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## Have You Ever Heard a FINRA Tweet? The Social Media Universe Meets the Securities World: Part 1

by Amy E. Haid

**A**s technology races forward in the arenas of electronic communications and commerce, connecting people the world over through social media technologies such as Facebook®, a tension has been created with highly regulated environments such as the securities industry. The duties owed to clients, coupled with the importance and sensitivity of personal investing and financial planning, require levels of vigilance

*Continued on page 28*

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### CONTENTS

#### Highlights of This Issue

by Stephanie A. Djinis,  
Editor-in-Chief, page 2

#### When a Fund is Sued: An Independent Director's Guide to Fund Litigation—Part 2

by Robert W. Helm, William K.  
Dodds, David M. Geffen and  
Jeanette Wingler, page 3

#### Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1

by Georgia Bullitt, Thomas  
Harman, Christopher  
Menconi, Bill Zimmerman  
and Christopher Jackson, page 12

### REGULATORY MONITOR

#### Life Insurance and Annuity Developments . . . . . page 35

- Regulators Examine Regulation of STOVA
- Status of Rule 151A

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# Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1

by Georgia Bullitt, Thomas Harman, Christopher Menconi,  
Bill Zimmerman and Christopher Jackson

Over the past 20 years, the registered investment company industry, its regulators and the popular press have engaged in an on-going debate regarding the risks and rewards of allowing registered investment companies to invest in derivatives and to obtain leverage through derivatives and other arrangements, such as prime brokerage.<sup>1</sup> During that period, investment companies have significantly increased their use of derivatives both for risk management purposes and as a means of obtaining exposures in a manner consistent with the Investment Company Act of 1940 (the 1940 Act).<sup>2</sup> Investment companies have also used derivatives as a substitute for direct investment when the desired direct investment is less liquid or is restricted, or when obtaining exposure through derivatives is believed to be more cost-effective.

The intensity of the debate regarding the use of derivatives by registered investment companies increased following the bankruptcy of Lehman Brothers and the US government bailout of American Insurance Group. Both

events created a public perception of derivatives as risky investments that behave in an unpredictable manner. At the same time, the Securities and Exchange Commission (SEC) intensified its focus on risks observed in leveraged and inverse exchange-traded funds (ETFs), which rely heavily on derivatives. In light of both the general market concerns and a desire to re-evaluate the use of derivatives by registered investment companies, including ETFs, the SEC announced this past spring that it was embarking on a review of the use of derivatives by registered investment companies and suspending requests for exemptive relief from actively-managed ETFs to permit

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investments in derivatives.<sup>3</sup> As part of its review, the SEC will also consider the recently reported recommendations of a Task Force created by the American Bar Association (ABA Task Force).<sup>4</sup> In speeches regarding the SEC derivatives review, Andrew Donohue, Director of the SEC's Division of Investment Management, indicated that one of the primary concerns of the Staff of the SEC regarding the use of derivatives by registered investment companies was the access to leverage provided by the instruments.<sup>5</sup> In analyzing leverage created by derivatives, the Staff focused both on what it called "indebtedness leverage" and on what it referred to as "economic leverage."<sup>6</sup> Indebtedness leverage involves the creation by an investment company of an obligation to a person or entity other than investment company shareholders that allows the investment company to participate in gains and losses on an amount that exceeds the initial investment by the investment company.<sup>7</sup> Examples include futures, forward contracts and written options. The other type of leverage, "economic leverage," is described by the Staff as heightened price sensitivity in a manner similar to debt. Unlike indebtedness leverage, economic leverage does not involve the creation of an obligation but may expose the investment company to a level of risk that exceeds the amount invested. For example, when an investment company purchases a long call option, it participates in gains on the price of the stock underlying the option in return for a premium that is a fraction of the market price of the stock. If there are no gains, the investment company simply loses the premium. In 1994, when the Staff last studied the use of derivatives by investment companies, the Staff concluded that disclosure was the most effective way to address concerns regarding investment company use of leverage. Given statements by the Staff in connection with the SEC's current review and the recommendations of the ABA Task Force, it seems unlikely that it will come to the same conclusion.<sup>8</sup>

In speeches regarding the review, the Staff indicated that it was also examining whether existing regulations appropriately address issues relating to concentration and diversification.<sup>9</sup> These statements raise practical issues for registered investment company boards and

advisers regarding how to comply with the 1940 Act, including whether the current methods used by investment companies to value derivatives and to calculate the amount of assets earmarked as "cover" are acceptable.

The use of derivatives by registered investment companies will also be affected by imminent legislative changes.<sup>10</sup> Congress is currently reconciling legislation passed by the United States House of Representatives (the House)<sup>11</sup> and the United States Senate (the Senate)<sup>12</sup> that will regulate both dealers and substantial users of derivatives and force a number of derivatives that are currently traded over-the-counter (that is, privately negotiated transactions off an established exchange) to be centrally cleared and traded on a regulated exchange or crossing facility. These changes are likely to change the marketplace for derivatives and limit the ability to obtain customized contracts that are tailored to the regulatory and investment needs of a particular counterparty, including an investment company.

This article summarizes the relevant regulatory, disclosure and tax implications of using derivatives for investment company managers and boards and discusses developing issues relating to their use of derivatives. The discussion includes an analysis of current regulation and anticipates future changes stemming from the pending financial reform legislation as well as the SEC review.

### **Regulatory Considerations for Registered Investment Companies Using Derivatives and Engaging in Short Selling**

The term "derivative" refers to a broad range of financial instruments whose value is dependent on the value of the underlying assets. The instruments may be traded on a regulated exchange or over-the-counter, may or may not have embedded optionality or leverage and may settle on a physical or cash (net) basis. The substantive provisions of the 1940 Act, either directly or indirectly, govern the use of derivatives and other complex instruments by investment companies registered with the SEC under the 1940 Act. The primary provisions include: (i) limitations on leverage or issuance of "senior securities," (ii) rules governing

custody, (iii) restrictions on the ability of investment companies to invest in financial services firms, (iv) rules relating to diversification, liquidity and concentration, and (v) disclosure requirements, including whether the use is consistent with an investment company's name and stated investment objectives.

A short sale refers to a sale of securities that the seller settles using borrowed securities.<sup>13</sup> The borrowing, if effected through a US broker-dealer, is subject to Regulation T of the Board of Governors of the Federal Reserve System (Reg T) and the maintenance margin requirements imposed by New York Stock Exchange Rule 431 and Rule 2520 of the Financial Industry Regulatory Authority (together, the Maintenance Margin Rules) and must be booked in a margin account. The broker-dealer settling the transaction must collect initial margin from the selling customer of 150 percent of the "current market value" of the security sold short plus maintenance margin. To the extent that a customer wishes to execute short sales through multiple broker-dealers but clear and settle transactions centrally, the customer will be required to enter into a prime brokerage arrangement. These arrangements, including the need for broker-dealers to collect margin, create issues for registered investment companies both under the provisions of the 1940 Act that restrict leverage and under the custody provisions in Section 17 of the 1940 Act.

### **Prohibition of Senior Securities— Implication for Derivatives**

The 1940 Act limits the amount of leverage that registered investment companies may assume by restricting direct borrowing and, more broadly, the issuance of "senior securities." The provisions are designed to prevent excess borrowing and limit increases in the speculative character of equity issued by registered investment companies.<sup>14</sup> Under the 1940 Act and related SEC interpretations, the concept of leverage is defined broadly. As a result, it is a good rule of thumb to assume that the 1940 Act leverage rules will be implicated if an investment company makes an investment in connection with which an obligation remains outstanding beyond the normal

settlement cycle for securities (that is, indebtedness leverage).

Section 18 of the 1940 Act restricts a registered investment company's ability to issue "senior securities." The term "senior security" is defined in Section 18(g) as "any bond, debenture, note or similar obligation or instruments constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." Open-end investment companies are prohibited from issuing senior securities but may borrow from a US regulated bank, so long as the investment company maintains an asset coverage ratio (that is, assets to debt) of at least 300 percent (including the amount borrowed) at all times that the borrowing is outstanding.<sup>15</sup> Closed-end investment companies are subject to less restrictive provisions and may issue or incur debt consistent with Sections 18(a) and (c) of the 1940 Act: (i) through issuance of a single class of debt, so long as the investment company maintains an asset coverage ratio of at least 300 percent and the debt is subject to specified restrictive covenants, (ii) through issuance of one class of preferred stock, so long as the investment company maintains an asset coverage ratio of at least 200 percent and the preferred stock is subject to specified restrictive covenants, and (iii) by borrowings from a bank or through a privately arranged financing. Both open-end and closed-end investment companies may enter into temporary, short-term borrowings of up to five percent of the investment company's total assets with any person. A loan is presumed to be for temporary purposes if it is repaid within 60 days and is not extended or renewed.<sup>16</sup>

The SEC provided important guidance on the application of the 1940 Act's leverage restrictions in Investment Company Act Release No. 10666 (Release 10666).<sup>17</sup> In the Release, the SEC explained how a registered investment company<sup>18</sup> could avoid creation of a senior security, and therefore comply with the 1940 Act leverage restrictions, in three specific contexts. The Release makes clear that the transactions described are examples only and that the principles articulated in the Release are intended to apply more broadly to "...all comparable trading practices which may affect

the capital structure of investment companies in a manner analogous to the securities trading practices.”<sup>19</sup> The SEC also highlighted in the Release risks inherent in structured transactions with embedded leverage. “The gains and losses from the transactions can be extremely large relative to invested capital; for this reason, each agreement has speculative aspects.”

The three transactions specifically addressed in Release 10666 were (i) a reverse repurchase transaction, (ii) a firm commitment agreement and (iii) a standby commitment, each of which involved future payment obligations for the investment company. In order for an open-end investment company to avoid creation of a senior security in connection with the transactions, the SEC indicated that the investment company must segregate or “cover” its obligations by establishing a segregated account holding only liquid assets, such as cash, US government securities or other appropriate high grade debt obligations, equal in value to its obligations under the transaction. The segregated assets must be marked-to-the-market on a daily basis. In later interpretive guidance, the SEC Staff expanded the types of instruments eligible to serve as “cover” in the segregated account to include equity and non-investment grade debt, provided the assets are liquid. The relief contemplated that the investment company would treat the assets as segregated for purposes of the investment company’s books and records, even if the assets were not physically segregated.<sup>20</sup> In both cases, the approaches were designed to reduce the investment company’s risk of loss and assure that it had available adequate liquid assets to meet obligations arising from the transaction. In some cases, an investment company would be allowed to earmark assets used for cover on the books of the investment company and not necessarily on the books of the custodian.<sup>21</sup> This may allow an investment company administrator to more easily substitute assets used for segregation purposes.<sup>22</sup>

Since the publication of Release 10666, investment companies have applied the segregation approach articulated in the Release to a variety of derivative transactions and other types of leveraged transactions, including short sales of securities, in order to avoid running afoul of the prohibition on issuance

of senior securities. However, there continues to be a lack of clarity regarding the amount of assets that must be segregated. For example, common questions that arise are whether the investment company must set aside liquid assets equal to: the notional amount of the contract (that is, the total reference amount for a swap, the strike price for an option or the delivery amount for a futures contract); the net value of the investment company’s position (that is, the out-of-the-money “exposure” on a swap, the value or delta of the party’s option position or the net obligation payable on cash sale for a futures contract); or some other measure of value, such as a risk-based measure used by CME Clearing to margin futures or by the Options Clearing Corporation to margin listed securities options. The SEC has provided guidance as to the amount of assets required to be segregated for some instruments but not for others. The SEC Staff has indicated that it is considering the question in connection with its review and the ABA Task Force provided recommendations on the topic in its Report.<sup>23</sup> We have included as an appendix to this Article a summary of the existing interpretive guidance relating to segregation, which we describe in more detail below.<sup>24</sup>

The SEC Staff has given informal guidance with respect to futures contracts that an investment company must segregate liquid or other qualifying assets equal to (i) the purchase price of the futures contract, if the investment company is long the position or (ii) an amount that, when added to the amounts deposited with a futures commission merchant, or broker as margin, equals the market value of the instruments or currency underlying the futures contract, if the investment company is short the positions. Based on regulatory filings by both open-end and closed-end investment companies, it can be inferred that the Staff has informally accepted the industry practice that, for futures contracts that are contractually required to be cash-settled, only the marked-to-the-market net obligation and not the notional value is required to be segregated.<sup>25</sup> With respect to options sold by an investment company—securities-based options as well as commodity options—the SEC Staff indicated that the investment company must segregate liquid assets equal to the

strike price of the options, less any margin on deposit in order to satisfy the requirements of Release 10666.<sup>26</sup> With respect to forward contracts, the SEC Staff has informally indicated that for forwards that are not contractually required to be settled on a net cash basis, the investment company should segregate liquid assets equal to the full notional value of the contract whereas, for cash settled forwards, the investment company may set aside liquid assets equal to the investment company's daily marked-to-market net obligations.<sup>27</sup> As noted by the ABA Task Force, the SEC has not provided guidance on the application of the segregation requirements to swaps and, in particular, whether the investment company is obligated to segregate liquid assets equal to the notional amount or the value of the investment company's net obligation under the swap, that is, the marked-to-market value of the amount owed by the investment company to the counterparty, determined on a net basis (that is, the counterparty's "Exposure," as defined in the ISDA (defined below) Credit Support Annex).<sup>28</sup>

The SEC Staff has also allowed investment companies to enter into short sales of securities in reliance on the segregation principles outlined in Release 10666. In a no-action letter issued to Robertson Stephens, the SEC Staff did not object to an arrangement in which the investment company segregated assets equal to the market value of the securities sold short.<sup>29</sup> In many cases, segregation is accomplished by having the open-end investment company-short seller physically post liquid assets as collateral. If the short position is cleared and settled through a prime broker, proceeds from the short sale would generally be retained by the prime broker itself and marked to the market daily and the balance (initially 50 percent and maintenance margin of between \$2.50 per share and 30 percent) plus any additional "house" margin required by the prime broker would be held in a special custody account at the investment company's custodian. The investment company would contractually arrange for the custodian to transfer excess collateral out of the special custody account and to withdraw from the assets held by the prime broker any monies in excess of the value of the extension of credit represented by

the securities loan. The minimum net equity required by the SEC in order for customers to use a prime broker would include assets held in the special custody account and apply exclusively at a point in time where the prime broker has extended credit to the investment company.<sup>30</sup>

In addition to the segregation approach, the Staff has also approved off-set as a means by which a registered investment company may avoid violation of Section 18 of the 1940 Act. Under this approach, an investment company enters into a position that fully off-sets its exposure on a derivative or short position.<sup>31</sup> For example, an investment company may off-set a short option position by selling short the identical stock at a price equal to or higher than the exercise price of a put option. In the event that the put option is exercised, the investment company would have off-setting gains on its short position that would be available to pay the strike price on the option.

### **Custody Rule—Implications**

Section 17(f) of the 1940 Act establishes rules relating to custody of assets by registered investment companies. This section and the rules adopted by the SEC under Section 17 determine, among other things, where and how an investment company may post collateral to a counterparty with respect to a derivatives transaction. The rules also establish a framework for the custody of liquid assets to be held in segregation in satisfaction of the requirements under Release 10666 and the related SEC Staff interpretations relating to avoidance of the prohibition on issuance of a senior security.

The 1940 Act and the rules adopted under Section 17 have effectively resulted in the vast majority of registered investment companies placing and maintaining their securities and other investments in the custody of a regulated US bank (or its foreign branches). Although Section 17(f) and the underlying rules permit a broker-dealer registered with the SEC to serve as a custodian to a registered investment company, the conditions imposed on use of a broker-dealer are sufficiently burdensome as to make the selection unworkable in many cases. For example, Rule 17f-1

prohibits a broker-dealer from imposing “a lien or charge of any kind” on the registered investment company’s assets in its custody, requires an annual, semi-annual and other periodic examination by an independent public accountant and provides that a copy of the custody agreement be ratified by the investment company board annually and transmitted to the SEC. Under the rule, a regulated bank, unlike a broker-dealer, may encumber assets that are custodied with it by a registered investment company. The bank may take a lien against the assets itself or grant a lien to a third party, such as a broker-dealer. Registered investment companies may not custody with entities engaged in a broker-dealer business that are not registered with the SEC, such as a foreign broker-dealer.

The custody rules also apply to collateral posted by a registered investment company to a dealer in connection with a derivatives transaction or prime brokerage arrangement. As a result of the 1940 Act requirements, investment companies typically hold posted collateral at their bank custodian in a special custody account administered under a tri-party control agreement designed to perfect the dealer’s interests in the investment company’s pledge account at the custodian through control, in accordance with Articles 8 and 9 of the Uniform Commercial Code. Investment companies often agree to post collateral in an amount that is commensurate with the assets they must earmark on their books in order to satisfy the segregation requirements. Assets held in a pledge account under a tri-party control agreement are reflected as owned by the investment company for purposes of calculation of the net asset value until foreclosed on by the dealer upon the investment company’s default or upon the bankruptcy of the prime broker, if held in connection with a short sale.<sup>32</sup> In negotiating derivatives documentation with US dealers, registered investment companies typically negotiate a tri-party control agreement with the dealer at the time they negotiate the credit support annex (NY law form published by the International Swaps and Derivatives Association, Inc. (ISDA)) to supplement the ISDA master agreement and provide in the credit support annex that the custodial arrangement reflected in the control

agreement will be the exclusive means by which the dealer may take collateral from the investment company. Similarly, an investment company would typically negotiate a tri-party control agreement providing for a special custody account in connection with opening a prime brokerage account.

While US derivatives dealers are generally familiar with the custody rules governing registered investment companies and the resulting need for investment companies to hold collateral with a bank custodian, these requirements are not always well understood by foreign derivatives dealers. Under the 1940 Act, investment companies generally must post collateral to a foreign dealer either with a US bank or through a foreign branch of a US bank.

The tri-party arrangements create issues for both US-based and foreign dealers. Most importantly, the arrangements restrict the ability of the dealers to use collateral posted by the investment company-counterparty to fund their hedging activity. In the US market and abroad, dealers in over-the-counter derivatives typically negotiate rights to rehypothecate or use collateral posted to them by the counterparty. Dealers then exercise these rights and use the cash or other assets to pay for the securities or other instruments used by the dealer to hedge its exposure under the derivatives. The tri-party arrangements entered into by investment companies generally prohibit any use of the investment company’s posted collateral by the dealer unless and until the investment company defaults. As a result, dealers accepting collateral from investment companies under these arrangements will need to look to alternative sources of funding for their hedging activity, which increases the costs of the transactions to the dealers. In addition, the structure of the collateral arrangements required with registered investment companies (that is, a pledge of collateral held under a control agreement), is not the customary means of handling collateral outside the US. Foreign dealers typically rely on a transfer arrangement rather than a pledge arrangement, in connection with which the counterparty transfers cash to the dealer to secure its obligations and is entitled to a return of the assets when it satisfies its obligations. Dealers generally document these

arrangements under a credit support annex published by ISDA and referred to generally as the “English Law-Transfer Form.”<sup>33</sup> As an operational matter, foreign dealers may not be set up to accept collateral from a counterparty other than through a transfer under an English Law-Transfer Form. As a result, registered investment companies may not, as a practical matter, be able to transact with some foreign dealers.

One exception to the provisions under the 1940 Act requiring investment companies to custody assets exclusively with a regulated bank is the rule governing custody of margin held in respect of listed futures contracts. Rule 17f-6 permits (but does not require) a registered investment company to place and maintain cash, securities and similar investments with a futures commission merchant (FCM) that is unaffiliated with the registered investment company (and unaffiliated with an affiliate of the investment company) in amounts necessary to effect the investment company’s transactions in exchange-traded futures contracts and commodity options. Exchange-traded futures contracts and commodity options include those traded on a contract market designated for trading consistent with the Commodity Exchange Act as well as a board of trade or exchange located outside the US, as contemplated by Part 30 under the Commodity Exchange Act.<sup>34</sup> Under Rule 17f-6, the registered investment company must enter into a written contract with the FCM governing the arrangement and include specified required terms.<sup>35</sup> The investment company must also arrange to transfer gains on positions (other than *de minimis* amounts) out of the FCM on the business day following receipt.

The Commodity Futures Trading Commission (the CFTC), through its regulation of the futures market, requires all market participants, including registered investment companies, to hold collateral against futures positions at an FCM. Commodity Exchange Act Section 4d(a)(2) requires all customers of an FCM to hold collateral against futures positions at the FCM. In 1984, in light of the SEC’s custody rules for registered investment companies, the CFTC adopted Interpretation 10 to facilitate access to the futures markets

by registered investment companies, consistent with SEC requirements that investment companies custody assets at a third-party custodian. In 2005, after adoption by the SEC of Rule 17f-6, the CFTC announced that, subject to an exception for FCMs that are affiliated with the registered investment company, use of tri-party collateral agreements, where collateral is held by a bank (or other third party custodian), were no longer permissible and the CFTC was amending Interpretation No. 10 accordingly.<sup>36</sup>

### **Limitation on Investments in Illiquid Securities**

Open-end investment companies (that is, mutual funds) but not closed-end investment companies are limited to investing not more than 15 percent of their net assets in illiquid securities, or five percent in the case of a money market fund. Any assets segregated by an investment company in order to satisfy the investment company’s requirements under Release 10666 must be treated as illiquid if the investment with respect to which the assets are being held is itself illiquid.<sup>37</sup> The investment company’s board is responsible for overseeing the liquidity of the investment company’s holdings. The purpose of this requirement, as well as the requirement for board review, is to ensure that the investment company will be able to comply with its redemption obligations.

The definition of a “liquid” instrument for purposes of this interpretation, and subject to requirements for a money market fund to hold certain “daily liquid assets” and “weekly liquid assets,” is an instrument that can be sold, in the ordinary course of business, within seven calendar days, at approximately the value at which the investment company valued the instrument for purposes of calculating net asset value. Futures and options that trade on a regulated exchange generally are treated as liquid instruments. The SEC Staff, when asked, has found over-the-counter options to be illiquid.<sup>38</sup> The SEC Staff has not addressed the question of whether a swap may be considered to be a “liquid” investment and, if so, what defining characteristics the swap would be required to have.

Investment companies and their boards take different positions regarding whether swaps and other other-the-counter derivatives are “liquid” instruments. Most swap transactions are documented under a master agreement, generally in the form published by the ISDA. Under the standard form of ISDA agreement, transactions are not freely transferable.<sup>39</sup> The inclusion of this provision in the governing documentation for a transaction may make it difficult for an investment company to conclude that the swap is liquid. As a result, investment companies often amend this provision to allow for free transferability of the transaction or a right to break the transaction at an agreed price. Inclusion of a transfer right or break right is consistent with prior SEC interpretations of when an instrument may be treated as liquid.<sup>40</sup>

In the case of swaps for which quotes are freely available and counterparties generally are willing to close out a position or neutralize the market exposure through an offsetting position, investment companies may also be comfortable concluding that the instruments are liquid. This position is easier to take in the case of instruments, such as credit default swaps, for which, in many cases, third party pricing is readily available through pricing services.

## Valuation Considerations

Rule 22c-1 under the 1940 Act provides that a registered open-end investment company may not sell or redeem any security except at a price based on the current net asset value of the security computed after receipt of the purchase or redemption order. As a consequence, open-end investment companies generally must value their assets daily.

In valuing their portfolios, investment companies (other than money market funds using amortized cost valuation in compliance with Rule 2a-7) must use “market value” for those securities for which market quotations are readily available and “fair value” for those securities and other assets for which market quotations are not readily available. The 1940 Act vests responsibility for valuation in the investment company’s board.<sup>41</sup>

In establishing market value, investment companies generally use the last quoted sales

price at the time of valuation for a security or, in the absence of recent sales, the bid price or the mean of the bid and asked prices. Investment companies typically rely upon (but are not required to use) pricing services to establish the official market price for portfolio holdings. Valuation information may also be obtained directly from an exchange or from a dealer. Thus, in the case of listed derivatives, investment companies will typically determine the market price based on an exchange price obtained directly from an exchange or through a third party pricing service. For an over-the-counter derivative for which there is a deep and well-established over-the-counter market, such as for credit default swaps or interest rate swaps, investment companies will often obtain pricing from a third party pricing service but may obtain pricing directly from third party dealers. To the extent that dealer quotations are used, the investment company should have procedures to evaluate the reliability of the quotations (that is, to become comfortable that the dealer stands ready to purchase the derivatives at the quoted price). If the investment company is not confident in the integrity of the quotes, it must value the instrument at fair value.

For instruments for which there is not a readily ascertainable price, the investment company must value the instrument at “fair value.” According to the SEC, fair value is “the price [at which an investment company] might reasonably expect to receive upon current sale.”<sup>42</sup> Fair value may be based on a model-driven analysis or any other reasonable methodology. Determination of fair value often requires dedication of additional resources to valuation by the investment adviser, assuming that authority over valuation is delegated to the adviser by the board, as it typically is.

Investment companies must ensure that values are current on a daily basis. The values must be current and not based on a value that an investment company hopes to obtain in the future. Valuations may not be made at zero unless the investment company reasonably believes that the current disposition value is zero. For example, in the face of a bankruptcy, where it is often difficult to value claims, there is a harm to shareholders to the extent that the investment company writes down the value of

a payable by the bankrupt entity to zero and then later collects on the claim. Under those circumstances, the new investors obtain an undisclosed windfall.

In 2008, the Financial Accounting Standards Board (FASB) adopted Statement of Financial Accounting Standards No. 161, entitled, “Disclosures about Derivative Instruments and Hedging Activity” (FAS 161). FAS 161, which applies to investment companies, is intended to provide users of financial statements with a better understanding of a company’s use of derivatives by requiring enhanced disclosure about how and why the company uses derivatives, how the company accounts for derivatives and how derivatives affect the company’s financial position, financial performance and cash flows. To meet these objectives, FAS 161 requires companies to, among other things, disclose their objectives and strategies for using derivatives in terms of primary underlying risk (for example, interest rate, credit, foreign exchange rate or overall price), disclose the fair values of derivatives and their gains and losses in a tabular format, and disclose information about counterparty credit risk, including concentrations, maximum potential exposures to credit losses and the extent to which master netting arrangements potentially reduce the company’s maximum amount of loss due to credit risk.<sup>43</sup> The SEC Staff is keenly aware of the disclosure requirements of FAS 161. In his May 11 speech to the Massachusetts Society of CPAs, the Director of the SEC’s Division of Investment Management “encourage[d] funds to approach this disclosure thoughtfully with a mind towards informing shareholders as to how derivatives were actually used during the period to meet the objectives of the fund.”<sup>44</sup>

With respect to valuation and accounting, we understand that the SEC Staff has been inquiring about the manner in which an investment company accounts for swaps when the investment company calculates its net asset value and the percentage of the investment company’s assets the swaps represent. These types of inquiries have arisen, for example, in circumstances where an investment company seeks to gain exposure to a particular asset class solely or primarily through the use of one or more swaps. We understand that the Staff’s inquiries in these circumstances stem

from a belief that the investment company is investing all or substantially all of its assets in swaps. Of course, that is highly unlikely to be the case. Rather, all or substantially all of the investment company’s investable assets will have been used to acquire government securities, with the swap representing either an asset or liability (collateralized by the government securities) to the investment company depending on market conditions.

### **Limitations on Investment in Securities of Issuers in a Securities-Related Business**

Section 12(d)(3) of the 1940 Act prohibits a registered investment company from purchasing “any securities issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the [Investment Advisers Act of 1940].” Although a number of purposes for the enactment of Section 12(d)(3) have been posited over the years, the SEC has stated that the provision was designed to prevent the abuses that Congress noted occurred during the 1920s and led to the 1929 Crash in connection with which mutual fund trust assets were exposed to the risks of the underwriting business of financial institutions.<sup>45</sup>

Although the prohibition was designed to address equity or debt ownership interests in a broker-dealer or investment adviser, the language is broad enough to cover over-the-counter derivatives, including both derivatives that are “securities” and those that are not. Over-the-counter options on securities should be deemed to be “securities”<sup>46</sup> “issued” by the dealer selling the instrument. Arguably the language referring to “any other interest in” is broad enough to encompass a counterparty interest in a derivative. Because most over-the-counter derivatives are entered into with dealers who are affiliated with entities engaged in underwriting or registered as advisers, investment companies generally assume that the prohibition would include most over-the-counter derivatives.

Rule 12d3-1 under the 1940 Act provides an exclusion from the prohibition if certain

conditions are met, but only in respect to acquisition of a “security” and not in respect to acquisition of another “interest in” such person. The Rule excludes from the prohibition of Section 12(d)(3) acquisitions of securities issued by any person that, in its most recent fiscal year, (i) derived 15 percent or less of its gross revenues from securities-related activities, unless the investment would result in the investment company’s having a control position with respect to the person after the acquisition or (ii) derived more than 15 percent of its gross revenues from securities-related activities, but immediately after the acquisition of the security by the investment company: (A) if the investment company acquired an equity security, the investment company does not own more than five percent of the outstanding securities of that class; (B) if the investment company acquired a debt security, the investment company does not own more than 10 percent of the outstanding principal amount of the issuer’s debt securities; and (C) the investment company has not invested more than five percent of the value of its total assets in the issuer’s securities. A key issue that arises with the application of this rule is whether the financial instrument being acquired by the investment company is a “security,” and, if so, whether it is a debt or equity security. The SEC Staff has indicated that a registered investment company may treat a cash-settled option issued by a broker-dealer on an equity security or index of equity securities as a *debt security* for purposes of Rule 12d31.<sup>47</sup>

Although the SEC avoided the question, a 2007 exemptive order raised the possibility that swaps, along with other derivative instruments, may not be “securities” within the meaning of the 1940 Act.<sup>48</sup> As a result, it is unclear whether the exclusion provided under Rule 12d3-1 would be available to investment companies entering into swap transactions with counterparties that are securities-related issuers, as defined in Section 12(d)(3). Notwithstanding the lack of clarity regarding whether Rule 12d3-1 would provide an exclusion to investment companies to enter into swaps and other derivatives with dealers, given that the Rule evidences the SEC’s views regarding what types of holdings are not sufficiently significant to implicate the concerns underlying Section

12(d)(3), it would appear to be not unreasonable for a registered investment company to rely on the guidance by analogy when entering into swaps. By analogy to the SEC’s positions with respect to over-the-counter options, it would seem reasonable to treat swaps as a “debt security” and, thus, to comply with the 10 percent debt ownership limit.

## Concentration

The 1940 Act requires registered investment companies to state in their registration statements each investment company’s policy regarding concentration in a particular industry or group of industries. The requirement also prohibits investment companies from deviating from that policy without the approval of the holders of a majority of the investment company’s outstanding voting securities. In the context of over-the-counter derivatives, this requirement raises the question of whether the relevant industry is that of the counterparty or the issuer of the underlying referenced instrument, or both, and whether investment companies have the ability to establish for themselves reasonable industry classification systems governing derivatives and counterparties.<sup>49</sup>

## Compliance with the Names Rule

The SEC adopted Rule 35d-1 to ensure that the name of a registered investment company, which is used to market the investment company, accurately describes the investments of the investment company.<sup>50</sup> Under the Rule, a registered investment company must invest at least 80 percent of the value of its net assets plus borrowings in the particular investments suggested by the investment company’s name. The types of borrowings covered by the Rule are those used for investment purposes. The adopting release for Rule 35d-1 specifically provides that an investment company may “include a synthetic instrument in the 80 percent basket if it has economic characteristics similar to the securities included in that basket.”<sup>51</sup> Based on this guidance, certain investment companies employ investment strategies where the investment company’s 80 percent exposure to the investments suggested by the investment

company's name is provided by various derivative investments rather than direct investments in securities. For example, an investment company entitled "The High Yield Bond Fund," under this guidance, may invest in swaps and other derivatives that expose 80 percent of the investment company's assets to high yield securities rather than investing 80 percent of the investment company's assets directly in high yield securities. Appropriate disclosure should be included in the registration statement of an investment company that relies on derivative-based investment strategies to satisfy the requirements of Rule 35d-1.<sup>52</sup>

### **Diversification Test Compliance**

Registered investment companies may elect to be classified as "diversified." In order for a registered investment company to be characterized as "diversified" at least 75 percent of the value of the investment company's total assets must be represented by cash and cash items, government securities, securities of other investment companies and other securities limited in respect to any one issuer to an amount not greater in value than five percent of the value of the total assets of the issuer and to not more than 10 percent of the outstanding voting securities of the issuer.<sup>53</sup> In the context of a derivative instrument, it is not clear whether the test refers to the derivatives counterparty or to the issuer of the underlying referenced securities. The SEC has not directly addressed the issue. However, the SEC and its Staff have expressed their views on the question of who is an issuer under Section 5(b)(1) in related contexts.<sup>54</sup> In *Hyperion*, the SEC Staff stated that the Staff generally has deemed the issuer of a security to be the person to whom the holder of the security looks for payment.<sup>55</sup> Using this analysis, a diversified investment company should be "diversified" with respect to its derivatives counterparties (for example, no more than five percent of the investment company's total assets may be attributable to any one counterparty).<sup>56</sup> It would not be inconceivable for the SEC or its Staff to take the position that a diversified investment company should also be diversified with respect to the referenced security underlying a derivative.<sup>57</sup> After all, the value

of the derivative derives from the value of the referenced security. Consequently, the success of the investment company's investment in a derivative lies not only with the ability of the counterparty to meet its obligation under the derivative but also with the fortunes of the issuer of the referenced security. In other words, legal recourse may be entirely separate from the economic exposure associated with an investment in a referenced security.

### **Compliance with Fundamental Policies**

Section 13(a)(2) and Section 13(a)(3) of the 1940 Act require registered investment companies to comply with the investment policies deemed to be "fundamental," as described in the registration statement for the registered investment company. Investment companies must also include a statement of fundamental investment policy in the recital filed by the investment companies with the SEC under Section 8(b)(1) of the 1940 Act. Fundamental policies may be amended only if authorized by a shareholder vote. As a result, investment companies must disclose their intended investment activities in the prospectus and statement of additional information and invest in a manner that is consistent with the disclosure and with their stated fundamental policies.

### **Disclosure Requirements**

The SEC Staff has stated that an investment company seeking to engage in the writing of put and call options must fully disclose such activity in its prospectus.<sup>58</sup> SEC guidance has further indicated that, so long as more than five percent of an investment company's net assets are "at risk from its involvement in derivative instruments and derivative-based transactions" the investment company prospectus should include specified disclosures.<sup>59</sup> These disclosures include the following: (i) identification of the types of derivative-based transactions in which the investment company may engage; (ii) a brief description of the characteristics of the transactions or instruments; (iii) the purpose for which the investment company intends to use derivatives; and (iv) identification of the risks of derivative

instruments and derivative-based transactions.<sup>60</sup> The SEC Staff has indicated that this disclosure should not be overly lengthy or highly technical and should facilitate investor understanding about relevant risks.<sup>61</sup> In connection with the risk disclosure, the SEC has required a description of the risks associated with the referenced instruments underlying the derivatives as well as the risks associated with the derivatives themselves, such as leverage, credit risk, market risk and liquidity risk. The SEC noted that the investment company's actual use of the derivatives must be consistent with the investment objectives and policies of the investment company, as described in the investment company's prospectus and statement of additional information, sales materials or other disclosure documents. The SEC also has required disclosure regarding the tax consequences to the investment company from the investment in derivatives. The SEC Staff continues to focus closely on the need for investment companies to disclose publicly and clearly the extent of their use of derivatives, the reason behind the use of derivatives (for example, hedging, covered call strategy, to obtain investment exposure, etc.) as well as the risks associated with the derivatives usage.<sup>62</sup> As discussed in Part 2 of this article, the SEC charges investment company directors with reviewing disclosures to ensure that they are adequate in light of the trading practices followed by the investment companies they oversee.

## Notes

1. See, e.g., Jennifer Lynch Koski & Jeffrey Pontiff, "How are Derivatives Used? Evidence from the Mutual Fund Industry," Wharton Financial Institutions Center, The Wharton School, University of Pennsylvania (Jan. 1996) at p.1 (Wharton Study), available at <http://fic.wharton.upenn.edu/fic/papers/96/9627.pdf> ("Theoretical work has advocated derivatives as a useful tool that allows investment managers to utilize information better, manage risk, and reduce transactions costs. In contrast, recent popular press commonly portrays derivatives as speculative, high-risk investments." (citations omitted)).

2. See A. Donohue, Speech by SEC Staff: Remarks Before the Practising Law Institute's Investment Management Institute 2010 (Apr. 8, 2010) (Donohue PLI Speech) ("In the past two decades, the investment company marketplace has been significantly reshaped by the use of derivative instruments. During this period, investment

companies have moved from relatively modest participation in derivatives transactions limited to hedging or other risk management purposes to a broad range of strategies that rely upon derivatives as a substitute for conventional securities. Open-end funds that mimic hedge fund strategies, typically involving derivative products, have become commonplace."); see also A. Donohue, Speech by SEC Staff: Luncheon Address Before a Meeting of the Business Law Section of the American Bar Association Committee on Federal Regulation of Securities (Apr. 24, 2010) (Donohue ABA Speech); A. Donohue, Speech by SEC Staff: Massachusetts Society of CPAs Investment Company InfoShare Program Keynote Address (May 11, 2010) (Donohue Mass CPAs Speech); A. Donohue, Speech by SEC Staff: Keynote Address at the ALI-ABA Compliance Conference (June 3, 2010) (Donohue ALI-ABA Speech).

3. See *SEC Staff Evaluating the Use of Derivatives by Funds*, SEC Release 2010-45 (Mar. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-45.htm>; see also Donahue PLI Speech, *supra* n.2 ("As we examine the market environment with respect to funds' use of derivatives, the Division [S]taff is deferring consideration of exemptive requests to operate ETFs that intend to use significant amounts of derivatives.").

4. See American Bar Association Section of Business Law, Committee on Federal Regulation of Securities, Report of the Task Force on Investment Company Use of Derivatives and Leverage, American (July 6, 2010), available at [http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest\\_files/DerivativesTF\\_July\\_6\\_2010\\_final.pdf](http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf) [hereinafter *ABA Task Force Report*].

5. See *id.* ("Because foremost among the issues presented by fund use of derivatives is leverage, and its implications for investors, fund managers and the markets, the Division's review includes looking at current practices involving derivatives and determining whether they are consistent with the policies and purposes underlying the [1940] Act and its regulations. In particular, we are looking at whether methods to obtain leverage are consistent with leverage restrictions embodied in section 18 as well as the concerns expressed in section 1(b) of the Act. For example, certain practices may allow a fund to obtain market exposures well beyond that which the Act explicitly allows through the use of derivatives and the use of various structures and offshore or special purpose vehicles.").

6. This distinction was discussed in detail in the Staff's 1994 study of derivatives. See Memorandum from the Division of Investment Management of the U.S. Securities and Exchange Commission on Mutual Funds and Derivative Instruments, 1994 SEC No-Act, LEXIS 952 (Sep. 26, 1994) (Memorandum), available at <http://www.sec.gov/news/studies/deriv.txt>.

7. *Id.* at pp.24-25.

8. See ABA Task Force Report, *supra* n.4, at 17. The ABA Task Force recommends that funds that invest in derivative instruments that involve leverage adopt policies and procedures that would include minimum asset segregation requirements, known as "Risk Adjusted Segregated

Amounts,” for each type of derivative instrument, based on relevant factors.

9. *See id.* (“[T]he Division is also looking at how funds are addressing risk in this area and asking whether funds that rely heavily on the use of derivatives, particularly those that seek leveraged returns, have appropriate expertise and maintain robust risk management systems and procedures in light of their investments.”). The ABA Task Force recommended that reference assets (and not counterparties) should be considered in calculating concentration and diversification requirements under the 1940 Act and that the calculation should be based on the market value of the instrument.

10. *See* Damian Paletta, “Finance Bill Close to Passage,” *Wall St. J.* (July 13, 2010) (noting that Senate vote on financial reform bill could occur during week of July 12, 2010).

11. The Wall Street Reform and Consumer Protection Act of 2009 passed by a vote of 223-202 on December 11, 2009.

12. The Restoring American Financial Stability Act of 2010 passed by a vote of 59-39 on May 20, 2010.

13. *See* Regulation SHO under the Securities Exchange Act of 1934 (“The term short sale shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”).

14. *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Rel. No. 10,666, 44 Fed. Reg. 25,128, 25,129 (Apr. 18, 1979), available at <http://www.sec.gov/divisions/investment/imseniorsecuritieslic-10666.pdf> (“Leveraging of an investment company’s portfolio through the issuance of senior securities and through borrowing magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company’s outstanding securities.”).

15. *See* Section 18(f)(1) of the 1940 Act, 15 U.S.C. § 80a-18(f)(1) (2006) (“It shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer, except that any such registered company shall be permitted to borrow from any bank: Provided, That immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company: And provided further, That in the event that such asset coverage shall at any time fall below 300 per centum such registered company shall, within three days thereafter (not including Sundays and holidays) or such longer period as the [SEC] may prescribe by rules and regulations, reduce the amount of its borrowings to an extent that the asset coverage of such borrowings shall be at least 300 per centum.”).

16. *See* Section 18(g) of the 1940 Act, 15 U.S.C. § 80a-18(g) (2006) (“A loan shall be presumed to be for temporary purposes if it is repaid within sixty days and is not extended or renewed; otherwise it shall be presumed not to be for temporary purposes. Any such presumption may be rebutted by evidence.”).

17. *See generally*, Investment Company Act Rel. No. 10,666, *supra* n.14.

18. In the Release, the SEC stated that the analysis contained therein was tailored to the trading practices of open-end investment companies, but noted that the analysis may similarly apply, as the circumstances require, to closed-end investment companies, which are also subject to Section 18 of the 1940 Act.

19. *Id.* at 25,129.

20. Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 634 (July 2, 1996), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf>.

21. *See* SEC Division of Investment Management, Generic Letter to Chief Financial Officers of Investment Companies, 1997 SEC No-Act. LEXIS 1022, \*4-\*5, n.9 (Nov. 7, 1997), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/lmcf0120797.pdf> (“Typically, investment companies have designated securities to be segregated on the records of their custodians. The Staff has been asked by registrants whether it would be consistent to segregate accounts on the fund’s records. The Staff has indicated that it would not object if assets segregated under Section 18 [of the 1940 Act] were designated solely on the fund’s records and not designated on the fund’s custodian’s records. . . . To the extent that a fund designates segregated assets solely on its records, the fund may need to implement additional procedures and controls to ensure that segregation is undertaken in accordance with the interpretation outlined in [1940 Act] Release [...] 10666.”).

22. Although we use the term “segregate” for ease of reference in this article, our reference is intended to encompass any type of earmarking or segregation that is allowable under SEC Staff positions.

23. *See* Donohue PLI Speech, *supra* n.2 (“It would seem that simply utilizing the amount invested in the derivative instrument would underestimate the exposures and risks in many cases and using notional amounts may at times overstate them. Furthermore, . . . [the transactions have] now exposed the fund to the credit and other risks associated with the issuing of the derivative instrument and its issuer.”). The ABA Task Force recommended that the SEC either provide guidance or use its rulemaking authority to address the size and nature of segregated accounts. In particular, the Task Force recommended that (i) registered investment companies be required to adopt written policies and procedures establishing minimum asset segregation requirements for the various types of derivative instruments using “risk adjusted segregated amounts” that would be based on relevant factors attributable to each instrument, (ii) registered investment companies adopt, and boards approve, policies and procedures addressing types of assets in the segregated amount and describing what constitutes an offsetting transaction, (iii) segregation policies be disclosed in the registered investment company’s statement of additional information, and (iv) investments with implicit leverage, such as leverage ETFs, not require segregation. *See* ABA Task Force Report, *supra* n.4, at 3.

24. The Appendix is included in Part 2 of this article, which will appear in an upcoming issue of *The Investment Lawyer*.

25. Susan Ervin and Matthew Kluchenek, "Possible Breakthrough to Expanded Use of Futures by Investment Companies," Vol. 39 No. 14, *Rev. of Sec. & Commodities Reg.* (Aug. 2006) (Inferring, based on disclosure in certain open-end and closed-end registered investment companies' registration statement amendments, that SEC Staff has informally changed policy to allow segregation of assets when "covering" cash-settled futures contracts to be calculated on basis of daily mark-to-market exposure rather than notional amount). For the basis of such Staff interpretations, *see generally*; Investment Company Act Rel. No. 10,666, *supra* n.14.

26. Pretzel & Stouffer Chartered, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 911 (Dec. 1, 1995); Dreyfus Strategic Investing, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2179 (June 22, 1987), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf>.

27. *See* "Possible Breakthrough to Expanded Use of Futures by Investment Companies," *supra* n.25 at 2 (citing disclosure in registration statement amendment of open-end registered investment company).

28. The ABA Task Force notes that "existing formal and informal guidance is not theoretically consistent. In the case of certain instruments, funds apparently are expected to segregate assets that are equivalent in value to the notional value of the instrument; in other cases, however, it is sufficient to segregate only an amount equal to the daily marked-to-market value of the obligation" and recommends that "further SEC guidance and/or rulemaking in certain areas would be useful." ABA Task Force Report, *supra* n.4, at 17.

29. Robertson Stephens Investment Trust, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 682 (Aug. 24, 1995), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/robertsonstephens040395.pdf>.

30. *See* Prime Broker Committee, SEC No-Action Letter 1994 SEC No-Act. LEXIS 466 (Jan. 25, 1994) (requiring that customer maintain minimum net equity with prime broker of at least \$500,000 in cash or securities with ready market or, if customer's account is managed by registered investment adviser or cross-guaranteed by another customer, of \$100,000).

31. *See Guidelines for the Preparation of Form N-8B-1*, Investment Company Act Rel. No. 7221, 37 Fed. Reg. 12,790 (June 9, 1972); *see also* Memorandum, *supra* n.6 at n.80 and accompanying text ("The Division [of Investment Management] also has permitted funds to cover certain derivatives by holding the underlying instruments or other offsetting instruments. For example, instead of maintaining a segregated account, a fund that sells a call option may cover the position by owning the securities against which the call is written (or securities convertible into the underlying securities without additional consideration) or by purchasing a call on the same securities at the same price.")

32. Upon the bankruptcy of the broker-dealer, the assets in the special custody account as well as the assets held directly by the broker-dealer, including any excess margin, would be treated as customer property subject to proceedings under the Securities Investor Protection Act (SIPA) and netted against the investment company's debit balance to establish the investment company's net equity claim. According to a recent court ruling, the value of net equity claim is valued as of the date of the bankruptcy filing. *Securities Investor Protection Corporation v. Lehman Brothers Inc.*, Memorandum Decision Granting Motion to Uphold Determination of Claim by SIPA Trustee, U.S. Bankruptcy Court, S.D.N.Y. (June 1, 2010). As a result, although the investment company's assets are held at the investment company's custodian, they are subject to administration as part of the SIPA proceeding to the same extent as the assets would be if held by the broker-dealer. However, unlike assets held directly by the broker-dealer in a margin account, assets in the special custody account are generally not subject to rehypothecation by broker-dealer.

33. ISDA has also published an English law Credit Support Deed that, although likely to satisfy 1940 Act requirements for registered investment company counterparties when coupled with a tri-party collateral agreement, is not a practical option because it is rarely accepted by dealers and may require registration of the security interest.

34. Pursuant to CFTC Regulation 30.10, persons located outside the US, who are subject to a comparable regulatory framework in the country in which they are located, may seek an exemption from the application of certain SEC regulations, including those with respect to registration.

35. Rule 17f-6 under the 1940 Act requires that the written contract between the FCM and the registered investment company provide that (1) the FCM comply with the segregation requirements of the Commodity Exchange Act and related rules, (2) the FCM, as appropriate, may place and maintain the investment company's assets to effect transactions for the investment company with another FCM, clearing organization, US or foreign bank, or a member of foreign board of trade and, if so placing the investment company's assets, the FCM shall obtain an acknowledgment that such assets are held on behalf of the FCM's customers in accordance with the Commodity Exchange Act, and (3) the FCM promptly furnish information pertaining to the investment company's assets as the SEC requests.

36. Commodity Futures Trading Commission, Amendment of Interpretation, 70 Fed. Reg. 24,768 (May 11, 2005), available at <http://www.cftc.gov/foia/fedreg05/foi050511b.htm>.

37. Prudential-Bache Government Plus Fund II, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2457 (Sept. 18, 1987).

38. *See* Delta Government Options Corp., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 856 (July 21, 1989). The SEC Division of Investment Management has indicated that certain derivative instruments may be illiquid under all or most market conditions, observing that a derivative that is designed to meet the needs of a particular investor

would, almost by design, not have the broad market required to support a finding that the instrument is liquid. The liquidity of other derivative instruments, however, may vary depending on market conditions, and presumably could be determined to be liquid under guidelines and standards established by the investment company's board of directors or trustees. See Memorandum, *supra* n.6. Accordingly, there may be instances when the trading market for a particular derivative instrument, including an over-the-counter derivative instrument, would support a determination that such instrument is liquid.

39. Section 7 of the pre-printed ISDA Master Agreement (both the 1992 and the 2002 version) provides "[Subject to limited exceptions for mergers, defaults and terminations,] neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party . . ."

40. See Prudential-Bache No-Action Letter, *supra* n.37 (treating as liquid portion of assets segregated by investment company with respect to short, over-the-counter options written by investment company exclusively to primary, US government securities dealers and in connection with which each dealer agreed to repurchase any option written by investment company for formula price).

41. See Section 2(a)(41) of the 1940 Act, 15 U.S.C. § 80a-2(a)(41) (2006); SEC Rule 2a-4, 17 CFR 270.2a-4(a)(1) ("Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.")

42. See Letter from Douglas Scheidt, SEC Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 9, 1999).

43. On May 26, 2010, FASB issued a proposed Accounting Standards update that includes enhanced requirements regarding financial instrument classification, impairment and hedge accounting. See Financial Accounting Standards Board, "Proposed Accounting Standards Update, Financial Instruments and Derivatives and Hedging" (May 26, 2010). The proposal was designed to address perceived inadequacies in current accounting standards by providing clearer disclosure in simpler format. If adopted, the proposal would require that most financial instruments, including derivatives, be measured at fair value and that changes in value be recognized in net income. The proposal treats transaction costs and fees relating to financial instruments as an expense in net income when incurred. Comments on the proposal are due by September 30, 2010.

44. Donohue Mass CPAs Speech, *supra* n.2.

45. See *Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses*, Securities Act Rel. No. 6505, Exchange Act Rel. No. 20,570, Investment Company Act Rel. No. 13,725, 1984 WL 482559, at \*3 (Jan. 17, 1984) (noting that testimony of Chief Counsel of

Investment Trust Study in 1940 and statements of SEC Staff indicate that "purpose of section 12(d)(3) was principally to prevent investment companies from exposing their assets to the entrepreneurial risks of securities related businesses.").

46. See *Caiola v. Citibank, NA*, 295 F.3d 312, 325 (2d Cir. 2002) ("Caiola, on the other hand, alleges that his synthetic options were simply cash settled over-the-counter options on Philip Morris stock and therefore are securities. We agree that these instruments are securities under section 3(a)(10) for a number of reasons.").

47. Dreyfus Capital Growth Fund, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 958, at \*4-5 (Sept. 16, 1992) ("We would not recommend enforcement action to the Commission under Section 12(d)(3) or rule 12d3-1 if the Fund deems cash-settled options issued by broker-dealers to be debt securities for purposes of rule 12d3-1.").

48. *Vanguard STAR Funds, et al.*, Investment Company Act Rel. No. 28,009, 2007 SEC LEXIS 2338 (Sept. 28, 2007) (Notice of Application); *In the Matter Of Vanguard STAR Funds et al.*, Investment Company Act Rel. No. 28,024, 2007 SEC LEXIS 2517 (Oct. 24, 2007) (Order).

49. The ABA Task Force noted that "[d]ue to the disclosure-based nature of the concentration requirements under the 1940 Act, it would seem reasonable to include reference assets in the calculation, and ignore the counterparty." ABA Task Force Report, *supra* n.4, at 30. Furthermore, the ABA Task Force stated that "calculation based on market value is the correct test." *Id.*

50. *Investment Company Names*, Investment Company Act Rel. No. 24,828, 2001 SEC LEXIS 86 (Jan. 17, 2001).

51. *Id.* at \*10 n.13.

52. The ABA Task Force recommended that the SEC or SEC Staff clarify that it would be appropriate for a registered investment company, "when considering derivative investments for purposes of the names rule, ... the reference asset, rather than the counterparty, would be the relevant focus for determining whether a fund invests in a manner that is consistent with its name." ABA Task Force Report, *supra* n.4, at 39.

53. See Section 5(b)(1) of the 1940 Act, 15 U.S.C. § 80a-5(b)(1) (2006) ("Diversified company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.").

54. See, e.g., Rule 5b-3 under the 1940 Act (repurchase agreements and refunded securities); Hyperion Capital Management, Inc., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 644 (Aug. 1, 1994) (Hyperion) (mortgage-backed and asset-backed securities); Putnam

Diversified Premium Income Trust, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 834 (July 10, 1989) (loan participations).

55. See *Hyperion*, *supra* n.54 at \*4, n.6 (citing Dreyfus New York Tax Exempt Bond Fund, Inc., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1924 (May 16, 1977) (under Section 5(b)(1), issuer is person against whom holder of security has legal claim) and Pennsylvania Tax-Free Income Trust, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 621 (Mar. 4, 1977) (under Section 5(b)(1), entity responsible for payment of bond obligation is issuer)).

56. Similar to questions that arise regarding the amount of assets that must be segregated to meet “cover” requirements under Release 10666 (see *supra* n.23 and accompanying text), there is a lack of clarity regarding the manner in which an investment company should measure its interest in a derivative instrument for purposes of determining compliance with investment limitations of the 1940 Act that are expressed as a percentage of the company’s assets (e.g., is the appropriate measure the notional value, the net out-of-the money exposure or some other value).

57. Alfred Jaretzki, Jr., “The Investment Company Act of 1940,” 26 *Wash. U. L.Q.* 303, 314 at n.34 (1941) (“The distinction between diversified and non-diversified companies is due in large part, it is believed, to a desire to inform stockholders of the character of the portfolio of the company in which they have invested.”). Furthermore, the ABA Task Force recommended that the SEC “acknowledge that diversification should be measured for purposes of Section 5(b) by looking only at the reference securities” and that “broad-based indices or other reference assets such as commodities or currencies should be excluded from these calculations.” ABA Task Force Report, *supra* n.4, at 27. The Task Force further recommended that the SEC “address counterparty diversification separately under Section 12(d)(3) of the 1940 Act....” *Id.*

58. See Investment Company Act Release No. 7221, *supra* n.31.

59. Letter to Registrant from Carolyn B. Lewis, 1994 SEC No-Act. LEXIS 470 (Feb. 25, 1994); see also Eric D. Roiter, “Investment Companies Use of OTC Derivatives: Does the Existing Regulatory Regime Work?,” 1 *Stan. J.L. Bus. & Fin.* 271, 277 (1995) (discussing SEC guidance on investment company use of derivatives).

60. See Letter to Registrant from Carolyn B. Lewis, *supra* n.59 (citing Items 4(b) and 4(c) of Form N-1A (currently Items 9(b) and 9(c) of Form N-1A), Item 8 of Form N-2 and Guide 3 to Form N-1A). Form N-2 governs the registration of closed-end registered investment companies and Item 8 of Form N-2 generally requires disclosure of the closed-end registered investment company’s investment objectives and policies and risk factors. This is analogous to Item 9 in the current Form N-1A. In Guide 3 to Form N-1A, the SEC Staff noted that a prospectus should contain clear and concise disclosure and that “registrants should avoid extensive legal and technical detail and need not discuss every possible contingency, such as remote risk.” Furthermore, the SEC Staff noted that “the level of disclosure as to a particular type of investment should be consistent with the prominence of that type of investment in the registrant’s portfolio.”

61. See Letter to Registrant from Carolyn B. Lewis, *supra* n.59.

62. The ABA Task Force noted that the SEC or SEC Staff should further develop disclosure expectations that relate to investment companies’ use of derivatives with respect to limits, practices and related risks. The Task Force also noted that shareholder letters and reports may be better suited than a registered investment company’s prospectus or statement of additional information for disclosure. See ABA Task Force Report, *supra* n.4, at 40-42.

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## Buying a Private Fund Manager: An Overview of Legal Issues

By Nathan J. Greene and Kasey Choi

**A**n unprecedented degree of uncertainty has characterized the asset management business environment over the last two years—a period that saw extreme market volatility, threatened changes to key tax structures, a rapidly shifting regulatory environment, and rising expectations from institutional investors. One collateral result is a dramatic fall-off in asset management industry mergers-and-acquisitions (M&A) deal activity relative to 2006 and 2007.

*Continued on page 10*

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### CONTENTS

#### Highlights of This Issue

By Stephanie A. Djinis,  
Editor-in-Chief, page 2

#### Have You Ever Heard a FINRA Tweet? The Social Media Universe Meets the Securities World: Part 2

By Amy E. Haid, page 3

#### Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 2

By Georgia Bullitt, Thomas  
Harman, Christopher Menconi,  
Bill Zimmerman and Christopher  
Jackson, page 19

### REGULATORY MONITOR

#### SEC Update . . . . . page 34

- SEC Proposes New Disclosure Requirements for Target Date Funds

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# Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 2

By Georgia Bullitt, Thomas Harman, Christopher Menconi,  
Bill Zimmerman and Christopher Jackson

**T**his article is focused on the legal considerations facing registered investment companies in connection with the use of derivatives. In Part 1, we focused on regulatory rules and interpretation by the Securities and Exchange Commission (SEC). Here, in Part 2, we discuss tax considerations, duties of fund boards and the changing regulatory environment, including implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well new developments stemming from the SEC's study on fund use of derivatives.

## Tax Considerations for Registered Investment Companies

Almost all registered investment companies seek to qualify for pass-through tax treatment, as a regulated investment company (RIC)

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This article is a continuation of Part 1 of the article appearing in the August 2010 issue of *The Investment Lawyer* (Vol.17, No.8). Endnote references have been modified so that Parts 1 and 2 exist independently. The article was jointly authored by Georgia Bullitt, Thomas Harman, Christopher Menconi, Bill Zimmerman and Christopher Jackson. Ms. Bullitt and Messrs. Harman, Menconi and Zimmerman are partners with Morgan Lewis & Bockius LLP and Mr. Jackson is General Counsel of Calamos Investments.

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under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code). In order to qualify as a RIC, an investment company must satisfy a number of requirements. The two requirements important to investments in derivatives relate to the investment company's source of income (the Qualifying Income Test), and the diversification of the investment company's holdings (the Diversification Test), both of which are found under Section 851 of the Code. Unfortunately, there is very little guidance provided by the Code and the Internal Revenue Service (IRS) regarding the treatment of derivatives under the Qualifying Income Test and the Diversification Test or, for that matter, under general federal income tax principles. Accordingly, any investment in derivatives should be preceded by a discussion with tax and audit professionals to make sure the investment manager understands how these instruments will be treated under these tests.<sup>1</sup>

Under the Qualifying Income Test, at least 90 percent of an investment company's gross income must be derived from: (i) dividends; (ii) interest; (iii) payments with respect to security loans; (iv) gains from the sale or other disposition of stock or securities or foreign currency; (v) certain other income, including, but not limited to gains from options, futures or forward contracts, derived from its business of investing securities or currencies (so-called Other Income), or (vi) income from certain qualified publicly-traded partnerships. The definition of "stock or securities" for this purpose is cross-referenced to Section 2(a)(36) of the Investment Company Act of 1940, as amended (the 1940 Act). That definition includes a broad range of instruments, including those "commonly known as a 'security,' or any certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."<sup>2</sup> The Other Income provision of the Qualifying Income Test is very important in analyzing how income from derivatives will be treated for these purposes. The IRS has ruled that most income from options, forwards and futures will produce "good income" provided the returns of the instruments are based on stocks and securities. In addition, income from hedges on investments in stocks and securities has been found to satisfy the Qualifying Income Test. The Other Income provision permits income from most swaps and other derivatives based on the performance of securities, such as total return swaps, to be treated as qualifying income for purposes of the Qualifying Income Test, even though the swap itself may not constitute a "security" and even though the contract is cash settled and, thus, does not provide a "right to...purchase [a security]." There is uncertainty, however, as to whether the income from derivative contracts would satisfy the Qualifying Income Test where the referenced instrument is not clearly a "security" under the 1940 Act. In 2006, the IRS issued a revenue ruling in which it concluded that income from swaps and other contracts based on broad-based commodities indices would not produce good income for the Qualifying Income Test because such swaps were not clearly "securities" under the 1940 Act and the

income produced by the swap did not otherwise qualify as Other Income.<sup>3</sup> Following the issuance of the revenue ruling, however, the IRS began issuing private letter rulings concluding that income and gains from certain commodity-linked notes would produce good income for the Qualifying Income Test.<sup>4</sup> The private letter rulings required the structured notes to meet specified criteria, including that they offer some degree of principal protection, in order to receive treatment as a debt instrument for purposes of the IRS' interpretation. As a result of these private letter rulings, RICs now typically obtain some of their exposure to commodities through commodity-linked notes rather than swaps.

RICs may also obtain exposure to commodities through derivatives held in an offshore subsidiary formed by the RIC for this purpose. The IRS has issued a number of private letter rulings concluding that income from a RIC's investment in wholly-owned, offshore subsidiaries constitutes good income for purposes of the Qualifying Income Test.<sup>5</sup> The IRS imposes few limits on the types of derivative investments such subsidiaries may make.<sup>6</sup> The investments must, however, comply with the senior security rules applicable to open-end investment companies under the 1940 Act. As a result, so long as an offshore subsidiary complies with the segregation requirements of Investment Company Act Release No. 10666 (Release 10666),<sup>7</sup> it may invest in commodity-linked swaps and other instruments, even though those instruments would not produce good income if an open-end investment company that owns the subsidiary had invested in the instruments directly. The dividends paid by such subsidiaries to their RIC parent will still be qualifying income for purposes of the Qualifying Income Test. A RIC that owns such an offshore subsidiary is limited to investing only up to 25 percent of its assets in such subsidiary under the Diversification Test (described below).

Under the Diversification Test, as of the end of each quarter, a RIC must (i) have at least 50 percent of its assets invested in cash, cash items, government securities, securities of other registered investment companies and other securities, with these other securities limited, in respect to any one issuer, to an amount

not greater than five percent of the RIC's total assets or 10 percent of the outstanding voting securities of such issuer and (ii) have no more than 25 percent of the value of the assets of the RIC invested in any one issuer, in any two related issuers controlled by it and engaged in similar trades or businesses, or in one or more qualified publicly-traded partnerships. Similar to the Qualifying Income Test, there is very little authority interpreting how derivatives should be treated for purposes of satisfying the Diversification Test. The most important questions to be answered in connection with the test are: (i) who the issuer of the derivative instrument is for this purpose and (ii) how the derivative instruments should be valued for this purpose. Regarding the issuer of a derivative, the IRS does not necessarily view the identity of the issuer in the same way as the SEC. The SEC generally looks to the credit risk associated with an instrument in determining the identity of the issuer. The IRS, on the other hand, tends to look not only to the credit risk involved but also to the underlying economic performance on which the derivative is based. Because of the lack of guidance, many RICs seek to comply with the Diversification Test by analyzing a derivative instrument both in terms of exposure to the derivatives counterparty and in terms of exposure to the issuers (or markets) of the underlying referenced investments. With reference to the valuation of derivative instruments, there is no guidance as to whether the applicable measure of value is the market value of the derivatives, the notional amount of the contract or some other measure, such as a model-based valuation. Most practitioners believe that the net fair market value of the derivative instrument should be used for purposes of measuring compliance under the Diversification Test.<sup>8</sup>

In addition to the RIC qualification tests discussed above, investment managers also need to consider the general tax consequences of investments in derivatives. Certain tax rules may apply to derivatives held by a RIC that might require gains and losses recognized to be treated as ordinary income, accelerate the recognition of income, and/or defer a RIC's ability to recognize losses. The result of the application of these rules may also affect the amount, timing or character of the income distributed

to shareholders of the RIC. As with the above discussion, there is very little clear authority on how a number of different derivative instruments should be treated under these rules. For example, the IRS in 2007 requested comments regarding the treatment of certain exchange traded notes. In the request, the IRS asked whether these instruments should be required to accrue income/expense during the term of the transaction as indicia that they were debt, if the notes would not otherwise be considered to be debt for US federal income tax purposes. The IRS has not issued any guidance on these instruments since requesting these comments.<sup>9</sup> The resolution of these timing and character issues could have relevance for some RICs in satisfying an additional RIC qualification regarding the requirements to annually distribute their income.<sup>10</sup>

### **Board Responsibility for Risk Management Oversight**

A Management investment company (*i.e.*, an open- or closed-end fund) has a board of directors (or board of trustees) that is responsible for the overall management of the company. As a result, boards have oversight responsibilities for the investment company's investments in, valuation of and performance under derivatives contracts as well as the investment company's disclosure of its investments and the attendant risks to shareholders. In Release 10666, the SEC noted that, in evaluating an investment company's participation in leveraged transactions, the directors must consider the "potential loss of flexibility" inherent in the transactions as well as ensure that the trading practices are consistent with the investment company's core investment policies. The SEC also focused in Release 10666 on the board's responsibility for full and complete disclosure regarding the investment company's investments in leveraged transactions. In that regard, the SEC noted that the board should review disclosure documents to "ensure complete disclosure" of material information relating to the trading practices, including the following: (i) potential risk of loss; (ii) identification of trading practices as separate and distinct from the underlying securities; and (iii) a description of the different goals inherent in participating

in the transaction as compared to investing in the underlying securities. The SEC also indicated in Release 10666, prior to adoption of Rule 35d-1 under the 1940 Act, that it was the responsibility of the investment company's board to ensure that the investment company's name accurately reflects its portfolio investment policies and trading practices.

Case law generally requires a fiduciary, such as an investment company board or the designated adviser, to act in a prudent manner. Under the "business judgment rule," actions by an investment company board or other fiduciary overseeing the investment company's investments, including the investment company's use of derivatives, are protected from judicial inquiry so long as the fiduciary acts in an informed manner, in good faith and in the honest belief that the action taken was in the best interests of the investment company.<sup>11</sup>

Investment company boards generally do not manage the day-to-day business of the investment company. Instead, the boards delegate such responsibilities to the investment adviser, the administrator, the custodian and other service providers.<sup>12</sup> The board continues to serve as a watchdog, however, ensuring that the investment company has appropriate policies and procedures to conduct its business and that the service providers to whom the investment company has delegated authority are acting appropriately.

In overseeing the use of derivatives by an investment company, the board typically seeks to establish that the investment company has: (i) properly identified the risks inherent in the instruments and the strategy and not exceeded any limitation on the use of such derivatives in the investment company's disclosure documents, (ii) adopted appropriate policies and procedures to comply with Section 18 of the 1940 Act and Release 10666, (iii) adopted procedures to value derivatives consistently and accurately in accordance with the investment company's general valuation policies and (iv) complied with the 1940 Act's provisions regarding custody of investment company assets. In addition, the board would oversee establishment of appropriate operational and compliance controls for booking the instruments and mitigating risks inherent in the instruments. In this regard, the board,

including through delegation to the investment adviser, would analyze and evaluate the relevant risks underlying derivatives used by the investment company, including not only market risk associated with the instrument and the referenced assets but also the credit, operational and valuation risks associated with the instruments and the counterparty as well as the collateral arrangements. Investment company boards often establish regular, periodic meetings with fund investment advisers to discuss specific risks associated with the derivatives book as well as valuations for the instruments. During periods of market stress, boards hold additional calls and meetings with investment advisers to discuss issues relating to all instruments held in the fund's portfolio, including derivative instruments.<sup>13</sup>

## Regulatory Implications and Recent Litigation

Non-compliance by investment companies with their obligations under the 1940 Act in connection with trading derivatives potentially impacts not only the investment companies themselves but also the derivatives counterparties. Under Section 47(b) of the 1940 Act, a contract that violates the 1940 Act may be unenforceable against the investment company or voidable by the investment company.<sup>14</sup> In addition, where an investment company engages in an unlawful derivatives transaction, the counterparty faces the risk that it may be subject to a regulatory action as an aider or abettor of the investment company's violation.<sup>15</sup>

It is not yet established how, if at all, the insider trading prohibitions under Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the Exchange Act) would apply to securities-based swaps, over which the SEC does have jurisdiction under the anti-fraud provisions of the Exchange Act.<sup>16</sup> Last year, the SEC brought an action against two individuals for insider trading in connection with credit default swaps.<sup>17</sup> The allegations involved a tip by a salesman at a dealer to a hedge fund trader regarding a change to a bond issuance that significantly affected the prices of credit default swaps on the debt. The SEC alleged that the salesman misappropriated confidential

information obtained from investment banking colleagues about the issuance in the course of his work and breached a duty of confidentiality by informing the hedge fund trader. The trader allegedly used the information to enter into a credit default swap at a lower price than would have been available had the information been public. The complaint included charges of violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.<sup>18</sup> The defendants responded by, among other things, asserting that the SEC does not have jurisdiction to bring the claims or to regulate trading activity associated with the swaps.<sup>19</sup> In denying the defendants' motions for judgment on the pleadings, the court reinforced the SEC's jurisdiction over securities-based swaps under the anti-fraud provisions of the federal securities laws<sup>20</sup> and noted that a trader cannot get around the definition of "security-based swap agreement"<sup>21</sup> by basing a material term on a security and simply not mentioning it.<sup>22</sup> The case was dismissed on June 25, 2010 based on a finding by the court that the SEC had failed to bring forward sufficient evidence to support its claims against the two traders. Significantly, the court did not hold that the SEC did not have a basis in law to sue the defendants.<sup>23</sup>

Given the continued uncertainty regarding the ability of the regulators to punish fraudulent or unsavory practices in the over-the-counter derivatives market, investment company directors and advisers should evaluate the integrity of their counterparties and take steps to protect themselves contractually. For example, investment companies often require counterparties to enter into confidentiality agreements in conjunction with negotiation of an ISDA Master Agreement in order to protect strategic trading information.

### **Evolving Regulation—What will the Future Bring?**

Regulatory focus on the use of derivatives has historically followed the occurrence of scandals or losses involving derivatives in the marketplace generally. Following losses in the collateralized mortgage obligation derivatives markets in 1994, a congressional subcommittee directed the SEC to undertake a study

regarding the use of derivatives by investment companies, focusing on the adequacy of laws and regulations governing their disclosure and use.<sup>24</sup> The result of the 1994 study was a determination by the SEC that additional regulation was neither necessary nor appropriate. In making this determination the SEC observed that: (i) further regulation could limit important benefits provided to investment companies through derivatives, such as assistance in hedging; (ii) the SEC would have difficulty developing tailored regulation because of the wide variety of derivative instruments available in the marketplace; and (iii) imposition of restrictions would be inconsistent with the general approach of the 1940 Act, which is designed not to impose restrictions on investment company investments themselves. The SEC, instead, concluded that the industry should focus on enhancing disclosure by investment companies regarding their use of derivatives and the inherent risks. The SEC has not provided formal guidance regarding the use of derivatives by the fund industry since the 1994 study.<sup>25</sup>

In March 2010, following the historic market downturn beginning in the fall of 2008 and subsequent media attention on the role derivatives played in the downturn, the SEC announced that it was again evaluating its regulations as they relate to the use of derivatives by investment companies.<sup>26</sup> In that regard, the SEC has reached out to the private bar for assistance,<sup>27</sup> has embarked on a formal review of the use of derivatives by investment companies and, significantly, has suspended any new approvals of exemptive requests by exchange-traded funds (ETFs) seeking to invest in derivatives.<sup>28</sup>

#### *SEC Review of the Use of Derivatives by Mutual Funds, Exchange-Traded Funds, and Other Investment Companies*

The SEC's review has focused on whether current uses of derivatives by investment companies appropriately comply with the 1940 Act requirements.<sup>29</sup> The Staff indicated that the study was not the result of observed problems but, rather, stemmed from a perceived need to update regulatory guidance in the area. Although the Staff has not yet

completed its review, in late July, it issued a letter to the Investment Company Institute commenting on disclosure-related issues it had observed in the course of its study to date.<sup>30</sup> The purpose of sending the letter was to “give investment companies immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them.”<sup>31</sup> In particular, the Staff expressed concern that the type of generic prospectus disclosures that funds typically provide regarding the possibility that the fund might invest in derivatives and the possible risks if it were to do so “may not enable investors to distinguish which, if any, derivatives are in fact encompassed in the principal investment strategies of the fund or specific risk exposures they will entail.”<sup>32</sup> The Staff indicated that prospectus disclosure regarding derivatives should be tailored to each fund’s particular use and should describe, in a plain English format, whether the use of derivatives will be for hedging, speculation or for exposure as well as the extent to which derivatives are expected to be used. The letter urged funds to evaluate disclosure on the basis of the degree of economic exposure the fund intended to seek through derivatives and the amount invested in derivatives. According to the Staff, risk disclosure should focus on the overall portfolio risk, taking into account the derivative strategies as well as other investments. The Staff also observed that disclosure in shareholder reports and financial statements should be improved to, among other things, discuss the impact of actual investment in derivatives over the reporting period and inform shareholders how derivatives were used during the period to meet the fund’s investment objectives. In closing, the Staff warned that it intends to continue to scrutinize fund disclosures regarding derivatives and will “compare a fund’s investment objectives, strategies and risks in its registration statement to its shareholder reports to assess whether the disclosures regarding the fund’s operations appear to be consistent with its registration statement disclosures.”<sup>33</sup>

Although the Staff has not yet spoken about other concerns it may have in connection with the study, the Staff has made several comments indicating that it is evaluating questions

relating to leverage and “whether ... current market practices involving derivatives are consistent with the leverage, concentration and diversification provisions of the Investment Company Act.”<sup>34</sup> Andrew Donohue, the current director of the SEC’s Division of Investment Management,<sup>35</sup> has also suggested that the Staff is evaluating whether existing regulations and market practices are consistent with Sections 1(b) and 18 of the 1940 Act, which state that a fundamental purpose of the 1940 Act is to restrict the ability of investment companies to incur leverage.<sup>36</sup> The SEC noted that it would focus closely on investment companies that seek to provide leveraged returns and the risk management practices used by those investment companies.<sup>37</sup>

Other target areas mentioned by the Staff in connection with the study include (i) valuation of the derivatives, (ii) appropriate measures of liquidity of derivatives and (iii) board oversight of fund use of derivatives. The Staff has reached out to the industry to collect information and make recommendations.

The Staff has not established any deadline within which to complete the review. However, given the pending retirement of Director Donohue in November 2010, it appears reasonable to assume that the Staff would complete the study prior to his departure. Moreover, completion of the study in the fall of 2010 should dovetail with the SEC’s development of new rules to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The focus at this time would also help to implement calls by SEC Commissioners, including Chairwoman Schapiro, for greater regulation of derivatives generally.<sup>38</sup> Of particular concern to registered investment companies is the focus by the Staff on leverage and compliance with the 1940 Act. The emphasis by the Staff on these topics suggests that it may be considering clarifying (especially in respect to the valuation of the risk underlying each derivative for purposes of calculating the amount of liquid assets to earmark as “cover”), revising or even repealing Release 10666. Any change to this standard is likely to change significantly the way in which investment companies use derivatives to obtain exposure or risk manage their holdings.

### *ABA Task Force on Investment Company Use of Derivatives and Leverage*

At the request of Director Donohue, the American Bar Association created a Task Force on Investment Company Use of Derivatives and Leverage (the ABA Task Force) to evaluate the inherent legal issues and make recommendations. On July 6, 2010, the ABA Task Force published a 51 page set of recommendations for regulating investment company use of derivatives and leverage (the Task Force Recommendations). The general theme of the Task Force Recommendations is to recommend moderation in regulation. The ABA Task Force recommended that the SEC rely on funds to establish appropriate procedures to ensure compliance with Section 18 of the 1940 Act, covering segregation, valuations of assets and an analysis of what transactions may be used as off-setting transactions, rather than revising Release 10666 or developing more specific rules. The Task Force endorsed principles-based regulation and enhanced disclosure by funds. The Task Force also recommended that the SEC publish guidance clarifying that the role of a fund's board when considering the fund's use of derivatives is that of oversight and not micro-management. Although the Task Force Recommendations include some specific recommendations in terms of application of the concentration rules, the "Names Rule," the diversification test and compliance with Section 12(d)(3) of the 1940 Act, and noted that "SEC guidance and/or rulemaking in certain areas would be useful,"<sup>39</sup> the Task Force recommended that the SEC continue to look to the framework established by Release 10666 but rely on a principles-based approach to provide flexibility to address all types of derivative instruments and to react to future market developments.<sup>40</sup> A summary of the ABA Task Force's key recommendations is attached as Annex B.

### *Financial Reform Legislation*

At the same time as the SEC has been focused on the use of derivatives by investment companies, Congress passed and President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act

of 2010 (the Dodd-Frank Act) which imposes material changes to the regulation of over-the-counter derivatives in the US. At the same time, legislators and regulators in Europe are also moving towards adoption of new regulatory regimes for the use of derivatives. Any such new European legislation and/or regulation would likely affect US market participants, such as investment companies, since US entities often trade with foreign banks and dealers.<sup>41</sup>

Some of the most important changes contained in the Dodd-Frank Act that will affect registered investment companies include: (i) requirements that swap contracts (a broadly defined term that would include most over-the-counter derivatives, including over-the-counter securities options) be centrally cleared and traded on an exchange or electronic platform,<sup>42</sup> (ii) grant of rulemaking and oversight authority to the SEC over security-based swaps, and to the Commodity Futures Trading Commission (the CFTC) over all other swaps,<sup>43</sup> (iii) registration and regulation of swap dealers and major swap participants (that is, entities that have a significant effect on the financial system or other participants),<sup>44</sup> (iv) imposition of position limits and trader reporting requirements,<sup>45</sup> and (v) restrictions on the ability of swap dealers to use posted collateral to fund their hedges.<sup>46</sup> The Dodd-Frank Act contemplates significant rulemaking activity on the part of the SEC and the CFTC in order to implement the stated purposes of the statute and establishes a fairly tight time table for implementation of certain of the requirements, including requirements that derivatives transactions be centrally reported. Most of the regulations are due to be issued a year from enactment, although the legislation contemplates that the regulators will implement interim changes in some areas prior to issuance of final rules. For example, the Dodd-Frank Act appears to require the CFTC and the SEC to adopt interim regulations, covering reporting of non-cleared derivative transactions, including those entered into prior to enactment of the Dodd-Frank Act as well as those entered into thereafter, within 90 days after signing of the legislation by President Obama (that is, 90 days after July 21, 2010, or October 19, 2010) and transactions entered into prior to enactment that were in effect on

the date of enactment must be reported not later than 30 days of the date of the interim final rule or otherwise as determined by the regulators.<sup>47</sup>

In response to the directives in the Dodd-Frank Act, the SEC and the CFTC have appointed a rulemaking committee and, on August 20, 2010, held a public roundtable to discuss governance and conflicts of interest issues arising from the rulemaking authority. The SEC and the CFTC also published a release asking for comments in respect to key terms they are required to define in the regulations as well as the structure of regulations regarding “mixed swaps” (the Definitions Release).<sup>48</sup>

One of the primary open questions for investment companies, as well as other institutional investors that use derivatives, is whether they or their investment adviser would be deemed to be a “major swap participant” or a “major security-based swap participant.” The terms are defined in the Dodd-Frank Act as persons that are not “swap dealers” or “securities-based swap dealers” that (i) maintain a “substantial position” in swaps or security-based swaps (with certain limited exceptions for entities such as commercial entities using swaps for hedging) and (ii) (a) whose derivatives portfolios create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets or (b) that is a “financial entity” that is highly leveraged relative to the amount of capital it holds and is not otherwise subject to bank capital requirements and maintains a substantial derivatives portfolio.<sup>49</sup> The CFTC and SEC, in consultation with the Board of Governors of the Federal Reserve System, are responsible for defining these terms as well as other significant definitions such as “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “eligible contract participant,” and “security-based swap agreement.”<sup>50</sup> Designation of an entity, such as an investment company, as a “major swap participant” or a “major security-based swap participant” would subject the entities not only to registration with the SEC and the CFTC, but also make them subject to capital requirements, minimum margin levels as well as reporting and recordkeeping requirements.

The legislation does not grant exemptive authority to the regulators to exclude entities that otherwise satisfy the definitions. This type of regulation is likely to impose high costs on participants that a fund board may find difficult to justify.

In addition to raising the threshold question about regulation of an investment company user of derivatives as a “major swap participant” or “major securities-based swap participant,” the Dodd-Frank Act and ensuing regulation will make it more difficult to enter into customized transactions as a result of requirements that transactions be centrally cleared and traded on a regulated exchange or regulated swap execution facility and will require substantially all derivatives transactions to be centrally and publicly reported. In addition, as a result of the ensuing regulation, swaps will likely become subject to position limits and standardized margining, in connection with which all margin, posted in connection with exchange transactions, will be required to be segregated and initial margin, in the case of over-the-counter transactions, will be required to be segregated and not eligible for use by the dealer to fund the transaction, unless the dealer receives customer consent. Costs associated with transacting in derivatives are likely to increase, particularly to the extent that dealers continue to play a facilitation role as principal and are restricted from using collateral posted by customers to fund hedge activity or member posting obligations to a clearinghouse.

There is a significant amount of work left to be done to migrate the bulk of the over-the-counter derivatives market to central clearing and exchange execution and to ensure that what remains of the over-the-counter market is subject to the reporting, position limit and margin requirements, among others, contemplated by the Dodd-Frank Act. A large amount of the planning and work for the initiative is dependent upon agency rule making and, thus, must wait for adoption of the new rules. In addition to the issuance of regulations, major decisions will have to be made by market participants before central clearing for the broad marketplace<sup>51</sup> can be implemented. These include: (i) legal documentation, (ii) customer and clearinghouse margin requirements and (iii) requirements for

segregation of collateral. Infrastructure will then need to be built and designed to connect participants to the clearinghouse platforms. The task of moving to central clearing is particularly daunting given the breadth and variety of the instruments used as well as the fact that regulation of derivatives spans a number of different jurisdictions. A number of challenges lie ahead for the industry to understand and then implement the proposed changes. As a result it is difficult to predict exactly what the market available to investment companies for derivatives will look like in the future.

## Conclusion

Notwithstanding continued skepticism expressed by regulators and the press about the integrity of the derivatives market (particularly, the market for over-the-counter derivatives), the use of derivatives by registered investment companies has become a well established practice. Moreover, although there were some well-publicized investment losses incurred by investment companies involving derivatives during the market turmoil of the past several years (for example, losses by money market funds due to structured investment vehicles (SIVs)),<sup>52</sup> by and large, investment companies appear to have survived the market meltdown well, including in respect to their derivatives books. From the perspective of registered investment companies, regulation of their use of derivatives seems to have worked well and investment companies continue to find important benefits from their use.

Although the fate of the over-the-counter derivatives market in the US is still somewhat

up in the air, it is almost certain that there will be significant changes over the coming months and years as a result of the Dodd-Frank Act and the regulation to be developed to implement the Dodd-Frank Act. In addition, given the strong focus by the SEC on re-evaluating the regulatory structure applicable to the use of derivatives by investment companies, it is likely that compliance requirements and possibly the ability to use certain instruments at all (particularly those that provide enhanced leverage) will change. Notwithstanding these changes, given the important role that derivatives have come to play in portfolio management for investment companies, it seems unlikely that the SEC will materially inhibit the use of derivatives by these entities. As a result, it will be increasingly important for the industry to engage in an active dialogue with regulators to ensure that they understand the ways in which investment companies use derivative products and assist the regulators in fashioning appropriate regulation that is both workable and preserves the benefits provided by the instruments.

## *IRS Circular 230 Disclosure*

To ensure compliance with requirements imposed by the IRS, we inform you that any US federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

## ANNEX A

### Investment Company Act of 1940 Asset Segregation Requirements for Certain Derivatives<sup>53</sup>

Type of Instrument	Investment Company's Investment	Segregation Requirement <sup>54</sup>
Futures	Long Position	Purchase price of the futures contract. <sup>55</sup>
Futures	Short Position	An amount that, when added to the amounts deposited with a futures commission merchant or broker as margin, equals the market value of the instruments or currency underlying the futures contract.
Options—security based	Short Position	Liquid assets equal to the strike price of the options, less any margin on deposit in order to satisfy the requirements of Release 10666.
Options—commodity based	Short Position	Liquid assets equal to the strike price of the options, less any margin on deposit in order to satisfy the requirements of Release 10666.
Forward Contracts— <i>not</i> contractually required to be settled on a net cash basis	Long Position	Liquid assets equal to the full notional value of the contract.
Forward Contracts—cash settled	Long Position	Liquid assets equal to the investment company's daily marked-to-market net obligations.
Swaps	Long Position	Market practice is generally to calculate the segregation requirement based on the daily mark-to-market exposure. SEC is currently evaluating whether such method is appropriate and whether another measure ( <i>e.g.</i> , value-at-risk, Black-Sholes or notional amount) would be more appropriate, particularly for derivatives that embed leverage or optionality.
Short sales of securities	Short Position	Liquid assets equal to (when aggregated with any margin deposited with the broker-dealer in connection with the short-sale) the market value of the securities sold short.

## ANNEX B

### Summary of Key Recommendations Report of the Task Force on Investment Company Use of Derivatives and Leverage Committee on Federal Regulation of Securities ABA Section of Business Law<sup>56</sup>

Recommendation	Key Points
Principles-based approach	Recommended that SEC adopt new rules and/or issue new interpretive guidance to implement and facilitate a principles-based approach with respect to an investment company's use of derivatives. These principles should be coupled with enhanced disclosure.
Diversification/ Concentration	<ul style="list-style-type: none"> <li>— Tests for diversification and concentration should be based on the exposure to values of reference assets, rather than counterparties.</li> <li>— Broad-based indices, or other reference assets that do not lend themselves to the concept of diversification (e.g., commodities) would be excluded from the calculation.</li> <li>— When calculating concentration the use of market values is the correct test.</li> </ul>
Counterparty Exposure	<ul style="list-style-type: none"> <li>— Current regulatory structure does not adequately regulate counterparty exposure.</li> <li>— SEC should consider regulation of counterparty risk outside of the diversification requirements of the 1940 Act through new rulemaking or interpretive guidance published by the SEC or its Staff. Such rulemaking or interpretive guidance should be done within the framework of Section 12(d)(3) of the 1940 Act by adopting a new rule thereunder.</li> <li>— Regulations or guidance should recognize that “one size does not fit all” and that the amount of acceptable risk may vary by fund type, consistent with existing statutory requirements. To the extent that the risk of counterparty is mitigated by possession of bankruptcy-remote collateral, a fund may decrease its exposure to risk of a single counterparty.</li> <li>— Nationally recognized exchanges or clearing houses would be excluded from the definition of counterparties.</li> </ul>
Limits on Leverage	<ul style="list-style-type: none"> <li>— New standards are called for to address such matters as the size and nature of segregated accounts contemplated under existing guidance (e.g., Release 10666). These standards should take the form of new rulemaking or guidance and address at least the following areas: <ul style="list-style-type: none"> <li>— Funds should be required to adopt written policies and procedures that establish minimum asset segregation requirements for each type of derivative instrument using “risk adjusted segregated amounts” or “RAS Amounts.”</li> <li>— RAS Amounts would be based upon relevant factors attributable to each derivative instrument (e.g., risk applicable to each particular instrument and any offsetting transactions).</li> <li>— High risk instruments would require higher RAS Amounts while plain vanilla instruments with low price volatility and risk may require segregation close to or equal to daily market value.</li> <li>— Funds' policies and procedures should also: (i) address types of assets that will make up the segregated amounts, taking into account the risk profile of the individual instruments; (ii) describe what constitutes an offsetting transaction and (iii) be approved by the investment company's board.</li> <li>— Investment company's segregation policies should be disclosed in the Statement of Additional Information (SAI).</li> <li>— Asset segregation should not be required in cases that do not involve explicit leverage (e.g., an investment in shares of a leveraged ETF, while it carries implicit leverage, presents no need for asset segregation).</li> </ul> </li> </ul>

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**ANNEX B** *Continued from previous page*

<b>Recommendation</b>	<b>Key Points</b>
Fund Names	SEC or Staff should clarify that Rule 35d-1 under the 1940 Act should be interpreted like Section 5(b); namely, investment companies would invest in accordance with their name by looking to reference assets.
Disclosure	— SEC or Staff could further develop disclosure expectations that relate to investment companies' use of derivatives with respect to limits, practices and related risks. — Shareholder letters and reports may be better suited than the prospectus and SAI for further disclosure initiatives. "VAR" or "value at risk" or other standardized risk measures might be useful disclosure metrics for consideration.
Director Oversight	SEC or Staff should publish guidance for investment company directors, incorporating the principles set forth by the Task Force in its Special Report. Such guidance should clarify that the role of investment company directors is that of <i>oversight</i> , and not of micro-management, of derivatives. (emphasis added)
Additional Insight	SEC or Staff should consider additional means to better develop insight into current practices of investment company use of derivatives and the appropriate level of regulatory oversight. Suggestions include an SEC roundtable to hear from industry participants.

## Notes

1. A detailed discussion of the type of income from derivatives that will satisfy the Qualifying Income Test or how such derivatives will be treated under the Diversification Test is beyond the scope of this summary. This summary only touches on a small number of examples of investments in derivatives.

2. The term “security” is defined in Section 2(a)(36) of the 1940 Act, 15 U.S.C. § 80a-2(a)(36), as: any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

3. See Rev. Rul. 2006-1, 2006-2 C.B. 261 modified and clarified in Rev. Rul. 2006-31, 2006-1 C.B. 1133. This revenue ruling reflects the fact that commodities-based derivatives have received considerable attention in the past few years as a result of RICs’ desire to gain exposure to changes in the prices of commodities.

4. See I.R.S. Priv. Ltr. Rul. 2006-28-001 (July 14, 2006).

5. See *e.g.*, I.R.S. Priv. Ltr. Rul. 2009-47-032 (Nov. 11, 2009).

6. A general description of the investments includes the following:

A subsidiary may invest in one or more of the following types of instruments: commodity and financial futures and options contracts (and fixed income securities that serve as collateral for such contracts); deliverable forward and cash settled non-deliverable forward contracts. Each of these contracts may be linked to the performance of one or multiple commodities (including a commodity index). A subsidiary may also invest in swaps on commodities or commodities indexes or in commodity-linked structured notes. Furthermore, a subsidiary may invest directly in commodities.

7. *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Rel. No. 10,666, 44 Fed. Reg. 25,128, 25,129 (Apr. 18, 1979), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf>.

8. In most cases, use of net fair market value lessens the importance of the determination as to the identity of the issuer of a derivative instrument.

9. See I.R.S. Notice 2008-2.

10. In addition, an excise tax may be imposed if a RIC does not annually distribute a sufficient amount of its income, the amount of which may be affected by the resolution of the timing and character rules applicable to derivative instruments.

11. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Ct. 1984); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006) (“Our law presumes that ‘in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.’ Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith.” (quoting *Aronson* at 812)).

12. See, *e.g.*, ABA Federal Regulation of Securities Committee, *Fund Director’s Guidebook* 49 (3rd ed. 2006).

13. See Independent Directors Council, Task Force Report, “Board Oversight of Derivatives” (July 8, 2008); see also G. Gohlke, Speech by SEC Staff: Mutual Fund Directors Forum Program—“Funds’ Use of Derivatives”—“If I Were a Director of a Fund Investing in Derivatives—Key Areas of Risk on Which I Would Focus” (Nov. 8, 2007) (outlining twelve areas of risk relating to derivatives investments on which investment company directors may wish to focus).

14. Although the language of Section 47 of the 1940 Act does not mention any right by a fund shareholder to bring suit on behalf of the fund to force rescission of a contract, the fund board should be able to assert Section 47 as a basis for rescission for a contract that violates the 1940 Act. Similarly, a fund shareholder may be able to bring a shareholder derivative action on behalf of the fund against the board, the officers and the adviser for breach of fiduciary duty. Such an action might cause a fund board to seek rescission.

15. See, *e.g.*, *In re Michael T. Sullivan, III*, Investment Company Act Release No. 24,219, 1999 SEC LEXIS 2738, at \*9-\*10 (Dec. 22, 1999) (“Aiding and abetting liability may be established by demonstrating: (1) a primary or independent securities law violation that has been committed by some other party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) knowing and substantial assistance by the aider and abettor of the conduct that constitutes the violation.”).

16. The Commodity Futures Modernization Act of 2000 (CFMA) amended Sections 9(a), 10, 15(c)(1), 16, 20(d) and 21A(a)(1) of the Exchange Act to give the SEC anti-fraud and anti-manipulation enforcement authority in respect to “security-based swap agreements.”

17. *SEC v. Rorech*, 09-cv-4329 (JGK) (S.D.N.Y. May 5, 2009) (complaint), available at <http://www.sec.gov/litigation/complaints/2009/comp21023.pdf>.

18. See *id.* at p.2 (“By the conduct alleged herein, the Defendants, directly or indirectly, have engaged, and, unless enjoined and restrained, will again engage, in transactions, acts, practices or courses of business that

constitute violations of Section 10(b) of the . . . Exchange Act . . . and Rule 10b-5 . . . thereunder.”).

19. *See* SEC v. Rorech, 673 F. Supp. 2d 217, 223-25 (S.D.N.Y. 2009) (summarizing arguments in denial of defendants’ motion for judgment on the pleadings).

20. *See id.* at \*225 (“In passing the CFMA, Congress extended the SEC’s security-related insider trading rules to apply to securities-based swap agreements. Congress thus made it clear that what was prohibited in trading securities was also prohibited in trading securities-based swap agreements.”).

21. Section 206B of the Gramm-Leach-Bliley Act defines a security-based swap agreement as a “swap agreement . . . of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.” 15 U.S.C. § 78c (2006).

22. *See Rorech*, 673 F. Supp. 2d at 224 (“In any event, it cannot be that traders can escape the ambit of § 10(b) Rule 10b-5 by basing a [credit default swap’s] material term on a security, but simply omitting reference to the security from the text of the [credit default swap] contract.”).

23. *See* SEC v. Rorech, 09-cv-4329, 2010 U.S. Dist. LEXIS 63804 (S.D.N.Y. 2010).

24. *See* Memorandum from the Division of Investment Management of the US Securities and Exchange Commission on Mutual Funds and Derivative Instruments, 1994 SEC No-Act, LEXIS 952 (Sep. 26, 1994), available at <http://www.sec.gov/news/studies/deriv.txt> (responding to request from congressional subcommittee with comprehensive study of mutual funds’ use of derivatives).

25. American Bar Association Section of Business Law, Committee on Federal Regulation of Securities, Report of the Task Force on Investment Company Use of Derivatives and Leverage, at 5 (July 6, 2010) (ABA Task Force Report), available at [http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest\\_files/DerivativesTF\\_July\\_6\\_2010\\_final.pdf](http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf).

26. *SEC Staff Evaluating the Use of Derivatives by Funds*, SEC Release 2010-45 (Mar. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-45.htm>; *See also* Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks Before the Hofstra Journal of International Business Law Conference on Investment Management Law (Oct. 9, 2009), available at <http://sec.gov/news/speech/2009/spch100909ajd.htm> (“The developments in the hedge fund industry, issues concerning derivatives and leverage and the regulatory implications, as I mentioned are of great significance.”); Andrew J. Donohue, Director, SEC Division of Investment Management, Luncheon Address at IA Week/IA Watch’s 9th Annual IA Compliance Fall Conference 2009 (Sep. 21, 2009), available at <http://sec.gov/news/speech/2009/spch092109ajd.htm> (“Another challenge the investment management industry faces, and one that I have been concerned about for some time, is the increasing use of derivatives and sophisticated financial instruments. I have concerns on multiple levels in this area, including those from a compliance

perspective.”); Andrew J. Donohue, Director, SEC Division of Investment Management, Speech at the Spring Meeting of the American Bar Association: Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality? (Apr. 17, 2009), available at <http://sec.gov/news/speech/2009/spch041709ajd.htm> (“One of my recurring concerns has been investment companies’ use of derivatives and what I perceive as the increasing gap between how the Investment Company Act of 1940 . . . and investors look at fund portfolios versus how investment advisers look at them.”); Andrew J. Donohue, Director, SEC Division of Investment Management, Keynote Address, Investment Company Institute, 2009 Mutual Funds and Investment Management Conference (Mar. 23, 2009), available at <http://sec.gov/news/speech/2009/spch032309ajd.htm> (“Another challenge the fund industry faces, and one that I had mentioned in 2007, but is highly relevant today, is the increasing use by funds of derivatives and sophisticated financial instruments.”).

27. *See* Nathaniel L. Doliner, Chair, American Bar Association—Business Law Section, “Message from the Chair,” *eSource* (monthly newsletter of ABA Business Law Section), vol.10, no.10 (Sep. 2009), available at <http://www.abanet.org/buslaw/newsletter/0083/> (“Our Federal Regulations of Securities Committee, chaired by Jeffrey Rubin, recently has formed a Task Force on Investment Company Use of Derivatives and Leverage. The Task Force is being chaired by Jay Baris. The Task Force’s activities at the Annual Meeting received a good deal of attention in the press. You will be hearing more about this important Task Force as its work proceeds.”); *see also* ABA Task Force Report, *supra* n.25.

28. “SEC Plans to Review Derivatives Used in Funds,” *New York Times* (Mar. 25, 2010) at <http://nytimes.com/2010/03/26/business/26sec.html>. “Staff Freezes Bids for Exemptive Relief By Some ETFs that Rely on Derivatives,” *BNA Corporate Law & Business*, Vol.42, No.13 (Mar. 29, 2010) at <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-83WTAZ?OpenDocument>.

29. “Staff Freezes Bids for Exemptive Relief By Some ETFs that Rely on Derivatives,” *supra* n.28 (“For his part, Andrew Donohue, director of the SEC’s Division of Investment Management, said that [a]lthough the use of derivatives by funds is not a new phenomenon, we want to be sure our regulatory protections keep up with the increasing complexity of these instruments and how they are used by fund managers...This is the right time to take a step back and rethink those protections.”)

30. Derivatives-Related Disclosures by Investment Companies (Letter to Karrie McMillan of the Investment Company Institute) (pub. avail. July 30, 2010), available at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

31. *Id.* at p.1.

32. *Id.* at p.2.

33. *Id.* at p.7.

34. *See SEC Staff Evaluating the Use of Derivatives by Funds*, *supra* n.26.

35. On August 17, 2010, Director Donohue announced that he plans to retire from his current position in November 2010. See SEC Press Release 2010-151, "Andrew J. Donohue to Leave SEC After Four Years Leading Division of Investment Management" (Aug. 17, 2010), available at <http://sec.gov/news/press/2010/2010-151.htm>.

36. See A. Donohue, Speech by SEC Staff: Remarks Before the Practising Law Institute's Investment Management Institute 2010 (Apr. 8, 2010).

37. See SEC Staff Evaluating the Use of Derivatives by Funds, *supra* n.26 ("The [S]taff generally intends to explore issues related to the use of derivatives by funds, including, among other things, whether . . . funds that rely substantially upon derivatives, particularly those that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of the fund's derivatives transactions.").

38. See Mary Schapiro, "Regulation of Over the Counter Derivatives," Before the United States Senate Subcommittee on Securities, Insurance, and Investment (June 22, 2009), available at <http://www.sec.gov/news/testimony/2009/ts062209mls.htm>; Elisse B. Walter, Speech at the Institute of International Bankers: Principles to Help Guide Financial Regulatory Reform, (Mar. 2, 2009), <http://www.sec.gov/news/speech/2009/spch030209ebw.htm>; Luis A. Aguilar, Speech at the North American Securities Administrators Association's Winter Enforcement Conference: Empowering the Markets Watchdog to Effect Real Results, (Jan. 10, 2009), available at <http://www.sec.gov/news/speech/2009/spch011009laa.htm>.

39. See ABA Task Force Report, *supra* n.25 at 16.

40. *Id.* at p.17.

41. See European Parliament Resolution of 15 June 2010 on Derivatives Markets: Future Policy Actions, Eur. Parl. Doc. A7-0187/2010 (advocating that new rules regulating use of derivatives should be put in place); "More Daylight and Stricter Rules for the Derivatives Market," European Parliament (June 15, 2010) ("Proposed EU rules on derivatives trading must be made clearer and tougher, so as to reduce speculative trading and ensure that as many derivatives as possible are traded through open channels that are subject to rules."), available at [http://www.europarl.europa.eu/pdfs/news/expert/infopress/20100614IPR76030/20100614IPR76030\\_en.pdf](http://www.europarl.europa.eu/pdfs/news/expert/infopress/20100614IPR76030/20100614IPR76030_en.pdf); Public Consultation on Derivatives and Market Infrastructures, European Commission Working Document (June 14, 2010), available at [http://ec.europa.eu/internal\\_market/consultations/docs/2010/derivatives/100614\\_derivatives.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/derivatives/100614_derivatives.pdf). Currently,

the proposed derivatives legislation is scheduled for public audition in late September 2010.

42. See Dodd-Frank Act § 723 (amending § 2 of Commodity Exchange Act) and § 763 (adding § 3c of the Exchange Act).

43. *Id.*

44. See Dodd-Frank Act § 731 (adding § 4s to the Commodity Exchange Act) and § 764 (adding § 15F to the Exchange Act).

45. See Dodd-Frank Act §§ 737 and 763(h).

46. See Dodd-Frank Act §§ 724 and 763(d).

47. Note that there is some ambiguity in the statutory language regarding the timing of this agency rulemaking. As of the date of printing, the regulators had not publicly indicated how they interpret the statutory language regarding adoption of interim final rules and whether they may postpone the adoption to a later time period.

48. See Joint SEC and CFTC Release, *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act*, Exchange Act Release No. 62,717 (Aug. 13, 2010).

49. See Dodd-Frank Act §§ 721 and 761.

50. See Joint SEC and CFTC Release, *supra* n.48.

51. J. Morrison, "The Operational Challenges of OTC Clearing," *The Magazine of the Futures Industry*, 26 (June 2010). A number of the world's largest swap dealers previously committed in March, in a letter to the Federal Reserve Bank of New York and other banking supervisors, to clear standardized credit default swaps and interest rate swaps through central clearinghouses by the end of June 2010.

52. Peter Eavis, "Even 'Safe' Funds Play with Fire," *CNNMoney* (Oct. 19, 2007), available at [http://money.cnn.com/2007/10/19/magazines/fortune/eavis\\_boa.fortune/](http://money.cnn.com/2007/10/19/magazines/fortune/eavis_boa.fortune/).

53. Information provided herein is based upon current information available as of the date of this article. All information is subject to verification and should not be relied upon without a review of current legal and regulatory requirements.

54. Assets to be segregated must be either liquid or other qualifying assets as set forth by the SEC and its Staff.

55. SEC Staff has informally indicated that, for futures contracts that are contractually required to be cash-settled, only the marked-to-market net obligation and not the notional value is required to be segregated.

56. See ABA Task Force Report, *supra* n.25.