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SEC CONCEPT RELEASE TACKLES INVESTMENT COMPANY USE OF DERIVATIVES

The increasing use of derivatives by investment companies raises important issues under the 1940 Act, including the prohibition of senior securities, diversification, exposure to securities-related issuers, portfolio concentration, and valuation. The Commission's concept release seeks comments on these issues, and, in particular, on the proposals of the Task Force on Investment Company Use of Derivatives of the Committee on Federal Regulation of Securities of the ABA's Business Law Section. Given the large number of comments received, the authors expect the next step may be a Commission roundtable on the subject, with input from all interested parties.

By Jay G. Baris and Andrew J. Donohue *

On August 31, 2011, the Securities and Exchange Commission published a Concept Release and requested comments on a wide range of issues concerning the use of derivatives by investment companies, including mutual funds, closed-end funds, exchange-traded funds, and business development companies ("funds").[1] The Concept Release summarizes how funds currently use derivatives and identifies issues that flow from their increased usage.

Although the Concept Release makes few, if any, specific proposals, it lays the groundwork for future action that could change the regulatory landscape affecting funds that use derivatives, especially involving fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, and valuation. Depending on which approach the Commission takes, these changes could have wide-ranging implications for funds, their investment advisers, independent directors, and investors.

[1] Concept Release and Request for Comments, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Co. Rel. No. 29776 (August 31, 2011), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf (the "Concept Release").

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What are derivatives and why is the Commission so concerned about them? The term "derivatives" is not defined in the Investment Company Act of 1940, as amended (the "1940 Act").[2] The Concept Release defines derivatives broadly as "instruments or contracts whose value is based upon, or derived from, some other asset or metric (referred to as the 'underlier,' 'underlying,' or 'reference asset')."[3] A "derivative transaction" includes any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to one or more commodities, securities, currencies, interest or other rates, indices, or other assets.''[4]

To be sure, derivatives, as we know them, did not exist when Congress enacted the 1940 Act. Today, funds use derivatives for a variety of purposes, including to leverage and boost returns, gain access to certain markets or reference assets, achieve greater transaction efficiency, and hedge interest rates, credit, and other risks. Derivatives usage by funds gives rise to concerns about risk management, especially in areas involving leverage, illiquidity, and counterparty risk. It comes as no surprise that the Commission is turning its attention to the issue of fund use of derivatives and leverage at this time.

In 1994, the Division of Investment Management, at the request of then-Chairman Arthur Levitt, prepared a study for the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.[5] The study addressed the Subcommittee's concerns about fund use of derivatives, disclosure, effects on competition, pricing, liquidity, risks, and use of derivatives by money market funds. That inquiry arose out of the volatility in the market for collateralized mortgage obligations and related derivatives, which earlier that year had rocked the financial markets. That year, the Investment Company Institute also published a study on fund use of derivatives.[6]

Nearly 15 years later, Andrew J. Donohue, then-director of the Division of Investment Management, revived these issues. In a speech at the Spring Meeting of the American Bar Association in 2009, Donohue addressed his recurring concerns about fund use of derivatives, and what he perceived as "the increasing gap" between how the law and investors look at fund portfolios versus how investment advisers look at them.[7]

The Donohue Speech traced the history of the Commission's policy on the economic effects and legal implications under the 1940 Act of certain transactions that resulted in leverage, beginning with a release known as Release 10666.[8] Release 10666 was not concerned with derivatives, but with other trading practices that involved certain degrees of leverage, and was thus similar to concerns raised by modern-day derivatives.[9] (We discuss Release 10666 below in more detail.) Citing the increased use of derivatives by funds since 1994, and reviewing the 1940 Act's technical

[2] 15 U.S.C. 80a. References to rules under the 1940 Act are to Title 17, Part 270 of the Code of Federal Regulations.

[3] Concept Release at 4.

[4] Concept Release, n. 3, citing Section 610(a)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

[5] Mutual Fund Derivative Instruments (Sept. 26, 1994), *available at* http://www.sec.gov/news/studies/deriv.txt.

[6] Investment Company Institute, *Investment in Derivatives by Registered Investment Companies* (Aug. 1994).

[7] *Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality,* Remarks of Andrew J. Donohue, Director, Division of Investment Management, before the American Bar Association Spring Meeting (Apr. 17, 2009), *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm#P42_8864 (the "Donohue Speech").

[8] Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

[9] Release 10666 did not refer to "derivatives," but its analysis provided the foundation for the Commission to provide exemptive release and no-action guidance in a number of cases under Section 18 of the 1940 Act involving "senior securities," including derivatives. *See* Donohue Speech, text near n. 11.

requirements, Donohue suggested that there was a growing dichotomy, or gap, between technical compliance with the 1940 Act versus actual performance of funds that use derivatives. In closing, Donohue emphasized three primary concerns:

- funds should have a means to deal effectively with derivatives outside of disclosure;
- a fund's approach to leverage should address both implicit and explicit leverage; and
- a fund should address diversification from investment exposures versus the amount of money invested.

He challenged the Committee on Federal Regulation of Securities of the ABA's Business Law Section, to devise an approach to address these concerns. He noted:

> Like layers of an onion, underlying these three concerns are a gamut of issues. For example, should the application of '40 Act leverage restrictions to derivatives held by investment companies be reexamined? Is the thirty year patchwork of stated Commission policy and staff positions regarding investment companies' use of derivatives sufficient or is regulatory and/or legislative action necessary to address the leverage created by investment companies' use of derivatives? If you believe action is necessary, what do you recommend? Do existing rules sufficiently address matters such as the proper procedure for investment company pricing and liquidity determinations of derivatives holdings? Are investment company boards exercising meaningful oversight of funds' use of derivatives, including risk management, proper accounting, and internal controls?

That day, the Committee responded by establishing the Task Force on Investment Company Use of Derivatives, which sent its report to the Division of Investment Management in July 2010.[10]

[10] *The Report of the Task Force on Investment Company Use of Derivatives and Leverage,* Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("2010 ABA Derivatives Report"), *available at* http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf.

The Donohue Speech, followed by the 2010 ABA Derivatives Report, set the stage for the Commission's ongoing review of fund use of derivatives and leverage. Other significant factors that need to be considered include:

- the increasing complexity of derivatives;
- the increasing use of derivatives by funds; and
- the new regulatory framework for over-the-counter ("OTC") derivatives, mandated by the Dodd-Frank Act.[11]

PURPOSE AND SCOPE OF THE CONCEPT RELEASE

The Concept Release states that the Commission seeks to evaluate whether the existing regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the 1940 Act and is consistent with investor protection. Rather than make proposals at this time, the Commission stated that the Concept Release will assist with this review and solicit public comment.

The Concept Release states that funds using derivatives must consider, among other things:

- leverage limitations in Section 18 of the 1940 Act that apply to funds;
- portfolio diversification;
- industry concentration;
- limitations on investments in securities-related issuers;
- valuation;
- accounting and financial reporting; and
- disclosures.

[11] The Dodd-Frank Act, and regulations under the Dodd-Frank Act, particularly those affecting OTC derivatives, may address some of the concerns that the Commission raised in the Concept Release. For example, the Dodd-Frank Act calls for additional trade reporting and increased pricing transparency, which may address Commission concerns about valuation.

The Concept Release recognizes that compliance with these statutory and regulatory restrictions may be difficult, because derivatives may involve multiple risk exposures, and values must be assigned to each exposure. These multiple exposures create challenges for funds, advisers, fund directors, and regulators because traditional measurements incorporated in laws enacted before the existence of derivatives may not translate easily when applied to modern derivative instruments.

For example, the value of a single derivative instrument can be measured at least two different ways, depending on the purpose of the valuation. Funds can value a derivative looking at its market value, or based on its "notional" value. Therein lies part of the complexity: different measurements may be more appropriate for different purposes, but the regulatory framework has not always been clear on this point.

HOW FUNDS USE DERIVATIVES

The Concept Release begins with a primer on how investment companies currently use derivatives, describes the nature and scope of reference assets, and provides examples of exchange-traded and OTC instruments. The Concept Release also describes how derivatives typically involve a form of leverage (that is, the ability of the fund to participate in future gains and losses in an amount that exceeds the fund's initial investment). Forms of leverage include:

- "indebtedness leverage" (obligations, or potential indebtedness to someone other than the funds' shareholders that enable the fund to participate in gains or losses in an amount that exceeds the amount of the fund's investment); and
- "economic leverage" (instruments that convey the right to a gain or loss in an amount in excess of the fund's investment, but do not impose a payment obligation on the fund above its initial investment).

The Concept Release describes the risks that derivatives involve and the challenges that investment advisers and fund directors face in ensuring that a fund uses derivatives in a manner consistent with its investment objective, policies, restrictions, risk profile, and relevant regulatory requirements, including those under federal securities laws. The Concept Release seeks comment on the types of derivatives used by funds and how funds use derivatives in practice.

SENIOR SECURITIES

The Concept Release states that "the protection of investors against the potentially adverse effects of a fund's issuance of senior securities is a core purpose of the 1940 Act."[12] Yet, the concept of "senior securities" in Section 18 of the 1940 Act makes no mention of derivatives. Indeed, most derivatives, as we know them today, did not exist when the statute was enacted. Simply stated, a senior security, as defined in Section 18(g) of the 1940 Act, is generally "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness," and "any stock of a class having priority over any other class as to the distribution of assets or payment of dividends." The definition excludes certain limited temporary borrowings. The statutory concept was designed to prevent funds from issuing senior securities and exposing the fund and its shareholders to: (i) potential abuse of the purchasers of senior securities; (ii) excessive borrowing and the issuance of excessive amounts of senior securities unduly increasing the speculative character of the fund's junior securities; and (iii) operating without adequate assets or reserves. Section 18 generally prohibits an open-end fund from issuing or selling any "senior security," although it permits a mutual fund to borrow from a bank, provided that the fund maintains 300 percent "asset coverage" (generally, the ratio of a fund's total assets less liabilities and indebtedness not represented by senior securities, to the aggregate amount of the fund's senior securities). This section also permits a closed-end fund to issue or sell a senior security, subject to asset coverage requirements (200 percent for equities or 300 percent for debt).

The Commission in 1979 published Release 10666, which interpreted how Section 18 applies to certain trading practices relating to reverse repurchase agreements, firm commitment agreements, standby commitment agreements, and other instruments that could be considered to involve leverage. The Commission essentially said that it would not raise issues under Section 18 as long as funds segregated an appropriate amount of liquid assets in the amount of the liability, to ensure that they had sufficient assets to cover their obligations. This guidance effectively established limits on leverage that funds could take on through these trading practices, an approach that worked well when funds knew with some precision the amount of the potential liability arising from such investments or trading practices. In short, the funds knew what they

[12] Concept Release at 19.

owed, and could segregate sufficient high-quality liquid assets to satisfy that liability.

The Release 10666 approach evolved significantly over the next 30 years, as the Commission's staff expanded, modified, and otherwise tweaked this interpretation through more than 20 no-action letters, addressing the growth and evolution of the derivatives market. Two important developments during this period were the issuance of no-action positions permitting segregation of less than the full amount of the exposure, and the use of any liquid asset to meet the segregation requirement. In light of the evolution of the Commission's approach, and the growing complexity of derivative instruments, funds frequently are unsure of the amount they may owe, yet they typically segregate only an amount equal to the current liability.

What amount and type of assets should a fund segregate with respect to particular derivatives to satisfy these regulatory concerns? The Commission and its staff have not addressed this issue with respect to many types of derivatives. While funds apparently have not sought guidance from the staff, some funds, with respect to certain derivatives, have disclosed their asset segregation procedures in their public filings, in full view of the Commission and its staff. The Commission is now seeking to understand the different approaches used by funds.

The Concept Release summarizes the differences between the two principal types of measurements that funds use to test asset segregation (that is, "mark-to-market" versus full notional value), and describes the limitations of each method. The Commission acknowledges that a "significant disparity" exists in practice, especially in the area of swaps.

The Commission discussed an alternative method suggested in the 2010 ABA Derivatives Report. Among other things, the Report suggested a principles-based approach to this issue. Under the Task Force's approach, funds would develop and maintain Risk-Adjusted Segregated Amounts ("RAS Amounts"). Funds would establish minimum amounts of required segregated assets based on the risk profiles of individual derivatives, taking into account various risk factors that they deem appropriate. Funds would disclose policies related to their RAS Amounts, which would be subject to oversight by fund directors.

The Concept Release also described various alternatives used by non-U.S. regulators, and a Value at Risk ("VaR") approach, which involves a more complex risk assessment methodology, advocated by some observers. It then seeks comment on whether the current asset segregation practices are adequate, asks for comments on the RASA approach and other alternative approaches discussed, and asks whether fund boards have sufficient expertise to oversee these alternatives.

An approach the Commission could consider would be to craft an exemptive rule providing exemptions from issues arising under Section 18 and Section 12 of the 1940 Act from the use of derivatives, subject to a number of requirements. These conditions might include requirements such as:

- for purposes of the rule, all instruments, regardless of whether they are technically "securities," will be treated as if they are securities;
- certain trading practices, such as reverse repurchase agreements and securities lending arrangements, are considered to be true borrowings and the proceeds are limited in what they can be invested in;
- activities conducted through subsidiaries (and affiliates, if permitted) must be consolidated with the fund for all purposes of all calculations and financial statement presentations;
- for Section 18 purposes, all borrowings (including certain trading practices and instruments that raise similar issues) need to be aggregated to determine whether the funds comply with Section 18 in full (as reflected above); and
- the assets segregated must either be money market-type instruments or other assets if permitted, and must present minor risks to the fund.

DIVERSIFICATION REQUIREMENTS

Most funds must state in their registration statements whether or not they are "diversified." If a fund is classified as diversified, then, generally, with respect to 75 percent of its assets, the fund may not invest more than five percent of its total assets in the securities of any one issuer.

This test is easily applied to funds that invest in traditional asset classes, such as stocks and bonds, because it is relatively simple to identify the issuer and assign a market value or fair market value to these securities. Compliance is more complicated when it involves complex derivatives, including, among other things, swaps and certain kinds of structured instruments that contain embedded derivatives.

The Commission summarized the challenge as follows:

> Given that derivatives generally are designed to convey a leveraged return based on a reference asset over a period of time, their mark-to-market values at a given point do not reflect the asset base on which future gains and losses will be based or otherwise represent the potential future exposure of the fund under the derivatives investment. Use of a mark-to-market value for derivatives held by a fund could thus permit a fund to maintain an ongoing exposure to a single issuer or group of issuers in excess of 5% of the fund's assets on a notional basis, while continuing to classify itself as diversified.

One of the challenges the Commission faces is whether to measure compliance with the diversification requirements by looking to the derivatives counterparties that are party to the derivatives contracts or that issue the securities; or by looking at the reference assets underlying the derivatives, which reflect the economic exposure sought by the fund; or by looking at both. The Commission seeks comments on this issue. In particular, it seeks comment on the 2010 ABA Derivatives Report's suggestion that funds should disregard the counterparty and look to the reference asset for purposes of determining diversification compliance. The Report suggested that counterparty diversification could be addressed separately within the framework of Section 12(d)(3).

An approach the Commission could consider would be to require that:

- the "issuer" for purposes of the calculation of diversification shall be both the reference asset and the issuer of the instrument; and
- the value of the reference asset for the purposes of the calculation of diversification shall be the value of the equivalent exposure, not the market value of the instrument.

EXPOSURE TO SECURITIES-RELATED ISSUERS

Section 12(d)(3) of the 1940 Act provides generally that funds may not purchase or otherwise acquire any security issued by, or any other interest in, the business of a broker, dealer, underwriter, or investment adviser ("securities-related issuers"). There is a limited exemption from this prohibition. Rule 12d3-1 generally provides that a fund may acquire securities of any "person" that derived 15 percent or less of its gross revenues from securities-related activities unless the fund would control such person after the acquisition. In addition, a fund may acquire any security issued by any person that, in its most recent fiscal year, derived more than 15 percent of its gross revenues from securities-related activities, provided that:

- immediately after the acquisition of any equity security, the fund owns not more than five percent of the outstanding securities of that class of the issuer's equity securities;
- immediately after the acquisition of any debt security, the fund owns not more than 10 percent of the outstanding principal amount of the issuer's debt securities; and
- immediately after any acquisition, the fund has invested not more than five percent of the value of its total assets in the securities of the issuer.

These provisions present compliance challenges for funds that use derivatives when a counterparty is a securities-related issuer. A similar issue arises when the counterparty is not a securities-related issuer, but the reference asset underlying the derivative creates economic exposure to a securities-related issuer.

The Commission seeks comment on the application of Section 12(d)(3) to derivatives, and specifically on the 2010 ABA Derivatives Report's suggestion that this section "provides an appropriate framework for dealing with fund counterparty exposures." An approach the Commission could consider would be to require that all such exposures be aggregated for purposes of compliance with the requirements of this exemptive rule.

PORTFOLIO CONCENTRATION

Investment companies must disclose in their registration statements whether they are "concentrating investments in a particular industry or group of industries." Derivatives present compliance challenges for funds in measuring concentration. The Concept Release summarized how a fund may gain exposure to more than one industry or group of industries by using derivatives:

> For example, if a fund and a bank enter into a total return swap on stock issued by a corporation in the pharmaceuticals industry, the fund will have gained exposure to the banking industry (*i.e.,* the industry associated with the fund's counterparty), as well as exposure to the pharmaceuticals industry *(i.e.,*

the industry associated with the issuer of the reference asset).[13]

The Commission seeks comment on whether funds should look to counterparties or reference assets for measuring concentration, and whether to use market value or notional value as the benchmark. An approach the Commission could consider would be to require that:

- the "issuer" for purposes of the calculation of concentration shall be both the reference asset and the issuer of the instrument; and
- the value of the reference asset for the purposes of the calculation of concentration shall be the value of the equivalent exposure, not the market value of the instrument.

VALUATION OF DERIVATIVES

The Concept Release also seeks comments on how funds value their derivatives exposure, particularly OTC derivatives. For example, these derivatives may have customized terms, including contractual restrictions on transferability. Moreover, there may be no quotations available from independent sources and, for some derivatives, the fund's counterparty may be the only available pricing source.

The 2010 ABA Derivatives Report recommended that for purposes of regulatory limitations (such as qualification as a diversified fund or concentration status), market value is the appropriate measure and the one contemplated in the 1940 Act. The Report also recommended that funds should disclose any voluntary limits on investments based on market value or other measures, such as notional value.[14]

OVERSIGHT BY FUND DIRECTORS

Among the practical challenges facing fund directors are the nature and extent of oversight they must provide to fund use of derivatives. The Concept Release asks whether directors are providing "appropriate oversight of the use of derivatives" by funds.[15] It also acknowledges that a fund's use of derivatives presents challenges for the independent directors to "ensure that the derivatives are employed in a manner consistent with the fund's investment objectives, policies and restrictions, its risk profile, and relevant regulatory requirements, including those under federal securities laws."[16]

If the Commission takes a principles-based approach to regulation of derivatives, say, concerning segregation of assets, it follows that the oversight responsibilities would increase, as fund directors would be required to review and approve self-policing policies and procedures.[17] Conversely, if the Commission takes a rules-based approach, fund directors could more easily monitor compliance with specific required parameters. The latter approach might ease compliance and oversight burdens, but leave fund directors with less flexibility to meet the needs of the funds and their investors.

Oversight by fund directors of derivatives use is analogous to their oversight responsibilities related to fair valuation, compliance, and auditing concerns. Directors need not be experts in these areas. Rather, they must be sufficiently independent and informed, and speak up when they see red flags. We hope and expect that the Commission will adopt a balanced approach with respect to its expectations for director oversight, one that respects the board's independent business judgment, as it has done in other areas in oversight of fund operations.

LOOKING AHEAD

The Concept Release addresses in one place a bundle of concerns that have been brewing for the past two decades or more. It elevates to the Commission level concerns that the staff have addressed during this time period. While the Concept Release introduces no concrete proposals, it suggests that (a) the Commission is likely to take some action to address these concerns, and (b) the actions it takes may be derived from some of the alternatives discussed in the Concept Release.

The Concept Release has generated nearly 50 public comments.[18] It will take the Commission and its staff a

[13] Concept Release at 65-66.

[14] 2010 ABA Derivatives Report at 36.

[15] Concept Release at 6.

[16] Concept Release at 14.

[17] For example, the 2010 ABA Derivatives Report recommends an alternative approach in which individual funds would establish their own asset segregation standards for derivative instruments. The oversight responsibilities of fund directors would be extended to include approval of policies and procedures that describe "Risk-Adjusted Segregated Amounts." Concept Release at 30.

[18] Public Comments on the Concept Release are *available at* http://www.sec.gov/comments/s7-33-11/s73311.shtml.

considerable amount of time and effort to sort through and evaluate these comments. Thus, absent any market trauma involving derivatives, it is not likely that we will see any major changes concerning fund use of derivatives in the coming months.

A possible goal of the Commission and the investment company community should be to ensure that a fund portfolio's economic, market, and other exposures should be consistent with the four corners and the spirit of the 1940 Act, regardless of whether the portfolio is constructed with the use of derivatives. The Commission should balance the benefits that funds and fund investors may derive from the use of derivatives with the potential for degrading the protections afforded fund investors by certain provisions of the 1940 Act. We would expect that the Commission will consider convening a roundtable on these issues and seek input from all interested parties. Investment company use of derivatives raises critical issues that require the appropriate balance of investor protection and common sense. ■