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March 28, 2016

Submitted electronically through http://www.regulations.gov

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)

Dear Mr. Fields,

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed rule regarding the "Use of Derivatives by Registered Investment Companies and Business Development Companies" (the "Release").[2]

We fully support the SEC in its examination of the use of derivatives and leverage in the asset management industry and in its efforts to promulgate rules that it deems necessary and appropriate in the interests of shareholder protection and risk monitoring. We support proposed Rule 18f-4 (the "Proposed Rule") as a critical component of the SEC's broader agenda to examine and enhance its regulatory oversight regime and we agree that the Commission's review of its regulations and guidance on the use of derivatives and leverage is timely.

For more than thirty years, funds have been using derivatives to implement their investment strategies and manage risk. As the SEC recognizes, funds "may use derivatives to gain, maintain, or reduce exposure to a market, sector, or security more quickly and/or with lower transaction costs and portfolio disruption than investing directly in the underlying securities."[3] Fidelity mutual funds use derivatives within the confines of the SEC's regulations and guidance primarily to hedge or manage risk, such as interest-rate risk, or to gain more timely or convenient exposure to a market consistent with a fund's investment guidelines. Fidelity funds limit the leverage derivatives can create by segregating assets constituting good cover

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[1]Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf.
[3] *Id.* at 80886-80887.

pursuant to the SEC Staff's current guidance in an amount greater than or equal to, in most cases, the total notional exposure creating leverage. Fidelity does not manage any mutual funds or exchange-traded funds ("ETFs") (collectively, "Fidelity Funds") that borrow money for purposes of investment.

Most of the Fidelity Funds are permitted to engage in various types of derivatives transactions, though many use them rarely or solely to hedge risk. Fidelity's leverage and coverage policies ultimately limit the use of derivatives by any Fidelity Fund. For example, Fidelity's high yield bond fund portfolio managers typically do not use derivatives as part of their fundamental strategies, although they have the ability to use derivatives to hedge or assume credit risk. By contrast, Fidelity's investment grade bond funds often use derivatives to hedge or assume interest rate risk, because interest rate swaps are typically liquid even in times of market stress. International funds may use forward currency contracts to hedge currency risk, including as protection against a decline in the value of existing investments denominated in a foreign currency.

Notwithstanding the potential benefits that derivatives may provide funds, we agree with the SEC that "[a] fund's use of derivatives may involve counterparty, liquidity, leverage, market, and operational risks."[4] Moreover, in certain situations, investment management practices involving leverage can create or amplify risk. Since 1979, the SEC has developed a framework of regulatory guidance on funds' use of derivatives, including the issuance of Release 10666[5] and a variety of exemptive orders and no-action letters addressing Section 18 of the Investment Company Act of 1940, as amended (the "1940 Act").[6] While this guidance has been helpful in attempting to address investor protection and concerns underlying Section 18, it has not kept pace with "the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds."[7] As a result, funds and their advisers have interpreted the SEC's guidance differently over the years, even with respect to the same instruments, potentially to the disadvantage of certain funds and their shareholders. We commend the SEC in its effort "to take an updated and more comprehensive approach to the regulation of funds' use of derivatives and the application of the senior security restrictions in Section 18."[8]

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[4] *Id.* at 80897.

[5] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 ("Release 10666") 44 Fed. Reg. 25128 (Apr. 27, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

[6] SEC Staff has issued more than 30 no-action letters addressing derivatives and financial commitment transactions. These include *Dreyfus Strategic Investing & Dreyfus Strategic Income*, SEC No-Action Letter (June 22, 1987) (permitting funds to cover futures, forwards, options, and short sales by segregating the full value of the potential obligation of the fund under the contract or position) and *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter (July 2, 1996) (the "Merrill Letter") (permitting segregated assets to include not only the specific instruments enumerated in Release 10666, but also any asset that is liquid and marked to market daily, regardless of type).

[7] Release at 80885.

[8] *Id.* at 80897.

I. EXECUTIVE SUMMARY

While we support the SEC's goals and the Proposed Rule, we recommend the following modifications that we believe will enhance the effectiveness of the Proposed Rule:

1. The SEC should revise the notional exposure calculation to exclude currency forward contracts that a fund uses to hedge foreign currency risk back to the U.S. dollar.

2. The SEC should clarify the definition of "notional amount" under the portfolio limitation requirements to ensure consistent application across the industry.

3. The SEC should expand the list of "qualifying coverage assets" for derivatives transactions and financial commitment transactions to include liquid instruments other than cash and cash equivalents, subject to specified haircuts that address concerns regarding the potential for depreciation in value of such assets.

4. The SEC should clarify the meaning of "assets that are convertible to cash or that will generate cash" in the definition of qualifying coverage assets for financial commitment transactions.

5. The SEC should permit funds to satisfy the required mark-to-market and risk-based coverage amounts by the margin a fund posts for cleared derivatives transactions.

6. The SEC should modify the requirements of the derivatives risk management program to: (1) exclude currency forward contracts from the group of derivatives measured for purposes of the proposed 50% notional exposure calculation; (2) provide a grace period for crossing the notional threshold before a fund must adopt a derivatives risk management program; (3) permit a fund to enter into a *de minimis* amount of "complex derivatives transactions" before it must adopt a derivatives risk management program; and (4) permit funds with sub-advisers to designate more than one derivatives risk manager.

II. ENHANCEMENTS TO THE PORTFOLIO LEVERAGE LIMITATIONS

The Proposed Rule would require each fund to comply with one of two alternative portfolio limitations designed to limit the amount of leverage the fund may obtain through derivatives transactions, financial commitment transactions, and other senior securities transactions.[9] Fidelity supports this requirement and believes that it provides a reasonable and

[9] *Id.* at 80993-80994.

comprehensive framework within which the industry can consistently manage funds' use of such instruments.

Using the portfolio limitation guidelines provided in the Proposed Rule, Fidelity collected data on all of our non-money market Fidelity Funds.[10] Each of the 464 funds tested (with over $1.56 trillion in aggregate total net assets) reported aggregate notional exposures below the proposed exposure-based limit of 150% as of December 31, 2015. Moreover, only two of the 464 funds reported notional exposures greater than 50% and 348 of the funds (75%) had 0% exposure.[11] Accordingly, we believe the SEC appropriately designed the exposure thresholds under the Proposed Rule to provide ample flexibility for funds to enter into derivatives transactions, financial commitments transactions, and other senior securities transactions.

The SEC Should Exclude Currency Hedging from the Exposure Calculation

Although we support the SEC's proposed exposure thresholds, we suggest modifications to the portfolio limitation calculations that will clarify application of the Proposed Rule. We recommend that the SEC modify the exposure calculation under the portfolio limitation rules to provide a narrow exclusion for currency forward contracts that a fund enters into for purposes of hedging the foreign currency risk of assets in the fund back to the base currency of the fund (which is the U.S. dollar for U.S. registered investment companies). The SEC states in the Release that it considered, but rejected, the idea of allowing a fund to reduce its exposure calculation by derivatives transactions that the fund enters into for hedging or risk-mitigating purposes.[12] The Commission believes "it would be difficult to develop a suitably objective standard for these transactions, and that confirming compliance with any such standard would be difficult, both for fund compliance personnel and for our staff."[13] Although we agree with the SEC's position in the context of hedging and risk mitigation more broadly, we believe that the narrow use of currency forward contracts to hedge the currency exposure of assets held in a fund back to the U.S. dollar can be identified easily and, therefore, warrants an exception.

Fund managers use currency hedging to mitigate the risks they encounter when investing internationally. A fund manager may use forward currency contracts to hedge currency exposures of non-U.S. dollar assets held in a fund to protect the fund against an adverse change in foreign currency values between the date an asset is purchased and the date on which it is sold. For example, a U.S. dollar-denominated international bond fund that has a position in a euro-denominated corporate bond also assumes the currency risk of the euro. To reduce the fund's exposure to the volatility of the euro, the fund's manager may take an offsetting position by selling euros and buying U.S. dollars in the forward market in the amount of the bond's value. As the value of the bond increases because of the increase in the value of the euro, the value of

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[10] We did not measure the exposure on our 35 money market funds because they do not trade derivatives and they engage in *de minimis* financial commitment transactions.
[11] The two funds, which seek to obtain exposure to a basket of commodities, are not offered to retail shareholders and are managed by an unaffiliated adviser.
[12] Release at 80909.
[13] *Id.*

the forward contracts decreases and offsets the gains in the bond's value, and vice versa. Accordingly, the gain or loss on these contracts directly offsets currency-related fluctuations in the value of the bond position.

As this example illustrates, one-to-one hedging for non-U.S. dollar assets of the fund with foreign currency forward contracts can be identified clearly within the fund, and it also ensures that the fund has the assets necessary to cover the derivatives position. Ideally, the net notional amount of currency forward contracts (expressed as a present value) intended to hedge non-U.S. dollar exposure would be equal to the market value (including accrued interest) of the non-U.S. dollar assets of the fund denominated in that currency. However, the reality is that security prices and other variables change on a day-to-day basis, causing values to shift such that funds may be slightly over- or under-hedged on any given day. As a result, a fund must rebalance its currency exposures to accommodate these fluctuations. For this reason, we suggest that the portfolio limitation rules exclude currency forward contracts of each currency in a notional amount of up to 105% of the market value of the assets in such currency held by the fund. We also recommend that the SEC limit this exclusion to transactions in which the fund uses currency forward contracts to hedge a non-U.S. dollar-denominated currency back to the U.S. dollar.

The importance of excluding currency forward contracts from the exposure calculation for funds that fully hedge their portfolios is highlighted when considering the asset segregation requirements under the Proposed Rule. With limited exceptions, under the Proposed Rule a fund's qualifying coverage assets for its derivatives transactions must consist solely of cash and cash equivalents.[14] Because currencies fluctuate, requiring a fund that is fully hedged with currency forward contracts to segregate cash and cash equivalents to accommodate these fluctuations would force the fund to maintain a significant cash position that may be inconsistent with its investment objective or to sell small portions of bonds on a daily basis. The result would be both inefficient and disruptive to the investment process, and could result in unnecessary transaction costs for the fund. We discuss the asset segregation requirements and our recommended modifications in more detail in the next section.

<u>The SEC Should Clarify the Definition of "Notional Amount" under the Portfolio Limits</u>

Under the Proposed Rule, the "notional amount" of a derivatives transaction means, subject to certain adjustments, "(i) the market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions); or (ii) the principal amount on which payment obligations under the derivatives transaction are calculated."[15] As drafted, the first prong of the definition suggests that the notional amount refers to the mark-to-market value of the derivatives transaction. We do not believe that the SEC intended for the industry to interpret the definition in this manner. The Staff notes in the Release that the "notional amount generally serves [as] a measure of the underlying economic exposure because it reflects the value of the underlying reference asset for that derivative or the amount of the underlying reference asset on which payment obligations are

[14] Proposed Rule 18f-4(c)(8)(i).
[15] Proposed Rule 18f-4(c)(7)(i)-(ii).

based."[16] The definition included in the Proposed Rule does not achieve this goal. To avoid confusion and inconsistent calculations of notional amount, we urge the Commission to clarify the meaning of notional amount and adopt the definition used in the ABA's 2010 report on investment company use of derivatives and leverage.[17] The Release refers to this definition in describing the SEC's intent to be consistent with industry understanding of the term "notional amount."[18] Accordingly, we recommend that the SEC modify the definition of "notional amount" to "the nominal or face amount that is used to calculate payments made on a particular instrument, without regard to whether its obligation under the instrument could be netted against the obligation of another party to pay the fund under the instrument."[19]

III. ENHANCEMENTS TO THE ASSET SEGREGATION REQUIREMENTS

The Proposed Rule includes requirements for both the amount and type of assets a fund must segregate for each derivatives transaction. These guidelines generally are more stringent than the standards under existing SEC guidance and would require a fund to maintain qualifying coverage assets with a value equal to: (1) the mark-to-market amount and (2) the risk-based coverage amount.[20] Fidelity recognizes the strides the SEC has made in striking a balance between a full notional and mark-to-market requirement in determining what constitutes appropriate cover. Segregating solely the full notional amount or mark-to-market amount may result in over- or under-collateralization and potentially ignores the economic reality of a particular instrument within a fund. We generally support the SEC's proposed model for an asset segregation test, which in some respects provides greater flexibility than the internal limitations we impose on the Fidelity Funds, but we recommend certain modifications that incorporate aspects of the existing guidance and industry practice.

<u>The SEC Should Expand the List of Qualifying Coverage Assets for Derivatives Transactions to Include Liquid Instruments Other Than Cash and Cash Equivalents</u>

Under the Proposed Rule, the standard for an asset that would qualify as a coverage asset for purposes of a fund's derivatives transactions is more rigid than the position the SEC has taken in its previous guidance. The Proposed Rule would limit qualifying coverage assets to cash and cash equivalents or the asset that satisfies the fund's obligation under a derivatives transaction.[21] The fund industry currently relies on a broader definition provided through SEC guidance, including the Merrill Letter in which the Staff deemed any liquid asset, including equity securities and non-investment grade debt, as a qualifying coverage asset for derivatives transactions.[22] As the SEC Staff recognized in the Merrill Letter, "the type of asset placed in the

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[16] Release at 80902, n.159.
[17] *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law, (July 6, 2010) ("ABA Task Force Report"), *available at* https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf.
[18] Release at 80902.
[19] ABA Task Force Report at n. 11.
[20] Proposed Rule 18f-4(a)(2).
[21] Proposed Rule 18f-4(c)(8)(i)-(-ii).
[22] *See* Merrill Letter.

segregated account would have no effect on the maximum amount of leverage that a fund can assume. Similarly, […] the assurance of the availability of adequate funds […] will be satisfied so long as only liquid assets are maintained in the segregated account, and the value of those assets is marked to the market daily."[23] We are unaware of any situation in which segregating liquid assets rather than cash or cash equivalents has caused any adverse impact on a fund.

We understand the SEC's concern that a fund could segregate liquid assets against its derivatives positions and, nonetheless, be unable to meet its obligations "when a fund's portfolio securities also experience declines in value at the same time that the fund is required to make additional payments under the derivatives transactions."[24] Accordingly, the SEC has determined that a more restrictive standard may be necessary in defining the quality of eligible coverage assets for derivatives transactions. We believe, however, that a middle ground exists in which funds maintain the benefits of segregating liquid instruments and the Commission mitigates the potential risk of asset depreciation, without being unduly restrictive.

In the Release, the SEC recognizes that "the mark-to-market coverage amount and risk-based coverage amount are conceptually similar to initial margin […] and variation margin […].[25] Accordingly, we suggest that the SEC modify the definition of qualifying coverage assets to align with the assets eligible for initial and variation margin under the final uncleared margin rules recently adopted by the Prudential Regulators[26] and the Commodity Futures Trading Commission ("CFTC") (together, the "Uncleared Swap Margin Rules"), as provided in the Appendix. These rules permit funds to post and receive as initial and variation margin cash and cash equivalents or, in the alternative, liquid assets subject to specified "haircuts" that take into account times of financial stress and ensure that funds have sufficient assets available to meet their obligations.[27]

In addition, we recommend that the SEC expand the definition of qualifying coverage assets further to include shares of registered mutual funds, which may constitute a large

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[23] *Id.*

[24] Release at 80896.

[25] *Id.* at 80932-80933.

[26] "Prudential Regulators" collectively refers to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

[27] Margin and Capital Requirements for Covered Swap Entities: Final Rule, 80 Fed. Reg. 74839 (Nov. 30, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf and Interim Final Rule, 80 Fed. Reg. 74915 (Nov. 30, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf (Prudential Regulators' Rules); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (CFTC Rule), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf. Although these rules relate to eligible assets for purposes of margin for uncleared derivatives, we do not believe there is any basis for applying a different approach for cleared derivatives. We recognize that the SEC has proposed different margin requirements for security-based swaps; however, we urge the Commission to adopt final rules that are consistent with those that the Prudential Regulators and the CFTC have adopted.

percentage of a fund's holdings, particularly for funds-of-funds that may not hold other instruments. Section 12(d)(1) of the 1940 Act allows registered funds to invest all of their assets in affiliated funds of any type. Furthermore, Rule 12d1-2(a)(1) expands this ability to permit funds-of-funds that rely on Section 12(d)(1)(G) to invest in unaffiliated funds.

We believe that adopting our proposed broader definition of qualifying coverage assets would provide funds with a more consistent standard across regulators and a more efficient means of complying with the coverage requirements without holding large cash positions to the detriment of a fund.

Unintended Consequences of Limiting Qualifying Coverage Assets for Derivatives Transactions to Cash and Cash Equivalents

Limiting qualifying coverage assets for derivatives transactions to cash and cash equivalents would be harmful to shareholders in certain funds. For example, equity and high income funds typically do not have investment objectives that include maintaining significant cash positions. These funds often invest extra cash in futures or swaps that track indices as a means to gain exposure to the market in anticipation of shareholder redemptions or future investments. The transaction costs associated with a futures contract or swap are often significantly lower than the cost to purchase the referenced securities in an index, thereby preventing a cash drag on the fund's performance. Under the Proposed Rule, to enter into any derivatives transactions, these funds would need to sell securities or underlying fund positions in order to meet the asset segregation requirements. The unintended consequence of this requirement is that these funds may deviate from their investment objectives to increase their cash positions, which could adversely affect returns for shareholders. In the Uncleared Swap Margin Rules, the Prudential Regulators and CFTC recognized that limiting eligible collateral to cash "is inconsistent with current market practice" and "would drain the liquidity of financial end users by forcing them to hold more cash."[28] In the alternative, these funds may be discouraged from utilizing derivatives in situations that would otherwise be beneficial to shareholders, such as for purposes of hedging interest rate or currency risk, equitizing cash, and adding or reducing market exposure.

Although the Proposed Rule permits funds to reduce the coverage amount for derivatives transactions by the value of any posted variation margin or initial margin, as applicable, this may result in potentially discriminatory treatment across funds and further highlights the need to expand the category of eligible segregation assets. As discussed, the Uncleared Swap Margin Rules define eligible collateral for purposes of satisfying variation and initial margin for uncleared swaps to include a range of instruments broader than just cash and cash equivalents. For purposes of the Uncleared Swap Margin Rules, however, certain derivatives, such as deliverable currency forward contracts, are not "swaps" and, therefore, market participants are not required to collateralize these transactions. We anticipate that if the SEC adopts the Proposed Rule in its current form, market participants may decide to post margin voluntarily if they determine that the benefits of using non-cash assets to reduce the mark-to-market and risk-

[28] Prudential Regulators' Rules at 74869 and CFTC Rule at 668.

based coverage amounts under the Proposed Rule outweigh the costs of unnecessarily posting collateral under the Uncleared Swap Margin Rules.

The narrow category of qualifying coverage assets under the Proposed Rule may result in inconsistent treatment of funds that trade other types of derivatives, such as non-deliverable forwards. Unlike deliverable currency forward contracts, non-deliverable forwards are swaps under the Uncleared Swap Margin Rules and are subject to the variation and initial margin requirements. The Uncleared Swap Margin Rules, however, do not require funds to post initial margin unless they reach a specified threshold. Many funds that trade these contracts will not reach the threshold at which they must post initial margin, but may decide to post initial margin voluntarily for no reason other than to take advantage of using non-cash assets to reduce the risk-based coverage amount under the Proposed Rule.

As these examples illustrate, limiting qualifying coverage assets to cash and cash equivalents may promote a system whereby funds unnecessarily pledge variation and/or initial margin to counterparties simply because the Proposed Rule does not permit segregating those same assets to satisfy the mark-to-market and risk-based coverage amounts (which would be held in an account at the fund's custodian for the benefit of the fund). This creates a perverse incentive for a fund to post margin voluntarily, which results in holding the fund's assets outside of its custody account.

We recommend that the SEC modify the asset segregation requirements under the Proposed Rule to include any liquid instruments that funds may pledge as margin under the Uncleared Swap Margin Rules as well as shares of registered mutual funds, with the applicable haircuts.[29] We believe that this enhancement to the Proposed Rule serves shareholder interests and addresses the SEC's goal of ensuring that a fund has sufficient assets to meet its obligations.

<u>The SEC Should Expand the List of Qualifying Coverage Assets for Financial Commitment Transactions to Include Liquid Instruments and Should Clarify the Meaning of "Assets That Are Convertible to Cash or That Will Generate Cash"</u>

The Proposed Rule imposes asset coverage requirements on a fund's financial commitment transactions that resemble, but in some ways depart from, the coverage requirements for derivatives transactions. The Proposed Rule requires a fund that enters into a financial commitment transaction to maintain qualifying coverage assets equal in value to at least the fund's full obligation under such transactions. In addition to cash, cash equivalents and assets that may be delivered to fulfill a fund's obligations under a financial commitment transaction, qualifying coverage assets include "assets that are convertible to cash or that will generate cash, equal to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to

[29] The Uncleared Swap Margin Rules do not include mutual funds in the margin haircut table. We recommend that the SEC apply haircuts to these funds in the same manner as their underlying securities index under the Uncleared Swap Margin Rules.

the financial commitment obligation and can be expected to satisfy such obligation."[30] For the same reasons we provided in our recommended modifications to qualifying coverage assets for derivatives transactions, we urge the SEC to expand the coverage requirements for financial commitment transactions to include all liquid instruments.

In addition, we note that the reference to "assets convertible to cash or that will generate cash"[31] for purposes of qualifying coverage assets for financial commitment transactions is vague and subject to inconsistent interpretations. To prevent funds from construing this definition differently and potentially disadvantaging some funds, we recommend that the SEC clarify that this language includes assets that a fund may liquidate for cash and cash equivalents prior to the date on which the fund's financial commitment obligation is due.

<u>The SEC Should Permit Funds to Satisfy the Required Mark-to-Market and Risk-Based Coverage Amounts by Margin Provided for Cleared Derivatives</u>

The Proposed Rule contemplates netting and offsetting arrangements that may reduce the mark-to-market and risk-based coverage amounts in the context of over-the-counter derivatives, but fails to account for cleared derivatives transactions. Unlike over-the-counter transactions under an ISDA Master Agreement, cleared derivatives must follow the rules of the applicable clearinghouse and the terms of any agreement with a fund's futures commission merchant that serves as the fund's agent in transactions with the clearinghouse. Clearinghouses require posting of margin and it is common practice to apply margin to settle outstanding exposure on a daily basis without a netting agreement. Accordingly, we recommend that the SEC permit a fund to satisfy the mark-to-market and risk-based coverage amounts in full with the respective variation margin and initial margin that the fund posts for cleared derivatives.

IV. ENHANCEMENTS TO THE DERIVATIVES RISK MANAGEMENT PROGRAM

The Proposed Rule requires a fund to adopt and implement a board-approved derivatives risk management program if the fund (i) engages in derivatives transactions with an aggregate notional value that exceeds 50% of the value of the fund's net assets or (ii) enters into any "complex derivatives transactions."[32] Fidelity agrees with the SEC that depending on the extent and complexity of a fund's derivatives use, a formalized risk management program further ensures compliance with any exposure and segregation requirements. We generally support the proposed elements and structure of the program and believe they ultimately will lead to a more efficient and consistent industry approach to monitoring derivatives risk. We suggest, however, a few modifications to the application of the risk management program and its requirements that we believe will enhance its effectiveness.

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[30] Proposed Rule 18f-4(c)(8).

[31] Proposed Rule 18f-4(c)(8)(iii).

[32] Proposed Rule 18f-4(a)(4).

The SEC Should Exclude Currency Hedging from the Calculation of the 50% Notional Exposure Threshold that Requires a Fund to Adopt a Derivatives Risk Management Program

As we explained in our discussion of the proposed portfolio leverage limitations, we recommend that the SEC exclude from the notional exposure calculation any currency forward contracts that a fund enters into for purposes of hedging foreign currency risk. Fund managers use currency hedging to mitigate the risks associated with international investing in a fund and the benefits of this practice warrant excluding these derivatives from the exposure calculation. For the same reasons, we urge the Commission to exclude currency forward contracts used for hedging from the group of derivatives transactions that a fund must measure for purposes of the proposed 50% notional exposure threshold, which determines whether a fund must adopt a derivatives risk management program. We do not believe a risk management program is necessary to monitor this specific subset of derivatives that a fund uses for risk mitigation purposes.

The SEC Should Provide a Grace Period for Crossing the Notional Threshold before a Fund Must Adopt a Derivatives Risk Management Program

The Proposed Rule establishes a 50% notional exposure threshold policy with respect to derivatives transactions that triggers the requirement for a fund to adopt a derivatives risk management program. We agree with this policy and believe that the SEC has set a fair and appropriate threshold. However, we recommend that the Commission incorporate into any final rule a reasonable time period during which a fund that temporarily exceeds the 50% threshold has an opportunity to cure before triggering the requirement to adopt a derivatives risk management program. We expect that significant time and resources will be necessary to develop and implement a formal derivatives risk management program. We believe it would be impractical to require a fund that temporarily exceeds the 50% threshold to adopt a permanent program if the fund intends to fall below the threshold within a reasonable time period.

In the final rules relating to registration of major swap participants and major security-based swap participants, the SEC and CFTC recognized the value of a grace period before requiring registration.[33] Those rules permit a person whose swap or security-based swap activity exceeds the applicable thresholds by 20% or less during a fiscal quarter to wait until the end of its next fiscal quarter before having to determine whether registration with the SEC or CFTC is necessary.[34] If the person's swap or security-based swap activities do not exceed any of the applicable thresholds during its next fiscal quarter, the person will not be required to register. We urge the SEC to adopt a similar approach with respect to the requirement to implement a derivatives risk management program. We recommend that the SEC permit a fund to exceed the 50% policy by up to 20% in a fiscal quarter (reaching no more than 70%, which is well below

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[33] Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012), *available at* https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.
[34] *Id.* at 30694.

the 150% portfolio limitation) without immediately requiring the fund to adopt a risk management program. Similar to the major swap participant and major security-based swap participant rules, we suggest modifying any final rule to require a fund to adopt a risk management program only if it continues to cross the 50% policy in the next fiscal quarter.

The SEC Should Permit a Fund to Enter into a De Minimis Amount of Complex Derivatives Transactions before It Must Adopt a Derivatives Risk Management Program

We generally agree with the requirement under the Proposed Rule for a fund to adopt and implement a board-approved derivatives risk management program if it enters into complex derivatives transactions. We understand the SEC's goal of protecting against the greater risk of loss and exposure to market risks that these instruments may present. However, the Proposed Rule would require a fund to adopt a risk management program before entering into even a single complex derivatives transaction, regardless of its size relative to a fund's net assets. We urge the SEC to modify this provision to allow a fund to enter into a *de minimis* amount of complex derivatives transactions without requiring it to adopt a risk management program. As with the 50% notional exposure threshold, we do not believe that a *de minimis* amount of complex derivatives transactions warrants the need for a fully developed program. Accordingly, we recommend that the SEC set a *de minimis* threshold (as proposed by the Investment Company Institute in its letter on the Release) at 1% of a fund's net assets (based on the complex derivative transactions' risk-adjusted notional value), which we believe would result in minimal impact to fund's portfolio.

The SEC Should Permit Funds with Sub-Advisers to Designate More than One Derivatives Risk Manager

The Proposed Rule requires any fund that must adopt a derivatives risk management program to designate an individual as the fund's derivatives risk manager, with board approval, who is responsible for administering the program.[35] The SEC indicates in the Release that a "fund could formally designate an employee or officers of the fund's sub-adviser to be responsible for administering the derivatives risk management program."[36] We generally agree with the flexibility this offers funds, but suggest some modifications to the Proposed Rule to address some of the complexities involved in the sub-advised fund context.

For many funds that employ sub-advisers, appointing an individual to oversee a derivatives risk management program may pose challenges. The role of a sub-adviser may vary from fund to fund. For some funds, the adviser may retain responsibility for providing the fund with administrative and compliance services, but engage a sub-adviser to manage the fund's investments. Other funds may use one or more sub-advisers to manage specific sleeves of a fund and may engage both affiliated and unaffiliated sub-advisers. Given the numerous ways in which sub-advisers may interact with a fund, we believe that imposing the responsibility for overseeing a fund's derivatives risk management program on a single individual may be

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[35] Proposed Rule 18f-4(a)(3)(ii).
[36] Release at 80943, n. 440.

impractical. In some cases, one or more sub-advisers may not have access to the necessary trading, operational, and compliance information available to the adviser or other sub-advisers to oversee the program effectively. Similarly, it may be unrealistic to expect a single individual to have the knowledge necessary to report to the board on a fund that uses multiple sub-advisers.

In order to provide the board with effective and informed reporting, we recommend that the SEC permit a fund's adviser to appoint either a single individual or a group of individuals to serve as the fund's derivative risk manager(s). Such individuals may be at the adviser and/or sub-adviser level and can coordinate regularly, ensuring that the people with the necessary expertise and information regarding the fund's derivatives risk management program are engaged.

V. CONCLUSION

We appreciate the opportunity to comment on the Release and Proposed Rule. We support the SEC's goals of augmenting investor protection and addressing concerns underlying Section 18 of the 1940 Act. We believe that with minor enhancements, the SEC can meet these goals. Finally, Chair White has described the SEC's five-part plan to issue rulemaking aimed at addressing risks in the asset management industry, which includes: (1) enhanced data reporting obligations; (2) liquidity risk management requirements; (3) measures to address risks related to funds' use of derivatives; (4) planning for the transition of client assets; and (5) stress testing requirements.[37] We urge the Commission and Staff to evaluate holistically their rulemaking efforts in these areas, with a specific focus on how the rules will work together.

* * *

Fidelity would be pleased to provide further information, participate in any direct outreach efforts the Commission undertakes, or respond to questions the Commission or Staff may have about our comments.

Sincerely,

Marc Bryant

[37] *See* Speech by Chair Mary Jo White at The New York Times DealBook Opportunties for Tomorrow Conference Held at One World Trade Center, New York, NY, *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

cc: The Honorable Mary Jo White, Chair
The Honorable Michael S. Piwowar, Commissioner
The Honorable Kara M. Stein, Commissioner

David W. Grim, Director, Division of Investment Management

APPENDIX

Proposed Haircuts for Non-Cash Qualifying Coverage Assets (Derived from CFTC and Prudential Regulators Uncleared Swap Margin Rules)

Asset Class[38]	**Discount (%)**
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, U.S. Government-sponsored enterprise ("GSE") securities as defined in the final rules): residual maturity less than one-year	0.5
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity between one and five years	2.0
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, GSE securities as defined in the final rules): residual maturity greater than five years	4.0
Eligible GSE debt securities: residual maturity less than one year	1.0
Eligible GSE debt securities: residual maturity between one and five years	4.0
Eligible GSE debt securities: residual maturity greater than five years	8.0
Other eligible publicly traded debt: residual maturity less than one-year	1.0
Other eligible publicly traded debt: residual maturity between one and five years	4.0
Other eligible publicly traded debt: residual maturity greater than five years	8.0
Equities included in S&P 500 or related index	15.0
Equities included in S&P 1500 Composite or related index but not S&P 500 or related index	25.0
Gold	15.0

[38] We suggest subjecting registered mutual funds to the same adjustments provided in the table with respect to their underlying index.