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May 1, 2020

Ms. Vanessa A. Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street N.E.  
Washington, D.C. 20549-1090

**Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (Investment Company Act Release No. 33704 (November 25, 2019)): File No. S7-24-15**

Dear Ms. Countryman:

This letter is submitted by the Committee on Investment Management Regulation of the New York City Bar Association (the “Committee”) and responds to the request of the Securities and Exchange Commission (the “Commission”) for comment set out in Investment Company Act Release No. 33704 (November 25, 2019) (the “Release”). In the Release, the Commission repropoed Rule 18f-4 under the Investment Company Act of 1940 (the “1940 Act”) in seeking to provide an updated and more comprehensive approach to the regulation of the use of derivatives and similar financing transactions under the 1940 Act, by open-end and closed-end investment companies registered under the 1940 Act (other than open-end funds regulated as money market funds under Rule 2a-7) and business development companies (“BDCs”) (collectively, “funds”). The Committee is composed of lawyers with diverse perspectives on investment management issues, including attorneys from law firms and in-house counsel to financial services firms, investment company complexes and investment advisers.

**Summary**

The Committee agrees fully with the Commission’s goals underlying repropoed Rule 18f-4 (the “Proposed Rule”) of addressing the investor protection concerns underlying Section 18 of the 1940 Act and providing an updated and more comprehensive approach to the regulation of funds’ use of derivatives. The Committee also believes that the Proposed Rule generally represents a significant improvement – in terms

of clarity, ease of implementation and flexibility – over Rule 18f-4 as proposed in 2015.<sup>1</sup> The Committee nonetheless is of the view that certain aspects of the Proposed Rule could benefit from clarification or, in some cases, reconsideration. The Committee is submitting this letter to highlight these aspects of the Proposed Rule and to respond to certain questions asked by the Commission in the Release. In particular, as discussed in more detail in the remainder of this letter, the Committee believes that:

1. Board Oversight and Reporting. With respect to board oversight and reporting:
  - The Committee supports the Commission’s change from the 2015 Proposal and agrees that a fund’s board should not be required to approve the fund’s derivatives risk management program (“DRMP”), as the Committee believes that fund management is better positioned than a fund board to evaluate the complexities of a DRMP and that such a requirement would be inconsistent with the Commission and staff’s initiative to reduce the burdens already placed on fund boards. At the same time, the Committee agrees with the appropriateness of having a fund’s board oversee the activities of the fund’s derivatives risk manager (“DRM”), receive meaningful reporting from the DRM on the administration of the DRMP, and ask probing questions regarding the implementation and effectiveness of the DRMP.
  - The Committee believes the interrelation of the Proposed Rule with Rule 38a-1 should be clarified so as not to require fund boards to approve a DRMP under Rule 38a-1 or to require a fund’s chief compliance officer (“CCO”) to co-administer the fund’s DRMP with the DRM.
  - In the Committee’s view, in seeking its desired flexibility regarding the escalation of derivatives issues to a fund’s board, the Proposed Rule should make clear that the fund’s DRM may rely on his or her good faith determinations as to when it is appropriate to escalate an issue to the fund board.
2. Choice of VaR Limits. The Committee believes that it would be consistent with the purposes of Section 18 to permit funds to choose whether to comply with a relative VaR limit (i.e., a VaR limit measured in relation to a designated benchmark index) or an absolute VaR limit. The Committee believes that either approach would fulfill Section 18’s purpose of reducing the risks of leverage, and thus it would be consistent with Section 18 to permit funds to choose which approach to follow.
3. Clarification of Scope of Limited Derivative User Exemption. The Committee believes that the exemption contained in the Proposed Rule for funds that are Limited Derivatives Users (as defined below) should be clarified expressly to provide that Limited Derivatives Users are exempt from the board approval and reporting requirements under Proposed Rule 18f-4(c)(5). Such an exemption appears implicit in the exemption for Limited Derivatives Users, but the current language of the Proposed Rule seems ambiguous on this point.
4. Leveraged/Inverse Funds. The Committee believes that the alternative leverage restrictions for leveraged/inverse funds reflect a commendable approach, but we submit that it is unnecessary to impose the additional sales practice requirements contemplated by the Proposed Rule. The requirements are unnecessary because, among other reasons, (i) leveraged/inverse funds are subject to a comprehensive disclosure regime and (ii) an investment adviser’s fiduciary duties,

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<sup>1</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 28, 2015) (the “2015 Proposal”).

or a broker's obligations when making a recommendation, already offer sufficient protection for an investor investing in a leveraged/inverse fund on the advice or recommendation of the adviser or broker.

5. Treatment of Reverse Repurchase Agreements. In the Committee's view, reverse repurchase agreements and similar financing transactions should not be treated like bank borrowings in the final version of Rule 18f-4 adopted by the Commission (the "Final Rule"), but should instead continue to be subject to the asset segregation framework articulated by the Commission more than 40 years ago.<sup>2</sup> The Committee believes that reverse repurchase agreements and similar transactions are distinguishable from bank borrowings and that asset segregation has functioned well to limit the risks posed by such transactions. Alternatively, the Committee believes that, if the Commission repeals Investment Company Act Release No. 10666 ("Release 10666"), reverse repurchase agreements and similar financing transactions should be treated as derivative transactions under the Final Rule such that their use by a fund would be subject to the Final Rule's VaR limitations and other requirements.
6. Unfunded Commitment Agreements. The Committee generally supports the treatment of unfunded commitment agreements under the Proposed Rule. The Committee believes that unfunded commitment agreements generally do not give rise to the type of leverage risk that Section 18 was meant to regulate, and that such agreements should not be treated as "senior securities" within the meaning of the 1940 Act. The Committee generally supports the Commission's proposal to require funds to make asset sufficiency findings in connection with entering into unfunded commitment agreements, but believes funds should be able to determine their own factors for consideration, including access to cash through the issuance of equity securities.
7. Closed-End Funds and BDCs. The Committee believes that the Proposed Rule should be modified with respect to its application to closed-end funds and BDCs:
  - To allow closed-end funds (and BDCs) to incur more leverage than open-end funds, which would be consistent with the existing statutory framework.
  - So as not to limit the use of derivatives by closed-end funds (and BDCs) that are sold exclusively to "accredited investors" within the meaning of rules under the Securities Act of 1933 (the "1933 Act"), "qualified purchasers" within the meaning of the 1940 Act or "qualified clients" within the meaning of the Investment Advisers Act of 1940 (the "Adviser Act"), as these investors are capable of understanding the risks posed by derivatives.
8. Calculation of VaR. In the Committee's judgment, the Final Rule should make clear that, when calculating VaR, a fund may take into account not just directly offsetting positions, but also its overall portfolio composition.

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<sup>2</sup> Securities Trading Practices of Registered Investment Companies, Release No. IC-10666 (Apr. 18, 1979) ("Release 10666").

## 1. Board Oversight and Reporting

### a. The Final Rule Should Not Require a Fund's Board, or a Board Committee to Approve the Derivatives Risk Management Program or any Material Changes to the Program

The Commission asks in the Release whether it should require a fund's board, or a board committee, to approve the fund's DRMP or any material changes to the DRMP. For the reasons noted below, the Committee supports the Proposed Rule's not including such a requirement.

The Proposed Rule would require, among other things, that a fund's board approve the designation of the fund's DRM who would be responsible for administering the fund's DRMP and would require the DRM to provide regular written reports to the board regarding, among other things, the DRMP's implementation and its effectiveness. The Committee appreciates the benefits of the requirement but believes that a board or a board committee should not be needed to approve the DRMP or any material changes to the DRMP. The Committee believes that the appropriate role for a fund board is oversight of the adviser's investment management process, including the use of derivatives, and that the board should not be required to take on a management role. Oversight should not mean that directors have to approve the DRMP, which is part of the investment management function. The Proposed Rule specifies that the DRMP should be tailored to a fund's use of derivatives in developing its investment portfolio. The DRMP would also have to include stress testing, backtesting, internal reporting and escalation, and program review elements. All of these components of the DRMP are technical and market-driven, and require relevant experience regarding derivatives risk management and are best dealt with by the DRM, who will have the technical expertise in understanding the unique risks that derivatives can pose to a fund. In short, the DRM, not a fund board, would be in the best position to approve the DRMP and any related material changes to it.

The Committee agrees with the appropriateness of having a board oversee the DRM's activities, receive meaningful reporting from the DRM on the administration of the DRMP, and ask probing questions regarding the implementation and effectiveness of the DRMP. A board should not, however, in the Committee's judgment, be placed in a position in which it is second guessing the determination of the DRM, a person who would seem is best positioned to understand and, together with the fund's portfolio manager(s), address unique risks associated with investing in derivatives. As previously noted in an American Bar Association task force report on fund's use of derivatives, a board's role is one of "oversight" and "directors should not be required to cross the line to micro-manage a fund's use of derivatives."<sup>3</sup> The Committee further agrees with the view expressed in the ABA Report that board oversight of derivatives "should not create any new or different responsibilities for a board."<sup>4</sup>

The Committee also believes that requiring board approval of the DRMP or changes to it may unnecessary impede efficient management of a fund and its derivatives transactions. If the DRMP needs, for instance, to be revised or updated to reflect market activity or developments, the DRM should be able to do so promptly without the need to seek and obtain board approval.

The Committee appreciates that the Commission and the staff have recently made significant strides in their initiative to review and reevaluate the responsibilities of fund directors and when appropriate, modernize the regulatory responsibilities of fund directors.<sup>5</sup> In 2017, Dalia Blass, Director of Division of

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<sup>3</sup> Report of the Task Force on the Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) (the "ABA Report") at 46.

<sup>4</sup> *Id.* at n. 30.

<sup>5</sup> Letter from Amy B.R. Lancellotta, IDC Managing Director, to Dalia Blass, Director, Division of Investment Management, SEC (Oct. 16, 2017), available at <https://www.ici.org/pdf/30912a.pdf>.

Investment Management announced the Division’s new “Board Outreach Initiative,” which was aimed at “reviewing and reevaluating what [the staff] ask[’s] fund boards to do.” Ms. Blass noted that the “list of responsibilities has grown significantly in 77 years” for fund boards.<sup>6</sup> Following the announcement of the Board Outreach Initiative, the staff issued two no-action letters<sup>7</sup> that, in our view, represent a modernized approach on how fund directors can fulfill their regulatory responsibilities. In the Committee’s mind requiring board approval of the DRMP and any material changes to the DRMP would undermine the progress the Commission and its staff have made in articulating the scope of director oversight and as noted above, would place on boards responsibilities that are best suited for fund management.

#### **b. Clarification of the Interrelation of the Proposed Rule with Rule 38a-1**

The Committee believes that the interrelation of the Proposed Rule with Rule 38a-1 under the 1940 Act should be clarified. Rule 38a-1 requires, among other things, that a fund’s board of directors approve the fund’s compliance policies and procedures and that a fund’s CCO administer the fund’s compliance program. The Proposed Rule does not require a fund board to approve the fund’s DRMP (see section 1.a “Board Oversight and Reporting” above) and requires the DRMP to be administered by the fund’s DRM, but at the same time the Release states that “Rule 38a-1 would encompass a fund’s compliance obligations with respect to proposed Rule 18f-4.”<sup>8</sup> This statement, and other references in the Release to Rule 38a-1, could be read to mean that a fund’s DRMP must be approved by the fund’s board under Rule 38a-1 and that a fund’s CCO would share responsibility for the implementation and oversight of the funds DRMP with the fund’s DRM.

As discussed above, the Committee believes that a fund’s DRMP should not need to be approved by the fund’s board because, among other things, the the board would likely lack the technical expertise to assess the adequacy of the program. The Committee believes similarly that a fund’s CCO should not have responsibility for the administration of the fund’s DRMP, as the DRM will have a technical expertise in derivatives that, in the experience of the Committee’s members, typical CCOs would not. Imposing on the CCO – whether directly or indirectly – responsibility for overseeing the DRMP and/or the DRM effectively requires the CCO to exercise portfolio management oversight. This amounts to a significant expansion of the CCO’s responsibilities as contemplated under Rule 38a-1. For these reasons, the Committee believes that the Final Rule should clarify the interrelation of the Proposed Rule with Rule 38a-1 and, in particular, should make clear that Rule 38a-1 does not require a fund’s DRMP to be approved by the fund’s board or the fund’s CCO to administer the DRMP, which should be the responsibility of the DRM alone.

#### **c. Derivatives Risk Manager Should be Subject to a “Good Faith” Standard for Risk Escalation**

Proposed Rule 18f-4(c)(1)(v)(B) requires the DRM to escalate material risks arising from a fund’s derivatives transactions to the fund’s portfolio managers and to the fund’s board, “as appropriate.” As explained in the Release, Proposed Rule 18f-4(c)(1)(v)(B) does not require a DRM to escalate material risks to the board automatically, and was intended to provide flexibility for the DRM to communicate directly with the board in circumstances in which the DRM determines board escalation to be appropriate. The Proposed Rule was intentionally flexible on this point because, as the Commission said in the Release, “[w]e believe that a fund’s [DRM] is best positioned to determine when to appropriately inform the fund’s portfolio management and board of material risks.”<sup>9</sup> The Committee agrees that the DRM should have the

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<sup>6</sup> Dalia Blass, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017), available at <https://www.sec.gov/news/speech/blass-keynote-icisecurities-law-developments-conference-2017>.

<sup>7</sup> Independent Directors Council, SEC Staff No-Action Letter (Oct. 12, 2018); Independent Directors Council, SEC Staff No-Action Letter (Feb. 28, 2019).

<sup>8</sup> Release at 81.

<sup>9</sup> *Id.* at 74.

flexibility to determine when it is appropriate to escalate a material risk to the fund's board. Nonetheless, because such determination is subjective, and different DRMs may come to different conclusions on this point, the Committee believes that, the Commission's release announcing and describing the Final Rule, should make clear that a DRM may rely on its good faith judgment in determining when board escalation is appropriate. Making clear that the Commission will respect a DRM's good faith judgment in this respect will help empower DRMs to exercise the escalation flexibility intended by the Proposed Rule and prevent fund boards from being overburdened with unnecessary escalations.

## **2. Permitting Funds to Choose the Relative VaR Test or Absolute VaR Test Would be Consistent with Section 18**

Under Proposed Rule 18f-4(c)(2)(i), a fund would be required to comply with a relative VaR test or, if the DRM is unable to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objective(s) and strategies, an absolute VaR test. Under the relative VaR test, the VaR of a fund's portfolio could not exceed 150% of the VaR of its designated reference index (the "Relative VaR Test"). Under the absolute VaR test, the VaR of a fund's portfolio could not exceed 15% of the value of the fund's net assets (the "Absolute VaR Test"). The Commission requested comment on, among other things, whether this condition should permit a fund to choose which VaR test to comply with regardless of the DRM's ability or inability to identify a designated reference index. If so, the Commission sought comment on whether this would be consistent with Section 18.<sup>10</sup>

The Committee believes that DRMs should be permitted to choose, as provided in their DRMPs, whether and when their funds comply with a Relative VaR Test or an Absolute VaR Test. Such an approach would be consistent with Section 18.

Section 18 (and, for BDCs, Section 61) of the 1940 Act limits the extent and the means by which funds may borrow or issue senior securities for the purpose of employing investment leverage. Congress included Section 18 to seek to limit "the extreme dangers" to which a fund's common shareholders are exposed in a leveraged structure. The legislative history of the 1940 Act noted that "[t]he volatility of the common stock of leverage investment companies accounts for a considerable part of the losses sustained by investors." To address these concerns, the 1940 Act included provisions such as Section 18 to seek to limit undue increases in the speculative character of a fund's junior securities that occur when a fund engages in excessive borrowing and the issuance of excessive amounts of senior securities. The Committee submits that if either a Relative VaR Test or an Absolute VaR Test would be consistent with Section 18, permitting a fund to comply with either at its discretion would be consistent as well. The 1940 Act's legislative history indicates that Congress adopted Section 18 in part to limit the considerable losses that may be experienced by a fund's common shareholders due to the share price volatility that results from a leveraged capital structure. The Committee submits that it would be consistent with this Congressional intent to allow a DRM to choose which VaR test most appropriately measures a fund's volatility in the context of its particular investment strategy.

Permitting a DRM to choose which VaR test to comply with for each fund under his or her supervision would allow a global asset manager to more closely align risk testing across its product line. As a practical matter, many asset managers operate global businesses that must comply with various regulatory regimes. In the European Union, the Committee of European Securities Regulators ("CESR") Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS govern the risk measurement and the calculation of global exposure and counterparty risk for public

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<sup>10</sup> *Id.* at 117.

investment companies offered in Europe (the “UCITS Guidelines”).<sup>11</sup> The UCITS Guidelines recognize that the effectiveness of a VaR test depends on various factors, such as a fund’s investment objective, which the fund’s adviser is best positioned to determine. The UCITS Guidelines make the UCITS responsible for deciding which VaR approach is the most appropriate methodology given the risk profile and investment strategy of the UCITS. The UCITS must be able to demonstrate that the VaR approach it utilizes is appropriate and must fully document its underlying assumptions. If the Commission were to adopt a similar approach it would allow global asset managers to streamline their risk management programs and more closely tailor their VaR tests to the risks and objectives of each fund, which would further the Congressional goal of seeking to limit the volatility of a fund’s common shares that can result from a leveraged capital structure.

We submit that requiring a fund to use a Relative VaR Test unless the DRM is “unable to identify” a designated reference index would create an ambiguous standard that could be applied arbitrarily. Neither the Release nor the Proposed Rule clearly defines what “unavailable” means in the context of identifying a designated reference index. This lack of a definition would seem to put the DRM in a difficult position of needing to determine the point at which an appropriate reference index is (or becomes) unavailable for use and could lead to potential second guessing of the DRM’s decision. Moreover, the definition of “designated reference index” in the Proposed Rule appears to be overly broad. The Proposed Rule states that a designated reference index must either be an appropriate broad-based securities market index or an “additional index” within the meaning of Form N-1A. For funds that seek absolute return, an additional index may exist that reflects markets or asset classes in which the fund invests, but such an index may not be an appropriate index for the fund due to differences in volatility, asset class weightings, short exposures and/or capacity constraints, among other factors. A DRM should be permitted to select the VaR test that is most appropriate for a fund’s investment objective, strategy, and risks .

The Committee believes that the Final Rule should provide the DRM with flexibility to determine whether to use a Relative VaR Test or an Absolute VaR Test, and to construct a designated reference index that, while objectively determined, is deemed suitable to the fund’s purposes. In such a case, DRMs would be able to tailor their firm’s risk programs to each fund and its specific investment objectives and strategies. Such a change would be consistent with the UCITS regime under which global fund managers currently operate. The Commission should consider the experience of global fund managers when adopting the conditions of the Final Rule.

### **3. Limited Derivatives Users Should Clearly be Excepted from Proposed Rule 18f-4(c)(5)**

Proposed Rule 18f-4(c)(3) expressly exempts a fund that meets the limited derivatives user requirements (a “Limited Derivatives User”) from paragraphs (c)(1) and (c)(2) of the Proposed Rule (*i.e.*, the requirement to adopt a DRMP with the elements set out in paragraph (c)(1), and the fund leverage risk limits set out in paragraph (c)(2)). The exemption does not, however, expressly state that Limited Derivatives Users would not be subject to the requirements under paragraph (c)(5) of the Proposed Rule. The Committee believes that the lack of such a statement may reflect a drafting oversight because the board approval and reporting requirements under paragraph (c)(5) relate to the elements of the DRMP required under paragraph (c)(1), from which a Limited Derivative User is exempt. If a Limited Derivatives User is exempt from the DRMP requirements under paragraph (c)(1), then it seems implicit that such Limited Derivatives User also would be exempt from the required board approval and reporting related to such requirements. The Committee believes that expressly exempting Limited Derivatives Users from paragraph (c)(5) would eliminate any uncertainty in this regard, would be consistent with the intended purpose of

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<sup>11</sup> CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788 (July 28, 2010), available at [https://www.esma.europa.eu/sites/default/files/library/2015/11/10\\_788.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf).

Proposed Rule 18f-4(c)(3) and would further the Commission’s policy goal of eliminating burdensome compliance costs for Limited Derivatives Users that may be disproportionate to the risks and impact of limited derivatives use.

#### **4. The Committee Supports the “Alternative Provision” for Leveraged/Inverse Funds, but Believes the Proposed Sales Practice Rules are Unnecessary**

The Committee supports the Proposed Rule’s “alternative provision” for leveraged/inverse funds (“L/I funds”), which, in the experience of the Committees’ members, serve a useful investment function.<sup>12</sup> We agree with the Commission regarding the parameters of the alternative provision,<sup>13</sup> but we strongly believe that it should not be conditioned on the adoption of the proposed sales practice rules for L/I funds (the “PSPR”) described in the Release. The Committee certainly recognizes the crucial need for investors to understand the risks involved with L/I funds, but we believe that need would be best addressed through the existing regulatory framework established by the Commission and the Financial Industry Regulatory Authority, Inc. (“FINRA”), which we submit has been shown to be effective in regulating L/I funds and the distributors that sell them. In our view, the PSPR would not provide additional benefits of consequence to many investors and could jeopardize the continuing existence of funds that the Commission appears to believe can be an appropriate investment choice for at least some investors. For these reasons, the Committee believes the PSPR should not be adopted.

In our view, L/I funds are subject to an “extensive regulatory regime”<sup>14</sup> that requires these funds to disclose their principal risks and allows shareholders to challenge the adequacy of the disclosure.<sup>15</sup> L/I fund investors have, in the experience of the Committee’s members, utilized this right to remedy instances when L/I funds have allegedly failed to disclose their risks, including the “unique”<sup>16</sup> risk arising from holding L/I funds over longer time periods.<sup>17</sup> The existing regulatory framework thus protects L/I fund investors by acting to ensure that L/I funds face a “penalty for failure to tell the truth.”<sup>18</sup> In short, the framework

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<sup>12</sup> L/I funds “are designed to hedge against or profit from short-term market movements without using margin.” Release at 177.

<sup>13</sup> The Committee agrees that L/I funds should be exempt from the Proposed Rule’s VaR tests if L/I funds: (1) seek, at most, to obtain 300% of the return (or the inverse) of the underlying index; (2) disclose their increased use of leverage; and (3) otherwise comply with the Proposed Rule, by among other things, instituting derivatives risk management programs. *See id.* at 200. The Committee recommends that such programs restrict L/I funds from using leverage for purposes unrelated to seeking the fund’s designated multiple of its underlying index.

<sup>14</sup> *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429, 434 (S.D.N.Y. 2003). In contrast, investors engaging in options trading under the framework from which the PSPR are drawn, *see* Release at 183, only receive “generalized explanatory information” drafted by an options market that addresses, among other things, the “risks involved.” *See* FINRA Rule 2360(a)(12); *see also id.*, at 2360(b)(11) (investors only receive such disclosure when their account is approved for options trading and when the disclosure is amended).

<sup>15</sup> *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983) (noting Section 11 under the 1933 Act “was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.”).

<sup>16</sup> Release at 178.

<sup>17</sup> *See, e.g., Rafton v. Rydex Series Funds*, No. 10 CV 01171, 2011 WL 31114 (N.D. Cal. Jan. 5, 2011) (rejecting motion to dismiss when the L/I fund prospectus “did not specify that the [L/I fund] was only appropriate for investors who thought the value of the 30-year Treasury Bond would fall *that day*” and ultimately resulting in a class action settlement) (emphasis in original); *In re Direxion Shares ETF Trust*, 279 F.R.D. 221 (S.D.N.Y. 2012) (same).

<sup>18</sup> William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171, 173 (1933) (noting the 1933 Act creates an “*in terrorem*” effect by providing for actionable fund disclosure).



contributes to L/I fund investors – and their distributors – being able to benefit from reliable L/I fund disclosure.<sup>19</sup>

L/I fund disclosure is, in turn, integral to distributors of L/I funds, which can only recommend purchases of L/I funds in accordance with standards of conduct<sup>20</sup> that the Commission and FINRA regularly enforce.<sup>21</sup> Indeed, distributors must, on a transaction-by-transaction basis, consider the nature of both the client and a particular L/I fund before concluding that the two are an appropriate match. The Committee thus believes that the PSPR – which only require distributors to reasonably conclude that an investor generally understands the risks associated with L/I funds, but not with respect to a particular L/I fund – do not represent an improvement over the existing regulatory framework.

Taken together, the existing regulatory framework’s ability to regulate L/I funds and their distributors explains why the Commission has long recommended that investors heed L/I fund prospectuses and cautioned distributors to abide by their obligations when selling L/I funds.<sup>22</sup> The Committee agrees with this approach and, as a result, believes that the alternative provision for L/I funds need not include the PSPR to address investor protection concerns.

We also offer additional points for the Commission’s consideration regarding the PSPR and their application to specific types of accounts and financial advice.

#### **a. The PSPR Should Not Apply to Discretionary Accounts**

The Committee believes that the PSPR should not apply to an advisory account with respect to which a client delegates investment discretion to a registered investment adviser (“Discretionary Account” managed by “Discretionary Adviser”). We believe that the PSPR are superfluous for Discretionary Accounts because a Discretionary Adviser’s fiduciary duty already requires that adviser to consider whether

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<sup>19</sup> The Commission recently noted that L/I fund prospectuses “warn that over periods longer than a day, the results of single-inverse ETFs very likely will diverge from the inverse of the underlying index” and faulted a dual registrant that failed to supervise representatives who ignored them. *See* In the Matter of Wells Fargo Clearing Services, LLC, Release No. 34-88295, at 4 (Feb. 27, 2020) (“Wells Fargo Order”). Courts have also found L/I funds capable of disclosing their risks. *See, e.g., In re ProShares Trust Sec. Litig.*, 728 F.3d 96, 103 (2d Cir. 2013) (affirming dismissal when L/I fund’s “disclosures, fairly read, put investors on notice that an ETF’s value might move in a direction quite different from and even contrary to what an investor might otherwise expect” if the shares were held longer than a day); *Elite Aviation LLC v. Credit Suisse AG*, 588 F. App’x 37, 38 (2d Cir. 2014) (affirming dismissal where leveraged exchange-traded note disclosure included “resounding theme . . . that the ETNs are unsuitable for any investment period longer than a single day”).

<sup>20</sup> *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019) (“IA Conduct Release”); Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019) (“Reg BI Release”).

<sup>21</sup> *See, e.g.,* Wells Fargo Order, *supra* note 19 (requiring remediation and instituting \$35 million penalty when dual registrant’s representatives did not heed L/I fund disclosure when recommending L/I funds); Release at 179-80 (collecting actions brought by the Commission and FINRA).

<sup>22</sup> *See, e.g.,* Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors (Aug. 1, 2009) (“The best form of investor protection is to clearly understand leveraged or inverse ETFs before investing in them. No matter how you initially hear about them, it’s important to read the prospectus, which provides detailed information related to the ETFs’ investment objectives, principal investment strategies, risks, and costs.”); *See id.* (“You should also consider seeking the advice of an investment professional . . . who understands your investment objectives and tolerance for risk. Your investment professional should understand these complex products, be able to explain whether or how they fit with your objectives, and be willing to monitor your investment.”) (citing FINRA Regulatory Notice 09-31, Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds (June 2009)).

a particular L/I fund is appropriate for its client in light of the client's investment objective and financial situation, among other factors.<sup>23</sup>

We submit, moreover, that the plain text of the PSPR belies their application to Discretionary Accounts. The PSPR require a distributor to reasonably believe “that the [*investor*] has such knowledge and experience in financial matters that *he or she* may reasonably be expected to be *capable* of evaluating the risks of *buying and selling* [L/I funds].”<sup>24</sup> In other words, the PSPR ask whether an investor can evaluate L/I funds when making an investment decision. Discretionary Accounts, however, rely on Discretionary Advisers to make investment decisions, which makes the PSPR inapposite. Applying the PSPR to Discretionary Accounts would also seem to defeat the purpose of such an account, which is to allow a client to rely on the skill and experience of the Discretionary Adviser.

The legal principles underpinning the relationship between a Discretionary Adviser and a client, which is one of principal and agent,<sup>25</sup> further counsel against adopting the PSPR. Not only does an agent have to act in the best interests of his or her principal,<sup>26</sup> but a principal under well-settled law also is deemed to have knowledge obtained by an agent acting within the scope of their relationship.<sup>27</sup> A Discretionary Adviser's knowledge regarding the risks applicable to L/I funds is thus imputed to the client.

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<sup>23</sup> An investment adviser's fiduciary duty to its client “means the adviser must, at all times, . . . provide investment advice in the best interest of its client, based on the client's objectives” and a “reasonable investigation into” the investment product being recommended. IA Conduct Release at 8, 16. The Commission has described how this fiduciary duty applies to L/I funds. *Id.* at 16 (“complex products such as [L/I funds] that are designed primarily as short-term trading tools for sophisticated investors may not be in the best interest of a retail client absent an identified, short-term, client-specific trading objective and, to the extent that such products are in the best interest of a retail client initially, they would require daily monitoring by the adviser.”). As a result, the PSPR are unnecessary where an existing fiduciary duty already requires an investment adviser to determine an L/I fund is, and remains, in the best interest of a client. *See, e.g., Wells Fargo Order, supra* note 19, at 7 (finding violations under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), when advisers “did not understand the risks of holding these products long term, did not adequately explain the risks to their clients, and were not themselves closely monitoring the positions”).

<sup>24</sup> Release at 415, 443 (emphasis added).

<sup>25</sup> “An agent is a person authorized by another to act on his behalf under his control.” *Proctor & Gamble Co. v. Haugen*, 222 F.3d 1262, 1278 (10th Cir. 2000) (citation omitted); *see also, e.g., Sabel v. Mead Johnson & Co.*, 737 F. Supp. 135, 138 (D. Mass. 1990) (citing Restatement (Second) of Agency §§ 12- 14 (1958) (“An agency relationship has three essential characteristics: (1) the power of the agent to alter the legal relationship between the principal and third parties and the principal and himself; (2) the existence of a fiduciary relationship toward the principal with respect to matters within the scope of the agency; and (3) the right of the principal to control the agent's conduct with respect to matters within the scope of the agency.”). This aptly describes the relationship between a Discretionary Adviser and a client, where the parties contractually define the scope of the Adviser's discretion, including any restrictions that the client wishes to place on the Adviser. *See, e.g., IA Conduct Release* at 9 (“The fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent.”) (citation omitted).

<sup>26</sup> *See Sokoloff v. Harriman Estates*, 96 N.Y.2d 409, 416 (2001) (“fundamental to the principal-agent relationship ‘is the proposition that an [agent] is to be loyal to his [principal] and is ‘prohibited from acting in any manner inconsistent with his agency or trust and is at all times bound to exercise the utmost good faith and loyalty in the performance of his duties’”) (quoting *Western Elec. Co. v. Brenner*, 41 N.Y.2d 291, 295 (1977) (quoting *Lamdin v. Broadway Surface Adv. Corp.*, 272 N.Y. 133, 138 (1936))).

<sup>27</sup> *See Apollo Fuel Oil v. United States*, 195 F.3d 74, 76 (2d Cir. 1999) (“In general, when an agent is employed to perform certain duties for his principal and acquires knowledge material to those duties, the agent's knowledge is imputed to the principal”) (citing Restatement (Second) of Agency §§ 9(3), 268, 272, 275 (1958)); *see also West Haven v. United States Fid. & Guar. Co.*, 174 Conn. 392, 395 (1978) (“It is the general rule, settled by an unbroken current of authority, that notice to, or knowledge of, an agent while acting within the scope of his

Notably, the Commission’s staff did not object to these agency law principles when they were cited to in “no-action” and interpretive requests that made it possible for Discretionary Advisers to cease delivering Form ADV Part 2 brochures and prospectuses to clients.<sup>28</sup> Just as the Commission’s staff recognized that it is reasonable for clients to direct such disclosure to their Discretionary Adviser, it is likewise reasonable for clients to direct fiduciaries to rely on their own skill and experience as opposed to reverting to those of the client.

#### **b. The PSPR Need Not Apply to Recommendations of L/I Funds**

The Committee believes that the PSPR should not apply to recommendations to purchase L/I funds. First, for the reasons stated above, we believe that the fiduciary duty owed by an adviser to its client appropriately regulates recommendations of L/I funds, including recommendations made in advisory accounts with respect to which a client has not delegated investment discretion to a registered investment adviser.<sup>29</sup>

We agree with Chairman Clayton, with respect to recommendations made in connection with brokerage accounts, that Regulation Best Interest (“Reg BI”) “substantially enhances [broker-dealer] obligations beyond the current ‘suitability’ requirements.”<sup>30</sup> The Commission has recently accepted that the current standard can police L/I fund recommendations,<sup>31</sup> so Reg BI stands only to address investor protection concerns further. Indeed, the Commission has already described how Reg BI affects recommendations of L/I funds.<sup>32</sup>

Moreover, Reg BI, like the PSPR, requires broker-dealers to amass an investment profile for each retail customer.<sup>33</sup> Reg BI then requires broker-dealers to have a reasonable basis that any recommendation to purchase a particular L/I fund be in the retail customer’s best interest based on that investment profile, among other factors. But, since Reg BI applies to each such recommendation, the Committee believes that Reg BI presents a higher bar than the PSPR, which makes the PSPR, unnecessary.

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authority and in reference to a matter over which his authority extends, is notice to, or knowledge of, the principal.”) (quoting Mechem on Agency (2d Ed.) § 1803).

<sup>28</sup> See, e.g., Goldman, Sachs & Co., SEC Staff No-Action Letter (June 20, 2013) (permitting discretionary adviser to “step[] ‘in the shoes’ as agent of the client for purposes of receiving [b]rochure [d]ocuments”); The Money Management Institute, SEC Staff Interpretive Letter (Apr. 11, 2019) (“a broker-dealer may satisfy its obligations under Section 5(b)(2) . . . by delivering the Mutual Fund prospectus to the investment adviser so long as the broker-dealer has actual knowledge that the client has authorized the investment adviser, consistent with its fiduciary duties, to manage the client’s account on a discretionary basis and to accept delivery of Mutual Fund prospectuses on behalf of the client.”).

<sup>29</sup> See *supra* note 23.

<sup>30</sup> Chairman Jay Clayton, Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors (July 8, 2019).

<sup>31</sup> See, e.g., Wells Fargo Order, *supra* note 19, at 7 (finding “unsuitable recommendations to buy and hold [L/I funds] to certain brokerage customers in light of their investment objectives, risk tolerance and circumstances”).

<sup>32</sup> See Reg BI Release at 264 (“broker-dealers recommending such products should understand that inverse and leveraged exchange-traded products that are reset daily may not be suitable for, and as a consequence also not in the best interest of, retail customers who plan to hold them for longer than one trading session, particularly in volatile markets. Without understanding the terms, features, and risks of inverse and leveraged exchange-traded products—as with the potential risks, rewards, and costs of any security or investment strategy—a broker-dealer could not establish a reasonable basis to recommend these products to retail customers.”).

<sup>33</sup> Both Regulation BI and the PSPR require broker-dealers to consider a client’s investment objectives, time horizon, financial situation, liquidity needs, and investment experience when advising a client. Compare 17 C.F.R. § 240.151-1(b)(2) with Release at 417.

### **c. Applying the PSPR to Unsolicited Transactions in Brokerage Accounts Will Lead to Unintended Consequences**

As the Commission is aware, the current suitability standard and Reg BI only apply to recommendations to invest in a fund.<sup>34</sup> The PSPR, which apply to all client accounts, even those that only engage in unsolicited transactions, thus represent a significant change in the law. If the Commission determines to apply the PSPR to unsolicited purchases of L/I funds, distributors, we contend, will block such transactions rather than meet the burden of complying with the PSPR. In our judgment, this result would unfortunately frustrate the Commission's goal of avoiding regulation that "effectively would preclude sponsors from offering the funds in their current form."<sup>35</sup>

We believe this result is unnecessary because L/I fund prospectuses are required to, and recently have been found to, disclose the risks associated with holding L/I funds for longer than a day.<sup>36</sup> The Committee agrees with the Commission that disclosure promotes "sound investment decisions"<sup>37</sup> and believes that L/I fund investors are capable of utilizing L/I fund prospectuses to act in their own best interests. We believe the Commission should continue to rely on a regulatory framework whose "fundamental purpose [is] to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*."<sup>38</sup>

### **5. The Final Rule Should Not Treat Reverse Repurchase Agreements and Similar Financing Transactions as Analogous to Bank Borrowings under Section 18**

The Committee believes that treating, as the Proposed Rule would do, reverse repurchase agreements and similar financing transactions as analogous to bank borrowings would represent an unfortunate reversal of the long-standing Commission interpretation and guidance that have functioned appropriately for over 40 years. The Commission and the staff have maintained a long-standing policy that they will not object to funds' engaging in reverse repurchase agreements without complying with the asset coverage and other requirements of Sections 18(a)(1) and 18(f) of the 1940 Act, so long as that the funds segregate assets, or otherwise "cover" their obligations under the instruments. In Release 10666, the Commission discussed potential senior leveraging regulatory concerns arising from certain fund trading practices. Release 10666 set out the means by which funds could eliminate these concerns, and that certain

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<sup>34</sup> See FINRA Rule 2111(a) ("A member . . . must have a reasonable basis to believe that a *recommended* transaction . . . is suitable for the customer, based on the information obtained through the reasonable diligence of the member . . . to ascertain the customer's investment profile.") (emphasis added); 17 C.F.R. § 240.15l-1(a) ("A broker, dealer . . . when making a *recommendation* of any securities transaction . . . to a retail customer, shall act in the best interest of the retail customer at the time the *recommendation* is made") (emphases added).

<sup>35</sup> Release at 180.

<sup>36</sup> See Wells Fargo Order, *supra* note 19, at 4.

<sup>37</sup> See Commission, "What We Do," available at <https://www.sec.gov/Article/whatwedo.html> ("The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors . . . should have access to certain basic facts about an investment. . . . To achieve this, the [Commission] requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.").

<sup>38</sup> *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171 (1994) (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)). *Affiliated Ute* itself quotes *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963), which itself cites *Wilko v. Swan*, 346 U.S. 427, 439 (1953), which itself quotes President Franklin D. Roosevelt, who stated that the 1933 Act adds to the "ancient rule of *caveat emptor*, the further doctrine, 'let the seller also beware.'"

transactions deemed to involve prohibited leverage could be dealt with effectively by segregating or earmarking liquid assets.

Contrary to historical practice, the Proposed Rule reflects the view that a fund may engage in reverse repurchase agreements and similar financing transactions so long as such transactions are subject to the relevant asset coverage requirements under Section 18 of the 1940 Act.<sup>39</sup> Thus, a fund would under the Proposed Rule be able to obtain financing by borrowing from a bank, engaging in a reverse repurchase agreement, or any combination of the two actions, so long as all sources of financing are included when calculating the fund's asset coverage ratio. The Committee, however, believes that this approach is neither necessary nor appropriate because: (1) traditional bank borrowings are not similar to reverse repurchase agreements; (2) the framework set out in Release 10666 should continue to apply to reverse repurchase agreements and similar financing transactions; and (3) the Committee believes that if the Commission determines to repeal Release 10666 then reverse repurchase agreements and similar financing transactions should be treated as derivatives transactions under the Final Rule.

**a. Bank Borrowings Are Not Analogous to Reverse Repurchase Agreements**

Bank borrowings involve an extension of credit to a fund and thus create an immediate liability for the fund. Unlike bank borrowings, however, transactions with segregated assets, such as reverse repurchase agreements and similar financing transactions, have only the possibility for creating additional liability in the future beyond the assets that have been segregated or earmarked on the fund's books.

In Release 10666, the Commission acknowledged that reverse repurchase agreements and other transactions may be used by a fund in a manner that would not warrant application of the restrictions imposed by Section 18. The Commission indicated that, if a fund using a reverse repurchase agreement set up a segregated account that was "properly created and maintained," the segregated account would limit the fund's risk of loss. Release 10666 further noted that properly maintained and segregated bookkeeping would function as "a practical limit on the amount of leverage which the [fund] may undertake and on the potential increase in the speculative character of its outstanding common stock." The segregated account would further function to "assure the availability of adequate funds to meet the obligations arising from such activities."

The Committee believes that the approach articulated in Release 10666 is consistent with the structure and purpose of Section 18 as it assures that, unlike a bank borrowing, the liability created by an effectively secured transaction is limited through a properly maintained segregated account. For that reason and the others mentioned above, the Committee believes that effectively secured transactions, such as reverse repurchase agreements and similar financing transactions, should not be treated as bank borrowings under any Final Rule.

**b. The Framework Set Out in Release 10666 Should Continue to Apply to Reverse Repurchase Agreements and Similar Financing Transactions**

In the judgment of the Committee's members, the framework set out in Release 10666 has worked well for funds and thus should continue to apply to reverse repurchase agreements and similar financing transactions. As noted above, the Committee believes that treating reverse repurchase agreements as analogous to bank borrowings would be reversing over 40 years of Commission and staff precedent regarding the understanding that no senior security exists when a fund covers a transaction by maintaining

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<sup>39</sup> Section 18 generally applies to BDCs pursuant to Section 61 of the 1940 Act. Among other differences, however, BDCs are subject to less restrictive asset coverage requirements.

segregated assets sufficient to satisfy 100% of the fund's obligations under the transaction.<sup>40</sup> The Committee further believes that reversal of precedent should only take place if the Commission has presented adequate rationale for the need to reverse its own past guidance. The Release provided no such explanation and it is thus unclear to the Committee what changes in the nature of reverse repurchase agreements or funds the Commission believes to have occurred since the issuance of Release 10666 that would justify the Commission's reversal of its position articulated in Release 10666.<sup>41</sup> The Committee believes that, in the absence of such justification, the framework articulated in Release 10666 should continue to apply to reverse repurchase agreements and similar financing transactions.<sup>42</sup>

**c. If the Commission Determines to Repeal Release 10666, Reverse Repurchase Agreements and Similar Financing Transactions Should be Treated as Derivatives Transactions under the Final Rule**

As suggested above, the Committee strongly believes that Release 10666 can be supported as the appropriate regime for transactions for which fund assets are fully segregated. The Committee believes that, if the Commission determines to repeal the guidance under Release 10666, reverse repurchase agreements and similar financing transactions should be treated in an analogous manner to that applicable to derivatives under the Proposed Rule and thus should be subject to a VaR-based limit on leverage risk for funds that are not Limited Derivatives Users.

The Release expresses the view that “secured borrowing[s] . . . more closely resemble bank borrowings with a known prepayment obligation rather than the more-uncertain payment obligation of many derivatives.”<sup>43</sup> Over the last 40 years, however, the Commission has treated derivatives, reverse repurchase agreements and similar financing transactions as analogous for purposes of Section 18 of the 1940 Act; the restrictions of Section 18 are not implicated to the extent a fund covers its obligations in relation to such transactions by segregating sufficient assets. This practice has allowed funds to build internal frameworks that generally provide consistency for purposes of Section 18.

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<sup>40</sup> Under Section 18(g) of the 1940 Act, the term “senior security” generally includes any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness. Section 18 does not, however, address reverse repurchase agreements nor does it explicitly require that a reverse repurchase agreement or similar financing transaction be treated as analogous to a bank borrowing. In Release 10666, the Commission essentially acknowledged that by covering its obligations under certain transactions, the fund would not be deemed to have issued a “senior security.”

<sup>41</sup> Moreover, the Commission's proposed treatment of reverse repurchase agreements may create a situation in which a fund that engages in reverse repurchase agreements would be subject to the 300% asset coverage requirement in Section 18, but a fund that engages in securities lending transactions would not be subject to the same treatment, even though each transaction may have a similar economic effect on the fund. Such disparate treatment for transactions that may create similar economic exposure to a fund also supports the Committee's recommendation to maintain the Commission's guidance in 10666.

<sup>42</sup> The Committee also notes that the lack of explanation for the Commission's reversal of its long-standing position on the treatment of reverse repurchase agreements and similar transactions raises difficult questions of administrative law for the Commission's proposed action. In particular, it is well-settled that a court may reject an agency's unreasonable interpretation of an ambiguous statute and courts have held that it is not reasonable for an agency to depart from its prior policy and practice without sufficient explanation. *See, e.g., Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006); *Northpoint Technology, Ltd. v. FCC*, 412 F.3d 145, 156 (D.C. Cir. 2005). In this case, the Committee believes that Section 18's application to reverse repurchase agreements is ambiguous given that Section 18 does not address reverse repurchase agreements or explicitly require that a reverse repurchase agreement or similar financing transaction be treated as analogous to a bank borrowing. As such, the Commission's proposed reversal of its position in this regard could be subject to significant judicial scrutiny if challenged.

<sup>43</sup> Release at 225.

On the basis of historic practices – and for consistency purposes going forward – the Committee is of the view that if the Commission repeals the guidance under Release 10666, reverse repurchase agreements and similar financing transactions should be treated as derivatives transactions and should be subject to the VaR-tests adopted under the Final Rule.

## **6. Treatment of Unfunded Commitment Agreements**

The Committee supports the change in the treatment of unfunded commitment agreements<sup>44</sup> contemplated by the Proposed Rule. Under Rule 18f-4 as initially proposed in 2015, a fund’s obligations under unfunded commitment agreements could not have exceeded the fund’s net asset value, with certain limited exceptions. The Committee appreciates the Commission’s reconsideration of that treatment, as we believe it could have significantly, and adversely, affected the ability of closed-end funds to invest in underlying private equity and private credit funds, and certain funds, including BDCs, to make unfunded commitments to provide additional funding to one or more of their portfolio companies in compliance with the 1940 Act and related Commission and staff guidance.

The Committee further supports the proposed exclusion of unfunded commitment agreements from the definition of “derivatives transaction” in the Proposed Rule. We believe such treatment is consistent with recent Commission considerations to provide increased access to the types of funds that may make significant use of unfunded commitment agreements, such as BDCs and closed-end funds that invest directly or indirectly in private equity and private credit. The Committee, as noted below in section 7.b., supports the ability for appropriate investors to continue access these types of vehicles under any Final Rule.

### **a. Unfunded Commitment Agreements Generally Do Not give Rise to Leverage Risk and Should Not be Treated as Senior Securities**

The Committee agrees with the views of commenters that were acknowledged by the Commission in the Release that unfunded commitment agreements generally do not give rise to the risks identified by the Commission in Release 10666 and do not have a leveraging effect on a fund’s portfolio; an unfunded commitment does not present an opportunity for a fund to realize gains or losses between the date of the fund’s commitment and its subsequent investment when the other party to the agreement calls the commitment.<sup>45</sup> As also noted by commenters, a fund often does not expect to lend or invest up to the full amount committed, and the fund’s obligation to lend is commonly subject to conditions, such as a borrower’s obligation to meet certain financial metrics and performance benchmarks, which are not typically present under the types of agreements that the Commission described in Release 10666. For these reasons, the Committee believes that the purpose of Section 18, as outlined by Congress, would not be advanced by subjecting unfunded commitment agreements to its limitations.<sup>46</sup>

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<sup>44</sup> Under Proposed Rule 18f-4(a), an unfunded commitment agreement is a “contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund’s general partner.”

<sup>45</sup> Release at 229-230. More specifically, the Commission previously has stated that commitments to purchase securities “whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in [Release 10666]. Such commitments...have no discernible potential for leverage.” Release 10666, *supra* note 2, at n. 12.

<sup>46</sup> For funds that invest primarily in private or thinly-traded companies, those funds’ investment strategies are not intended to result in the fund holding significant assets in cash in order to segregate against ordinary course liabilities (*i.e.*, unfunded commitments). In particular, for BDCs, the 1940 Act requires that at least 70% of a BDC’s assets be invested in “eligible portfolio companies.” Requiring a BDC to maintain a significant cash

We note further that the definition of senior security in Section 18(g)<sup>47</sup> requires that a senior security be both a security and either evidence indebtedness or be a stock having priority as to dividends or liquidation over some other class of stock. The Committee believes that unfunded commitment agreements do not generally satisfy the definition of senior security and, as discussed, we believe that the Commission came to a similar conclusion in Release 10666.

#### **b. Asset Sufficiency Concerns and “Reasonable Belief” Determinations**

The Committee appreciates the Commission’s concern that, although unfunded commitment agreements generally do not raise undue speculation associated with derivatives transactions, such agreements could raise asset sufficiency concerns underlying the 1940 Act.<sup>48</sup> In our view, the Commission’s concerns with respect to unfunded commitment agreements would seem to be more aptly described as liquidity, and not leverage, concerns. The Committee is generally supportive of the Commission’s proposal set out in the Release to permit a fund to enter into an unfunded commitment agreement if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due (a “reasonable belief”).<sup>49</sup> We also support the Commission’s proposal to not require funds to account for their unfunded commitment agreements in determining compliance with the asset coverage requirements set forth in Sections 18 and 61 of the 1940 Act.<sup>50</sup>

We are nonetheless concerned the Proposed Rule would prescribe certain specific factors that a fund must take into account when forming its “reasonable belief” – namely, a fund: (i) must consider its reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions); (ii) may not consider cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments; and (iii) may not consider cash that may become available from issuing additional equity (although a fund could consider its ability to issue the issuance of debt (*e.g.*, borrowings from financial institutions or the issuance of debt securities)).<sup>51</sup> The Committee requests that the Commission reconsider whether funds should be required to consider the list of enumerated factors under the Proposed Rule. A more flexible approach would be consistent with the Commission’s acknowledgement that, in addition to considering its investment strategy, portfolio liquidity and borrowing capacity, as well as the contractual provisions of its unfunded commitment agreements, a fund may have other unique facts and circumstances that are appropriate to consider. The Commission staff, on exam, would be able to review a fund’s records to assess what factors a fund considered when entering into unfunded commitment transactions.

In the Committee’s view, should the Commission determine either to recommend or require funds to consider their ability to raise cash through capital raising efforts, the funds should be permitted to consider their ability to issue equity securities in addition to their ability to issue debt. Closed-end funds and BDCs may, from time to time, trade at a premium to their net asset value, and funds that have effective

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position in order to comply with Section 61 or otherwise treat them as “senior securities” arguably undermines the statutory framework adopted by Congress for BDCs.

<sup>47</sup> The definition of “senior security” appears solely in Section 18(g) and, as a result, the Commission should not seek to interpret it using the broader statutory authority provided in Section 2 of the 1940 Act.

<sup>48</sup> Release at 232.

<sup>49</sup> Proposed Rule 18f-4(e)(1).

<sup>50</sup> Similar to the Committee’s views with respect to the treatment of reverse repurchase agreements, the Committee does not believe there is a sufficient legal basis under which unfunded commitment agreements should be subject to treatment as a “senior security” for purposes of Section 18 or otherwise be treated as analogous to a bank borrowing for such purposes. *See* Section 5 herein.

<sup>51</sup> Proposed Rule 18f-4(e)(2).



shelf registration statements may be able to issue equity in the secondary markets, such as through an at-the-market program, on a time frame that is similar to issuing notes or other debt securities. The Commission has recently adopted rules to make the capital markets more accessible – at a lower cost and shorter timeframe – to certain closed-end funds and BDCs.<sup>52</sup> In light of the expansion of securities offering reform to these types of funds, the Committee believes that the Commission should permit a fund to determine whether it has a “reasonable belief” with respect to its ability to raise cash through both equity and debt offerings.

## **7. Application of the Proposed Rule to Closed-End Funds**

### **a. Distinguishing between Open- and Closed-End Funds is Supported by Section 18**

Section 18 differentiates between open- and closed-end funds (and BDCs) in terms of the degree and composition of leverage permitted in their respective capital structures. The Committee suggests that the Final Rule should reflect these pre-existing statutory distinctions. The Congressional rationale for providing closed-end funds and BDCs with additional flexibility was presumably that they could bear additional leverage because of the absence of daily liquidity. Although Release 10666 was addressed only to open-end funds under subsection (f)(1) of Section 18, we believe that an approach that provides separate limits would be consistent with the existing regulatory regime.

The Committee suggests that the statutory differences, cited in Section I.B.1 of the Release support a measureable, but not extreme, distinction in Rule 18f-4 between open-end and closed-end funds in the application of limits. The limit under the Relative VaR Test could, for example, be extended to 250% for closed-end funds. The exception for Limited Derivatives Users that are closed-end funds could be extended to 25% of net assets.

### **b. Funds whose Investors are Limited to Qualifying Investors Should Have the Same Flexibility as Private Funds**

Some closed-end funds and BDCs are sold exclusively to a limited category of investors, such as “qualified purchasers,” “qualified clients” or “accredited investors” (collectively, “Qualifying Investors”). The Commission has recently explored ways of expanding access to investment opportunities currently available to investors in private funds.

Registration under the 1940 Act (or election to operate as a BDC) mandates investor protections that private funds do not necessarily guarantee. These protections exist regardless of whether a fund's shares are publicly offered under the 1933 Act. Offering particular types of closed-end funds, such as interval funds or “tender offer” funds, or BDCs to Qualifying Investors may be done for various reasons, including undertaking strategies that involve special investment risks, including use of derivatives. The Committee urges that these funds should not effectively have to choose between being registered under the 1940 Act and being subject to the full panoply of requirements in the Proposed Rule (recognizing that the designation of the Proposed Rule under Section 18(f) reflects its principal focus on open-end funds).

A small advisory organization that offers a fund or BDC to Qualifying Investors, as an extension of its sponsorship of private funds, may not have the resources to hire and maintain separate risk personnel, including a DRM, or develop and maintain an DRMP. Such an organization could, however, develop and maintain compliance policies and procedures regarding the use of derivatives across their platform, including any funds.

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<sup>52</sup> Securities Offering Reform for Closed-End Investment Companies, Release No. 33-10771 (April 8, 2020).

The Committee believes that it would be appropriate to relax limits on the use of derivatives for funds that are sold exclusively to Qualifying Investors and that disclose the heightened investment risks inherent in their use of derivatives as part of their investment strategies.

## **8. Confirm that Portfolio Composition, not Just Offsetting Positions, Dampens VaR**

The Release acknowledges that funds may employ derivatives to hedge certain risks, such as “portfolio exposures.” It refers to the process of “determining whether transactions are ‘hedges’” as requiring “an analysis of historical correlations and predicting future price movements of related instruments or underlying reference assets” that can “break down in times of market stress.” In the Committee’s view this description accurately indicates the process of structuring a derivative to establish the bands within which that derivative performs its function, whether to leverage or hedge risks, and identify when it may fail.

We submit, that, in focusing on the individual derivative, the Release deemphasizes the ameliorative effects of overall portfolio structuring. The Committee recommends that for closed-end funds, including interval funds and “tender offer” funds, which do not face immediate liquidity needs (beyond the next applicable repurchase or tender offer amount), a broader definition of hedging be permitted that does not require identification of “the asset [sic] being hedged or netted and the derivative transaction used to hedge or net that asset” or that contemplates relief only for “directly-offsetting derivatives transactions ... having the same underlying reference asset.” The strategy, for example, that elicited the name of “hedge fund” *i.e.*, a long-short strategy by which market tail risks are reduced by the see-saw nature of the portfolio exposures, should be permitted, within limits to be clarified, for such interval/tender funds. While the prediction of relative price movements for individual assets underlying derivatives is imperfect, and thus the advisability of measuring VaR to a specified confidence level, the effect of major market movements will be dampened by the rise in the value of short positions offsetting the fall in long positions. The Proposed Rule does not ascribe any weight to this effect in its measurement of VaR generally. The Committee suggests that, in adopting the Final Rule, the Commission’s accompanying release specifically acknowledge and reflect that the measurement of VaR for such funds take into account – but require monitoring of the validity of the thesis – that long-short funds’ risk levels legitimately calculate a combined VaR that reflects a lower level than an index of long-only securities and that permits some additional use of derivatives (*e.g.*, short positions) under the method adopted.

## **Related Regulatory Framework Matters**

The Committee appreciates the Commission’s dedication to assessing and updating the regulatory framework surrounding the use of derivatives and other similar transactions by funds. We note, however, that the Release and the Proposed Rule (as was the case with the Commission’s 2015 proposal) are silent on numerous issues raised in the ABA Report and the Commission’s own concept release on funds’ use of derivatives published in 2011,<sup>53</sup> such as concentration and diversification testing and compliance, fund exposure to securities-related issuers and valuation matters. The Committee urges – consistent with the Commission’s recent request for public comment on Rule 35d-1 under the 1940 Act (commonly referred to as the fund “names rule”)<sup>54</sup> and in light of the growth in the use of derivatives by funds – that the Commission continue to seek to address these other matters as part of its ongoing efforts to create a comprehensive regulatory framework for funds’ use of derivatives.

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<sup>53</sup> Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776 (Sept. 7, 2011).

<sup>54</sup> Request for Comment on Fund Names, Release No. IC-33809 (March 2, 2020).

\* \* \*

The Committee appreciates the opportunity to comment on the Proposed Rule. If we can be of any further assistance in this regard, please call me at (212) 728-8293.

Respectfully



Barry P. Barbash, Chair

Committee on Investment Management Regulation

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