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Securities and Exchange Commission Tackles Fund Use of Derivatives

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On August 31, 2011, the Securities and Exchange Commission (the "Commission") published a Concept Release and requested comments on issues concerning the use of derivatives by investment companies, including mutual funds, closed-end funds, exchange-traded funds and business development companies. These issues include, among other things, the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, and valuation.

Although the Concept Release makes few specific proposals, it lays the groundwork for future action that could change the regulatory landscape affecting funds that use derivatives. Depending on which direction the Commission takes, these changes could have wide-ranging implications for investment advisers, funds, and independent fund directors.

The Concept Release summarizes how funds currently use derivatives and issues that flow from their increased usage.

Funds use derivatives for a variety of purposes, including to leverage and to boost returns, gain access to certain markets or reference assets, achieve greater transaction efficiency, and hedge interest rates, credit, and other risks. Derivatives usage gives rise to concerns about risk management, especially in areas involving leverage, illiquidity, and counterparty risk.

The Concept Release appears to be motivated by a belief that the time for a comprehensive review of how funds use derivatives at the Commission level is ripe. This review comes in light of several factors, including:

- The growth of mutual fund assets;
- The increasing use of derivatives by funds;
- The increasing complexity of derivatives;
- Concerns expressed by Commission staff over the past few years about leverage by funds; and
- The new regulatory framework for over-the-counter ("OTC") derivatives, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1]

[1] 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.

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PURPOSE AND SCOPE

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 Investment Company Act of 1940 (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;
- Investment in securities-related issuers;
- Valuation;
- Accounting and financial reporting; and
- Disclosures.

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 required by laws enacted before the existence of derivatives may not translate easily when applied to modern compliance concerns.

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 the complexity: different measurements may be more appropriate for different purposes, but the law is not always clear on this point.

BACKGROUND ON FUND USE OF DERIVATIVES

The Concept Release begins with a primer on how investment companies use derivatives, starting with the commonly accepted definition of "derivative" (an instrument or contract whose value is based upon, or derived from, some reference asset). It describes the nature and scope of reference assets, and provides examples of exchange-traded and over-the-counter instruments.

The Concept Release also describes how derivatives typically involve a form of leverage (that is, the ability of the fund counterparty to participate in gains and losses in an amount that exceeds the fund's initial investment). Forms of leverage include:

- "Indebtedness leverage" (instruments that create indebtedness that may exceed 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).

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The Concept Release describes the purposes for which funds use derivatives, the risks they involve, and the challenges that investment advisers and fund directors face to ensure that a fund uses derivatives in a manner consistent with its investment objectives, policies, restrictions, risk profile, and relevant regulatory requirements, including those under federal securities laws.

The Concept Release seeks comment on how funds use derivatives in practice.

SENIOR SECURITIES

The Concept Release states that restricting the use of "senior securities" to protect investors is one of the core purposes of the 1940 Act. 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 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 creating too much leverage to the detriment of investors. Section 18 generally prohibits an open-end fund from issuing or selling any "senior security" other than borrowing from a bank, and unless it maintains 300 percent "asset coverage" (generally, the ratio of a fund's total assets less liabilities and exposure to senior securities, to the value of the fund's senior securities).

Years later, in 1979, the Commission interpreted how Section 18 applies to reverse repurchase agreements and other instruments that could be considered to involve leverage (again, still no mention of "derivatives"). The Commission determined that Section 18 compliance would not be raised if funds "cover" senior securities by maintaining "segregated accounts" consisting of liquid assets to ensure that funds had sufficient assets to cover the leverage. This guidance effectively established limits on leverage. The Commission's staff expanded, modified, and otherwise tweaked this interpretation over the next 30 years through more than 20 no-action letters, reacting to the growth of the derivatives market.

What amount of assets should a fund segregate with respect to particular derivatives to satisfy these regulatory concerns? The Commission has not addressed this issue with respect to many derivatives. Funds, however, have openly established asset segregation procedures, in full view of the Commission and its staff. The Commission is now asking whether these practices are adequate, whether they should be codified, or whether the Commission should establish alternative requirements.

Alternative approaches to asset segregation. 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 Report of the Task Force on Investment Company Use of Derivatives and Leverage (the "2010 ABA Derivatives Report").[2] Among other things, the 2010 ABA Derivatives

[2] *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), *available at* http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf. Jay G. Baris, a partner of

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Report suggested a principles-based approach to this issue. Under the Task Force's approach, funds would establish their own asset segregation standards for derivatives that involve leverage within certain accepted parameters. They would establish publicly disclosed minimum "Risk Adjusted Segregated Amounts" (the "RASA approach") that would take into consideration various risk factors they deem appropriate.

The Concept Release also described various alternatives used by non-US 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.

DIVERSIFICATION REQUIREMENTS

Investment companies 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 works well with funds that invest in traditional asset classes, such as stocks and bonds, because it is relatively simple to 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 dilemmas 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 created the economic risks. 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 2010 ABA Derivatives Report suggested that counterparty diversification could be addressed separately.

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").

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Rule 12d-3-1 provides a limited exemption from this requirement. The rule 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 the 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, for example, 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."

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 the concern as follows:

> 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).

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.

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.

LOOKING AHEAD

The Concept Release addresses in one place a bundle of concerns that have been brewing for the past two decades or

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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 indicates 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.

It seems likely that the Commission will take some action to address these concerns, but it is equally likely that the issues discussed in the Concept Release will generate a significant number of substantive comments. It will take the Commission and its staff a 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.

> *Use of Derivatives by Investment Companies under the Investment Company Act of 1940,* Investment Company Act Rel. No. 29776 (Aug. 31, 2011), available at http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

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