

SEC Issues Concept Release on Funds' Use of Derivatives

The Securities and Exchange Commission held an open meeting on August 31, 2011 to announce the publication of a [concept release](#) (the "Concept Release") on the use of derivatives by investment companies under the Investment Company Act of 1940, as amended (the "1940 Act"). The Concept Release requests data and comments regarding the types of derivatives used by mutual funds and other investment companies, such as business development companies and exchange-traded funds, the purposes for which funds use derivatives, and whether funds' use of derivatives has undergone or may be undergoing changes. The Commission requests comments to the Concept Release to help it determine whether "the 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."

The Concept Release represents the latest step in the Commission's ongoing review of the use of derivatives by funds. The Concept Release states that, as part of this review, the SEC staff has met with industry groups and fund complexes, and has considered the American Bar Association's Section of Business Law's July 2010 "Report of the Task Force on Investment Company Use of Derivatives and Leverage."

The Concept Release discusses the history and application of certain 1940 Act provisions which govern derivatives activity and invites comment on the attendant costs, benefits, and risks associated with the use of derivatives. In addition to a general request for comments on any matters relevant to the use of derivatives by funds, the Concept Release specifically discusses and requests comment on (i) the application of the 1940 Act's restrictions on senior securities and leverage to derivatives; (ii) the application of the 1940 Act's restrictions on investments in securities-related issuers to derivatives; (iii) the application of the 1940 Act's provisions concerning portfolio diversification and concentration to derivatives; and (iv) the valuation of derivatives.

Some preliminary observations on the Concept Release:

Questions; no clear direction. The Commission does not show any bias in favor of or against funds' use of derivatives, current industry interpretations of the law, or SEC pronouncements. The Commission appears to be very much in a fact-finding mode. Nonetheless, the nature of the SEC's questions and the tone of the Concept Release suggest that the Commission expects to take some action in the future, most likely with respect to senior securities, leverage, and/or asset segregation (almost half of the Concept Release is dedicated to these topics).

Timing; Dodd-Frank. The Concept Release barely mentions the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the most far-reaching legislation of derivatives markets in history. Key provisions of the Dodd-Frank Act—mandatory clearing, regulation of swap dealers and major swap participants, margin and capital requirements, public reporting of derivatives transactions, and many others—will almost certainly have a profound effect on the way funds enter into and maintain derivatives positions and on the nature and degree of risk derivatives pose. It is somewhat surprising to see the Commission's long-awaited derivatives initiative appear now, on the eve of a new regulatory era for derivatives. It is even more surprising that neither the Commission's questions nor its commentary acknowledge the significant changes the Dodd-Frank Act may bring. For example, mandatory clearing is likely to change any regulatory analysis of credit risk and exposures (such as for purposes of diversification and for purposes of Section 12(d)(3)'s limitations on investments in securities-related issuers). In addition, mandatory real-time transaction reporting is likely to change derivatives valuation practices substantially. Any regulatory action the Commission

may ultimately take will likely reflect the changes wrought by the Dodd-Frank Act, notwithstanding that the Concept Release does not discuss them in any detail.

Substantive regulation. In its discussion of approaches to regulating the use of leverage through derivatives, the Commission describes a number of substantive regulatory schemes in place in other jurisdictions throughout the world (such as the regulation of UCITS). The Commission does not note, however, that many of those jurisdictions rely on institutional trustees or other similar arrangements—as opposed to individual trustees, most of whom must be “disinterested” trustees—and do not have as robust disclosure, custody, and other requirements as those to which funds are subject in the United States. Those elements of the U.S. regulatory structure have been important contributors to ensuring the responsible use of derivatives to date, and may deserve a greater role in the Commission’s thinking.

Custody. The Concept Release makes little mention of custody issues. In our experience, many of the counterparties to derivatives transactions with Lehman Brothers who lost the most money in the Lehman insolvency did so because of the excess collateral they deposited with Lehman and its affiliates. Mutual funds were largely spared those losses because most funds require that collateral be posted in escrow accounts with their custodians. The Commission might do well to take custody issues more directly into account in its thinking about derivatives and the risks they pose, and specifically to consider whether the custodial rules for cleared derivatives currently being considered by the CFTC will provide comparable protections to those now afforded to mutual funds.

Regulatory authority. Substantive regulation of derivatives use under Section 18 of the 1940 Act requires a broad reading of the statute’s limitations on the issuance of “senior securities.” In the Concept Release, the Commission in fact takes a relatively broad view of its authority under that Section. The Commission may need to develop in more detail the legal underpinning for its authority in this area (and how it exercises that authority) in order to respond to legal challenges to any new rules or interpretations, especially in light of the apparent unwillingness of the federal judiciary to defer generally to the Commission as to its rulemaking activities.

Some omissions. In light of the broad scope of the Concept Release, the number of derivatives-related issues that the Commission does *not* explore in depth is also notable. Some of these include liquidity and risk management practices; the role of mutual fund boards in derivatives oversight; adequacy of disclosure; and issues arising under Rule 35d-1 (the “names rule”).

The deadline for submitting comments to the Commission on the Concept Release is November 7, 2011.

If you would like to learn more about the developments discussed in this alert, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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