

ICI Supports Derivatives Risk Management Program for Funds

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Seeks Changes to SEC Rule Proposal to Preserve Benefits of Using Derivatives

Washington, DC, March 28, 2016—The Investment Company Institute (ICI) supports adoption by the Securities and Exchange Commission (SEC) of a proposed rule governing registered funds' use of derivatives, but strongly opposes the SEC's portfolio limits, which would harm a large number of funds and their shareholders, ICI says in a [comment letter](#) today.

"Funds have used derivatives for decades to provide investment services and to manage risk for shareholders," says ICI President and CEO Paul Schott Stevens. "We support strengthening regulations around their use. The portfolio limits, however, would stymie funds' efficient and effective portfolio management and harm shareholders. We hope the SEC will consider changes to the rule proposal to acknowledge and preserve the ability of funds to continue to use derivatives as an effective portfolio management tool."

In particular, Stevens says, the proposed portfolio limits will disproportionately affect bond funds, even "plain-vanilla" funds. "Nothing before the Commission or in its proposing release suggests that these bond funds are engaged in 'undue speculation' through their use of derivatives," Stevens says.

ICI's letter describes how fund managers use derivatives to serve shareholders efficiently, by hedging risk; enhancing liquidity; gaining or reducing exposure when other instruments are difficult, costly, or impossible to access; managing or equitizing cash; and reducing costs. The Institute called upon the SEC to preserve these beneficial uses of derivatives in its final rulemaking. For more detail on funds' use of derivatives, see [page 6 of ICI's letter](#).

ICI Supports Enhanced Asset Segregation Requirements, Recommends Changes

Currently, a fund investing in derivatives transactions must segregate liquid assets to "cover" the transaction, helping to ensure the fund has sufficient assets to meet its derivative payment obligations. The SEC proposal would enhance these asset segregation requirements, requiring funds to maintain minimum amounts of "qualifying coverage assets" for each derivatives transaction and financial commitment transaction.

ICI supports enhancements to the asset segregation requirements, in particular the addition of risk-based coverage amounts for derivatives transactions. Although the SEC would only allow cash and cash equivalents to be used as qualifying coverage assets, ICI strongly urges the SEC to expand the types of eligible assets for several reasons:

- The Commission should stay consistent with international standards and other recent U.S. regulations. The SEC should permit the types of highly liquid qualifying coverage assets that U.S. regulators recently approved for initial and variation margin standards for derivatives, which are conceptually similar standards.
- Permitting the use of highly liquid qualifying coverage assets would allow funds to stay true to their investment objectives and avoid harming investors by, among other things, creating a "cash drag" on the performance of a fund that would otherwise be fully invested.
- ICI's recommendation would avoid strain on the supply of available cash-equivalent securities.

ICI believes the SEC also should apply risk adjustments to the value of noncash assets in calculating the amount of a fund's qualifying coverage assets. See [page 10 of ICI's letter to the SEC](#) to read more about the types of assets ICI believes should be eligible.

Portfolio Limits Mean De-Registration or Major Strategy Change for Hundreds of Funds

The SEC's proposal would require a fund that invests in derivatives transactions to comply with one of two portfolio limits—either a 150 percent notional exposure limit (Exposure-Based Limit) or a 300 percent risk-based limit (Risk-Based Limit). The proposal defines exposure to include “the aggregate notional amounts of the fund's derivatives transactions.”

Though the SEC proposal incorporated a study of funds within the industry, ICI suggests that the SEC analyzed limited data, which did not permit a full evaluation of the impact of the proposed restrictions. The SEC's Division of Economic and Risk Analysis (DERA), for example, analyzed about 1,200 funds.

By contrast, ICI supplements the record with a broader study analyzing data from 6,661 funds with a total of \$13.6 trillion in assets under management, about 80 percent of industrywide assets of long-term registered funds. The ICI study finds that at least 471 funds with \$613 billion in assets under management would exceed the SEC's proposed 150 percent notional exposure test.

ICI also contends that notional amounts, on which the proposed portfolio limits are based, are an unreliable and inappropriate measure of risk, and explains:

“A fund with high notional exposure may be more risky, less risky, or equally as risky as a fund having no exposure to derivatives. In fact, notional amounts typically overstate the risks that a fund may incur from derivatives.”

ICI's letter cautions that adoption of portfolio limits based on notional exposure “may impact negatively funds that are currently serving millions of shareholders.”

ICI's study reveals that taxable bond funds would be disproportionately affected by the limits, if the SEC were to adopt them. The ICI letter says that a fund that is unable to adjust its portfolio to the limits would be forced to de-register, which may mean the end of the fund's commercial viability and tax consequences for the fund's shareholders. Altering a fund's investment strategies to comply with the portfolio limits, ICI says, may result in a fund (and its shareholders) incurring additional costs and risks. See [page 34 of ICI's letter](#) to the SEC for more detail on opposition to the SEC's portfolio limits proposal.

ICI Offers Alternative Using Portfolio Limits as “Backstop”

Based on its analysis, ICI calls on the SEC to examine the consequences of its policy decisions. If the Commission determines portfolio limits are necessary, it should use them as a “backstop” measure with modifications, allowing funds to adjust the notional amounts attributable to derivatives based on underlying asset classes.

ICI's alternative approach would also change calculation of the notional amount by, among other things, excluding direct hedging transactions and financial commitment transactions from portfolio limits and permitting netting across different instruments. ICI also advises raising the Exposure-Based Limit to 200 percent, a level that could still achieve the SEC's goals in the rulemaking if the SEC decides to continue to pursue portfolio limits of this type. For more detail on ICI's alternative, see [page 46 of its letter to the SEC](#).

ICI Supports Derivatives Risk Management Program, Appropriate Board Oversight

ICI's letter also supports a requirement for each fund, depending on the extent and complexity of the fund's derivatives use, to develop and maintain a written, principles-based risk management program for derivatives transactions. In addition to broad support for the program, ICI recommended changes to the proposal to improve the functionality of the final rule. For example, ICI suggests giving funds the ability to appoint a group or committee to serve as derivatives risk manager, rather than solely an individual as proposed by the SEC. See [page 25 of ICI's letter](#) to read more about the Institute's recommendations related to the derivatives risk management program.

ICI also agrees with the SEC's decision to give boards of directors an oversight role in the risk management program. However, the letter expresses concern that certain proposed board duties go far beyond oversight and require decisions that should be made by the investment adviser as part of management of the fund's investment program. ICI supports the detailed [comments of the Independent Directors Council](#) on the responsibilities of a fund board.