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March 24, 2020

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

Re: Release No. 34-87607; File No. S7-24-15, RIN 3235- AL60, Proposed Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customer's Transactions in Certain Leveraged/Inverse Investment Vehicles

Ladies and Gentlemen:

Thank you for the opportunity to share our views on the Proposed Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customer's Transactions in Certain Leveraged/Inverse Investment Vehicles (hereafter the proposed rule).

Morningstar brings a different perspective to the questions in the request for comment. As the world's largest provider of mutual fund data and ratings, Morningstar has a long history of advocating for transparency in global financial markets. Morningstar's mission is to empower investor success. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the proposed rule and its possible effects for investors.

In this letter, we want to focus on the Commission's principles-based approach to derivatives risk management, the requirements around the designated reference index for the VaR benchmark, and the proposed requirements relating to leveraged ETFs.

I. We Agree with the Commission's Principles-Based Approach Toward Derivatives Risk Management

We approve of the Commission's principles-based approach towards derivatives risk management and believe that the proposed rule[1] is a marked improvement over the proposal in December 2015.[2] The risk manager and the board have a duty to ensure that appropriate stress tests are meeting these principles in accordance with the specific strategy and portfolio constructed for each fund. We agree with the Commission that relevant principles for a risk management program by a fiduciary should include considering factors such as the fund's non-derivatives investments in identifying and assessing derivatives risks,[3] establishing risk management program guidelines based on their appropriateness to the fund,[4] and incorporating market risk factors in stress testing.[5] In addition, we agree that the fiduciary should consider the "accuracy and effectiveness of a fund's VaR model and calculations" through daily backtesting,[6] and fostering "an open and effective dialogue among the derivatives risk manager and the board."[7] Despite some limitations, VaR remains the best single approach that can incorporate complex derivatives that hedge or extend risks associated with a partial return, such as currency or interest-rate risks. The proposal requires that the advisor, a fiduciary, use a prudent approach including VaR and other tools.[8] We approve of the principles-based approach as this will allow for prudent design of additional stress testing. Specific prescriptions lead to exclusion of appropriate tests, so it is our opinion that aside from data being required in a standardized format to the SEC and the public, fund advisors under the oversight of boards and advisors are in the best position to identify and implement relevant stress tests.

The board should have policies regarding what constitutes a material risk. The board's normal oversight should ensure that the policy is adequate and effective.[9] Further, if a risk is material, whether from a derivative, a concentration of a holding or external to the holdings, the board should always be apprised. We do not believe that the derivatives risk manager should have discretion regarding which material risks should

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customer's Transactions in Certain Leveraged/Inverse Investment Vehicles (Securities and Exchange Commission). P. 4515. https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf (hereafter proposed rule).

[2] Use of Derivatives by Registered Investment Companies and Business Development Companies (Securities and Exchange Commission) https://www.govinfo.gov/content/pkg/FR-2015-12-28/pdf/2015-31704.pdf.

[3] Proposed rule, P. 4460.

[4] Proposed rule, P. 4461.

[5] Ibid.

[6] Proposed rule, P. 4464.

[7] Proposed rule, P. 4465.

[8] Proposed rule, P. 4463-4464.

[9] Proposed rule, P. 4466.

be brought to the attention of the board, but instead should include all material risks in its regular reports pursuant to proposed rule 17 CFR Part 270.18f–4(c)(5)(iii).[10]

II. The Designated Reference Index Should Be Independent but the Proposed Rule Imposes Unnecessary and Anticompetitive Restrictions

We agree with the Commission that the designated reference index should be "an unleveraged index that is selected by the derivatives risk manager" that "reflects the markets or asset classes in which the fund invests."[11] We also agree with the proposed definition that would "require that the designated reference index not be administered by an organization that is an affiliated person of the fund, its investment advisor, or principal underwriter."[12] The proposed rule would go further to require that the designated reference index not be "created at the request of the fund or its investment advisor, unless the index is widely recognized and used."[13] We share the Commission's concerns with respect to maintaining the independence of index providers and eliminating conflicts of interest. However, creating an index at the request of a fund or its investment advisor need not present a conflict in the management of the index, as index providers develop and maintain the index methodology independently as their own intellectual property. We believe that this requirement, along with the "widely recognized" qualifier, could entrench incumbents, further concentrating monopoly power in the index business, and prevent funds from finding an appropriate derivatives reference index, leaving their risk management program to rely solely on absolute VaR testing. We therefore suggest that the definition of a designated reference index in proposed rule 18f–4(a)(2) be amended to exclude the requirements for the designated reference index to be "widely recognized" and not be created by the request of a fund or its advisor.[14]

We think that the Commission can regulate conflicts presented by index providers in other ways. For instance, the Commission could require designated reference indexes created at the request of the fund or its investment advisor to be compliant with the International Organization of Securities Commissions' "Principles for Financial Benchmarks," which provide a framework for ensuring best practices in index administration.[15] In particular, Principle 3, "Conflicts of Interest for Administrators," guides index administrators to "document, implement, and enforce policies and procedures for the identification, disclosure, management, mitigation, or avoidance of conflicts of interest."[16] In their statement of compliance, index administrators should

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[10] Proposed rule, P. 4560.
[11] Proposed rule, P. 4471.
[12] Ibid.
[13] Ibid.
[14] Proposed rule, P. 4559.
[15] International Organization of Securities Commissions. 2013. "Principles for Financial Benchmarks." https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf (hereafter IOSCO Principles).
[16] IOSCO Principles, P.16.

note their policies and procedures in addition to any material conflicts of interest. This principle aims to "protect the integrity and independence of Benchmark determinations,"[17] which we believe is the Commission's primary concern when considering conflicts that may arise from a fund or investment advisor requesting the creation of an index for use as the fund's derivatives reference index. By requiring such indexes to be compliant with the IOSCO principles, the Commission can ensure that the index methodology is independent and that conflicts of interest are disclosed, mitigated, and avoided when possible while still providing sufficient flexibility for derivative risk managers to choose an appropriate designated reference index.

III. We Applaud the Commission's Safeguards for Leveraged ETFs

Without an intervention to ensure appropriate access, the aspect of the proposal streamlining the launch process for these products could lead to a proliferation of leveraged ETFs. We applaud the Commission for adding safeguards to ensure that investors who purchase them have been evaluated for suitability of the product. These are uniquely confusing products with performance that will significantly vary from many investors' expectations, and we think if the SEC permits more of them, investors should demonstrate sufficient familiarity and understanding before purchasing them. As such, we appreciate the compromise the SEC is making: leveling the playing field by allowing competition in the product space and simultaneously adding safeguards so that retail investors, even in self-directed brokerage accounts, have to jump through some hoops before purchasing these products.

The volatility of leveraged ETFs and their complexity make them unsuitable for most ordinary investors. Under the SEC proposal, brokers have obligations to assess suitability of these products for their clients, regardless of whether in conjunction with a recommendation or simply for a self-directed account. The proposed rule requires brokers to approve their customers' accounts to engage in the buying or selling of leveraged ETF shares. A broker may approve one of their customer's accounts if they have "a reasonable basis for believing that the customer 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."[18] Additionally, a broker "must seek to obtain"[19] the customer's investment objectives, their estimated liquid net worth, and their investment experience and knowledge, amongst other information. Investment experience is described to include "knowledge (e.g., the number of years, size, frequency, and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and

[17] IOSCO Principles, P.16.
[18] Proposed rule, P. 4496.
[19] Proposed rule, P. 4494.

other financial instruments."[20] We think some requirements ensuring that individuals have knowledge of the products they are purchasing are appropriate.

We have recently explained the challenge of understanding the returns of these products with concrete examples and data.[21] We advocate for knowledge of the risks before purchase by ordinary investors. Most importantly, investors should understand and acknowledge that the returns they earn for periods longer than a day may differ materially from the fund's targeted leverage ratio. If the Commission's requirements can ask individuals in self-directed accounts or those being advised by brokers to verify this understanding through some means, e.g., a Q&A, interactive tool, etc., then we think this will help ensure that the investors who purchase them are aware and comfortable with the risks presented. That being said, we are sensitive to the fact that sophisticated investors and institutions may use these products in appropriate ways and we do not believe that the regulatory hurdles should make those who are aware and comfortable with the risks unable to purchase these products or require them to undergo a formidable process to purchase the products. We encourage the Commission to strike an appropriate balance in this regard.

In summary, we approve of the Commission's improvements to the risk management requirements and encourage the Commission to have more accountability to the board regarding material risks. We ask the Commission to consider allowing more flexibility around the creation of the designated reference index. We applaud the approach the Commission has taken regarding leveraged ETFs and ask the Commission to continue to strike the appropriate balance towards the accessibility of these products in the final rule.

We thank the Commission for the opportunity to comment on the proposed rule. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact either of us as indicated below:

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Sincerely,

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[20] Proposed rule, P. 4494.
[21] Sethi, J. 2020. "A New SEC Proposal Would Open the Door for More Leveraged ETFs." (Morningstar) https://www.morningstar.com/articles/972536/a-new-sec-proposal-would-open-the-door-for-more-leveraged-etfs.