April 30, 2020

Via Electronic Filing (rule-comments@sec.gov)

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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 (SEC Rel. No. 34-87607; IA-5413; IC-33704; File No. S7-24-15)

Dear Ms. Countryman:

The Investment Adviser Association ("IAA")[1] appreciates the opportunity to comment on the reproposal of exemptive Rule 18f-4 under the Investment Company Act of 1940 ("Investment Company Act") to permit mutual funds (other than money market funds), exchange-traded funds ("ETFs"), registered closed-end funds, and companies that have elected to be business development companies (together, "funds") to enter into derivatives transactions and certain other transactions under Sections 18 and 61 of the Investment Company Act.[2] The IAA also appreciates the opportunity to comment on the Commission's proposed new sales practice Rule 211(h)-1 under the Investment Advisers Act of 1940 ("Advisers Act"). Rule 211(h)-1 would require an adviser to form "a reasonable basis for believing that [a] client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles" before the adviser may place an order to buy or sell such a vehicle for a natural person client.

[1] The IAA is the largest organization dedicated to advancing the interests of SEC-registered investment advisers. For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's member firms manage more than $25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[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*, SEC Rel. No. 34-87607; IA-5413; IC-33704 (Nov. 25, 2019) [85 FR 4446 (Jan. 24, 2020)] ("Proposal"), available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

The Proposal reflects the Commission's thoughtful consideration of comments on its 2015 derivatives proposal,[3] and we generally support the Commission's comprehensive approach to modernizing the regulatory framework around funds' use of derivatives under the Investment Company Act, with certain modifications to reduce unnecessary burdens on advisers, and support the important use of derivatives for risk management. However, we strongly oppose proposed Rule 211(h)-1 because it is both unnecessary and inconsistent with the approach of the overarching, principles-based Advisers Act fiduciary duty for investment advisers that was recently reaffirmed and is currently enforced by the Commission. We are also concerned that adopting this rule would set a troubling precedent because it would apply a prescriptive rule under the Advisers Act to investment advice related to a particular type of publicly-traded security by imposing eligibility requirements that apply to retail investors. We do not believe it is sound public policy for the Commission to begin down this path.

We discuss our comments and recommendations on the two proposed rules below.

I. Proposed Derivatives Rule

Funds using derivatives must consider requirements under Sections 18 and 61 of the Investment Company Act, which limit a fund's ability to obtain leverage or incur obligations to persons other than the fund's common shareholders through the issuance of "senior securities." Proposed Rule 18f-4 would limit the ability of funds to enter into derivatives transactions, reverse repurchase agreements, and similar transactions by limiting the funds' value at risk (VaR) exposure.[4] It would also require funds to adopt a written derivatives risk management program and appoint a derivatives risk manager approved by the fund's board.[5] Funds that meet the proposed "limited derivatives user" test would not be required to have a derivatives risk management program.[6] The rule would also include specific requirements for funds that obtain leveraged or inverse exposure to an underlying index, generally on a daily basis.[7]

We generally support the Commission's approach. In particular, we appreciate and support the withdrawal of the 2015 proposal that would have required funds to comply with a

[3] *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Rel. No. IC-31933 (Dec. 11, 2015) [80 FR 80884 (Dec. 28, 2015)] ("2015 Proposal"), available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

[4] Proposed Rule 18f-4(c)(2) would impose a limit on fund leverage risk by requiring funds to comply with a relative VaR test, or if the derivatives risk manager is not able to identify a designated reference index that is appropriate for the fund taking into account the fund's investments, investment objectives and strategy, then an absolute VaR test.

[5] Funds' derivatives risk management programs would need to include risk identification and assessment, risk guidelines, stress testing, backtesting internal reporting and escalation, and periodic review of the program. In addition, proposed Rule 18f-4(c)(5) would require board oversight and reporting.

[6] Proposed Rule 18f-4(c)(3) for limited derivatives users.

[7] Proposed Rule 18f-4(c)(4) for leveraged/inverse funds.

portfolio limitation of notional exposure to derivatives. The IAA had opposed these proposed overall portfolio limitations because, in our view, conditioning the use of derivatives on compliance with either the 150 percent or 300 percent previously-proposed tests was unnecessary to protect investors and appropriately limit leverage in fund portfolios, and would have reduced investor access to certain types of funds and portfolio strategies – including some that serve to mitigate investment risk.[8]

In the current Proposal, the Commission seeks to modernize regulation of funds' use of derivatives to reflect the significant market developments and use of derivatives by funds since the SEC issued its initial guidance in 1979.[9] We believe the proposed derivatives rule seeks to strike a more appropriate balance between investor protection concerns and an updated approach to the use of derivatives by funds, but we recommend that the Commission include the modifications suggested in the letters of the Investment Company Institute and SIFMA AMG, which we broadly support. We believe these recommendations will improve the proposal to more easily allow market participants to benefit from the important uses of derivatives made by funds.

II. Proposed Sales Practice Rule

While we support the Commission's approach to the proposed derivatives rule, we strongly oppose the proposed sales practice rule for investment advisers related to retail investor transactions in leveraged/inverse investment vehicles.[10] Investment advisers registered with the Commission are already subject to the robust Advisers Act fiduciary duty that governs all aspects of their advisory relationships and that was recently reaffirmed by the Commission.[11] Proposed Rule 211(h)-1 is both duplicative of and inconsistent with the principles-based approach to the fiduciary duty. We are also extremely concerned that the proposed rule, which, for the first time, establishes under the Advisers Act an eligibility standard that retail clients of investment advisers must meet in order to invest in certain publicly-traded securities, sets an unsound precedent. In addition, we have concerns about how advisers would definitively demonstrate compliance in practice with the rule as proposed.

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[8] Letter from Robert C. Grohowski, IAA General Counsel, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies (Mar. 28, 2016), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/160328cmnt.pdf.

[9] *See, e.g.*, *Securities Trading Practices of Registered Investment Companies*, SEC Rel. No. IC-10666 (Apr. 18, 1979).

[10] "Leveraged/inverse investment vehicle" is defined in the proposed rule as "a registered investment company (including any separate series thereof), or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time." Proposed Rule 211(h)-1(d).

[11] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, SEC Rel. No. IA-5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] ("Fiduciary Duty Interpretation").

A. Background

Proposed Rule 211(h)-1 would require investment advisers and their supervised persons, before placing an order to buy or sell shares of a leveraged/inverse investment vehicle for a client that is a natural person (or the legal representative of a natural person), to approve the client's account to engage in those transactions and adopt and implement policies and procedures reasonably designed to achieve compliance with the rule.[12] The approval process is outlined in proposed Rule 211(h)-1(b) and would require advisers to "exercise due diligence to ascertain the essential facts relative to the client, his or her financial situation, and investment objectives, including, at a minimum,"[13] the client's:

- Investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon;
- Employment status (name of employer, self-employed or retired);
- Estimated annual income from all sources;
- Estimated net worth (exclusive of family residence);
- Estimated liquid net worth (cash, liquid securities, other);
- Percentage of the client's estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and
- Investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.[14]

Based on the above information, the adviser must approve or disapprove the client's account for buying and selling leveraged/inverse investment vehicles, and approvals must be in writing. An adviser may only provide the approval if it "has a reasonable basis for believing that the client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse

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[12] The Commission states that Proposed Rule 211(h)-1 is based on current FINRA options account approval requirements for broker-dealers. Proposing Release at 4492. We believe that application of transaction-based broker-dealer sales practice rules to investment advisers is inappropriate. The overarching fiduciary duty under the Advisers Act provides robust principles-based protection covering the entire advisory relationship with clients.

[13] Proposed Rule 211(h)-1(b)(1).

[14] Proposed Rule 211(h)-1(b)(2).

investment vehicles."[15] Proposed Rule 211(h)-1 also includes a recordkeeping requirement related to the information collected, written approvals, and policies and procedures.[16]

The Commission's rationale for proposing Rule 211(h)-1 includes addressing investor protection concerns and ensuring that retail investors are capable of evaluating the risks associated with leverage/inverse investment vehicles.[17] We agree with these goals, and we believe that the framework of the Advisers Act fiduciary duty addresses these concerns for all types of investment strategies and securities. We understand that relatively few of our members use leveraged/inverse investment products in client portfolios, but we are commenting because of our deep concern about the Commission's policy shift away from the Advisers Act fiduciary duty's principles-based approach. We believe that it would be a mistake for the Commission to adopt a rule for investment advisers that is focused on a particular type of investment. All investments have risks, but may also have value in the context of a client's particular portfolio. Investment advisers must ensure that their advice is consistent with a client's goals and risk tolerance and is in the client's best interest under the facts and circumstances specific to that client. If it is not, then the advice is also not consistent with the adviser's fiduciary duty.

B. The Proposed Sales Practice Rule is Both Duplicative of and Inconsistent with the Broad, Overarching Advisers Act Fiduciary Duty

The Commission recently reaffirmed, and in some cases clarified, an adviser's longstanding principles-based fiduciary duty to its clients. In so doing, it stressed the broad scope of the fiduciary duty under the Advisers Act and the application of that duty to the entire adviser-client relationship. It also emphasized the importance of the fiduciary duty to the Commission's investor protection efforts.[18] Rejecting requests by some commenters to adopt rule text for the fiduciary duty, the Commission was clear in the Fiduciary Duty Interpretation that "[t]he relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statute or rule text."[19] The Commission underscored its view, and we strongly agree, that "adopting rule text is not necessary to achieve our goal in this Final Interpretation of reaffirming and in some cases clarifying certain aspects of the fiduciary duty," and stressed its "belie[f] that this principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."[20]

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[15] Proposed Rule 211(h)-1(b)(1).

[16] Proposed Rule 211(h)-1(c).

[17] Proposing Release at 4492.

[18] Fiduciary Duty Interpretation at 33669.

[19] *Id.* at 33670.

[20] *Id*.

The principles-based fiduciary duty holds advisers to a high standard of investor protection while providing the flexibility for them to meet their clients' investment goals. It is thus unnecessary for the Commission to adopt a sales practice rule for advisers on top of their fiduciary duty. The proposed rule is also inconsistent with the approach of the principles-based fiduciary duty in that it would, for the first time, create detailed, prescriptive requirements under the Advisers Act for investment advice related to a particular type of publicly-traded security. We strongly believe that adopting such a requirement would set an unwise precedent.

1. *The Proposed Sales Practice Rule is Duplicative of the Recently Reaffirmed Fiduciary Duty and is thus Unnecessary.*

The Commission requests comment on whether the proposed rule should apply to investment advisers in light of their fiduciary duty.[21] The proposed rule is duplicative of the fiduciary duty under the Advisers Act and is thus not necessary for investment advisers.

Under an adviser's duty of care, the adviser must provide advice that is in the best interest of its client. In order to do so, the adviser needs to develop a reasonable understanding of the client's investment objectives and have a reasonable belief that the advice it provides is in the best interest of the client based on the client's investment objectives.[22] In developing a reasonable understanding of a retail client's investment objectives, an adviser should "at a minimum, make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals."[23] The Commission recognizes that "[h]ow an adviser develops a reasonable understanding will vary based on the specific facts and circumstances, including the nature of the client, the scope of the adviser-client relationship, and the nature and complexity of the anticipated investment advice."[24]

An adviser's fiduciary duty applies to advice related to leveraged and inverse investment vehicles in the same way it applies to all other investments and strategies with varying risks and complexities. The Fiduciary Duty Interpretation explicitly recognizes that complex products may be in a retail client's best interest if they are consistent with the client's risk tolerance and objectives. The adviser must conduct sufficient inquiry and analysis to understand both the client's objectives and the client's risk tolerance to ensure that its advice is appropriate for that client. The Fiduciary Duty Interpretation does not set prescriptive eligibility requirements for retail clients to invest in particular strategies or securities. Instead the onus is on the adviser to conduct sufficient due diligence of the client and the strategy or product to be able to provide advice that is in that particular client's best interest.

[21] Proposal at 4496.

[22] Fiduciary Duty Interpretation at 33673.

[23] *Id.*

[24] *Id.*

The requirement under proposed Rule 211(h)-1(b)(1) that advisers "exercise due diligence to ascertain the essential facts relative to the client, his or her financial situation, and investment objectives" is thus duplicative of an adviser's fiduciary duty and is wholly unnecessary. This is the case regardless of whether the adviser has discretionary authority over a client's account. Advice, whether discretionary or not, must always satisfy an adviser's duty of care.

We strongly agree with the Commission's statement in the Fiduciary Duty Interpretation that investment advisers "serve a large variety of clients, from retail clients with limited assets and investment knowledge and experience to institutional clients with very large portfolios and substantial knowledge, experience, and analytical resources… [T]he principles-based fiduciary duty imposed by the Advisers Act has provided sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[25] This accurately and appropriately captures the wide breadth of the Advisers Act fiduciary duty, and as such a sales practice rule is not warranted for any particular type of investment.

2. *The Proposed Sales Practice Rule is Also Inconsistent With the Advisers Act Fiduciary Duty.*

The proposed sales practice rule is inconsistent with the Advisers Act fiduciary duty in two important respects. Imposing a prescriptive eligibility standard for retail clients of investment advisers before they may invest in a certain type of publicly-traded security "would micromanage" and be an unwarranted interference in how investment advisers provide fiduciary advice to their clients, in stark contrast to the principles-based analysis an adviser must conduct under its fiduciary duty.[26] It would also undermine one of the main reasons retail investors retain

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[25] *Id.* at 33671.

[26] In this regard, we agree with the statement on the proposed rule by Commissioners Peirce and Roisman. *See* Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices, Commissioner Hester M. Peirce and Commissioner Elad L. Roisman (Nov. 26, 2019), available at https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices ("Peirce/Roisman Statement").

investment advisers to make investments on their behalf, namely their investment knowledge and expertise.[27]

Proposed Rule 211(h)-1 is designed to help ensure that retail investors "are capable of evaluating the risks"[28] of inverse and leveraged investment vehicles. The proposed rule would require an adviser, before approving a transaction for a retail investor in a leveraged/inverse investment vehicle, to have "a reasonable basis for believing that the client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles."[29]

A primary reason that a retail client employs an investment adviser, however, is to obtain advice from a competent investment professional that, pursuant to the Advisers Act fiduciary duty, is required to "conduct a reasonable investigation"[30] into investments and determine whether investments "fall within the retail client's risk tolerance and objectives."[31] But here, an investment adviser could not invest in these publicly-traded securities on a client's behalf even where the adviser has determined that they are in the client's best interest based on the client's objectives and risk tolerance unless "the adviser is sure the client has the ability to understand them on his or her own."[32]

Rather than focusing on whether an adviser has determined that a leveraged/inverse investment vehicle is in the client's best interest, the proposed rule instead focuses on an investor's knowledge of and experience in financial matters, and whether the adviser has accurately assessed that knowledge and experience. The Commission has not previously required investment advisers to apply such a standard in connection with any other investment and we do

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[27] We have made a similar point to the Commission in other contexts as well. For example, in our comments on the Commission's recent proposal on the definition of "accredited investor," we recommended that the Commission amend the definition to include discretionary clients of SEC-registered investment advisers. We explained that, "[i]n managing assets on a discretionary basis, advisers have the authority to make investment decisions on behalf of their clients on an ongoing basis. They are stepping into the shoes of their clients and continuously managing their clients' portfolios to optimize their clients' investment goals," which, we pointed out, they must do in their clients' best interest. *See* Letter from Gail C. Bernstein, IAA General Counsel, regarding Amending the "Accredited Investor" Definition (March 18, 2020), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/about/Comment_Letter_Compendiums/2020/IAA_Comment_Letter_on_Accredited_Investor_and_QIB_Proposal_final_3_18_20.pdf.

[28] Proposal at 4492.

[29] Proposed Rule 211(h)-1(b)(1).

[30] Fiduciary Duty Interpretation at 33674.

[31] *Id.* at 33673.

[32] Peirce/Roisman statement.

not believe it should do so now. We agree that clients should understand the investment objectives, costs, and risks related to a particular investment. We do not believe that they should be held to a particular level of knowledge in financial matters such that they must understand all technical details of a particular investment.

It is also not clear why the Commission proposes to take this approach with respect to one type of investment – leveraged/inverse investment vehicles – when there are many other investments that have significant investment risk and volatility, but are not subject to this type of rule. We believe this unprecedented approach is significantly at odds with the framework of the Advisers Act fiduciary duty – including as the Commission recently reaffirmed it in the Fiduciary Duty Interpretation – and in our view it would be a mistake for the Commission to apply this standard to investment advisers.

C. The Proposed Sales Practice Rule Would Result in Unwarranted Interference in Access to Investments

We are deeply concerned that adopting this rule would set a troubling precedent. Unlike other rules under the Advisers Act, this rule would include prescriptive requirements for advice related to a particular type of publicly-traded security. We believe the Commission will begin down an unwise slippery slope if it starts restricting an adviser's ability to invest in a publicly-traded security on behalf of any client for which the adviser determines, consistent with its fiduciary duty, that such an investment is in that client's best interest. The Fiduciary Duty Interpretation clearly requires advisers to have an understanding of any investment strategies or products they intend to recommend to their clients. The Fiduciary Duty Interpretation also clearly reminds advisers that it would not be consistent with their fiduciary duty to invest in *any* strategy or security for a client that is not aligned with that client's investment objectives and risk tolerance. We urge the Commission not to restrict the access of retail investors that are represented by investment advisers to investments through this proposed rule.

D. It is Unclear How an Adviser Would Demonstrate Compliance with the Proposed Sales Practice Rule

In addition to our concerns discussed above, it is also not clear how an adviser would definitively demonstrate compliance with proposed Rule 211(h)-1(b). The Commission states that it is "not proposing a bright-line test for this determination. Rather, the determination would be based on all of the relevant facts and circumstances."[33] However, we question how an adviser would be able to show that it had "a reasonable basis for believing that the client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles."[34]

[33] Proposal at 4494.

[34] Proposed Rule 211(h)-1(b)(1).

We are concerned that advisers would have difficulty demonstrating compliance with this provision and would be subject to second-guessing in hindsight.

Proposed Rule 211(h)-1(b)(2) includes in the information to be collected from a retail client "Investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments." Even if a retail investor provided this information to an investment adviser, we are concerned that it may not be sufficient to satisfy the rule's requirement. For example, this information may show a retail investor's experience in some or all of these instruments, but perhaps not detailed knowledge of them. As Commissioners Peirce and Roisman state, "[b]y providing so little information about the results we are aiming to achieve, we worry that such a requirement will either become a meaningless check-the-box exercise or a regulatory deterrent for brokers and advisers to offer these ETFs on their menus at all."[35] We agree with this concern and recommend, instead, that the Commission remind investment advisers about the application of the Advisers Act fiduciary duty to all strategies and products, including those at issue here. We are very concerned that the inconsistent approach in the proposed rule is an inappropriate departure from the principles-based fiduciary duty that has long served clients well.

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We appreciate the Commission's consideration of our comments on these important proposals and would be happy to provide any additional information that may be helpful. Please contact the undersigned at (202) 293-4222 if we can be of further assistance.

Respectfully,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

cc: The Honorable Jay Clayton, Chairman
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison Herren Lee, Commissioner

Dalia Blass, Director, Division of Investment Management

[35] Peirce/Roisman Statement.