



NASAA

March 27, 2020

By email to: rule-comments@sec.gov

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

RE: File No. S7-24-15: 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

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I am writing in response to U.S. Securities and Exchange Commission (“SEC” or the “Commission”) Release No. 34-87607, *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* (the “Proposal”).² The Proposal would make significant changes to derivative risk management and leverage standards for funds, and to sales practice rules related to “leveraged/inverse investment vehicles.”

NASAA agrees that the current rules governing the use of derivatives by funds – which were first adopted in 1979³ and have been clarified over the years through a patchwork of no-action letters and Commission and staff guidance – should be updated with uniform and clearly

¹ Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA’s membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² The Proposal is available at <https://www.sec.gov/rules/proposed/2019/34-87607.pdf>.

³ *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979).

articulated risk management standards. We also support the Commission's effort to improve fund reporting related to leverage and the use of derivatives.

However, enhancements must be made to the Proposal in order to strengthen investor protection. Specifically, derivative risk managers should be required to report failures to meet risk management program standards, such as stress tests and backtests, to a fund's board of directors immediately, and to report such failures to investors at least annually. Additionally, broker-dealers and investment advisers seeking to sell leveraged/inverse investment vehicles should be required to ascertain the maximum amount an investor is willing and able to lose on leveraged/inverse investments, and provide enhanced disclosures to investors describing the substantial risks inherent in these vehicles.

I. Risk Management Program

NASAA generally agrees that funds seeking to use derivatives, or funds employing leveraged or inverse strategies, should be subject to comprehensive risk management programs.⁴ NASAA supports the proposal to require funds to appoint skilled derivative risk managers to implement and monitor such programs. However, we have concerns regarding the discretionary nature of internal reporting, and the transparency of public reporting.

A. Board Oversight of Derivative Risk Management

The Proposal would require a derivative risk manager to create and adopt a written risk management program with associated policies and procedures. Such a program would include both standard and tailored risk guidelines, procedures for stress testing and backtesting, and internal reporting and escalation procedures. The Commission would expect a fund's board of directors to "understand the program and the derivatives risks it is designed to manage" and to "ask questions and seek relevant information regarding the adequacy of the program and the effectiveness of its implementation."⁵

While these are positive provisions, fund boards must have a contemporaneous view into certain parts of the risk management process. As proposed, while a fund's board can establish the frequency of reporting, a derivative risk manager is not required to report to the board immediately when a fund fails a stress test⁶ or exceeds the maximum value at risk ("VaR") threshold during backtesting.⁷ As proposed, a fund's board could conceivably meet at the end of a quarter only to find that the fund had failed multiple stress tests, and repeatedly exceeded backtesting allowances. Put another way, a board might not learn that the fund was experiencing significant difficulties in managing its exposures until after the fund had been materially harmed. Given the significance of failures to meet testing criteria, NASAA believes that fund boards should be informed of such

⁴ Proposal at 48.

⁵ *Id.* at 80.

⁶ *Id.* at 65-66; 74-75.

⁷ *See Id.* at 84-87.

failures when they occur so that they can either reset the frequency of reporting or become more actively involved in risk management oversight. Leaving the “timely disclosure” of such failures to the risk manager’s discretion, as proposed, is insufficient.

B. Public Disclosure and Transparency

The Proposal would require a fund using leverage to disclose a designated reference index and VaR threshold in its annual report.⁸ NASAA supports these disclosures but believes they are too limited. Because leveraged products “present serious risks, magnifying losses for investors in times of turbulence,” and are “rarely appropriate for retail use,”⁹ NASAA believes that investors should understand not only the metrics used to measure risk, but should have specific information as to how well a fund has adhered to, or how often it has failed to meet, those metrics.¹⁰ At a minimum, the number of exception reports, failed stress tests, and VaR-based threshold breaches should be included in the fund’s annual report.

II. **Sales Practices Rules for Leveraged/Inverse Investment Vehicles**

NASAA supports the heightened scrutiny and sales practice rules described in the Proposal.¹¹ The proposed collection, review, and account approval requirements would enhance investor protection. However, among the minimum due diligence criteria enumerated in the Proposal,¹² NASAA believes that the amount an investor is willing or able to lose should also be a recorded metric. We also do not believe a single form that provides static information should control investments into these risky products over time. Given the recent unprecedented market volatility, it is not unreasonable to believe that investors who may qualify to trade in these vehicles at one point could quickly and unexpectedly fail to meet a firm’s standards for continued leveraged or inverse trading.

Finally, consistent with fiduciary duties and impending Regulation Best Interest conduct standards, NASAA believes firms seeking to sell leveraged/inverse investment vehicles should be required to explain to their customers how such exposures can increase the risk of loss by compounding negative results or reacting to market movements in unexpected ways.¹³ Consistent

⁸ *Id.* at 97-99.

⁹ Commissioners Robert J. Jackson and Allison Herren Lee, *Statements on Proposed Rules on Funds’ Use of Derivatives* (Nov. 26, 2019), available at <https://www.sec.gov/news/public-statement/jackson-lee-statement-proposed-rules-funds-derivatives>.

¹⁰ Proposal at 63, Questions 31 and 33.

¹¹ *See Id.* at 187-88.

¹² *See id.* at 187.

¹³ NASAA also suggests that the Commission’s staff should conduct examinations of sales and the performance of leveraged/inverse investment vehicles after the proposed rules are implemented to determine if they are in fact sufficient to protect retail investors.

with the Commission's views,¹⁴ investors who utilize highly leveraged or inverse products – especially those holding these investments for substantial periods – are at a significant risk of loss in times of increased volatility. Providing this information and ensuring that investors understand the risks associated with leveraged and inverse trading should be a requirement before allowing investors to be exposed to such products.

III. Conclusion

For the foregoing reasons, NASAA generally supports the work of the Commission in updating the standards applicable to funds' use of derivatives and leverage while enhancing investor protection. We urge the Commission to strengthen this proposal by mandating immediate board notification of testing failures, and annual public disclosure of failures in the derivative risk management program. Further, the Commission should require broker-dealers and investment advisers to determine the amount an investor can lose in leveraged/inverse investment vehicles, and provide enhanced disclosures of the risks of investing in such products.

Thank you for considering these views. NASAA looks forward to continuing to work with the Commission in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

A handwritten signature in black ink, appearing to read 'C. Gerold', with a stylized flourish at the end.

Christopher Gerold
NASAA President
Chief, New Jersey Bureau of Securities

¹⁴ Proposal at 288; *see also* Statements of Commissioners Jackson and Lee, *supra* note 9.