April 30, 2020

Via Electronic Submission:

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule Regarding Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (File No. S7-24-15)

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] and the Alternative Investment Management Association ("**AIMA**")[2] (together, the "**Associations**") are pleased to have the opportunity to provide comments to the U.S. Securities and Exchange Commission ("**Commission**" or "**SEC**") on its proposed rule on the "Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due

---

1 Managed Funds Association (**MFA**) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

2 AIMA is the global representative of the alternative investment industry, with more than 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council ("**ACC**") to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | www.managedfunds.org

Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles" ("**Proposal**").[3]

The Associations support the Commission's policy objective to limit excess speculation and protect investors. We appreciate that the Commission's Proposal is meant to provide additional certainty with respect to the use of derivatives by registered investment companies and business development companies (collectively, "**Funds**") under Section 18 of the Investment Company Act of 1940 ("**1940 Act**").

However, we disagree with the way the Commission has proposed to go about meeting that stated objective by setting the relative value at risk ("**VaR**") test as the default test for limiting Funds' use of derivatives. This proposed approach fails to account for actual Fund operations and the diversity of Funds in the marketplace. The Commission has tacitly insisted on the use of the relative VaR test as a complement to Fund derivatives risk management programs by setting the threshold for use of the absolute VaR test at a level that we believe is difficult to reach. We believe this is based on a flawed analogy to Section 18 and that the proposed approach also fails to account for the role of the rest of the derivatives risk management program and Fund disclosure in protecting Fund investors. We are also concerned that the thresholds at which the Commission proposes to set VaR limits are too low and could limit investors' choices unreasonably. To demonstrate the practical adverse impact of these choices, we note that had Proposed Rule 18f-4 (the "**Proposed Rule**") been in effect in the last few months (March and April 2020), it likely would have exacerbated market volatility and investor losses by forcing Funds out of positions in economically disadvantageous times and/or by prohibiting them from effectively managing risk through the use of derivatives. We believe that, in addition to protecting investors from undue speculation, the Commission should also protect the ability of investors to access a broad array of liquid and transparent investment options, which ability we think will be threatened by these and certain other aspects of the Proposal, as discussed in more detail herein.

We believe that with our recommended modifications, the Commission's Proposal could achieve the Commission's objectives in ways that would be simple to administer and enforce. We recommend that in a final rule the Commission:

- Provide Funds with flexibility in selecting either the absolute or relative VaR test to use with respect to their strategy;
- Raise the absolute and relative VaR test limits to at least 20% and 200%, respectively;
- Allow Funds to develop their VaR calculation models by using more data points than provided by the Proposal;
- Allow Funds that breach their VaR test seven calendar days to come back into compliance;
- Eliminate a "time out" period for a Fund to trade derivatives after a breach of its VaR test;
- Eliminate the sales practice rule for leveraged/inverse Funds; and
- Eliminate the Fund requirement to publicly report VaR-based limit breaches and derivatives exposures.

---

[3] 85 Fed. Reg. 4446 (Jan. 24, 2020) (the "**Proposing Release**").

I. Background

The Associations' members advise Funds that we anticipate will be adversely affected by the Proposal, including those that employ managed futures strategies, use derivatives to hedge against portfolio risks, and use derivatives to more efficiently achieve investment exposures. Managed futures Funds, for example, are strategies that seek returns from trading in futures and other derivatives. Many equity strategies use derivatives to hedge risk or to gain exposure efficiently to certain sectors or geographies. Some Fund futures strategies are volatility-targeting, meaning these Funds actively manage their leverage to try to ensure the Fund's portfolio remains close to the stated target. Still others are managed as absolute return Funds, meaning that they pursue stable, positive returns regardless of market movements while seeking to reduce risk. Investors use these Funds to diversify from equities, manage risk in gaining exposure to certain sectors and geographies, manage risk from volatile markets, and seek returns through all market conditions, among other reasons.

The Associations appreciate that the Proposal takes into consideration our prior comments to the Commission's 2015 proposed rulemaking to address the use of derivatives by Funds, and sets aside a notional-based leverage limit.[4] We appreciate that the Commission's efforts through rulemaking are meant to provide additional certainty with respect to Funds' use of derivatives and other transactions that may create leverage under Section 18. We are concerned, however, that the Commission's proposed VaR limit levels could impair Funds' ability to invest successfully and manage risk in their targeted strategies, make certain strategies unavailable to investors (*i.e.*, volatility-targeting strategies), and stifle innovation in Fund offerings as the Proposal will make it more difficult to offer more innovative Funds than those that track an index fairly closely or do not use derivatives. Overly restricting VaR limits on Funds will limit investment tools for investors to diversify their portfolio, manage risk and seek returns through different market and economic environments. As discussed below, the Associations provide recommendations to achieve the Commission's objectives in ways that would minimize impediments to the ability of investors to diversify their investment portfolio and manage risk through different market environments.

II. Recommendations on the VaR Limit Regime

A. Provide Funds with Flexibility in Electing the Relative or Absolute VaR Test

The Associations seek flexibility under a final Rule 18f-4 for Funds to choose the most appropriate VaR limit test under which to operate. Under the Proposed Rule, a Fund (other than a Fund eligible for the limited derivatives user exception, or for the alternative conditions for leveraged/inverse Funds, the latter discussed below) would be permitted to enter into derivatives transactions only if three conditions are satisfied: (i) the Fund adopts and implements a derivatives risk management program that includes compliance with requirements related to the Fund's derivatives risk manager and internal reporting and escalation of material derivatives risks; (ii) the Fund is in compliance with a limit on Fund leverage risk based on the Fund's VaR; and (iii) the Fund is in compliance with certain board oversight and Fund reporting requirements. The Associations support the first and third prongs of this test regarding various aspects of a derivatives risk management program, however, we have suggestions for improvements to the second prong.

[4] 80 Fed. Reg. 80884 (Dec. 28, 2015). *See* letter from MFA and AIMA to SEC on March 28, 2016, on SEC Use of Derivatives by RICs and BDCs, available at: https://www.managedfunds.org/wp-content/uploads/2020/04/MFA-AIMA-Comment-Letter-on-SEC-Derivatives-Proposed-Rule-Final-4.pdf.

With regard to the second prong, the Proposed Rule requires that as a default, Funds that are able to identify an unleveraged "designated reference index"[5] would be required to enter into derivatives transactions[6] such that the Fund's VaR would not exceed 150% of the VaR of the designated reference index. If, and only if, the derivatives risk manager cannot identify a designated reference index that is appropriate for the Fund taking into account the Fund's investments, investment objectives, and strategy, the Fund would be required to comply with the absolute VaR test, meaning the Fund's VaR could not exceed 15% of the value of the Fund's net assets.

Although we generally support the use of a properly calibrated VaR test as a means to limit Fund leverage risk, we strongly believe that Funds need to have the flexibility to choose the most appropriate test rather than only being permitted to use the absolute VaR test if an appropriate designated reference index cannot be identified for the reasons discussed below. The presumption in favor of the relative VaR test will only add uncertainty to the derivatives risk manager's decision-making and would needlessly increase the regulatory and compliance burden on Funds.

i. The Commission's Analogy to Section 18 Leverage Limits is Flawed

In our view, the Commission's justification for setting the relative VaR test as the default test by analogy to Section 18 limits on a Fund's leverage is flawed. Funds should have the ability to choose the most suitable VaR test for their strategy.

The Proposing Release states that the proposed requirements under the limit on Fund leverage risk are designed to limit leverage risk "consistent with the investor protection purposes underlying Section 18 and to complement the proposed risk management program." The Proposing Release cites to the Commission concern stated in Release 10666[7] that emphasized the undue speculation and asset sufficiency concerns underlying Section 18, and states that the Commission continues to believe that the senior security provisions of Section 18 should be a practical limit on the amount of Fund leverage and potential increase in the speculative character of the Fund's common stock, and that Funds should not operate without adequate assets or reserves. The Proposing Release states that a VaR test, "and especially one that compares a Fund's VaR to an unleveraged index that reflects the markets or asset classes in which the Fund invests," can be used to identify whether a Fund is using derivatives for leverage or for other reasons. The Commission proposed the relative VaR test "as the default means of limiting leverage risk because it

[5] The Proposed Rule would define the term "designated reference index" to mean an unleveraged index that is: (1) selected by the derivatives risk manager and that reflects the markets or asset classes in which the fund invests; (2) not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used; and (3) an "appropriate broad-based securities market index" or an "additional index," as defined in the instructions to Item 27 in Form N-1A. The Proposing Release and Proposed Rule contemplate that a fund may use more than one index for this purpose where relevant (a "**blended index**"). In the case of a blended index, the Proposed Rule provides that none of the indexes that compose the blended index may be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.

[6] A derivatives transaction would be defined to mean: (i) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument (derivatives instrument) under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and (ii) any short sale borrowing.

[7] *See* Release 10666.

resembles the way that [S]ection 18 limits a Fund's leverage risk." This and other statements in the Proposing Release suggest that the Commission's view is that the relative VaR test is more closely tied to Section 18 than the absolute VaR test.[8]

However, we believe that an analogy to the relative VaR test percentage limit for derivatives trading to the hypothetical VaR of a Fund engaging in bank borrowings has a tenuous connection to Section 18 at best. The Commission's assumption appears to be that a Fund that borrows the maximum amount permitted under Section 18(f) of the 1940 Act would have a VaR of 150% of the value of some hypothetical index that reflects the assets and markets in which it invests. However, the VaR of a Fund that borrows such an amount could be more or less than 150% of the VaR of its designated reference index depending on how it invests the borrowed amounts, unless the Fund invests those borrowed amounts in a passive manner that largely tracks its index. Accordingly, we do not believe that the relative VaR test, as compared to the absolute VaR test, is more closely tied to the method by which Section 18 of the 1940 Act limits leverage risk, and are requesting that the Commission allow Funds to determine which VaR test is most appropriate for their strategy.

ii. The Commission's Proposal to Set the Relative VaR Test as the Default Test Ignores the Role of Fund Disclosure in Setting Investor Expectations

In the Proposing Release, the Commission articulates the concern that a rule that would allow more Funds to rely on the absolute VaR test "may be inconsistent with investors' expectations where a designated reference index is available."[9] To illustrate this concept, the Commission cites to a short-term fixed income securities Fund positing that an investor in this type of Fund would expect the Fund to have a low level of volatility commensurate with the volatility of the markets or assets in which the Fund invests, namely bonds, but by using the absolute VaR test, that Fund could "substantially leverage its portfolio."[10] However, this Commission's position appears to ignore the role that Fund disclosure aside from a Fund's performance benchmark plays in educating investors regarding the risks that they will face in investing in the Fund. Funds can and do set investor expectations regarding the extent to which they trade derivatives through the registration statement drafting process.[11] The Commission's position also appears to disregard the range of different types of Funds that invest in the same universe of securities using different strategies. For example, a Fund that has a strategy to engage in long and short positions in relation to different components of an index would have an inherently different risk and return profile compared to a long-only Fund based on the same index. Each Fund could have very different relative VaR levels compared to the index. In the Commission's short-term fixed income securities Fund example, the Fund would disclose in its registration statement that it planned to use derivatives and the risks that such use could be expected to have on the

---

[8] The Proposing Release analogizes that the proposed 150% relative VaR test limit resembles the hypothetical VaR of a fund that obtains the full amount of bank borrowings permissible under Section 18(f) and has total assets equal to 150% of the fund's net assets. The Proposing Release states that such a fund's VaR would be approximately 150% of the VaR of the fund's designated reference index. Statements elsewhere in the Proposing Release describe that the Commission set the absolute VaR test at 15% of a fund's net assets with the intent of providing approximately comparable treatment for funds that rely on the absolute VaR test and funds that rely on the relative VaR test and use the Standard & Poor's ("**S&P**") 500 as their designated reference index during periods when the S&P 500's VaR is approximately equal to the historical mean.

[9] Proposing Release at 4471.

[10] *Id*.

[11] Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure of the SEC Division of Investment Management, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010), *available at* http://www.sec.gov/divisions/investment/guidance/ ici073010.pdf.

investor's investment. In another example involving a type of MFA member Fund, an investor in a volatility targeting Fund may have an even better understanding of the risks he or she faces in investing than an investor in a long-only equity Fund because the Fund's target volatility is stated in the Fund's prospectus. Furthermore, this justification has the potential to stifle innovation in Fund offerings as it will make it more difficult to offer more innovative Funds than those that track an index fairly closely or do not use derivatives. We are concerned the Proposal will limit the variety of Funds currently available to investors and limit product innovation in the future.

iii. The Commission's Concept of a Designated Reference Index Appears to Have its Origins in Unrelated Commission-Imposed Fund Disclosure Requirements Rather than the 1940 Act Itself

In addition, the concept of a designated reference index appears to originate from Fund disclosure requirements rather than the 1940 Act itself thus undercutting the Commission's position that a relative VaR test, which is based on a designated reference index, is more closely aligned with Section 18 of the 1940 Act. In setting the relative VaR test as the default test under the Proposed Rule, the Commission appears to build its analysis on the premise that the 1940 Act assumes that all Funds are benchmarked, that Fund investors expect benchmarked Funds and that therefore the relative VaR test with its comparison to a Fund's designated reference index should be the default because that test more closely aligns with the 1940 Act. We do not think this underpinning assumption is accurate. The definition of a designated reference index borrows heavily from the concept of a performance benchmark as defined in Form N-1A. It appears that the Commission has concluded that because Funds generally have a performance benchmark, they would also generally have a designated reference index. Today, Form N-1A, the Commission form that sets forth the required content of the disclosure in an open-end Fund's registration statement, requires that a Fund compare average annual total returns to a broad-based securities market index.[12] Although this is a disclosure requirement that applies to certain Funds, we are not aware of its origins being founded in a requirement set forth in the 1940 Act except in the broadest sense that Funds are required to have a registration statement.[13] The Commission did not introduce the requirement that a Fund compare its performance to that of an appropriate securities market index until its Form N-1A amendments in 1993. In the adopting release for those registration statement form amendments, the Commission stated it was following industry practice rather than stating that it was implementing a statutory imprimatur.[14] The assertion that a leverage-limiting test based off of a disclosure requirement is more closely grounded in Section 18 than an alternative test where that disclosure requirement has been in effect for a fraction of the time the 1940 Act has been is not borne out.

[12] Form N-1A, Item 4(b)(2)(iii).

[13] Section 8(b) of the 1940 Act.

[14] Disclosure of Mutual Fund Performance and Portfolio Managers, SEC Release No. IC-19832 (Apr. 6, 1993) ("However, as several commenters acknowledged, it is common practice for funds to include index comparisons in their annual reports and sales literature. To this extent, the adoption of this disclosure requirement is a codification of the disclosure practices of some funds. Moreover, comparisons are widely used by investment professionals in evaluating the performance of mutual funds, and are frequently used in the mutual fund industry as a means of measuring the compensation of portfolio managers and, in some cases, investment advisers to mutual funds.")

iv. Requiring One of the Two VaR Tests to be a Default Does Not Account for the Role of the Derivatives Risk Management Program in Protecting Investors

We also submit that the Commission's proposal to set the 150% relative VaR test as the default threshold test does not account for the appropriate role of derivatives risk managers in making the most informed decision for their Funds, and the role of the board in overseeing those decisions. If the presumption in favor of the relative VaR test were truly needed, that would greatly discount the role of derivatives risk managers and Fund boards in making good faith, informed decisions for their Funds. Furthermore, the presumption fails to account for the aspects of the derivatives risk management program that Funds will be required to have in place which will complement the Fund's management of its derivatives risk generally, including other types of risk that may be posed by a Fund's use of derivatives not addressed by either VaR test.

*   *   *

For all the foregoing reasons, Funds should not be limited in their ability to rely on the absolute VaR test. Accordingly, we recommend that the Commission provide Funds the necessary flexibility to determine whether to comply with the relative VaR test or the absolute VaR test based on each Fund's risk profile and investment strategy, regardless of whether a Fund can be benchmarked against a designated reference index.

B. Guidance Regarding the Absolute VaR Test

In the event that the Commission does not permit Funds to elect which VaR test with which to comply, the Fund industry needs further guidance on when it is appropriate for a Fund to use the absolute VaR test. As proposed, the guidelines for determining whether a designated reference index is available are vague. We are concerned that under the guidelines one could interpret a Fund as *needing* to select a designated reference index and to use the relative VaR test when in fact it would be most appropriate for the Fund to operate under the absolute VaR test. For example, a Fund may have an index against which it compares its own performance for disclosure and reporting purposes,[15] which is not its designated reference index.

In particular, our managed futures Fund members do not believe there exist unleveraged indices that accurately reflect the markets, asset classes, or ways in which they invest. They may, however, still use an index for benchmarking purposes. The two types of indices are not synonymous, and we believe it would be helpful for the Commission to acknowledge such. Explicit Commission guidance that the Commission would not expect managed futures Funds to be able to identify a designated reference index would assist these Funds with ensuring compliance with the right VaR test for the appropriate type of Fund. We also welcome further guidance from the Commission on the types of Funds expected to use the absolute VaR test. Such guidance would help derivatives risk managers make the appropriate determination for a Fund with less concern over disagreement with Commission staff on the availability of a designated reference index.

---

[15] See Form N-1A, Item 4(b)(2)(iii) and Instruction 6 to Item 27.

C. Change the Limits and Mechanics for Determining Compliance with VaR-Based Tests

i. Increase the Absolute VaR Test Limit to At Least 20% with a Conforming Increase to the Relative VaR Test Limit

The Associations contend that the absolute and relative VaR test limits should be raised to at least 20% and 200%, respectively. We believe that the Commission's Division of Economic and Risk Analysis ("**DERA**") staff analysis underestimates the real-world measure of the VaR of the S&P 500 index in two important ways, which has resulted in the Commission setting an unnecessarily low absolute VaR limit. As a result, the proposed 15% absolute VaR test would significantly constrain Funds subject to that test to a greater extent than the Commission has concluded. To avoid unintended consequences from this test, we request that the Commission increase its limit for the absolute VaR test to at least 20%.

We understand that part of the analysis that went into the Commission's conclusion that a 15% limit would be appropriate for the absolute VaR test was based on the DERA staff's finding that the historical mean (or average) VaR of the S&P 500 index from the index's inception in 1957 to June 2019 was approximately 10.4%.[16] As a result, the Proposing Release sets the absolute VaR test at 15% of a Fund's net assets in a manner that, based on DERA's analysis, would give significant space between the VaR experienced by the common S&P 500 benchmark and the Commission's outer bound VaR limit. The Commission also justified its selection of the 15% absolute VaR limit by suggesting comparable treatment for Funds that rely on the absolute VaR test and Funds that rely on the relative VaR test and use the S&P 500 as their designated reference index (*i.e.*, allowing the Fund to have roughly 1.5 times the historic mean VaR of the S&P 500 index). The Proposing Release then states that "there would only be a small number of Funds, if any, that would have to adjust their portfolios in order to comply with the VaR-based limit on Fund leverage risk," which clearly indicates that the Commission did not intend to cause Funds to change the way they implement their strategies in order to comply with the proposed limits.[17]

However, the DERA staff analysis the Commission relied on in the Proposing Release has two primary shortcomings. First, using the mean VaR calculation for the S&P 500 index ignores the significantly constraining impact that the limit would actually have on the S&P 500, and by analogy numerous Funds that are similarly not engaged in unduly speculative activities. Second, the analysis fails to account for the fact that the proposed VaR calculation has a disproportionately negative impact on certain types of Funds that target specific levels or ranges of volatility, which is the case for many managed futures strategies.

While the average calculation of the VaR of the S&P 500 index is a useful data point for consideration in setting the absolute VaR limit, it is not the metric associated with this index that should be considered. In fact, we believe that it may be more instructive to analyze the actual impact of a proposed limit on the S&P 500 index. In this way, the Commission would be able to consider the way that the absolute VaR threshold applies to a benchmark that is decidedly not unduly speculative, in order to determine how to set the appropriate outer bound limit. Our view is that this exercise should result in an absolute VaR limit that would not in fact constrain a common benchmark such as the S&P 500. We understand that the VaR of the S&P 500 index itself would have significantly exceeded the proposed 15% limit, rising above 20%

---

[16] Proposing Release at 4475 and n. 218. DERA staff calculated descriptive statistics for the VaR of the S&P 500 using Morningstar data from March 4, 1957 to June 28, 2019, based on daily VaR calculations, each using three years of prior return data and calculated using historical simulation at a 99% confidence level for a 20-day horizon using overlapping observations.

[17] Proposing Release at 4519.

absolute VaR for a multi-year period after the 2008-2009 financial crisis. Notably, this exceedance would have occurred during a lengthy period after the financial crisis when markets had stabilized and the index was not experiencing abnormal volatility. We do not believe that a test designed as an outer bound on undue speculation should reasonably limit a common benchmark such as the S&P 500, and find that by solely focusing on the average VaR of the S&P 500 index the Commission has proposed to set a limit that is far too low to stand the test of time and allow Funds to operate in a variety of market environments, including the current volatility brought on by the global COVID-19 health pandemic.

We also believe that the proposed absolute VaR limit should be raised to help account for the mismatch between the way that certain Funds operate, and the underlying assumptions built into the proposed VaR calculation. As noted above, many of our members operate Funds that target a specific volatility or range of volatilities. These strategies are disclosed to investors and may be chosen by investors seeking specific risk profiles from these investments. In order to achieve these volatility targets, these Funds adjust their position sizes based on volatility in the underlying markets. However, the proposed VaR calculation requires Funds to determine VaR by assuming constant positions throughout the entire look-back period for the test. For some Funds, this assumption is incompatible with their strategies.

As a result, the VaR calculation may give a misleading picture of Fund risk. In particular, during periods of low volatility that follow periods of high volatility, these types of Funds would have increased position sizes to target their disclosed volatility goals during a low volatility period, but the proposed VaR calculation would assume that these same position sizes would have been maintained during higher market volatility periods within the look-back period, despite the fact that these types of Funds would have actually held lower position sizes during more volatile market conditions. Thus, the VaR calculations for these Funds may appear meaningfully higher than the actual risk of these Funds during certain market environments. We believe that the Commission should account for the disproportionate impact of the proposed VaR calculation by increasing the absolute VaR limit to at least 20%, and increasing the companion relative VaR test to at least 200% in tandem.

ii. Adopt the UCITS Model for the Required Confidence Level and Time Horizon for VaR Calculation Models

The Commission should adopt, consistent with the UCITS model, a 95% confidence level that scales to 99% and a time horizon of 20 trading days. The Proposed Rule requires that any VaR model used by a Fund for purposes of determining the Fund's compliance with the applicable VaR test would have to, among other things, use a 99% confidence level and a time horizon of 20 trading days. Under this calculation methodology, a Fund's VaR results may be disproportionately impacted by a single observation. Depending on the market environment captured by the look-back period used for the analysis, the 99% confidence level could result in an unstable and imprecise VaR result that may not be the most reflective measurement of Fund risk. We think the Commission should adopt the UCITS model because using a 95% confidence level that scales up to 99% is a better measurement for risk, and years of experience with UCITS support this approach.

In order to account for these limitations inherent to a 99% confidence level VaR test, but still keep the robust VaR methodology desired by the Commission, the Commission should allow Fund derivatives risk managers to scale the confidence level. By allowing Fund derivatives risk managers to run a VaR test at a 95% confidence level and then scale those results to a 99% confidence level, the VaR measurement would be based on additional observations which may provide a more stable VaR result that better represents the risk in a Fund. At the same time, the result would still embody the same extremely high confidence level proposed by the Commission.

This method is used under the UCITS model and has worked well.[18] Absent robust evidence to support an alternative, the long standing UCITS model should be adopted. Moreover, many Fund managers, especially those operating managed futures Funds, also sponsor UCITS funds that trade in parallel to the U.S. domestic Funds. Today, it is possible for those Fund managers to manage these parallel portfolios in compliance with the 1940 Act and rules thereunder as well as the UCITS Guidelines. The Proposed Rule would reduce efficiencies and potentially increase operation costs borne by Fund investors. The Associations recommend that the Commission refine the Proposed Rule to allow Fund derivatives risk managers to run a VaR test at a 95% confidence level and then scale those results to a 99% confidence level, with a time horizon of 20 trading days.

iii. Extend the Period by Which A Fund Must Return into Compliance After a VaR Limit Breach and Eliminate the "Time Out" Period for New Derivatives Transactions

To better protect investors from needless disruption if a Fund exceeds its VaR test limit, the Commission should allow Funds seven calendar days to return to compliance. Under the Proposed Rule, if a Fund exceeds its VaR limit, the Fund would need to return to compliance with the VaR test within three business days. In such event, if the Fund is not in compliance with its VaR test within three business days, among other things, the Fund would be prohibited from entering into any derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the Fund's VaR) until the Fund has been in compliance with its VaR test for three consecutive business days. We are concerned that these two requirements would unnecessarily harm investors without benefit. We also anticipate that the draconian consequences of these proposed measures would cause Funds to put in place buffers in their VaR limit testing programs such that Funds would not be able to utilize the full extent of their VaR capacity, effectively imposing lower thresholds than those stated in the Proposed Rule. These potential harms far outweigh the Commission's concern regarding "gaming" the system,[19] and ignore other tools the Commission has for enforcing its limits on Fund VaR.

The Commission should allow a Fund that has exceeded its VaR test limit seven calendar days to come back into compliance. Rather than looking to the bank borrowings requirements in Section 18, this would more closely align with the test a Fund must already use to determine if an investment (including a derivatives investment) is illiquid.[20] Credit facilities generally contemplate and permit an immediate reduction in the outstanding amount of borrowings. If all derivatives could be terminated in the same manner as credit facilities, a three business day period could make sense. However, not all derivatives that Funds trade can be immediately liquidated. Funds may enter into uncleared, non-exchange traded swaps, which have different termination provisions than bank borrowings. Funds often negotiate optional termination provisions in their swap documentation for liquidity purposes, which allow them to terminate the swap and receive the proceeds of the trade within seven calendar days. Permitting a Fund seven calendar days to return to compliance with its VaR limit would allow Funds to exercise those negotiated provisions and better protect investors by preventing a Fund from having to exit certain derivatives trades at potential "fire sale" prices in order to avoid taking remediation steps under the Proposed Rule.

---

[18] *See* Committee of European Securities Regulators, *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (July 28, 2010), Section 3.6.1 (Calculation Standards).

[19] The Proposing Release states the concern that not having the three consecutive business day "time out" "could potentially lead to some funds having persistently high levels of leverage risk beyond that permitted by the applicable VaR test." Proposing Release at 4479.

[20] Rule 22e-4(a)(8) under the 1940 Act.

Requiring a Fund to exit a trade or trades in a shorter period of time than expected in order to avoid the required remedial steps would be disruptive to the Fund's trading and could result in an actual, booked substantial loss to Fund investors as compared to the theoretical risk for Fund investors of a VaR limit breach. It should also be noted that even futures markets and specific futures contracts at those markets can experience dislocations that might prevent a Fund from trading back below its applicable VaR limit for a period of time through no fault of the Fund. For example, futures exchanges have limits on how far a contract's price can move in a certain amount of time before trading is halted. Futures and options contracts can enter into a "limit up" or "limit down" band sometimes for days on end, making it impossible to trade out of positions.[21] Markets generally enter into "limit up" and "limit down" trading during market turbulence, which is also when Funds may exceed their VaR limit. We note that had the Proposed Rule been in effect during the last few months (March and April 2020), it likely would have exacerbated market volatility and investor losses by forcing Funds out of positions in inopportune times and/or prohibiting them to further manage risk through the use of derivatives.

Restricting the ability of a Fund to enter into certain derivatives transactions for the "time out" period after a breach of a certain amount of time could also be very disruptive to a Fund's investment strategy, leading to actual, booked trading losses. An example of where this requirement could go wrong is with regard to the futures roll. Futures contracts have a finite period that an investor can hold them before the contract expires. Futures contracts expire on a weekly, monthly or quarterly basis, for the most part. As a contract nears expiration and delivery, Funds holding a position long or short for a period longer than the contract period must "roll" those positions to the next nearby contract. This involves the off-set of the current contract and the opening of a position in the new contract for the same underlier. In addition, for position limit compliance purposes and to avoid the risk of having to take delivery of the contract underlier, Funds rarely trade in the "spot month" of a contract where position limits are tightest, looking to roll positions forward in advance of the beginning of that "spot month" period.

Were a Fund to find itself in the Proposed Rule's "time out" period on derivatives trades (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the Fund's VaR), it could be prevented from engaging in the rolling of its trades because those trades might not individually or in the aggregate reduce the Fund's VaR, but are a necessary step for the Fund to maintain its trading strategy. As discussed, we believe the "time out" period is likely to cause significant problems for Funds and their investors. The Commission has many other tools for preventing "gaming" including by requiring Funds to implement a derivatives risk management program and to provide reports to their board and the Commission as remediation measures. Accordingly, we recommend that the Commission eliminate the Proposed Rule's restriction on a Fund from entering into certain new derivatives transactions if it cannot return to compliance with the VaR test within three business days.

---

[21] A price limit is the maximum price range permitted for a futures contract in each trading session. When markets hit the price limit, different actions occur depending on the product being traded. Markets may temporarily halt until price limits can be expanded, remain in a limit condition or stop trading for the day, based on regulatory rules, *available at* https://www.cmegroup.com/trading/price-limits.html.

III. Eliminate the Sales Practices Rules for Leveraged/Inverse Funds

We are concerned with the precedent that the Proposal sets by introducing individual sales practice rules for investment products that the Commission may view skeptically despite other investor protection and sales practice rules already in place. As set forth in the Proposing Release, a Fund that is a "leveraged/inverse investment vehicle"[22] would not be required to comply with the limit on Fund leverage risk or to consider such derivatives transactions for purposes of computing asset coverage. Instead, a leveraged/inverse Fund would be required to: (i) disclose in its prospectus that it is not subject to the limit on Fund leverage risk, and (ii) not seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse return) of the underlying index. In addition, under the proposed sales practices rules, before a broker-dealer or investment adviser (collectively, "**firm**")[23] could accept an order from or place an order for a customer or client who is a natural person (or the legal representative of a natural person – together, a "**retail investor**") involving shares of a leveraged/inverse investment vehicle, the firm would have to (i) approve the retail investor's account for buying and selling shares of leveraged/inverse investment vehicles pursuant to a due diligence requirement, (ii) adopt and implement certain policies and procedures and (iii) make and maintain certain records. The due diligence requires a firm to "seek to obtain, at a minimum, certain information" regarding a retail investor's financial situation, investment objective and experience, and to "have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles" and "specifically to approve or disapprove" the retail investor's account to engage in such transactions based on all relevant facts and circumstances.

We are concerned that introducing sales practice rules for leveraged/inverse Funds sets an unnecessary precedent for the sale of individual investment products that are publicly traded securities. The Commission already has comprehensive investor protection standards through Regulation Best Interest ("**Regulation BI**") and its companion interpretive release, the investment adviser standard of conduct ("**Standard of Conduct**"). Creating additional qualification standards for public products will frustrate investors as well as complicate the purchasing process. It also would fundamentally change the framework for purchasing publicly traded securities by: (1) introducing different retail investor tiers; and (2) substituting the Commission's judgment of the riskiness of a product for the current rule-based disclosure regime.

At its core, one of the greatest strengths of the federal securities laws is that they do not form a regime of merit regulation: the Commission does not use its position to endorse or oppose investments. Rather, the regulatory regime imposes certain neutral, rule-based protections, fosters investor education and choice through a disclosure framework, and then allows investors to make informed investment decisions. Adopting the proposed sales practices rules would create a very different regime, beginning with the Commission's determination for the riskiness of products and the tiering of different levels of retail investors. We note that the FINRA regime for options accounts is an exception that proves the rule, because

---

[22] Under the proposed sales practices rules, a "leveraged/inverse investment vehicle" is defined as "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time." Note that this definition excludes trusts or funds that hold only commodities and currencies.

[23] The Proposing Release states that the term "firm" "collectively refers to Commission-registered broker-dealers and investment advisers" as well as "associated persons of such broker-dealers" and "supervised persons of such investment advisers."

(unlike leveraged/inverse Funds, which are investment companies, and virtually all other securities for which the most an investor can expect to lose is his or her investment), options trading presents a risk of unlimited loss.

Before importing and expanding a regime emulating the FINRA regulation of options accounts and imposing a form of merit regulation, we believe the Commission should allow the Regulation BI and Standard of Conduct regime to take full effect and then analyze whether investor understanding of leveraged/inverse vehicles warrant imposing a heavier-handed regulatory regime. We recommend that the Commission eliminate the sales practice rules for leveraged/inverse Funds.

IV. Eliminate the Public Reporting Requirement

The Commission should eliminate the Fund requirement to publicly report VaR-based limit breaches and derivatives exposures. The Proposal would require all Funds (except BDCs) subject to the limit on Fund leverage risk to report the Fund's derivatives exposure at the end of the reporting period and the number of VaR backtesting exceptions the Fund identified during the relevant reporting period on Form N-PORT. Information reported for the third month of a Fund's fiscal quarter on Form N-PORT would be made publicly available 60 days after the end of the fiscal quarter.[24]

Public reporting of exposure amounts and VaR backtesting exceptions, regardless of the magnitude of the Fund's derivatives exposure or number of exceptions, could cause confusion among investors who may not understand the relevance of or context for the data. For example, we believe that public reports of VaR test limit breaches for March or April 2020 or other periods could have exacerbated investor panic. The exposure reported would simply give investors access to a point-in-time, blunt notional figure for derivatives exposure (as adjusted under the definition for limited categories of derivatives). That figure would not differentiate between derivatives transactions used for hedging, used to obtain unleveraged investment exposure, or used to obtain leverage. The VaR backtesting information would not provide any indication to investors as to whether a Fund is adequately managing its derivatives risks or whether the reported exceptions are isolated instances that are not reflective of the Fund's overall risk profile.

In addition, while the time lag on which the information is reported is discussed in the Proposing Release as being protective of Funds, the time lag may also reduce or eliminate any potential value to be derived by investors from receiving information on derivatives exposure as of a single point in time. However, at the same time, the public reporting, even with proposed time lags, could reveal proprietary information about a Fund's strategy that its competitors could use. The Proposing Release did not cite any reason that derivatives exposure amounts should be publicly available, and merely notes in support of making certain VaR backtesting information public that such public disclosure would be delayed and would not provide any details other than the number of instances of an exceedance, and therefore would not produce adverse effects for the Fund. We disagree and believe that such disclosures would create unnecessary investor confusion and potentially reveal proprietary information about a Fund's trading. Instead of requiring information a Fund reports on Form N-PORT to be made public, reporting to the Commission and to a Fund's board should be adequate.[25] Accordingly, we recommend that the Commission eliminate the proposed requirement that a Fund publicly report VaR-based limit breaches and derivatives exposures.

---

[24] *See* Proposing Release at 4499-4503.

[25] *See* Proposed Rule 18f-4(c)(5).

We would be happy to have further discussions with the Commission and its staff regarding how best to achieve its goals regarding Fund use of derivatives.

****

We thank the Commission for the opportunity to provide comments on the Proposal. We would welcome the opportunity to schedule meetings with the Commission and its staff to discuss our responses and views in greater detail. Please do not hesitate to contact Jennifer Han, Associate General Counsel, MFA, at (202) 730-2600, or Jiří Król, Deputy CEO, AIMA, at (202) 919-4940 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,
Sincerely,

/s/ Jennifer W. Han

Jennifer W. Han
Associate General Counsel
MFA

/s/ Jiří Król

Jiří Król
Deputy CEO,
Global Head of Government Affairs
AIMA

CC: The Honorable Jay Clayton, Chairman
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner
Ms. Dalia Blass, Director, Division of Investment Management