.

The regulation of segregated accounts by various global exchanges gives excellent guidance for a rule that could, hopefully, become something like international accounting standards. A global standard should be the long-term goal for all securities regulation. (I remember Alan Greenspan remarking in a luncheon speech, in the early '80s that forex trading was going on around the clock throughout the globe with no regulation, and that it was not possible to regulate it. I was shocked, but everyone else just kept eating their chicken.)

III. Diversification

Unfortunately, the '40 Act's stipulation that valuation be as of the most recent quarter is so far out of sync with technology (and trading patterns) that it is simply inapplicable. A quarter is an eternity in today's trading time. Even if the valuation were set at the previous day, gigantic changes could throw the fund out of compliance in one day, let alone a quarter.

It's definitely a conundrum that a derivative can potentially leverage the value of a holding to above 5% while not, itself, having enough market value to raise the value of the underlying security. Classifying funds into those that do or do not hold certain types of derivatives (see above, "cigarette pack") may end up being a better indication to shareholders of the true nature of the security than the '40 Act's "diversified" label.

IV. Securities-related issuers

OTC derivatives were invented by securities-related issuers. The '40 Act should be interpreted literally (p. 59):

> "In the case of OTC derivatives, if a fund's counterparty is a securities-related issuer, the fund's transaction with the counterparty may represent the acquisition of a security issued by, or an interest in, that issuer "

If AIG was responsible for fulfilling its obligation in CDSs it issued to global banks, then a fund which may have invested on those CDSs would have lost money for shareholders

(had the U.S. taxpayers' money not bailed it out). The intent of the law should be the primary consideration.

I wonder here whether the '99 Financial Services Modernization Act and subsequent consolidation of securities issuers and banks dilutes the securities-issuing segment of an institution to under 15% in many cases, thus changing the intent of the '40 Act.

V. Industry concentration

Again, the days of large managed diversified funds (like Fido Magellan in its heyday) are probably limited. So many funds—index funds, ETFs, even derivative-only funds—are single-industry (or single "idea") funds from inception. This may be a problem that will solve itself.

VI. Valuation – See comments in General Section **I** above.

I wish to compliment the Commission on a thorough investigation into the issues and questions implied by the use and evolution of derivatives. If only it had come 20 years earlier….

You have given the industry much to chomp on, such as in this question on p. 45:

> "Would a formula combining the current mark-to-market value of a fund's derivative investments with a measure of potential future exposure based upon a percentage of the notional amount of its derivative contracts provide a more robust measure of risk than the notional amount or mark to-market value of the derivative?"

Realizing that the SEC's humanpower and budget are limited and will continue to be so, you have done a great job of detailing very complex issues in understandable, "plain English." Arthur Leavitt would be proud.