



April 22, 2020

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Submitted via electronic filing: <http://www.sec.gov/rules/proposed.shtml>

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, RIN 3235-AL60; File No. S7-24-15

BlackRock, Inc. (together with its affiliates, “**BlackRock**”)¹ respectfully submits its comments to the Securities and Exchange Commission (“SEC” or “Commission”) in response to the SEC’s request for comment on re-proposed Rule 18f-4 (“Proposal”) under the Investment Company Act of 1940, as amended, (“1940 Act”)² regarding the use of derivatives by registered investment companies and business development companies and required due diligence by broker-dealers and registered investment advisers regarding retail customers’ transactions in certain leveraged/inverse investment vehicles.

We appreciate the SEC’s work on this issue and have encouraged the implementation of rules regarding the use of derivatives and leverage in funds. BlackRock believes that when used appropriately, derivatives can be effective tools in seeking to achieve returns and control risks in US registered funds. For example, derivatives can be used to adjust levels of risk in a portfolio in a manner that may be more cost-effective, tax-efficient, or provide greater liquidity than replicating the same exposures through physical securities. That said, the use of derivatives can present risks, which must be properly managed. As such, we agree with the objectives of the Proposal to improve the consistency of the Commission’s existing rules regarding the use of derivatives by US registered funds and to ensure that appropriate risk management practices are in place to address the risks associated with various derivatives strategies.

¹ BlackRock is one of the world’s leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed-income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world.

² See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers’ Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (Jan. 24, 2020), available at <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.

BlackRock portfolio managers use derivatives for three main purposes: (i) to hedge (mitigate) risks to which the portfolio is subject, (ii) to replicate the characteristics of physical securities, and (iii) to generate portfolio exposures to implement an investment view. Hedging mitigates unwanted risk exposures in the portfolio. Hedging can either be targeted (a) on an absolute basis to reduce overall portfolio risk or (b) on a relative (or “active”) basis to reduce tracking risk relative to a fund’s benchmark. In other cases, portfolio managers use derivatives to replicate the risk-return profile of a physical security or a group of securities (e.g., an index or sector) because doing so is more efficient from a transaction cost, tax, liquidity, or operational perspective or because the physical security is not readily investable. The final use of derivatives is to generate exposures to a security or asset class to implement an investment view that cannot be easily achieved through investments in physical securities (e.g., the use of credit default indices and their associated options).

We agree with the Commission’s view that the use of derivatives should not be unlimited or unregulated. We believe the Proposal strikes the appropriate balance between limiting leverage and acknowledging these important uses of derivatives. While we have some requests for clarification and recommendations for technical revisions, we are very supportive of the Proposal, which we view as markedly improved from the previous version of the Proposal issued in 2015.³

I. Executive Summary

We are supportive of the Proposal and encourage the SEC to finalize its rulemaking on the use of derivatives by registered investment companies and business development companies. To encourage effectiveness and efficiency, we recommend the following clarifications or modifications, discussed in more detail throughout our letter.

- **Scope:**
 - **Money Market Funds:** The proposed definition of a “fund” excludes money market funds regulated under Rule 2a-7⁴ under the 1940 Act from the Proposal. However, given the broad definition of “derivatives” under the Proposal, certain transactions that money market funds undertake may be considered derivatives. We believe money market funds should be permitted to invest in all transactions that are consistent with Rule 2a-7, irrespective of whether those transactions are deemed “derivatives transactions” under Rule 18f-4, and that money market funds should be exempt from compliance

³ See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at <https://www.sec.gov/rules/proposed/2015/ic-31933.pdf>.

⁴ See Money Market Fund Reform, Investment Company Act Release No. 29132, 75 Fed. Reg. 10059 (Mar. 4, 2010), available at <https://www.federalregister.gov/documents/2010/03/04/2010-4059/money-market-fund-reform>.

with the requirements of Rule 18f-4, given the strict risk limitations already imposed on them by Rule 2a-7. Alternatively, if the SEC does not wish to allow money market funds to continue to engage in these transactions without being subject to the proposed rule as a whole, we would recommend that when-issued securities and forward repurchase agreements, certificates of deposit, and other similar long-settlement securities not be considered “derivatives” for purposes of the rule and should not be subject to the asset coverage test.

- **Reverse Repurchase Agreements and Similar Financing Transactions:** The proposal would expand the 300% asset coverage requirements of Section 18 of the Investment Company Act to include reverse repurchase agreements and other similar financing transactions. The approach under the Proposal would limit a fund’s use of reverse repurchase agreements and other similar financing transactions, such as tender option bonds, as compared to the current approach, which is based on asset segregation. This change could impact closed-end funds in particular, as closed-end funds typically use more leverage than open-end funds. In order to avoid unintended consequences, the SEC could instead address their concerns regarding undue speculation and asset sufficiency through an asset segregation framework, discussed in more detail below.
- **Derivatives Risk Management Program:** We are supportive of the proposed risk management program. Consistent with existing Rule 22e-4, we recommend that the SEC allow a fund’s investment adviser, along with the fund’s officer or officers, to serve as the derivatives risk managers, as those individuals and the committee to which they would delegate are best placed to manage a fund’s derivatives risk on a real-time basis. Additionally, we recommend that the SEC affirm that the role of a fund’s Board of Directors is one of general oversight, rather than day-to-day management of the risk management program.
- **Limits on Fund Leverage:** The SEC proposes a relative value-at-risk (VaR) test and an absolute VaR test. Under the relative VaR test, the VaR of a fund’s entire portfolio must not exceed 150% of the VaR of its designated reference index. If the derivatives risk manager is unable to identify an appropriate designated reference index, a fund would be required to comply with the absolute VaR test, under which the fund’s portfolio must not exceed 15% of the value of the fund’s net assets. We are supportive of the use of VaR-based limits on fund leverage risk.
 - **VaR Limits:** We recommend that the VaR limits be consistent with existing limits under the Undertakings for the Collective Investment in Transferable Securities (UCITS) framework, which are 200% for relative VaR and 20% absolute VaR.
 - **Relative vs. Absolute VaR:** We recommend additional clarity on the instances in which a fund can utilize the absolute VaR test instead of the relative VaR test.

- **Designated Reference Index:** We recommend additional clarity around the definition of the designated reference index and recommend that leveraged indexes should be defined as indexes that seek to provide a multiplier of returns.
- **VaR Modeling:** UCITS regulation provides flexibility to apply a re-scaled limit to VaR with a holding period and/or confidence level differing from the default 20 days and 99%, respectively, such as a one-day time horizon and a 95% confidence interval. We recommend alignment with UCITS rules.
- **Remediation:** Under the Proposal, if a fund breaches the VaR limit, the fund may not enter into derivatives transactions (other than derivatives transactions designed to reduce the fund's VaR) until the fund has been in compliance with the VaR test for three consecutive business days. We recommend that funds be permitted to enter into certain derivatives transactions even during the remediation period for the following reasons: 1) rolling current holdings; 2) meeting liquidity and redemption needs; 3) mitigating risks within the fund's portfolio more generally; and 4) responding to abnormal market conditions or events.
- **Limited Derivatives User Exception:** The proposal would provide an exception from the rule for limited derivatives users. The exception would be available to a fund that either limits its notional derivatives exposure to 10% of its net assets or uses derivatives transactions solely to hedge certain currency risks. We are supportive of the limited derivatives user exception; however, we recommend that the SEC make certain adjustments to the proposed exception in order to better align with market practices.
 - **Temporary Exceedances of the Exposure-Based Exception:** We recommend the SEC allow for temporary exceedances of the 10% threshold. Large inflows into a fund could temporarily lead to exceedance of the 10% threshold, which would not necessarily represent a fund's typical derivatives exposure. We also are seeking additional clarity regarding how long a fund has until it must comply with the rule's requirements after it breaches the 10% threshold.
 - **Currency Hedging Exception:** We recommend clarification on the "negligible amount" of currency derivatives a fund can hold in excess of the value of the hedged instruments. We recommend the SEC characterize "negligible amount" as exceedances of 10% or less of the value of the hedged instruments, under normal conditions.
 - **Fund of Funds:** We recommend the SEC provide a limited derivatives user exception to certain fund of fund arrangements that have no holdings other than underlying funds and derivatives that are utilized to mitigate a risk inherent in the underlying funds.
- **Public Reporting Requirements:** The Proposal would require funds to report new publicly disclosed information on Form N-PORT, including VaR results and the number of times a fund breached the VaR limits. We believe the public disclosure of VaR breaches is not appropriate for investor protection and could be misleading. Similar to the provisions in Rule 22e-4 (discussed

below), we recommend this reporting be made to the SEC as the regulator for monitoring purposes, rather than disclosed to the public.

- **Alternative Requirements for Certain Leveraged/Inverse Funds and Proposed Sales Practices:** We are supportive of the proposed alternative requirements, but do not agree with the proposed amendment to Rule 6c-11 (“the ETF Rule”)⁵ to include leveraged/inverse funds in the scope of the rule without the implementation of additional guardrails around these products, namely the clearer identification and categorization of exchange-traded products (ETPs).
- **Implementation:** The Proposal would give funds a one-year implementation period to come into compliance with Proposed Rule 18f-4. Given the complexities involved in applying this rule to many different types of funds, we recommend an 18-month implementation period.

II. Scope

The proposed rule would apply to mutual funds, ETFs, registered closed-end funds, and business development companies.

A. Money Market Funds

The proposed definition of a “fund” excludes money market funds regulated under Rule 2a-7 under the 1940 Act from the Proposal. The SEC noted that it excluded money market funds from the scope of the Proposal because it does not believe money market funds “typically engage in derivatives transactions or the other transactions permitted by Rule 18f-4.”⁶ However, given the broad definition of “derivatives” that is being considered under the Proposal, certain transactions in which money market funds participate may be considered derivatives. Rule 2a-7 does not prohibit money market funds from investing in “derivatives” that otherwise comply with Rule 2a-7. We recommend that money market funds should continue to be permitted to invest in all transactions that are consistent with Rule 2a-7, irrespective of whether those transactions are deemed “derivatives transactions” under Rule 18f-4, and that money market funds should be exempt from compliance with the requirements of Rule 18f-4, given the strict risk limitations already imposed on them by Rule 2a-7.

Many money market funds do, for example, engage in, or have the ability to engage in, “when issued” transactions, forward settling transactions, and reverse repurchase agreements, as consistent with the risk-limiting provisions of Rule 2a-7. Under the Proposal, these transactions would be considered “derivatives

⁵ See Exchange-Traded Funds, Investment Company Act Release No. 33646, 84 Fed. Reg. 57162 (Oct. 24, 2019), available at <https://www.federalregister.gov/documents/2019/10/24/2019-21250/exchange-traded-funds>.

⁶ The SEC stated that they believed “that these transactions would generally be inconsistent with a money market fund maintaining a stable share price or limited principal volatility and especially if used to leverage the fund’s portfolio.

transactions.” Money market funds use these types of securities for supply, liquidity, and risk management. For example, government money market funds often purchase US Treasury securities on a “when-issued” basis. These Treasury securities may be purchased immediately following the announcement of a US Treasury auction but before the actual auction occurs.⁷ At the time of purchase, a money market fund would know the material terms of this security, although it settles beyond the usual settlement period for a Treasury security. It is not uncommon for government agency issuances to have long settlement periods to align with the agency’s desired cash flow, as well. Additionally, money market funds may also invest in other long forward-settling transactions, such as forward-settling repurchase agreements or certificates of deposit (CDs) over month- or quarter-ends, when supply in the marketplace can be more challenging. In these transactions, the money market fund would agree to the terms of a repurchase agreement or CD at the time of trade. In all of these transactions, the risk of the trade is captured into the money market fund on the trade date and would reflect the interest rate exposure and credit exposure of these transactions in the dollar-weighted average maturity and dollar-weighted average life of the fund. If money market funds are not exempted from the Proposal (rather than excluded), the money market funds would not be permitted to invest in these securities. Government money market funds in particular may find that this would limit supply options.

Rather than present the traditional concerns that derivatives transactions may raise, there are significant benefits to the money market funds being able to enter into these transactions. Money market funds may be able to receive better pricing and secure much-needed supply.⁸ These transactions are not used to leverage the portfolio or replicate exposure.

We therefore strongly recommend that money market funds should retain their ability to invest in these transactions and other similar transactions without being subject to the derivatives risk management program requirements, fund limits, and other provisions of the proposal. Money market funds are already subject to significant risk mitigation requirements under Rule 2a-7.⁹

Alternatively, if the SEC does not wish to allow money market funds to continue to engage in these transactions without also being subject to the proposed rule as a whole, we recommend that when-issued securities and forward repurchase agreements and CDs, and other similar long settlement securities should not be considered “derivatives” for purposes of the rule and should not be subject to the asset coverage test. There is no justification for treating these

⁷ U.S. Treasury auctions are typically announced on Thursdays and held the following Mondays. These treasuries then typically settle on Tuesdays (or T+3).

⁸ Government money market funds are required to purchase 99.5% of their securities in U.S. Government securities or cash or fully collateralized repurchase agreement.

⁹ Rule 2a-7 requires a money market fund to own 10% of daily liquid assets (other than tax-exempt funds), 30% of weekly liquid assets and no more than 5% of illiquid securities. These funds are also required to be stress tested and have a significant amount of transparency.

securities as derivatives, as they do not implicate the concerns that Section 18 of the Investment Company Act was designed to address.

If the SEC does not permit money market funds to invest in securities consistent with 2a-7, or does not narrow the definition of a derivatives transaction, money market funds should be included in the definition of funds and be permitted to rely on the proposed Rule.

B. Reverse Repurchase Agreements and Similar Financing Transactions

The Proposal would expand the 300% asset coverage requirements of Section 18 of the Investment Company Act to include reverse repurchase agreements and other similar financing transactions. Under these requirements, funds would be permitted “to obtain financing by borrowing from a bank, engaging in a reverse repurchase agreement, or any combination thereof, so long as all sources of financings are included when calculating the fund’s asset coverage ratio.”¹⁰

The approach under the Proposal would limit a fund’s use of reverse repurchase agreements and other similar financing transactions, such as tender option bonds (TOBs) as compared to the current approach, which is based on asset segregation. This change could impact closed-end funds in particular, as closed-end funds typically use more leverage than open-end funds.

In order to avoid these unintended consequences, the SEC could instead address their concerns regarding undue speculation and asset sufficiency through an asset segregation framework. Under the framework, reverse repurchase agreements and similar financings would not be treated like bank borrowings, as long as the fund segregates liquid assets to fully cover the fund’s obligations for those instruments, marked-to-market on a daily basis. Since the SEC stated in the Proposal that that reverse repurchase agreements and similar financing transactions “more closely resemble bank borrowings with a known repayment obligations rather than the more-uncertain payment obligations of many derivatives,”¹¹ utilizing an asset segregation framework for these transactions would be a more appropriate way to alleviate any asset sufficiency concerns. If the 300% asset coverage test were to apply, we would recommend additional clarity on how to apply the test to reverse repurchase agreements and TOBs.

We also recommend additional clarity around the definition of “similar financing transactions.” The Proposal states that although securities lending arrangements are structurally similar to reverse repurchase agreements, securities lending would not be considered a “similar financing transaction” for purposes of Section 18’s asset coverage regime so long as the fund “does not sell or otherwise use non-cash collateral received for loaned securities to leverage the fund’s

¹⁰ See Proposal at 4504.

¹¹ See Proposal at 4504.

portfolio, and the fund invests cash collateral solely in cash or cash equivalents.”¹² Presently, funds are permitted to invest cash collateral in highly liquid, short-term instruments, such as US Treasuries, that may not qualify as “cash or cash equivalents.” However, the Proposal does acknowledge that these kinds of “highly liquid, short-term investments” limit a fund’s “ability to use securities lending transactions to increase leverage in its portfolio.”¹³ Accordingly, we recommend that the Commission permit highly liquid short-term instruments, that are not “cash or cash equivalents,” to be included in a fund’s asset coverage calculation.

III. Derivatives Risk Management Program

The Proposal would require funds to adopt and implement a written derivatives risk management program with several specific elements including risk identification and assessment, risk guidelines, stress testing, backtesting, internal reporting and escalation, and a periodic review of the program. We are supportive of the proposed risk management program and agree that it will codify best practices many funds already have in place, including stress testing, backtesting, and other risk management tools. Funds already have in place a liquidity risk management program, as required under Rule 22e-4 (the “Liquidity Risk Management Rule”). However, some of the elements of the risk management program under proposed Rule 18f-4 would deviate from the structure of the risk management program under Rule 22e-4. As the liquidity risk management program structure under the Liquidity Risk Management Rule has proven to be effective, the SEC should use a similar structure for the proposed derivatives risk management program under Rule 18f-4.

For example, the derivatives risk management program in the Proposal would require a fund adviser’s “officer or officers” to serve as the fund’s derivatives risk manager. However, the Liquidity Risk Management Rule allows a fund’s “investment adviser, officer, or officers” to be responsible for administering the fund’s liquidity risk management program. In the final rule, the SEC noted, “The Commission continues to believe this approach properly tasks the person(s) who are in a position to manage the fund’s liquidity risks on a real-time basis with responsibility for administration of the liquidity risk management program.”¹⁴

Therefore, consistent with Rule 22e-4, the SEC should allow a fund’s investment adviser, along with the officer or officers, to serve as the derivatives risk manager, as those individuals are best placed to manage a fund’s derivatives risk on a real-time basis. Typically, where an investment adviser is appointed, the investment adviser delegates to a committee comprised of experts from a variety of functions—a structure that we believe lends itself to both liquidity risk management and derivatives risk management.

¹² See Proposal at 4504.

¹³ See Proposal at 4504.

¹⁴ See Liquidity Risk Management Rule at 82213.

The Proposal also sets out various responsibilities for the fund's Board of Directors in overseeing the risk management program. Among other Board requirements, under the Proposal, the derivatives risk manager would be required to provide to the Board regular written reports regarding the program's implementation and effectiveness and describing any exceedances of the fund's guidelines and the results of the fund's stress testing and backtesting. By contrast, Liquidity Risk Management Rule requires the Board to "review, no less than annually, a written report prepared by the investment adviser, officer, or officers designated to administer the liquidity risk management program that describes a review of the program's adequacy and effectiveness."¹⁵ In Rule 22e-4, the SEC stated that the role of the Board would be in "overseeing the fund's liquidity risk management program"¹⁶ and eliminated certain of the more specific and detailed approval requirements in the original proposal. In making this change, the SEC acknowledged that "the role of the Board under the rule is one of general oversight, and, consistent with that obligation, we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."¹⁷

We believe that the Board plays an important role in reviewing regulatory compliance. However, the level of involvement under Proposed Rule 18f-4 is overly granular and inconsistent with the SEC's approach to Board oversight in other regulations. Board members should not be required to oversee the day-to-day management of the derivatives risk management program. The SEC should instead affirm that the role of a fund's board is one of general oversight and align the Board's role in the derivatives management program with the existing role of the fund Board in the liquidity risk management program under Rule 22e-4.

IV. Limits on Fund Leverage

The SEC proposes a relative VaR test and absolute VaR test. Under the relative VaR test, the VaR of a fund's entire portfolio must not exceed 150% of the VaR of its designated reference index. If the derivatives risk manager is unable to identify an appropriate designated reference index, a fund would be required to comply with the absolute VaR test, under which the fund's portfolio must not exceed 15% of the value of the fund's net assets.

We are supportive of the use of VaR-based limits on fund leverage risk. We agree that VaR tests enable risk to be measured in a reasonably comparable and consistent manner across diverse types of instruments and provide an adequate overall indication of market risk. The VaR tests will be particularly beneficial when used in conjunction with elements of the derivatives risk management program, including stress testing, backtesting, and risk guidelines.

¹⁵ See Liquidity Risk Management Rule at 82213.

¹⁶ See Liquidity Risk Management Rule at 82215.

¹⁷ See Liquidity Risk Management Rule at 82212.

A. VaR Limits

We believe the VaR limits should be consistent with existing limits under the UCITS framework. For purposes of calculating global exposure, UCITS funds can use a relative VaR or absolute VaR approach. Under the relative VaR approach, a UCITS fund can have a relative VaR of up to 200% of the VaR of the relevant index. Under the absolute VaR approach, the absolute VaR of a UCITS cannot be greater than 20% of its net asset value.¹⁸

A globally consistent approach would allow similar strategies to be managed consistently across a platform. The UCITS framework has been a globally successful regulatory framework for decades, effectively regulating fund leverage risk. In the UCITS Directive, the European Parliament, Commission, and Council of the European Union acknowledged that UCITS should be permitted to use derivatives “as a part of their general investment policy or for hedging purposes in order to reach a set financial target or the risk profile indicated in the prospectus.” They added, “In order to ensure investor protection, it is necessary to limit the maximum potential exposure relating to derivative instruments so that it does not exceed the total net value of the UCITS’ portfolio.”¹⁹ This led to the 200% and 20% limits for UCITS, which have proven over the years to effectuate the Directive’s investor protection objective. Harmonized limits would allow firms to manage their risk in a globally consistent manner and to rely on derivatives risk management tools and tests already in place to meet regulatory requirements. The SEC should align the US framework with this proven-effective regime.

Moreover, the recent market volatility during the COVID-19 health crisis has shown the importance for funds to have access to the derivatives markets both to hedge risk and the flexibility to respond to quickly changing market demands. In March 2020, the relative VaR of some of BlackRock’s funds increased as overall market volatility increased. During March, most of our funds remained under the 200% relative VaR and 20% absolute VaR limits, but some would have breached the 150% and 15% limits, as proposed. During times of market volatility, funds need the flexibility to utilize the derivatives market to meet investment objectives and hedge increased market risk. A relative VaR limit of 200% and absolute VaR limit of 20% would largely allow for this flexibility, while still protecting against excessive use of leverage.

B. Relative vs. Absolute VaR

The Proposal states, “If the derivatives risk manager is unable to identify an appropriate designated reference index, a fund would be required to comply with the absolute VaR test.”²⁰ We recommend that the SEC provide additional clarity on the

¹⁸ See Committee of European Securities Regulators, *CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (July 28, 2010).

¹⁹ See UCITS Recital (43): <https://www.esma.europa.eu/databases-library/interactive-single-rulebook/ucits/recital>

²⁰ See Proposal at 4454.

instances in which a fund can utilize the absolute VaR test instead of the relative VaR test. Specifically, we recommend that the SEC provide the derivatives risk manager with the discretion to select whether a fund should use the relative or absolute VaR test. If the derivatives risk manager determines that the fund should utilize the absolute VaR test, the risk manager could provide appropriate disclosures and reporting to the Board.

C. Designated Reference Index

As discussed above, the Proposal would require that under the relative VaR test, the VaR of a fund's entire portfolio must not exceed 150% of the VaR of its designated reference index. The Proposal would define a "designated reference index" as an "unleveraged index that is selected by the derivatives risk manager, and that reflects the markets or asset classes in which the fund invests."²¹ The proposed definition would also "require that the designated reference index not be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used. Additionally, the designated reference index must either be 'appropriate broad-based securities market index' or an 'additional index' as defined in Item 27 of Form N-1A."²²

We recommend several points of clarity around the definition of the designated reference index. First, we recommend additional guidance as to what constitutes an "unleveraged" reference index. Specifically, we believe that leveraged indexes should be defined as indexes that seek to provide a multiplier of returns. For example, 1940 Act registered commodity futures-based ETFs invest in commodity futures to provide exposures to the relevant commodity. It is common for commodity indexes to be based on the futures for the applicable commodity. These indexes are designed to provide a 1-for-1 valuation for the commodity exposure and not a multiplier of such value. Therefore, we would recommend the SEC clarify that a leveraged index is an index that provides for a multiplier of returns, and that an index would not be considered leveraged solely because it includes derivatives.

Second, we recommend a change to the definition of a designated reference index with respect to indexes administered by unaffiliated third parties ("unaffiliated indexes"). We recommend that an unaffiliated index created at the request of the fund or its investment adviser be permitted as a designated reference index. For unaffiliated indexes, including indexes that were created at the request of a fund or its investment adviser, the index provider, in its sole discretion, determines the composition of the index, the rebalance protocols of the index, the weightings of the securities and other instruments in the index, and any updates to the methodology.

²¹ See Proposal at 4471.

²² See Proposal at 4471.

Third, we recommend a change to the definition of a designated reference index as it applies to affiliated indexes. The Proposal would “require that the designated reference index not be administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.”²³ We recommend that an index fund that tracks an affiliated index (a “self-indexed fund”) be allowed to use an affiliated index as its designated reference index, even if not widely recognized or used.

For an index fund, including a fund that tracks an affiliated index or an index that was created at the request of the fund or the investment adviser, the index the fund tracks is the most appropriate designated reference index because that index best represents such fund’s investment objective and strategy. Additionally, in both scenarios described above, the Board’s general oversight of the fund, including approving its investment objective and strategy and the derivative risk management program’s implementation and effectiveness, mitigates concerns about the index being improperly used to increase the fund’s leverage.

Finally, the Proposal allows the derivatives risk manager to select a designated reference index that is a blended index, which the SEC acknowledges “would give some flexibility in identifying or constructing a designated reference index.”²⁴ The Proposal appears to allow flexibility for the derivatives risk manager to create a proprietary blend, as long as the components of the blend meet the proposed requirements for a designated reference index and the index is disclosed as an “additional index” (as opposed to an “appropriate broad-based securities market index”). We recommend that the SEC clarify whether a fund may use a designated reference index that is a blended benchmark, the components of which are comprised of third-party indices that are widely recognized and used but has been calculated by the fund’s investment adviser. For example, would a mutual fund’s reference benchmark that is an unmanaged weighted index with the following composition qualify as a blended index: 36% S&P 500® Index; 24% FTSE World (ex-U.S.) Index; 24% ICE BofAML Current 5-Year U.S. Treasury Index; and 16% FTSE Non-U.S. Dollar World Government Bond Index? We recommend that the SEC provide clarification that funds can continue to use those types of blended reference benchmarks.

D. VaR Modeling

With respect to VaR modeling, the Proposal would require that a fund’s VaR model use a 99% confidence level and a time horizon of 20 trading days. The SEC notes that “the proposed confidence level and time horizon requirements also are similar to those in other VaR-based regulatory schemes,” reflecting a desire to achieve global consistency.²⁵ However, UCITS regulation provides flexibility to apply a re-scaled limit to VaR with a holding period and/or confidence interval differing

²³ See Proposal at 4471.

²⁴ See Proposal at 4471.

²⁵ See Proposal at 4476.

from the default 20 days and 99%, respectively, such as a one-day time horizon and a 95% confidence interval. We believe that this flexibility is important to apply to the SEC's rule in order to achieve global consistency with the UCITS framework.

The Proposal also states that it should be the responsibility of the derivatives risk manager to choose the appropriate VaR model (e.g., a historical simulation, Monte Carlo simulation, or parametric methodology) for the fund's portfolio. We are supportive of this discretion and agree that this will allow funds to use a VaR model that is appropriate for the fund's investments.

V. Remediation

Under the Proposal, if a fund breaches the VaR limit, it must come back into compliance within three days. If it does not, the derivatives risk manager must report to the fund's Board, analyze the circumstances that caused the issue and update the program elements to make sure it does not happen again. In addition, the fund "may not enter into derivatives transactions (other than derivatives transactions that, individually or in the aggregate, are designed to reduce the fund's VaR) until the fund has been in compliance with the applicable VaR test for three consecutive business days and has satisfied the board reporting requirement and program analysis and update requirements."²⁶

We recommend funds be permitted to enter into certain derivatives transactions even during the remediation period for the following reasons: (1) rolling current holdings, (2) meeting liquidity and redemption needs, (3) mitigating risks within the fund's portfolio more generally, and (4) responding to abnormal market conditions or events. These transactions are important for funds to avoid disruption and should not be restricted for any period of time.

VI. Limited Derivatives User Exception

Under Proposed Rule 18f-4, funds that use derivatives only in a limited way would not be required to adhere to the proposed rule's risk management program requirement and VaR-based limit on fund leverage risk. We are supportive of a limited derivatives user exception in order to avoid imposing disproportionate costs and compliance burdens on funds that only use derivatives in a limited way. We agree that those costs would be disproportionate to the resulting benefits. As proposed, the exception would be available to a fund that either limits its notional derivatives exposure to 10% of its net assets, or that uses derivatives transactions solely to hedge certain currency risks. We recommend the SEC make certain adjustments to the proposed exception in order to better align with market practices.

²⁶ See Proposal at 4479.

A. Temporary Exceedances of the Exposure-Based Exception

First, we recommend the SEC allow for temporary exceedances of the 10% threshold. Large inflows could temporarily lead to exceedance of the 10% threshold, which would not necessarily represent a fund's typical derivatives exposure. For example, during periods of large redemptions or subscriptions, ETFs and index products often use index futures or swaps to equitize cash in order to maintain low tracking error to the benchmark. These kinds of temporary exceedances are unrelated to increasing the fund's leverage and would not be unduly speculative. To require a fund that briefly exceeds the 10% threshold to come into compliance with the derivatives risk management program requirements and leverage limits would run counter to the SEC's stated goal of avoiding disproportionate costs and compliance burdens on limited derivatives users.

Second, the Proposal states that in the event that a fund exceeds the threshold for the limited derivatives user exception, the fund would have to "reduce its derivatives exposure promptly or establish a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable."²⁷ The Proposal does not define what "reasonably practicable" means, so it is unclear how long a fund can be in breach of the threshold without needing to comply with the derivatives risk management requirements and leverage limits. As such, we recommend additional clarity around when a fund exceeds the threshold.

B. Currency Hedging Exception

We are supportive of the currency hedging exception, as these transactions are used to hedge risk, rather than for speculative purposes. However, we seek a clarification. The Proposal states that "the notional amount of the currency derivatives the fund holds cannot exceed the value of the instruments denominated in the foreign currency by more than a negligible amount."²⁸ We recommend clarification as to what would be characterized as "negligible." We would ask that the Final Rule clarify that "negligible amounts" be characterized as exceedances of 10% or less of the value of the hedged instruments, under normal conditions. We believe that this would be in line with the Commission's rationale behind the exposure-based exception, which considers anything under 10% of net assets to be "relatively limited."²⁹

C. Fund of Funds

We recommend that the SEC provide a limited derivatives user exception to certain fund of fund arrangements that have no holdings other than underlying

²⁷ See Proposal at 4486.

²⁸ See Proposal at 4488.

²⁹ See Proposal at 4485.

funds and derivatives that are utilized to mitigate a risk inherent in the underlying funds (i.e., interest rate risk or inflation risk).³⁰

We believe that these arrangements should be accorded a limited derivative user exception. Fund of funds have a stated investment objective to hedge a specific risk while obtaining the non-hedged exposure through underlying funds. This means that all of the derivatives in the fund of fund are utilized for hedging a specific risk. This fact pattern should address the Commission's concerns that it may be hard to identify which interest rate derivatives are being used for hedging and which interest rate derivatives are being used for other purposes.

VII. Public Reporting Requirements

The Proposal would require funds that rely on Proposed Rule 18f-4 to report new publicly disclosed information on Form N-PORT, including VaR results and the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model ("VaR Breaks"). We believe that the public disclosure of VaR results and VaR breaks are neither necessary nor appropriate for the protection of investors because such information could be misleading.

In the Proposal, the SEC acknowledges that "because the proposed rule would require that the fund's backtest be conducted using a 99% confidence level and over a one-day time horizon, and, assuming 250 trading days in a year, a fund would be expected to experience a backtesting exception approximately 2.5 times a year, or 1% of the 250 trading days."³¹ Therefore, a VaR Break would not necessarily warrant investor concern, however the investor may not have the background information to reach that conclusion.

Moreover, the SEC amended the Liquidity Risk Management Rule to rescind the original requirement in the rule that funds publicly disclose aggregate liquidity classification information about their portfolios. In the amended rule, the SEC explained that in order to understand the liquidity classification information disclosed, it would take significant, detailed disclosure and nuanced explanation to effectively inform investors, and such a long narrative discussion would not be consistent with the nature of, and could undermined the purpose of, Form N-PORT.³² We believe that Proposed Rule 18f-4 would similarly require too much detailed explanation to effectively inform investors of the meaning of VaR breaks.

³⁰ One example of these fund of fund arrangements is the iShares Interest Hedged Corporate Bond ETF, which invests in an underlying ETF to obtain exposure to certain investment grade corporate bonds and invests in US Treasury futures contracts and interest rate swaps in order to mitigate the interest rate risk of the corporate bonds to which the fund is obtaining exposure. Another example is the iShares Inflation Hedged Corporate Bond ETF, which invests in an underlying ETF to obtain exposure to certain investment grade corporate bonds and invests in inflation swaps and other instruments in order to mitigate the inflation risk of the corporate bonds to which the fund is obtaining exposure.

³¹ See Proposal at 4464

³² See Final Rule at 31862

Therefore, we recommend this reporting be made to the SEC as the regulator for monitoring purposes rather than disclosed to the public.

VIII. Alternative Requirements for Certain Leveraged/Inverse Funds and Proposed Sales Practices

In addition to an alternative approach for certain leveraged or inverse funds, the proposal would impose additional sales practices rules requiring broker-dealers and investment advisers to engage in due diligence before accepting or placing an order for a customer or client that is a natural person to trade a leveraged/inverse investment vehicle. The Proposal would also amend Rule 6c-11, which permits ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the Commission, to remove the provision excluding leveraged/inverse ETFs from the scope of that rule.

Should the Commission choose to implement sales practice rules, we recommend that exchange-traded notes should be included within the scope if they have the same or similar return profiles as the leveraged/inverse funds and listed commodity pools included in the proposed definition.

While we are supportive of the proposed alternative requirements, we do not agree with the proposed amendment to the ETF Rule to include leveraged/inverse funds in the scope of the rule without the implementation of additional guardrails around these products, namely the clearer identification and categorization of exchange-traded products (ETPs). BlackRock has long advocated for a more comprehensive approach to ETP classification to improve investors' abilities to understand and analyze the risks of individual ETPs.³³ In our view, clearer labeling of ETPs will ensure that investors understand that certain products, like those with leveraged or inverse features, have greater embedded risks and more complexity than others.

IX. Implementation

The proposal would give funds a one-year transition period to comply with the Proposed Rule 18f-4; the one-year period would begin the date that the adopting release is published in the Federal Register. Given the complexities involved in applying this rule to many different types of funds, we recommend that this implementation period be extended to 18 months, with the option to implement early.

While the Proposal codifies many existing risk management best practices we already implement, it would also introduce significant operational changes, compliance monitoring, and reporting. For example, if finalized as proposed, the rule would require new VaR testing that deviates from existing VaR testing conducted under the UCITS framework. Additionally, the creation of the new

³³ See BlackRock comment letter on SEC Proposed Rule 6c-11: <https://www.blackrock.com/corporate/literature/publication/sec-proposed-rule-exchange-traded-funds-092618.pdf>

derivatives risk management programs across funds, including sub-advised funds, would also require significant new procedures, including Board reporting and approvals. The proposed asset coverage requirements would materially deviate from the current requirements around asset segregation and require several changes to our existing systems.

Rule 22e-4, which was analogous to Proposed Rule 18f-4 in the level of complexity and comprehensiveness, allowed for nearly a two-year implementation period. We believe that an 18-month transition period would result in a smoother implementation across the industry.

We thank the SEC for the opportunity to comment and express our support and appreciation for your efforts.

Sincerely,

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Managing Director, Legal & Compliance

Mary Warner
Director, Risk and Quantitative Analysis

Samantha DeZur
Director, Global Public Policy