Before the

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

In the Matter of	)	
	)	Release No. IC–31933
Use of Derivatives by Registered	)	File No. S7–24–15
Investment Companies and	)	RIN 3235–AL60
Business Development Companies	)	80 Fed. Reg. 80884
	)	

COMMENTS OF THE COMPETITIVE ENTERPRISE INSTITUTE

March 28, 2016

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Mr. Brent J. Fields
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Mr. Secretary:

On behalf of the Competitive Enterprise Institute (CEI), we respectfully submit these comments in response to the Securities and Exchange Commission's notice of proposed rulemaking concerning the use of derivatives by registered investment companies and business development companies.[1] CEI is a nonprofit public interest organization dedicated to the principles of limited constitutional government and free enterprise. One of CEI's major projects is reducing regulatory barriers that affect access to capital and investor choice.[2] CEI has pursued this objective through policy analysis, Congressional testimony, and litigation.[3]

1. Summary

The SEC proposes this rule "to take an updated and more comprehensive approach to the regulation of funds' use of derivatives."[4] However, the SEC's cost-benefit analysis is flawed in that it focuses on the supposed benefits of limiting exposure to derivatives to investors in funds and business development companies while ignoring the costs of doing so. In addition, the rule would effectively make certain types of exchange-traded funds unavailable to retail investors, leaving these individuals exposed to greater risk of market volatility in boom-and-bust cycles and "black swan" economic shocks. Most importantly, the agency appears to ignore the limits placed on its authority to regulate derivatives and futures by the Commodity Futures Modernization Act of 2000.

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1. Use of Derivatives by Registered Investment Companies and Business Development Companies, *Notice of Proposed Rulemaking*, 80 Fed. Reg. 80884 (Dec. 28, 2015) [hereinafter NPRM], *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf.
2. Many of the policy solutions CEI has put forward over the years were incorporated into the Jumpstart Our Business Startups (JOBS) Act, signed by President Barack Obama in 2012.
3. *See, e.g.*, Christopher Culp, *A Primer on Derivatives: Their Mechanics, Uses, and Regulation* (Competitive Enter. Inst. Issue Analysis, 1995), *available at* https://cei.org/sites/default/files/A%20Primer%20on%20Derivatives.pdf; *see also* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010) (CEI as co-counsel for petitioners).
4. NPRM, *supra* note 1, 80 Fed. Reg. at 80892.

2. Background

The Investment Company Act of 1940 (the "1940 Act"), as amended,[5] empowers the SEC to regulate the practices of "investment companies,"[6] subject to various exceptions and limitations.[7] Among other things, Section 18 of the 1940 Act restricts the ability of certain investment companies to issue "any class of senior security."[8] A "senior security" is defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends."[9]

These restrictions on an investment company's ability to issue senior securities depends on whether it is an "open-end" or "closed-end" company.[10] A company is closed-end unless it is "offering for sale or has outstanding any redeemable security of which it is the issuer."[11] Section 18 makes it "unlawful for any registered closed-end company to issue any class of senior security, or to sell any such security of which it is the issuer," except in certain circumstances.[12]

Specifically, for a closed-end company to issue a senior security that "represents an indebtedness,"[13] the company must:

1. Have at least 300% asset coverage[14] immediately after issuing it;[15]

2. Prohibit the declaration of any "dividend" or "distribution, upon any class of the capital stock," or the "purchase of any such capital stock" unless the class of senior securities has at the time of such declaration at least 300% asset

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5. Act of August 22, 1940, ch. 686, 54 Stat. 789, 15 U.S.C. §§ 80a-1–80a-64, *available at* http://legcounsel.house.gov/Comps/Investment%20Company%20Act%20Of%201940.pdf

6. 1940 Act § 1(a), 15 U.S.C. § 80a-1.

7. *See generally, e.g.*, 1940 Act § 3(b)–(c), 15 U.S.C. § 80a-3(b)–(c).

8. *See* 1940 Act § 18, 15 U.S.C. § 80a-18.

9. 1940 Act § 18(g), 15 U.S.C. § 80a-18(g).

10. *Compare* 1940 Act § 18(a), 15 U.S.C. § 80a-18(a), *with* 1940 Act § 18(f), 15 U.S.C. § 80a-18(f).

11. 1940 Act § 5(a), 15 U.S.C. § 80a-5(a).

12. 1940 Act § 18(a), 15 U.S.C. § 80a-18(a).

13. A "senior security representing indebtedness" means "any senior security other than stock." 1940 Act § 18(g), 15 U.S.C. § 80a-18(g).

14. "Asset coverage" is defined in Section 18(h) of the 1940 Act. 1940 Act § 18(h), 15 U.S.C. § 80a-18(h); *see also* NPRM, *supra* note 1, 80 Fed. Reg. at 80887 n.34.

15. 1940 Act § 18(a)(1)(A), 15 U.S.C. § 80a-18(a)(1)(A).

coverage—after deducting any dividend, distribution, or purchase price—or, in the case of dividends declared upon preferred stock, at least 200% asset coverage after deducting the amount of such dividend;[16] and

3. Provide the holders of such senior security, voting as a class, the ability to "elect at least a majority of the members of the board of directors" of the company if, "on the last business day of each of 12 consecutive calendar months," the class of senior securities has under 100% asset coverage, until such time as the class of senior securities has at least 110% asset coverage on the last business day of each of three calendar months.[17]

For a closed-end company to issue a senior security in the form of stock, the company must:

1. Have at least 200% asset coverage immediately after issuing it;[18]

2. Prohibit the declaration of any dividend, or any other distribution, "upon the common stock of such investment company, or the purchase of any such common stock," unless the class of senior security has at the time of any such declaration or purchase at least 200% asset coverage, after deducting the dividend, distribution or purchase price;[19]

3. Provide the holders of such senior securities, voting as a class, the ability "to elect at least two directors at all times," and, "subject to the prior rights ... of the holders of any other class of senior securities outstanding," the ability to "elect a majority of the directors" if dividends on the securities go unpaid for two full years, until all dividends in arrears are paid;[20]

4. Require the majority of holders of such securities, voting as a class, to approve any plan to reorganize the company that adversely affects the securities;[21] and

5. Give complete priority to such stock over any other class with respect to the distribution of assets and the payments of dividends.[22]

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16. 1940 Act § 18(a)(1)(B), 15 U.S.C. § 80a-18(a)(1)(B).
17. 1940 Act § 18(a)(1)(C), 15 U.S.C. § 80a-18(a)(1)(C).
18. 1940 Act § 18(a)(2)(A), 15 U.S.C. § 80a-18(a)(2)(A).
19. 1940 Act § 18(a)(2)(B), 15 U.S.C. § 80a-18(a)(2)(B).
20. 1940 Act § 18(a)(2)(C), 15 U.S.C. § 80a-18(a)(2)(C).
21. 1940 Act § 18(a)(2)(D), 15 U.S.C. § 80a-18(a)(2)(D).
22. 1940 Act § 18(a)(2)(E), 15 U.S.C. § 80a-18(a)(2)(E).

As for open-end companies, Section 18 generally bars them from issuing or selling any class of senior security, except in the form of borrowing money from a bank.[23] Immediately after taking out any such loan, the company's asset coverage for all its borrowings must be at least 300%.[24] If this asset coverage ratio ever falls below 300%, the company must reduce its borrowings within three days to bring the ratio up to at least 300%.[25]

In 1979, the SEC issued a general policy statement, known as Release 10666,[26] in which it explained that "reverse repurchase agreements," "firm commitment agreements," and "standby commitment agreements" may constitute a form of a "senior security" that "evidences an indebtedness" of an investment company.[27] The agency advised that the "issue of compliance with Section 18 will not be raised" with respect to a company that enters into such agreements so long as it "covers" them by "establishing and maintaining certain 'segregated accounts'" equal to the obligation incurred in connection with its agreements.[28] These accounts, the agency explained, must "freeze[] certain assets of the investment company" and render them "unavailable for sale or other disposition."[29] Subsequently, through the 1970s, 1980s, and 1990s,[30] SEC staff issued over 30 "no-action letters" concerning companies' "obligations in connection with various transactions that implicate [ICA] section 18."[31] Although Release 10666 did not specifically address derivatives,[32] agency staff has addressed a number of questions about derivatives in both no-action letters and other forms of guidance.[33]

The SEC now proposes to formally interpret the term "senior securities" to encompass many types of derivatives and financial commitment transactions.[34] This

23. 1940 Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1).

24. *Id.*

25. *Id.*

26. Securities Trading Practices of Registered Investment Companies, *General Statement of Policy*, 44 Fed. Reg. 25128 (1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

27. *Id.* at 25131.

28. *Id.* at 25132.

29. *Id.*

30. *See* NPRM, *supra* note 1, 80 Fed. Reg. at 80897

31. *See id*. at 80888.

32. *Id.* n.49.

33. *Id.* at 80888.

34. NPRM, *supra* note 1, 80 Fed. Reg. at 80890.

interpretation, by itself, would effectively make it impossible for many investment companies that currently rely on derivatives and financial commitment transactions to continue doing so. However, the agency also proposes to exercise its exemption authority under Section 6(c) of the 1940 Act, which authorizes the SEC to "conditionally or unconditionally … exempt any … classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder."[35] The agency may grant such exemptions only to the extent that they are "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]."[36]

Specifically, the agency proposes to exempt investment companies from restrictions on their issuance of senior securities in the form of a derivatives contract or financial commitment transaction if the company:

1. Approves asset segregation policies to determine "risk-based coverage amounts" for each transaction and maintains "qualifying coverage assets" for all derivative and financial commitment transactions;[37]
2. Approves a policy that limits either:
    a. The company's aggregate "notional" exposure to 150% of its net assets;[38] or
    b. The company's risk-based exposure, calculated using a complex formula, to 300% of its net assets;[39] and
3. Approves a formalized risk management program, or ensures the company will monitor compliance to ensure the fund engages in no "complex" derivatives transactions and only a limited amount of derivatives transactions in general.[40]

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35. 1940 Act § 6(c), 15 U.S.C. § 80a-6(c).

36. *Id.*

37. NPRM, *supra* note 1, 80 Fed. Reg. at 80898.

38. NPRM, *supra* note 1, 80 Fed. Reg. at 80901.

39. *Id.*

40. NPRM, *supra* note 1, 80 Fed. Reg. at 80935.

3. The proposed rule would hurt investors by depriving funds of a key risk management tool

The proposed rule purports to protect investors from excessive risk, but it would in fact deprive investors of a key risk management tool by limiting how much leverage funds can obtain through derivatives. The NPRM equates greater leverage with greater risk—but in reality, leverage is often an important means of *managing* risk. Although the proposed rule would exempt funds that use derivatives for "hedging," these exemptions would not encompass the universe of funds that deploy leverage to manage risk in ways that do not involve hedging.

The proposed rule would allow funds to choose one of two leverage limits—150% and 300%, respectively—with the first determined by assessing a fund's market exposure by measuring the gross notional value of its derivatives, and the second determined by a Value-at-Risk test. The first of these limits is deeply flawed, because looking at the gross notional amount of a fund's derivatives gives an incomplete and often misleading picture of its actual market exposure. And the rule would allow funds to use the Risk-Based exposure limit only to the extent that they use derivatives to reduce, rather than manage, risk. Risk should be seen not as something that is always to be reduced, but rather something that should be managed.

The gross notional exposure of a single derivative is the total value of that leveraged position's assets.[41] To determine the market exposure of a fund using the gross notional value method, the notional value of every leveraged asset in the fund is first tallied, and that sum is then divided by the fund's total "qualifying coverage assets" (essentially cash equivalents) to determine that fund's "market exposure." Although measuring the notional value of a leveraged asset is not completely unrelated to determining its risk, it can be quite misleading when relied upon to the extent that the agency proposes here. As Dr. James A. Overdahl, a former SEC Chief Economist, explained in a recent paper evaluating the agency's proposed rule:

> Gross notional amounts are understood to be poor measures of market exposure, because for most derivative transactions the cash flow obligations are a small

41. For example, a Brent crude oil contract's underlying assets are comprised of 1,000 barrels of Brent crude oil. The gross notional value of this contract is calculated by multiplying the price per barrel of the contract by 1,000 (i.e., the number of barrels). Thus, at the time of this filing, the gross notional exposure of a Brent crude oil futures contract is approximately $40,000—the price of one barrel multiplied (~$40) by the number of barrels in the contract. The initial margin requirement for entering into a front month Brent crude oil futures contract is $3,500, meaning a trader must put up $3,500 in order to enter into this contract. Thus, the contract is leveraged at roughly 11x.

> percentage of notional amounts.
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> Gross notional amounts can also be misleading because they do not account for differences across different types of derivative contract. That is, the meaning of the gross notional amount can vary depending on the type of derivative being considered. For example, in an interest rate derivative, the notional amount refers to the hypothetical underlying amount used to calculate cash flow obligations. For a credit default swap, the notional amount refers to the par amount of credit protection bought or sold and is used for coupon payment calculations for each payment period and the recovery amounts in the event of a default. For an equity derivative, the notional amount refers to the hypothetical amount that can be used to calculate equity swap cash flows, or the value of the delivery obligation for physically-settled equity forwards.
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> The SEC argues that one advantage of using notional amounts as a measure of market exposure is that it can be applied consistently across all types of funds, including funds using different strategies and different types of derivatives. However, this consistency disregards the differences in the risk characteristics of various types of derivative instruments. Even in the DERA White Paper,[42] allowance is made for Eurodollar futures, where the notional value is adjusted to market standard conventions. It appears that such an adjustment would not be permitted under the proposed rule.
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> Using gross notional amounts to measure risk exposure fails to account for differences in risk across the different underlying assets used to construct derivative instruments.[43]

Limiting the leverage a fund can deploy by using the "gross notional" method may indeed stop some funds from engaging in practices that might be reasonably described as excessive risk-taking. However, this approach will also ensnare many funds that do not engage in excessively risky behavior, but that instead provide retail investors with relatively low-risk strategies that offer returns with a very low correlation to more traditional investments. Such funds include certain types of bond funds, managed futures funds, and risk parity funds—the latter two of which employ leverage not for speculative purposes but for equalizing the amount of risk posed by different asset classes and markets. These "liquid alternative" funds make available to non-accredited investors strategies that were previously available only to wealthy

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42. Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies* (SEC Division of Economic and Risk Analysis 2015) (''DERA White Paper''), https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

43. James A. Overdahl, *Proposed Rule 18f-4 on the Use of Derivative Instruments by Registered Investment Companies: Data and Economic Analysis* 14–15 (Delta Strategy Grp., 2016) (citations omitted), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2754153.

accredited investors. Such funds are relatively new, which may explain why the SEC's survey determined that few funds subject to the 1940 Act would find themselves above the 150% threshold imposed by the proposed exposure limit.[44]

There is no basis for curtailing these funds at this early stage in the industry's development. But the costs of restricting their availability will be borne by retail investors in the form of a less favorable risk-return ratio. Investors will remain subject to "sudden losses" which, as SEC Chair Mary Jo White has noted, are a matter of concern. But investors in long-only unlevered stock index funds are at least as susceptible to sudden losses as are investors in funds that manage their risk through the use of leverage beyond the amount permitted by the proposed rule.

Managed futures funds are particularly likely to be caught up by this proposed rule, as some of them will likely exceed even the 300% threshold allowed by the Risk-Based Portfolio Limit's Value-at-Risk test. The large gross notional exposure that often characterizes these funds is not a reasonable measure of the risk they are taking on, contrary to the DERA White Paper's conclusion that such funds are inconsistent with the purposes underlying Section 18 of the 1940 Act.[45]

In short, the proposed rule would ultimately harm investors by discouraging funds from making low-risk, low-volatility "liquid alternative" investments. These funds are plainly meeting market demand, especially as investors seek higher returns in the current low interest rate environment, as former SEC Commissioner Luis A. Aguilar has recognized.[46] The proposed rule would make it difficult for non-accredited investors to turn to fund managers for risk management, perversely leading some investors to rely on riskier methods by themselves. For example, an investor who purchases "plain vanilla options" on a stock index fund might expose himself to far more "sudden losses" than a retail investor who purchases shares in a liquid alternative mutual fund. Yet by curtailing the market for funds that offer alternative investments, the proposed rule could lead investors to take the riskier approach.

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44. *See* NPRM, *supra* note 1, 80 Fed. Reg. at 80956 (finding that 96% of funds in DERA sample had aggregate exposures below 150%).

45. *See* DERA White Paper, *supra* note 42.

46. Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n, Public Statement: Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance (Dec. 11, 2015), *available at* http://www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html#_edn12.

4. In assessing the costs and benefits of the proposed rule, the SEC's analysis is inconsistent and opportunistic

Over the past decade, courts have warned the SEC about its failure to produce comprehensive cost-benefit analyses. As one appeals court has stated, the SEC has a "statutory obligation to determine as best it can the economic implications of the rule."[47] Courts have invalidated rules for which the agency's economic analysis is deficient; for instance, in 2011, the U.S. Court of Appeals for the D.C. Circuit vacated the SEC's rule for proxy access, finding that the SEC "inconsistently and opportunistically framed the costs and the benefits" of that rule.[48]

Yet instead of attempting to perform such an analysis for this proposed rule, the SEC has summarily declared that it is "unable to quantify the economic effects because we lack the information necessary to provide a reasonable estimate."[49] But the agency has not even sought to obtain such information through empirical measures such as surveys of funds or more theoretical methods. Substantial economic costs such as loss of investor choice and reduced levels of capital formation are mentioned in passing, but the only costs quantified are basic compliance expenses the rule would impose on funds and business development companies.[50] As for the supposed upside, however, the SEC insists that the rule would produce large, economy-wide benefits.[51] This disconnect illustrates the same sort of "inconsistency" and "opportunism" that led the D.C Circuit to strike down the agency's Dodd-Frank proxy access rules in 2011.[52]

5. The proposed rule exceeds the SEC's statutory authority

A. The rule is inconsistent with Congress's intent in enacting Section 18 of the 1940 Act

To justify conditionally exempting investment companies from the limits imposed on them by Section 18,[53] the SEC purports to explain how its proposed exemptions are

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47. Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).
48. Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011). The court invalidated the rule even though the statutory authority the SEC relied on—the Dodd-Frank Wall Street Reform and Consumer Protection Act—clearly authorized the agency to promulgate the rule.
49. NPRM, *supra* note 1, 80 Fed. Reg. at 80957.
50. *See id.* at 80981–988.
51. *Id.* at 80957–963 (arguing that proposed rule would promote market efficiency, competition, and capital formation).
52. *Bus. Roundtable*, 647 F.3d at 1146; *see also supra* text accompanying note 48.
53. NPRM, *supra* note, at 80892 n.91 (citing agency's obligations under Section 6(c) of the 1940 Act).

"consistent with … the purposes fairly intended by the policy and provisions of [the 1940 Act]."[54] As the NPRM explains, in enacting Section 18, Congress was concerned that "[e]xcessive borrowing and the issuance of excessive amounts of senior securities by funds" that could result in the "potential abuse of the purchasers of senior securities."[55] A 1994 letter sent from then-SEC Chairman Arthur Levitt to a subcommittee of Congress elaborated on this rationale for Section 18, noting that during the 1920s and 1930s, "senior securities … were sold to the public as low risk investments."[56] However, many investment companies at the time held "common stocks that did not provide the stable asset values or steady income stream necessary to support senior charges."[57] Therefore, "[s]enior securities tended to lead to speculative investment policies to the detriment of senior securityholders."[58]

Hence, Section 18 limits the ability of closed-end companies to issue senior securities, while it contains an outright prohibition on their issuance by open-end companies (except for bank loans).[59] These restrictions aim to protect members of the public who might otherwise purchase senior securities from investment companies without realizing the risks they entail.[60] Yet the agency now seeks to regulate investment companies' use of derivatives not because it wishes to protect the "purchasers" of these "senior securities"—i.e., the counterparties that enter into derivatives contracts with mutual funds—but instead to safeguard fund investors.[61] In doing so, ironically, the proposed rule may well end up harming the very purchasers of so-called senior securities that Congress sought to protect with Section 18.

B. Congress amended the 1940 Act in 2000 to explicitly restrict the SEC's authority to regulate derivatives

Not only is the proposed rule contrary to the purposes of Section 18, but it appears to exceed to SEC's authority. In 2000, Congress passed the Commodity Futures Modernization Act (CFMA),[62] which among other things amended the 1940 Act to

54. 1940 Act § 6(c); 15 U.S.C. § 80a-6(c).

55. NPRM, *supra* note 1, 80 Fed. Reg. at 80887.

56. *Mutual Funds and Derivative Instruments*, Division of Investment Management Memorandum transmitted by Chairman Levitt to Representatives Markey and Fields, at 23 (Sept. 26, 1994), *available at* http://www.sec.gov/news/studies/deriv.txt.

57. *Id.*

58. *Id.*

59. 1940 Act § 18; 15 U.S.C. § 80a-18; *see also supra* notes 23–25 and accompanying discussion.

60. *See supra* notes 55–58 and accompanying discussion.

61. NPRM, *supra* note 1, 80 Fed. Reg. at 80887.

62. Pub. L. No. 106-554, app. E, 114 Stat. 2763, 2763A-365 (2000).

deny the SEC the statutory authority to interpret the term "senior securities" in Section 18 to encompass many kinds of derivatives that the agency now seeks to regulate. The agency ignores these limits on its authority, without even attempting to explain how they can be reconciled with its proposed rule.

In 1979, when the agency issued Release 10666,[63] Congress had not specifically addressed whether derivatives or financial commitment transactions fell under the definition of "security" under the 1940 Act[64]—or, for that matter, under the Act's definition of "senior security," which means any "bond, debenture, note, or similar obligation or instrument *constituting a security*."[65] To the extent that the 1940 Act's applicability to derivatives was unclear, when Congress passed the CFMA in 2000, it amended the Investment Company Act with the specific goal of clarifying the statutory authority of the SEC and other federal agencies to regulate derivatives.[66]

The CFMA amended the 1940 Act's list of items that constitute a "security," adding to this list the term "security future,"[67] which "has the same meaning as provided in section 3(a)(55)"[68] of the Securities Exchange Act of 1934 (the "1934 Act").[69] The CFMA added Section 3(a)(55) to the 1934 Act, defining a "security future" as:

> a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under paragraph (12) of this subsection as in effect on January 11, 1983 (other than any municipal security as defined in paragraph (29) of this subsection as in effect on January 11, 1983). The term "security future" does not include any agreement, contract, or transaction excluded from the Commodity Exchange Act under section 2(c), 2(d), 2(f), or 2(g) of the Commodity Exchange Act (as in effect on December 21, 2000) or sections 27 to 27f of title 7.[70]

Congress made these changes to the 1934 Act and the 1940 Act to clarify the respective roles of the SEC and the Commodity Futures Trading Commission (CFTC) to regulate derivatives, which were clouded with considerable regulatory

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63. *See* NPRM, *supra* note 1, 80 Fed. Reg. at 80888 & n.49.
64. 1940 Act § 2, 15 U.S.C. § 80a-2.
65. 1940 Act § 18(g), 15 U.S.C. § 80a-18(g (emphasis added).
66. CFMA § 209 (amending 1940 Act § 2).
67. 1940 Act § 2(a)(36), 15 U.S.C. § 80a-2(a)(36).
68. 1940 Act § 2(a)(52), 15 U.S.C. § 80a-2(a)(52).
69. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp).
70. 1934 Act § 3(a)(55)(A), 15 U.S.C. § 78c(a)(55)(A).

uncertainty in the 1990s.[71] The CFMA clarified that non-security based derivatives fell outside the scope of the SEC's authority, and that many other forms of derivatives—including over-the-counter (OTC) swaps—fell outside the scope of the both the SEC's and the CFTC's authority.[72] The CFMA also exempted from either agency's jurisdiction so-called "hybrid instruments" that involve futures contracts partially connected to bank transactions.[73]

Yet the NPRM appears to ignore the CFMA's amendments to the 1940 Act. Indeed, the agency fails to explain how it possesses the authority to regulate the issuance of these instruments by investment companies—or, for that matter, how the CFMA affects its ability to regulate derivatives in general.[74] Instead, the agency simply asserts that derivatives and financial commitment transactions resemble traditional types of senior securities, without parsing the statutory definition or examining how Congress has changed its scope since Release 10666 was issued in 1979.[75] Thus, to the extent that funds subject to the 1940 Act enter into derivatives contracts that are exempted by the CFMA, the SEC has no authority to treat such contracts as "securities"—let alone "senior securities" whose issuance implicates Section 18.

Nonetheless, the proposed rule purports to regulate all forms of exchange-traded and over-the-counter derivatives used by investment companies, such as swaps, forwards, futures, and options—including both security-based and non-security-based derivatives[76]—regardless of whether they are excluded from the 1940 Act by the CFMA.[77] Thus, even if the SEC possesses the authority to treat certain kinds of derivatives as senior securities, therefore, its proposed rule is nevertheless invalid because it rests on an impermissible construction of the 1940 Act.[78]

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71. *See, e.g.*, Kai Kramer, *Aren't We Still in the "Garden of the Forking Paths"? A Comment on Consolidation of the SEC and CFTC*, 4 HOUS. BUS. & TAX L. J. 410, 434–41 (2004).

72. *See* CFMA § 209;*see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. VII 124 Stat. 1376 (2010).

73. *See* CFMA tit. IV (codified as amended at 7 U.S.C. §§ 27–27f).

74. *See generally* NPRM, *supra* note 1.

75. *See id.*

76. NPRM, *supra* note 1, 80 Fed. Reg. at 80902–903, table 1.

77. *See* 7 U.S.C. §§ 2, 27–27f.

78. *Cf.* Abbott Labs. v. Young, 920 F.2d 984, 988 (D.C. Cir. 1990) ("The 'reasonableness' of an agency's construction depends on the construction's 'fit' with the statutory language as well as its conformity to statutory purposes.").

C. The SEC fails to justify departing from its longstanding treatment of derivatives used by investment companies

The proposed rule also marks a major departure from the agency's longstanding practice of issuing no-action letters and allowing investment companies to enter into derivatives transactions so long as they maintain segregated accounts.[79] As the NPRM acknowledges, the fund industry has come to rely on the agency's 37-year track record of permitting such transactions, in accordance with its 1979 general policy statement.[80] The agency now seeks to reverse course and impose significant new burdens on investment companies that wish to enter into derivatives contracts, yet the agency fails to articulate the factors justifying this proposed about-face. This runs contrary to the Supreme Court's holding that an agency's "settled course of behavior embodies" its "informed judgment that, by pursuing that course, it will carry out the policies committed to it by Congress."[81]

For example, the agency points to the "dramatic growth in the volume and complexity of the derivatives markets over the past two decades,"[82] but does not adequately explain how these changing circumstances merit the abandonment of its established approach. Similarly, when the SEC issued its "Hedge Fund Rule" in 2004, which narrowed the exemption from registration for hedge fund advisers, the agency "cited, as justification for its rule, a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds."[83] Yet the D.C. Circuit nevertheless vacated the rule, noting the agency's failure to cite "any evidence that the role of fund advisers with respect to investors had undergone a transformation."[84] Here, too, the agency has not shown that the increased use of derivatives by funds transforms the nature of these transactions in such a way that merits upending nearly four decades of precedent.

To be sure, the Supreme Court "normally accord[s] particular deference to an agency interpretation of longstanding' duration,"[85] recognizing that such an interpretation

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79. *See supra* notes 26–33 and accompanying discussion.

80. *See, e.g.*, NPRM, *supra* note 1, 80 Fed. Reg. at 80893 n.99.

81. Atchison, T. & S.F.R. Co. v. Wichita Bd. of Trade, 412 U.S. 800, 807–808 (1973).

82. NPRM, *supra* note 1, 80 Fed. Reg. at 80885.

83. Goldstein v. SEC, 451 F.3d 873, 882 (D.C. Cir. 2006).

84. *Id.*

85. Alaska Dep't of Envtl. Conservation v. EPA, 540 U.S. 461, 487 (2004) (internal quotations and citation omitted).

often rests on a "body of experience and informed judgment to which courts and litigants may properly resort for guidance."[86] But if an agency "chang[es] its course," it is "obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance."[87] Here, the SEC proposes to change course, but it has not made the heightened showing necessary to justify departing from its established practice.[88]

Just as many investment companies have long relied on the SEC's longstanding approach to derivatives, so has Congress, which has revised federal securities laws on several occasions since 1979—including legislation specifically related to the subject of derivatives regulation.[89] Indeed, given the "dramatic growth of derivatives"[90] in recent years, Congress's decision not to give the agency express authority to regulate investment companies' use of derivatives is especially telling. As the Supreme Court recently emphasized, Congress is expected to "speak clearly" if it wishes to assign to an agency decisions of vast economic and political significance.[91] If Congress wished to empower the SEC to regulate investment companies' use of derivatives, "it surely would have done so expressly," especially given the "deep 'economic and political significance'" of the question.[92] Yet Congress has declined to give the agency this authority, despite its many opportunities to do so. To the contrary, insofar as Congress has passed laws regulating derivatives, it has delegated such authority to the CFTC—not the SEC.[93] To paraphrase from the Court's opinion in *King v. Burwell*, this is not a case for the SEC.[94]

For the foregoing reasons, the proposed rule is both unwise and unlawful. We urge the SEC to refrain from issuing the rule.

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86. *Id.* (quoting Bragdon v. Abbott, 524 U.S. 624, 642 (1998)).
87. Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mutual Auto. Ins. Co., 463 U.S. 29, 41–42 (1983).
88. *Cf. Goldstein*, 451 F.3d at 883 (holding that SEC failed to "adequately to justify departing from its own prior interpretation" of a statutory provision).
89. *See, e.g.*, CFMA tit. IV; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at scattered sections of U.S.C.).
90. NPRM, *supra* note 1, 80 Fed. Reg. at 80885.
91. Utility Air Regulatory Grp. v. EPA, 134 S. Ct. 2427, 2444 (2014).
92. King v. Burwell, 135 S. Ct. 2480, 2489 (2015) (quoting *Utility Air Regulatory Grp.*, 134 S. Ct. at 2444).
93. *See supra* notes 62–75 and accompanying discussion.
94. *King*, 135 S. Ct. at 2489. ("It is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health insurance policy of this sort. This is not a case for the IRS." (citation omitted)).

Respectfully Submitted,

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