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# SEC On Investment Company Derivative Use

**By Jay G. Baris and Andrew J. Donohue**

The Securities and Exchange Commission is asking how it should regulate the way investment companies including mutual funds, closed-end funds, exchange-traded funds, and business development companies ("funds") use derivatives. In a concept release published August 31, 2011, the Commission examined the current regulatory scheme and set the stage for future regulation that likely will have far-reaching implications for funds, their investment advisers, independent directors, investors and counterparties.

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. Over the past 30 years, the Commission has expressed concern about the use of derivatives, especially in areas involving leverage, illiquidity, and counterparty risk.

The Commission's concern is rooted in a perceived gap between how the law and investors look at fund portfolios versus how investment advisers look at them. In a 2009 speech to the American Bar Association's Committee on Federal Regulation of Securities of the ABA's Business Law Section, Andrew J. Donohue, counsel at partner at Morgan Lewis & Bockius in Washington, D.C. and former director of the SEC's Division of Investment Management, 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 bar association group to suggest how the Commission should revise regulations concerning leverage restrictions, pricing, liquidity, risk management and oversight by fund boards.

In response, the Committee established the Task Force on Investment Company Use of Derivatives, which sent its report to the Division of Investment Management in July 2010 (the ABA Derivatives Report").

The Donohue Speech and the 2010 ABA Derivatives Report laid the groundwork for the Commission to tackle these often knotty issues, which are further complicated by other factors, including the increasing complexity of derivatives; the increasing use of derivatives by funds; and the new regulatory framework for over-the-counter derivatives, mandated by the Dodd-Frank Act.

## SENIOR SECURITIES

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


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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).

In 1979, the Commission 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.

The Commission's regulatory approach evolved over the next 30 years as derivatives and their use grew in complexity. The Commission adjusted its views on what amount and type of assets that funds should segregate, but generally avoided addressing issues related to specific types of derivatives.

In the concept release, 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 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 risk-adjusted segregated amounts ("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 approach.

The Commission could craft a rule that exempts funds from certain prohibitions in Section 18 and Section 12 of the 1940 Act that arise 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.


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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 must decide whether funds should measure compliance with the diversification requirements by looking to the derivatives counterparties or by looking at the reference assets underlying the derivatives, or both. The Commission seeks comments on, among other issues, 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"). An exemptive 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% of its gross revenues from securities-related activities, provided that it complies with some specific conditions.

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, when a fund and a bank enter into a total return swap on stock issued by a corporation in the energy sector, it also gains exposure to the banking industry (i.e., the industry associated with the fund's counterparty).


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- The Commission seeks comment on whether funds should look to counterparties or reference assets for measuring concentration, as well as 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

Further at issue is how funds value their derivatives exposure, particularly OTC derivatives, which may have customized terms, including contractual restrictions on transferability, and few quotes available from independent sources.

The ABA 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.

## 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 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."

With a principles-based approach to regulation, oversight responsibilities of fund directors would increase. On the other hand, with 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.

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

It would be reasonable to speculate that future action is likely to be derived from some of the alternatives discussed in the concept release. But, barring any market crisis, 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 letter and spirit of the 1940 Act, whether or not a fund uses derivatives. The Commission should balance the benefits derived 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 continue to seek input from all interested parties,


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beyond the views contained in the nearly 50 comment letters it received. Investment company use of derivatives raises critical issues that require the appropriate balance of investor protection and common sense.

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