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For Funds' Use of Derivatives, a Promising New Regulatory Framework

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Comprehensive SEC rules govern most activities in the US-registered fund industry, but the use of derivatives is not one of them. For more than 40 years, funds employing these practical portfolio management tools for their investors have instead had to negotiate an increasingly complex accumulation of guidance, no-action letters, and informal comments from Commission staff.

Now, constructive reform might soon be on the way. In a [promising new proposal](#), the SEC has consolidated this cumbersome regulatory framework into a single, comprehensive rule.

Carefully designed to protect investors, the proposal would require a fund to develop and maintain a formal derivatives risk management program, administered by a dedicated derivatives risk manager and overseen by the fund's board. Each fund would be able to tailor elements of its program to the types of derivatives it uses, and to how they affect its portfolio and strategy.

The proposal would also require funds to limit their use of leverage, as determined by a measure called "value-at-risk" (VaR). Unlike the limits on gross notional exposure contemplated in the SEC's 2015 proposal on this topic, VaR tests yield useful information about a fund's economic risk and help constrain it. Asset managers commonly use VaR tests already, and this should enable firms to manage their leverage risk consistently across funds and ease the proposed rule's significant compliance burdens.

We at ICI are pleased that the proposal would achieve the SEC's goals of limiting undue speculation and ensuring that funds can meet their obligations under their derivatives transactions, while permitting funds and their investors to benefit from these important portfolio management tools. The [deeply flawed 2015 proposal](#) would have hampered funds' ability to manage their portfolios effectively, and the Commission deserves credit for its efforts toward crafting a far better approach this time around.

But no rulemaking proposal can be perfect, especially one as complex as this. As we explained in [comments to the SEC](#) on Monday, some targeted adjustments to the proposal could enhance it considerably.

Among our [main recommendations](#), we are urging the SEC to exclude certain firm and standby commitments from the definitions of *derivatives transaction* and *senior security*. Doing so would ensure that funds investing solely or primarily in these instruments—which neither create leverage nor pose any of the other risks that transactions more commonly known as derivatives can—do not unduly fall subject to a rule designed to mitigate these risks.

The SEC would also do well to modify the criteria that funds must use when selecting a securities index for comparison against their relative VaR. Our thinking here is that an index reflecting a fund's investment strategy—rather than simply the markets or asset classes in which it invests—would align more closely with investors' expectations of its volatility and risk.

Perhaps most important, the Commission should revise the proposal's limits on leverage. A moderate increase would control undue speculation just as well as the proposed limits, but would force fewer funds to deregister or change their investment strategy. It also would align fund leverage restrictions in the United States with those in other major jurisdictions.

For the many benefits they can provide to investors, derivatives have become one of the most important devices in a fund manager's

toolkit. Not only do they help funds lower their costs and enhance their liquidity, they also help funds better manage risk, access hard-to-reach asset classes, equitize cash, and more.

The time is now for a sound regulatory framework in this space—one that establishes robust safeguards to protect investors while fully preserving the benefits that derivatives can provide them. As the SEC works to refine its proposal in the coming months, ICI will be engaging closely with exactly that goal in mind.

Paul Schott Stevens was President and CEO of ICI.

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