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Panel on Institutional Accounts, Investment Companies, Financial Futures and Related Options - The SEC Perspective

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Investment Companies, Financial Futures and Related Options - The SEC Perspective

I. INTRODUCTION

Investment companies, commonly known as mutual funds, registered with the Securities and Exchange Commission ("SEC" or "Commission") under the Investment Company Act of 1940 ("ICA"), are increasing their use of futures contracts, options on futures and options on stocks or stock indexes. Funds buy and sell futures contracts and options primarily to hedge portfolios or specific portfolio securities, and also to profit from expected price rises in specific securities. New registrations uniformly provide for investment in these instruments, and existing funds are obtaining shareholder authorization for their use and amending prospectuses to describe fund investment policies in the options and commodities area.

Financial futures and stock indexes weren't around in 1940 when the ICA became law. The ICA was designed to protect against abuses such as over-leveraging, speculation, insider conflict of interest, lack of shareholder disclosure and control, and improper accounting by investment companies documented by the SEC study 1/ of the investment company industry following the Great Depression. Today, each from their own perspective, investment companies, their accountants and lawyers, commodities and securities firms, clearing firms, and (last but by no means the least affected!) the regulators, the SEC and the Commodities Futures Trading Commission ("CFTC"), are wrestling with the ICA's strictures. The overlap of the commodities and securities markets through the use of financial futures and options has created regulatory overlaps, gaps and conflicts. This discussion will frame key issues from the perspective of the SEC's Division of Investment Management ("Division"), which administers the ICA and its companion statute, the Investment Advisers Act of 1940. These acts contain more "quality," or merit regulation, than the other federal securities laws, putting a heavy burden on the Division to ensure compliance with a complex statutory scheme and protect investment company shareholders. This is especially true today, with investors pouring money into mutual funds at a time of growth

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1/ See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. 477, 76th Cong., 2d Sess. (1939).

in the U.S. and international financial and securities markets. 2/ In the area of commodities and options, the basic issue facing the Division is how to define the parameters of permissible activity and then structure regulatory requirements and guidelines for investment companies.

II. FUND USE OF FUTURES AND OPTIONS

A. Futures Contracts

Mutual funds use futures contracts either to take advantage of expected increases in prices of specific instruments or in the market generally or to protect portfolios against expected declines in such prices. A fund may use either financial futures or futures on an underlying index to achieve such results.

For example, by taking a long position on--or "buying"--a futures contract on the Standard & Poor's 500 Index, a fund will benefit if the value of the index rises. Normally, a fund enters into a long futures position on the Standard & Poor's 500 Index as an anticipatory hedge. In other words, the fund may believe the market as a whole will increase in value and may desire to benefit from the expected rise. However, because of high transaction costs, an illiquid position, or tax reasons, it may be inadvisable for the fund to expand its portfolio. By buying a futures contract on the Standard & Poor's 500 Index, the fund could participate in the expected market rise without actually purchasing stocks. If the fund later decides to acquire certain stocks, the profits earned from the futures contracts may cushion the effect of purchasing these stocks at their higher prices. A similar strategy may be employed with respect to individual financial instruments by buying financial futures on the instruments.

Conversely, a fund may believe the market as a whole will decline in the short-term, yet not desire to liquidate any portfolio securities. By taking a short position on--or "selling"--a futures contract on the Standard & Poor's 500 Index, the fund could hedge its portfolio against the possible downward market movement. A decline in the value of the fund's portfolio will

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2/ The Investment Company Institute, in the ICI 1986 Mutual Fund Fact Book, estimates that the number of mutual fund shareholders grew from 12.1 million in 1980 to 35 million in 1985, of which 57% were in equity, bond and income funds. These funds are the most likely to use futures and options.

be offset by gains on the short futures position. Likewise, the fund could hedge specific portfolio instruments by selling financial futures on these instruments.

B. Options

In addition to entering into futures contracts, a mutual fund may purchase or write options, either on futures contracts or directly on an instrument or underlying index. By selling--or "writing"--options, a fund enhances income by the premiums received for these options. Of course, the fund also assumes a risk in doing so. For example, writing puts (a promise to buy at a certain price) may obligate the fund to purchase an instrument or take a long position in a futures contract at a disadvantageous price if the holder exercises. Similarly, writing calls (a promise to sell at a certain price) may force a fund to sacrifice appreciation on an instrument or a futures contract. However, a fund actively engaged in writing options believes that premiums received will over time exceed losses on exercised options.

A fund also may purchase options. For example, a fund may hope to gain from the potential increase in the price of certain instruments or an index. By purchasing calls on such instruments or a futures contract on the index, the fund could participate in such an increase with limited expense and risk. Of course, if the expected price increases do not materialize, the option expires unexercised and the fund has no gain to offset the premium paid.

Alternatively, if a fund anticipates a decline in the price of certain portfolio securities or of the portfolio as a whole, it may choose to limit such losses by purchasing puts on individual financial instruments or purchasing puts on futures contracts. As is the case with purchasing calls, the puts may expire unexercised, in which case the fund will lose the premiums paid.

As a general matter, investment companies are permitted to engage in futures and options transactions only for hedging purposes, not speculation, although companies may elect to write options against portfolio securities in order to generate premium income. The ICA and its rules have a number of limitations which act to restrict commodities investments.

Investment companies desiring to enter into futures contracts or desiring to write options, either on a futures contract or directly on an instrument or index, are subject to custody and leverage restrictions under sections 17(f) and 18(f) of the

ICA. 3/ Other areas which affect investment companies and those they deal with include registration requirements of the Commodities Exchange Act ("CEA"), CFTC rules and policy, capital structure and governance requirements of the ICA, restrictions and requirements regarding advertising under both the CEA and the ICA, and the Internal Revenue Code.

III. ICA SECTION 17

A. Custody

ICA section 17(f) contains custody requirements for mutual fund assets, which must generally be placed and maintained with qualified banks or member companies of a national securities exchange defined in the Securities Exchange Act of 1934. A futures commission merchant ("FCM") may not function as a fund custodian. If futures margin payments are placed with an FCM as required under rules of the CFTC, a fund could violate section 17(f). In response to requests from investment companies and FCMs, the Division has given "no-action" 4/ responses to permit a fund's use of futures under the following circumstances:

1. Initial margin deposits may be made to a third party custodial account placed with the fund's custodian bank in the FCM's name. The FCM is entitled to withdraw sums on the account only upon the fund's default. 5/

2. A fund may permit an FCM to hold excess variation margin on an overnight basis if, by 10:30 a.m. the next day the fund demands payment and the excess is paid to the fund. Under these circumstances the staff has deemed the time period during which the fund does not have proper custody of its assets as too inconsequential to mandate section 17 requirements. 6/

3/ An investment company <u>purchasing</u> options (either on futures or directly on an instrument or index) is not subject to these restrictions, because once the premium is paid no asset of the investment company is at risk.

4/ A no-action request asks the SEC staff to state that it would not recommend that the Commission take action if a proposed course of action is followed by the requestor.

5/ <u>E.g.</u>, Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Koenig Tax-Advantaged Liquidity Fund, Inc. (pub. avail. March 27, 1985).

6/ <u>E.g.</u>, SteinRoe Bond Fund, Inc. (pub. avail. Jan. 17, 1984).

Also, exemptive orders 7/ have been granted that allow variation margin gains to build up before fund demand is made on the FCM under conditions which limit the amount of excess variation margin held by an FCM to, for example, the lesser of $50,000 or 1/8 of 1% of total assets. 8/ The staff is aware of the need for more general relief in this area and expects to recommend a rule to the Commission which will codify the standards of the exemptive orders and permit funds to maintain a certain amount of excess margin with an FCM.

B. Affiliated FCM Transaction

Section 17(e)(1) makes it unlawful for an affiliate (or an affiliate of an affiliate), acting as an agent, to accept any compensation for the purchase or sale of any property except in the course of such person's business as an underwriter or broker. Section 17(e)(2) prohibits such a person, acting as a broker, from receiving commissions or fees for effecting transactions in securities unless they are the usual and customary commissions. Investment Company Act rule 17e-1 describes the circumstances when commissions shall be deemed usual and customary. The rule requires that the commission must be reasonable and fair compared to commissions received by others providing similar services and that the board of directors, and a majority of the disinterested directors, adopt procedures to ensure the reasonableness of the commissions and review all transactions on a quarterly basis for compliance.

An FCM is not a broker under section 2(a)(6) of the ICA. Therefore if it is an affiliate of a fund, it could not accept commissions from the fund for futures transactions. The staff

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7/ Applications for exemptive relief are filed under ICA section 6(c), which allows the Commission, conditionally or unconditionally, to exempt any person, security or transaction from any provision of the ICA, if and to the extent that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purpose intended by the policy and provisions of the ICA. Procedures and guidelines for filing applications and, where applicable, requests for no-action or interpretive advice to be processed by the Division of Investment Management are set forth in Release IC-14492 (April 30, 1985).

8/ See Drexel Bond Debenture Trading Fund, Notice IC-13861 (April 2, 1984), Order IC-13916 (May 1, 1984); Valic Timed Opportunity Fund, Notice IC-13891 (April 17, 1984), Order IC-13943 (May 16, 1984).

has given no-action relief in this area provided a fund complies with the conditions of sections 17(e)(1) and (2) and rule 17e-1. In the staff's view, while an FCM is not technically within the ICA definition of broker, it is not inconsistent with the purpose of section 17 for an FCM to execute futures transactions for an affiliated fund under the stated conditions. The Division is considering rulemaking to codify the no-action position.

IV. SENIOR SECURITY ISSUES

Section 18, which was designed to prevent speculative abuses through over-leveraging, limits the extent to which a fund may issue "senior securities", such as obligations evidencing indebtedness and bank borrowings. The staff's interpretation has been that "the purchase of a commodities futures contract and the ensuing leverage may involve the creation of a senior security." Guidelines for the Preparation of Form N-8B-1 ("Guidelines"). 9/ This is because the purchase of a commodities contract obliges the investment company to pay an amount in the future if certain conditions occur. The issuance of naked puts on securities also raises the section 18 issue. Guidelines, Item 4(b). A senior security may be created by transactions that expose the investment company shareholders to a substantial degree of risk through a leveraged investment or the issuance of debt that may have priority over shareholder claims. 10/

In general, funds may engage in futures transactions when no potential leveraging is involved. In the past, the Division has given no-action assurance when certain factors or safeguards exist to ensure that no leveraging will occur. For example, the Division has granted no-action under section 18 of the ICA to funds writing options if (i) in the case of a call, it is a "covered" call, 11/ or (ii) in the case of a put, the fund segre-

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9/ Release IC- 7221 (June 9, 1972). Form N-8B-1 was replaced with Forms N-1 and N-1A for the registration of management investment companies, effective January 1, 1979. The Guidelines have not been withdrawn because they contain certain regulatory positions that remain applicable, though some portions have been superseded by the published guides to the new forms. The Guidelines for futures remain outstanding.

10/ Release IC-10666 (April 18, 1979).

11/ For purposes of section 18, a call is considered "covered" if the fund owns the stock on which the call is written (or, if the call is written on an index, the fund may cover by

(Footnote continued)

gates cash, government securities, or high-grade debt in an amount equal to the strike price (less the amount of margin on deposit). 12/ Similarly, the Division has granted no-action relief under section 18 to funds using futures when (i) in the case of selling a future, the fund owns the securities underlying the future (*e.g.*, in the case of a future on the Standard & Poor's 500 Index, the fund owns a portfolio of stock with a volatility substantially similar to that of the index, or (ii) in the case of buying a futures contract, the fund segregates cash, government securities, or high-grade debt in an amount equal to the contract price (less any initial or variation margin already deposited). 13/ Finally, a fund writing calls on futures contracts will not run afoul of section 18 if it either owns a long futures contract or owns the assets underlying the futures contract. Conversely, a fund can write puts on futures contracts if it either owns a short futures contract or segregates cash, government securities, or high-grade debt in an amount equal to the put's strike price (less initial and variation margin). 14/

The staff recognizes the need for a comprehensive review of section 18 issues and more explicit guidance. However, section 18 provides an effective curb against potential abuse and the staff generally reacts cautiously to requests for greater latitude in the use of futures and related options. It is fair to say there's a "wait and see" attitude - a need for the Division to review the use by funds of these instruments before further action.

Continued footnote

owning a portfolio with a volatility substantially similar to that of the index). A call may also be covered if the fund owns a call on the same stock with the same or lower strike price.

12/ *See*, *e.g.*, Putnam Option Income Trust II (pub. avail. Sept 23, 1985); *see also* Release IC-10666 (April 18, 1979).

13/ *See*, *e.g.*, Koenig Tax-Advantaged Liquidity Fund, Inc. (pub. avail. March 27, 1985); Putnam Option Income Trust II (pub. avail. Sept. 23, 1985).

14/ *Id*.

V. DISCLOSURE

A. Requirements

Open-end management companies register with the SEC by filing Form N-1A, 15/ which provides for the use of a simplified short form prospectus (Part A) to satisfy the prospectus delivery requirements of the Securities Act of 1933. Part B of the form is a "Statement of Additional Information" ("SAI") which must be made available upon request. Closed-end management investment companies register on Form N-2. 16/

The forms and staff guides contain various requirements affecting disclosure about fund use of futures and options 17/ although, other than the Guidelines to old Form N-8B-1, the staff has not developed formal guides. The staff continues to develop disclosure policy as part of our ongoing review of registration statements and amendments. Also, we expect to develop new guides covering this area in conjunction with amendments to Forms N1-A and N-2.

Generally, funds must give complete disclosure about "fundamental" investment policies demonstrating the nature of the company and degree of risk of investment. 18/ Fundamental policies must be observed by the investment company, and unlike "operating" policies, can't be changed without shareholder approval. In many cases, use of futures and options will involve a fundamental policy and thorough disclosure is required. As common in an emerging area, fund disclosure about commodities and their markets is comprehensive and lengthy. As the fund industry and public become more sophisticated and knowledgable the disclosure will

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15/ As last amended in Release IC-14606 (July 1, 1985).

16/ As last amended in Release IC-14606 (July 1, 1985).

17/ See Items 4(a)(ii)(B)(1), 4(a)(ii)(C), 4(a)(ii)(D), 4(b), 4(c), 13(b)(2), 13(c), 13(b)(7) and 20 and Guides 3, 4, 21, 25 and 28 to Form N-1A, and Items 2(h), 7(a), 7(b)(2), 7(b)(7), 7(c) and 8 to Form N-2. The Guides consist of a compilation and adoptation of applicable Commission releases and staff positions and interpretations; they are not rules of the Commission and unless noted otherwise in the Guides) represent the views of the staff of the Division of Investment Management rather than an official position of the Commission.

18/ See ICA sections 1(b)(6), 8 and 13.

tend to be cut back. At this point, the staff looks for discussion about the specific futures and options which the fund expects to use, including a complete description of their use and any restrictions. For example, the staff has requested information in the prospectus about:

- the risk of imperfect correlation between a futures contract and the portfolio being hedged;

- the risk that a portfolio using such futures and/or options may not outperform a portfolio which does not make use of such instruments;

- the potential for unlimited risk of loss on futures activities notwithstanding the existence of cash segregated accounts or hedging intent; and

- whether and to what extent the investment adviser has had any experience in trading futures and options.

The SIA should include:

- a discussion of the responsibility of any Board of Trade or clearing corporation as to the liquidity of a futures or options contract;

- information regarding margin requirements and valuation calculations;

- examples of the uses by and effects on the fund of futures and options strategies; and

- a discussion of important tax aspects regarding such activities.

VII. AGENDA

A. Rulemaking and interpretative guidance re section 17 and 18 issues. The Division's first priority is recommending that the Commission adopt a rule providing greater flexibility to funds and FCMs in maintaining margin accounts. Division staff have met with staff of the Division of Trading and Markets of the CFTC on this issue and understand the need for relief by FCMs from the current requirements for third party custody accounts.

B. Staff revision of Guidelines re futures and options - likely to be published as a new Guide with related modification to the existing Guides to investment company registration forms. Division staff are currently working on amendments to Form N-1A and a comprehensive revision of Form N-2 for recommendation to the Commission in late 1986; we hope to put out the Guide when these amendments and revisions are published for public comment.

C. Continued liaison with the CFTC, on a more regular and formalized basis. The Division and the CFTC are considering the possibility of joint action in certain areas, such as coordinating a definition of "bona fide hedging," a joint release on required disclosure, and other resource sharing in areas where each can take advantage of the other's expertise.