

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 271**

**[Release No. IC-29776; File No. S7-33-11]**

**RIN: 3235-AL22**

**Use of Derivatives by Investment Companies under the Investment Company Act of 1940**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Concept release; request for comments.

**SUMMARY:** The Securities and Exchange Commission (the “Commission”) and its staff are reviewing the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act” or “Act”) and companies that have elected to be treated as business development companies (“BDCs”) under the Act (collectively, “funds”). To assist in this review, the Commission is issuing this concept release and request for comments on a wide range of issues relevant to the use of derivatives by funds, including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, valuation, and related matters. In addition to the specific issues highlighted for comment, the Commission invites members of the public to address any other matters that they believe are relevant to the use of derivatives by funds. The Commission intends to consider the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds and, if so, the nature of any such initiatives or guidance.

**DATES:** Comments should be received on or before November 7, 2011.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/concept.shtml>);
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov); or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-33-11. This file number should be included on the subject line if comments are submitted by e-mail. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/concept.shtml>).

Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. Therefore, you should only submit information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Edward J. Rubenstein, Senior Special Counsel, or Michael S. Didiuk, Senior Counsel, at (202)-551-6825, Office of Chief Counsel, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5030.

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### I. INTRODUCTION

The activities of funds, including their use of derivatives, are regulated extensively under the Investment Company Act,<sup>1</sup> Commission rules, and Commission guidance.<sup>2</sup> Derivatives may be broadly described 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”).<sup>3</sup>

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<sup>1</sup> 15 U.S.C. 80a. All statutory references to the Investment Company Act are to 15 U.S.C. 80a, and, unless otherwise stated, all references to rules under the Investment Company Act are to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270]. All references to the Securities Act of 1933 (the “Securities Act”) are to 15 U.S.C. 77a, and, unless otherwise stated, all references to rules under the Securities Act are to Title 17, Part 230 of the Code of Federal Regulations [17 CFR 230]. All references to the Securities Exchange Act of 1934 (the “Exchange Act”) are to 15 U.S.C. 78a, and, unless otherwise stated, all references to rules under the Exchange Act are to Title 17, Part 240 [17 CFR 240].

<sup>2</sup> The staff has also issued no-action and other letters that relate to fund use of derivatives. In addition to Investment Company Act provisions, funds using derivatives must comply with all other applicable statutory and regulatory requirements, such as other federal securities law provisions, the Internal Revenue Code (the “IRC”), Regulation T of the Federal Reserve Board (“Regulation T”), and the rules and regulations of the Commodity Futures Trading Commission (the “CFTC”). See also Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the “Dodd-Frank Act”), available at <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

<sup>3</sup> See, e.g., *Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008) (“2008 IDC Report”) at 1, 3, available at [http://www.ici.org/pdf/ppr\\_08\\_derivatives.pdf](http://www.ici.org/pdf/ppr_08_derivatives.pdf). See also *Mutual Funds and Derivative Instruments*, Division of Investment Management Memorandum transmitted by Chairman Levitt to Representatives Markey and Fields (Sept. 26, 1994) (“1994 Report”) at text accompanying n. 1 (“[t]he term ‘derivative’ is generally defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate (e.g., interest rates or currency exchange rates), security, commodity, or other asset.”), and at n. 2 (the “term ‘derivative’ generally is used to embrace forward contracts, futures, swaps, and options”), available at <http://www.sec.gov/news/studies/deriv.txt>; John C. Hull, *Options, Futures, and Other Derivatives* (7<sup>th</sup> ed. 2009) (“Hull”) at 1, 779 (“A derivative can be defined as a financial instrument whose value depends on (or derives from) the values of other, more basic underlying variables,” and a derivative is an “instrument whose price depends on, or is derived from, the price of another asset”) (italics in original); rule 3b-13 under the Exchange Act, which defines “eligible OTC derivative instrument,” and rule 16a-1(c) under the Exchange Act, which defines “derivative securities;” section 5200(b) of the Revised Statutes of the United States [12 U.S.C. 84(b)] (as amended by section 610(a)(3) of the Dodd-Frank Act, *supra* note 2), which

As detailed below,<sup>4</sup> funds employ derivatives for a variety of purposes, including to increase leverage to boost returns, gain access to certain markets, achieve greater transaction efficiency, and hedge interest rate, credit, and other risks.<sup>5</sup> At the same time, derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity (particularly with respect to complex OTC derivatives), and counterparty risk, among others.<sup>6</sup>

The dramatic growth in the volume and complexity of derivatives investments over the past two decades, and funds' increased use of derivatives,<sup>7</sup> have led the Commission and its staff

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defines a "derivative transaction" to include "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."

<sup>4</sup> For a definition, and examples of types, of derivatives, *see infra* Section I.B.

<sup>5</sup> *See* 2008 IDC Report, *supra* note 3, at 8-11. *See also infra* Section I.B.

<sup>6</sup> *See* 2008 IDC Report, *supra* note 3, at 12-13. *See also Mutual Fund Derivative Holdings: Fueling the Need for Improved Risk Management*, JPMorgan Thought Magazine (Summer 2008) ("2008 JPMorgan Article"), available at <http://www.jpmorgan.com/cm/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1158494213964&blobheader=application%2Fpdf&blobnocache=true&blobheadername1=Content>.

<sup>7</sup> While complete data concerning the nature of derivatives activities of funds is unavailable, for a partial snapshot of derivatives activity by selected fund complexes *see Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, Investment Company Institute ("ICI") Comment Letter to the CFTC at 18 (Apr. 12, 2011), available at <http://www.ici.org/pdf/25107.pdf>. *See also, e.g.*, Tim Adam and Andre Guettler, *The Use of Credit Default Swaps by U.S. Fixed-Income Mutual Funds*, FDIC Ctr. for Fin. Research, Working Paper No. 2011-01, (Nov. 19, 2010) ("Adam and Guettler Article"), available at [http://www.fdic.gov/bank/analytical/cfr/2011/wp2011/CFR\\_WP\\_2011\\_01.pdf](http://www.fdic.gov/bank/analytical/cfr/2011/wp2011/CFR_WP_2011_01.pdf) (study of the use of credit default swaps ("CDS") by the largest 100 U.S. corporate bond funds between 2004 and 2008 reflects an increase from about 20% of funds using credit default swaps in 2004 to 60% of funds using them in 2008; among CDS users, the average size of CDS positions (measured by their notional values) increased from 2% to almost 14% of a fund's NAV over the same period, with the CDS positions representing less than 10% of NAV for most funds, but with some funds exceeding this level by a wide margin, particularly in 2008; CDS are predominantly used to increase a fund's exposure to credit risks (net sellers of CDS) rather than to hedge credit risk (net buyers); the frequency of credit default swap usage by the largest bond funds is comparable to that of most hedge funds), available at [http://www.fdic.gov/bank/analytical/cfr/2011/wp2011/CFR\\_WP\\_2011\\_01.pdf](http://www.fdic.gov/bank/analytical/cfr/2011/wp2011/CFR_WP_2011_01.pdf); *Assess the Risks: Key Strategies for Overseeing Derivatives*, Board IQ at 1 (Jan. 15, 2008) ("In recent years, the use of derivatives by mutual funds has soared."), available at

to initiate a review of funds' use of derivatives under the Investment Company Act.<sup>8</sup> The staff generally has been exploring the benefits, risks, and costs associated with funds' use of derivatives. The staff also has been exploring issues relating to the use of derivatives by funds such as: whether current market practices involving derivatives are consistent with the leverage, concentration, and diversification provisions of the Investment Company Act; whether funds that rely substantially upon derivatives, particularly those that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of their derivatives investments; whether funds' boards of directors are providing appropriate oversight of the use of derivatives by the funds; whether existing rules sufficiently address matters such as the proper procedures for a fund's pricing and liquidity determinations regarding its derivatives holdings; whether existing prospectus disclosures adequately address the particular risks created by derivatives; and whether funds' derivative activities should be subject to any special reporting requirements.

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<http://www.interactivedata.com/uploads/BoardIQ1207.pdf>; 2008 JPMorgan Article, *supra* note 6.

<sup>8</sup> In a press release issued in March 2010, the Commission announced that the staff was conducting a review to evaluate the use of derivatives by mutual funds, registered exchange-traded funds ("ETFs"), and other investment companies. The press release indicated that the review would examine whether and what additional protections are necessary for those funds under the Investment Company Act. The press release further indicated that pending completion of this review, the staff would defer consideration of exemptive requests under the Act relating to ETFs that would make significant investments in derivatives. See SEC Press Release 2010-45, *SEC Staff Evaluating the Use of Derivatives by Funds* (Mar. 25, 2010) ("2010 Derivatives Press Release"), available at <http://www.sec.gov/news/press/2010/2010-45.htm>. As part of the staff's review to evaluate fund use of derivatives, and to further enhance its knowledge of how funds are using, and managing their use of, derivatives, the staff met with industry groups as well as with some fund complexes that use OTC derivatives. The staff also reviewed fund disclosures relating to the use of derivatives and their risks. In addition, the staff considered *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](http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf).

## A. Purpose and Scope of the Concept Release

The goal of the Commission's and staff's review is to evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Act and is consistent with investor protection. The purpose of this concept release is to assist with this review and solicit public comment on the current regulatory regime under the Act as it applies to funds' use of derivatives. We intend to use the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime and the specific nature of any such initiatives.<sup>9</sup>

A fund that invests in derivatives must take into consideration various provisions of the Investment Company Act and Commission rules under the Act. The fund must consider the leverage limitations of section 18 of the Investment Company Act, which governs the extent to which a fund may issue "senior securities."<sup>10</sup> A fund's use of derivatives also may raise issues under Investment Company Act provisions governing diversification,<sup>11</sup> concentration,<sup>12</sup> investing

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<sup>9</sup> Section 2(c) of the Investment Company Act provides that "[w]henever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

<sup>10</sup> See sections 18(a)(1) and 18(f)(1) of the Investment Company Act. See also *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666") [44 FR 25128 (Apr. 27, 1979)], and *Registered Investment Company Use of Senior Securities—Select Bibliography* ("Senior Security Bibliography"), available at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm> (prepared by the staff). See also discussion *infra* at Section II. (Derivatives under the Senior Securities Restrictions of the Investment Company Act).

<sup>11</sup> See sections 5(b)(1) and 13(a)(1) of the Investment Company Act. See also *infra* discussion at Section III. (Derivatives under the Investment Company Act's Diversification Requirements).

<sup>12</sup> See sections 8(b)(1)(E) and 13(a)(3) of the Investment Company Act. See also Form N-1A, Item 4(a), instruction 4 to Item 9(b)(1), and Item 16(c)(1)(iv); Form N-2, Item 8.2.b (2), and Item 17.2.e. See also *infra* discussion at Section V. (Portfolio Concentration).

in certain types of securities-related issuers,<sup>13</sup> valuation,<sup>14</sup> and accounting and financial statement reporting,<sup>15</sup> among others,<sup>16</sup> as well as under applicable disclosure provisions.<sup>17</sup>

Derivatives generally entail the potential for leveraged future gains and/or losses that may significantly impact the overall risk/reward profile of a fund. Applying the Act's provisions relating to diversification, concentration, and investments in securities-related issuers, among others, may require determining what value to assign to the derivative and which of the derivative's multiple exposures should be measured for purposes of the relevant provision. This determination may be complex because there are at least two potential measures of the "value"<sup>18</sup>

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<sup>13</sup> See section 12(d)(3) of the Investment Company Act and rule 12d3-1 thereunder. See also *infra* discussion at Section IV. (Exposure to Securities-Related Issuers Through Derivatives).

<sup>14</sup> See section 2(a)(41) of the Investment Company Act. See also *Restricted Securities*, Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)] ("ASR 113"), available at <http://www.sec.gov/rules/interp/1969/ic-5847.pdf>; *Accounting for Investment Securities by Registered Investment Companies*, Investment Company Act Release No. 6295 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)] ("ASR 118"), available at <http://www.sec.gov/rules/interp/1970/ic-6295.pdf>. See also *infra* discussion at Section VI. (Valuation of Derivatives).

<sup>15</sup> See generally section 30(e) of the Investment Company Act.

<sup>16</sup> See, e.g., Investment Company Act provisions relating to custody (section 17(f) and related rules), and fund names (section 35(d) and rule 35d-1). Also, an open-end fund should consider the effect that the use of derivatives may have on the liquidity of the fund's portfolio. For general guidance on liquidity and open-end funds, see, e.g., *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Investment Company Act Release No. 17452 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)], available at <http://www.sec.gov/rules/final/1990/33-6862.pdf>. See also *Revisions of Guidelines*, Investment Company Act Release No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)], available at <http://www.sec.gov/rules/other/1992/33-6927.pdf>.

<sup>17</sup> See, e.g., section 8(b) of the Investment Company Act, and Items 4(a), 4(b), 9(b), 9(c), and 16(b) of Form N-1A. Certain derivatives-related disclosure issues were discussed in a 2010 staff letter to the ICI. See *Derivatives-Related Disclosures by Investment Companies*, Letter from Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, ICI (July 30, 2010) ("2010 Staff Derivatives Disclosure Letter"), available at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

<sup>18</sup> The Bank for International Settlements (the "BIS") reports gross market values (positive and negative) for open derivative contracts, which are defined as "the sums of the absolute values of all open contracts with either positive or negative replacement values evaluated at market prices prevailing at the reporting date. Thus, the gross positive market value of a dealer's outstanding



of a derivative for purposes of applying various provisions of the Act: the current market value or fair value reflecting the price at which the derivative could be expected to be liquidated; and the notional amount reflecting the contract size (number of units per contract) multiplied by the current unit price of the reference asset on which payment obligations are calculated.<sup>19</sup> In

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contracts is the sum of the replacement values of all contracts that are in a current gain position to the reporter at current market prices . . . The gross negative market value is the sum of the values of all contracts that have a negative value on the reporting date. . . .” *Guide to the International Financial Statistics*, Bank for International Settlements (July 2009) (“BIS Guide”) at 31, available at <http://www.bis.org/statistics/intfinstatsguide.pdf>. See also Sarah Sharer Curley and Elizabeth Fella, *Where to Hide? How Valuation of Derivatives Haunts the Courts – Even After BAPCPA*, 83 Am. Bankr. L.J. 297, 298-99 (Spring 2009) (“In a simple interest rate swap . . . [t]he value of the swap is the net difference between the present value of the payments each party expects to receive and the present value of the payments each party expects to make. The value is generally zero to each party at the inception of the swap, and becomes positive to one party and negative to the other depending on what direction the interest rates move.”); *CFTC Glossary, Mark-to-Market Definition*, available at <http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm> (stating that marking to market is accomplished for a futures or option contract by “calculating the gain or loss in each contract position resulting from changes in the price of the contracts at the end of each trading session. These amounts are added or subtracted to each account balance.”).

<sup>19</sup> The BIS describes “notional amounts outstanding” as “a reference from which contractual payments are determined in derivatives markets.” BIS Guide, *supra* note 18, at 30. “Notional value” can be defined as “the value of a derivative’s underlying assets at the spot price.” In the case of an options or futures contract, the notional value is the number of units of an asset underlying the contract, multiplied by the spot price of the asset. See [www.investorwords.com/5930/notional-value.htm](http://www.investorwords.com/5930/notional-value.htm). The “spot price” of a derivative’s underlying asset is the asset’s price for immediate delivery, *i.e.*, in the current market, in contrast with the asset’s future or forward price. See, *e.g.*, Hull, *supra* note 3, at 789. “Notional value” is also defined as “the underlying value (face value), normally expressed in U.S. dollars, of the financial instrument or commodity specified in a futures or options on futures contract.” See *CME Group Glossary*, available at <http://www.cmegroup.com/education/glossary.html>. “‘Notional principal’ or ‘notional amount’ of a derivative contract is a hypothetical underlying quantity upon which interest rate or other payment obligations are computed.” ISDA Online Product Descriptions and Frequently Asked Questions at <http://www.isda.org/educat/faqs.html#7>. See also Hull, *supra* note 3, at 786 (“Notional principal” is the “principal used to calculate payments in an interest rate swap. The principal is ‘notional’ because it is neither paid nor received”); Frank J. Fabozzi, et al., *Introduction to Structured Finance*, at 27 (2006) (“[In an interest rate swap] [t]he dollar amount of the interest payments exchanged is based on some predetermined dollar principal, which is called the *notional amount*.”) (italics in original); 2010 ABA Derivatives Report, *supra* note 8, at n.11 (noting that the term “notional amount” is used differently by different people in different contexts, but is used, in the Report, to refer to “the nominal or face amount that is used to calculate payments made on a particular instrument, without regard to whether its obligation under the instrument could be netted against the obligation of another party to pay the fund under the instrument.”).

addition, derivatives often create exposures to multiple variables, such as the credit of a counterparty as well as to a reference asset on which the derivative is based.

The Commission or its staff, over the years, has addressed a number of issues relating to derivatives on a case-by-case basis. The Commission now seeks to take a more comprehensive and systematic approach to derivatives-related issues under the Investment Company Act. In particular, in this release the Commission discusses and seeks comment on the following issues, among others, relating to funds' use of derivatives:<sup>20</sup>

- the attendant costs, benefits and risks;
- the application of the Act's prohibitions and restrictions on senior securities and leverage;
- the application of the Act's prohibition on investments in securities-related issuers;
- the application of the Act's provisions concerning portfolio diversification and concentration; and
- the application of the Act's provisions governing valuation of funds' assets.

In addition to the specific issues highlighted for comment, the Commission invites members of the public to address any other matters that they believe are relevant to the use of derivatives by funds.

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<sup>20</sup> The Commission recognizes that there are other significant derivatives-related issues under the Investment Company Act that this release does not address, such as disclosure-related issues, which the Commission may consider at a later date.

## B. Background Concerning the Use of Derivatives by Funds

As noted above, derivatives may be broadly defined to include instruments or contracts whose value is based upon, or derived from, some reference asset. Reference assets can include, for example, stocks, bonds, commodities, currencies, interest rates, market indices, currency exchange rates, or other assets or interests, in virtually endless variety.<sup>21</sup>

Derivatives are often characterized as either exchange-traded or OTC.<sup>22</sup> Exchange-traded derivatives – such as futures, certain options,<sup>23</sup> and options on futures<sup>24</sup> – are standardized contracts traded on regulated exchanges, such as the Chicago Mercantile Exchange and the Chicago Board Options Exchange. OTC derivatives – such as swaps,<sup>25</sup> non-exchange traded

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<sup>21</sup> For example, the reference asset of a Standard & Poor's ("S&P") 500 futures contract is the S&P 500 index. 2008 IDC Report, *supra* note 3, at Appendix C at C5.

<sup>22</sup> *See, e.g.*, Robert W. Kolb & James A. Overdahl, *Financial Derivatives*, at 21 (2010) ("Kolb & Overdahl").

<sup>23</sup> An option is the right to buy or sell an asset. There are two basic types of options, a "call option" and a "put option." A call option gives the holder the right (but does not impose the obligation) to buy the underlying asset by a certain date for a certain price. The seller, or "writer," of a call option has the obligation to sell the underlying asset to the holder if the holder exercises the option. A put option gives the holder the right (but does not impose the obligation) to sell the underlying asset by a certain date for a certain price. The seller, or "writer," of a put option has the obligation to buy from the holder the underlying asset if the holder exercises the option. The price that the option holder must pay to exercise the option is known as the "exercise" or "strike" price. The amount that the option holder pays to purchase an option is known as the "option premium," "price," "cost," or "fair value" of the option. For a basic explanation of options, *see, e.g.*, Hull, *supra* note 3, at 6-8, 179-236, and Kolb & Overdahl, *supra* note 22, at 13-16.

<sup>24</sup> Options on futures generally trade on the same exchange as the relevant futures contract. When a call option on a futures contract is exercised, the holder acquires from the writer a long position in the underlying futures contract plus a cash amount equal to the excess of the futures price over the strike price. When a put option on a futures contract is exercised, the holder acquires a short position in the underlying futures contract plus a cash amount equal to the excess of the strike price over the futures price. *See, e.g.*, Hull, *supra* note 3, at 184, 341-54, and 782.

<sup>25</sup> A "swap" is generally an agreement between two counterparties to exchange periodic payments based upon the value or level of one or more rates, indices, assets, or interests of any kind. For example, counterparties may agree to exchange payments based on different currencies or interest rates. *See generally, e.g.*, Kolb & Overdahl, *supra* note 22, at 11-13; Hull, *supra* note 3, at 147-73. *See also* section 3(a)(69) of the Exchange Act for the definition of "swap" (using the definition in section 1a of the Commodity Exchange Act, 7 U.S.C. 1a (the "CEA")); section 3(a)(68) of the Exchange Act for the definition of "security-based swap;" section 721(a)(3) of the

options, and combination products such as swaptions<sup>26</sup> and forward swaps<sup>27</sup> – are contracts negotiated and entered into outside of an organized exchange. Unlike exchange-traded derivatives, OTC derivatives may be significantly customized, and may not be guaranteed by a central clearing organization. OTC derivatives that are not centrally cleared, therefore, may involve greater counterparty credit risk, and may be more difficult to value, transfer, or liquidate than exchange-traded derivatives.<sup>28</sup> The Dodd-Frank Act and Commission rules thereunder seek to establish a comprehensive new regulatory framework for two broad categories of derivatives – swaps and security-based swaps – designed to reduce risk, increase transparency, and promote market integrity within the financial system.<sup>29</sup>

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Dodd-Frank Act, *supra* note 2, for the definition of “cleared swap;” and section 721(a)(12) of the Dodd-Frank Act for the definition of “foreign exchange swap.” *See also Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, Securities Act Release No. 9204 (Apr. 29, 2011) [76 FR 29818 (May 23, 2011)] (“Swap Definition Release”), *available at* <http://www.sec.gov/rules/proposed/2011/33-9204.pdf>.

<sup>26</sup> A “swaption” is an option to enter into an interest rate swap where a specified fixed rate is exchanged for a floating rate. *See, e.g.,* Hull, *supra* note 3, at 172, 658-62, 790.

<sup>27</sup> A forward swap (or deferred swap) is an agreement to enter into a swap at some time in the future. *See* Swap Definition Release, *supra* note 25, at n. 147. *See also, e.g.,* Hull, *supra* note 3, at 171, 779 (“deferred swap”).

<sup>28</sup> An OTC derivative may be more difficult to transfer or liquidate than an exchange-traded derivative because, for example, an OTC derivative may provide contractually for non-transferability without the consent of the counterparty, or may be sufficiently customized that its value is difficult to establish or its terms too narrowly drawn to attract transferees willing to accept assignment of the contract, unlike most exchange-traded derivatives.

<sup>29</sup> The Dodd-Frank Act, *supra* note 2, was signed into law on July 21, 2010. The Dodd-Frank Act mandates, among other things, substantial changes in the OTC derivatives markets, including new clearing, reporting, and trade execution mandates for swaps and security-based swaps, and both exchange-traded and OTC derivatives are contemplated under the new regime. *See* Dodd-Frank Act sections 723 (mandating clearing of swaps) and 763 (mandating clearing of security-based swaps). Some of these changes will require Commission action through rulemaking to become effective. *See Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps*, Exchange Act Release No. 64678 (June 15, 2011) [76 FR 36287 (June 22, 2011)], *available at* <http://www.sec.gov/rules/exorders/2011/34-64678.pdf>. For summaries of other recent, pending, and future Commission and staff initiatives relating to derivatives, *see, e.g., Testimony on Enhanced Oversight after the Financial Crisis: The Wall Street Reform Act at One-*

A common characteristic of most derivatives is that they involve leverage.<sup>30</sup> Certain derivatives investments entered into by a fund, such as futures contracts, swaps, and written options, create obligations, or potential indebtedness, to someone other than the fund's shareholders, and enable the fund to participate in gains and losses on an amount that exceeds the fund's initial investment.<sup>31</sup> Other derivatives entered into by a fund, such as purchased call options, provide the economic equivalent of leverage because they convey the right to a gain or loss on an amount in excess of the fund's investment but do not impose a payment obligation on the fund above its initial investment.<sup>32</sup>

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*Year*, by Chairman Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, before the United States Senate Committee on Banking, Housing and Urban Affairs (July 21, 2011), available at <http://www.sec.gov/news/testimony/2011/ts072111mls.htm>. See also, e.g., <http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml#derivatives>; <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#07-12-12>; <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#08-12-11>; <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#01-06-12>; <http://www.sec.gov/news/press/2011/2011-137.htm>; <http://www.sec.gov/rules/other/2011/34-64926.pdf>; and <http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml>.

<sup>30</sup> The Commission has stated that “[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return.” Release 10666, *supra* note 10, at n. 5.

<sup>31</sup> The leverage created by such an arrangement is sometimes referred to as “indebtedness leverage.” 1994 Report, *supra* note 3, at 22.

<sup>32</sup> This type of leverage is sometimes referred to as “economic leverage.” See 1994 Report, *supra* note 3, at 23 (“Other derivatives provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations . . . such as changes in stock prices or interest rates. In essence, these derivatives magnify a fund’s gain or loss from an investment in much the same way that incurring indebtedness does.”). The 1994 Report gives a leveraged inverse floating rate bond, with an interest rate that moves inversely to a benchmark rate, as another example of an instrument that displays economic leverage. See also 2010 ABA Derivatives Report, *supra* note 8, at 20-21 (discussion of “implied” or “economic” leverage”). For additional discussion of the leveraging effects of derivatives (not limited to “economic leverage”), see 2010 ABA Derivatives Report, *supra* note 8, at 8-9. See also 2008 IDC Report, *supra* note 3, at 3 (“Market participants are able to acquire exposure (either long or short) to a large dollar amount of an asset (the notional value) with only a small down payment, enabling parties to shift risk more efficiently and with lower costs. The leverage inherent in these instruments magnifies the effect of changes in the value of the underlying asset on the initial amount of capital invested. For example, an initial 5% collateral deposit on the total value of the commodity would result in 20:1 leverage, with a potential 80% loss (or gain) of the collateral in

Funds use derivatives to implement their investment strategies, and to manage risk.<sup>33</sup> A fund may use derivatives to gain, maintain, or reduce exposure to a market, sector, or security more quickly and/or with lower transaction costs and portfolio disruption than investing directly through the securities markets. At the same time, use of derivatives may entail risks relating, for example, to leverage, illiquidity (particularly with respect to complex OTC derivatives), and counterparty risk, among others.<sup>34</sup> A fund's use of derivatives presents challenges for its investment adviser and board of 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 respect to some primary types of reference assets, funds may use derivatives for the following purposes, among others:

- Currency derivatives.<sup>35</sup> A fund may use currency derivatives to increase or decrease exposure to specific currencies, to hedge against adverse impacts on the

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response to a 4% movement in the market price of the underlying commodity.”).

<sup>33</sup> 2008 IDC Report, *supra* note 3, at 7-11. A fund may also use derivatives to hedge current portfolio exposures (for example, when a fund's portfolio is structured to reflect the fund's long-term investment strategy and its investment adviser's forecasts, interim events may cause the fund's investment adviser to seek to temporarily hedge a portion of the portfolio's broad market, sector, and/or security exposures). Industry participants believe that derivatives may also provide a more efficient hedging tool than reducing exposure by selling individual securities, offering greater liquidity, lower round-trip transaction costs, lower taxes, and reduced disruption to the portfolio's longer-term positioning. *See id.* at 11.

<sup>34</sup> *See, e.g.*, 2008 IDC Report, *supra* note 3, at 12-13. *See also* 2008 JPMorgan Article, *supra* note 6.

<sup>35</sup> *See* Swap Definition Release, *supra* note 25, at II.C.1, for a description of certain currency derivatives (foreign exchange swaps, foreign exchange forwards, foreign currency options, non-deliverable forwards, currency swaps, and cross-currency swaps). The 2010 ABA Derivatives Report, *supra* note 8 at 6-7, gives as examples of currency derivatives forward currency contracts, currency futures contracts, currency swaps, and options on currency futures contracts. As a general matter, futures, forwards, swaps, and options can all be used to increase or decrease exposures to reference currencies. A fund's investment adviser selects the particular instrument

fund's portfolio caused by currency fluctuations, and to seek additional returns. For example, currency derivatives can provide a hedge against the risk that a fund's investment in a foreign debt security will decline in value because of a decline in the value of the foreign currency in which the foreign debt security is denominated.<sup>36</sup> Funds also may use currency derivatives to hedge against a rise in the value of a foreign currency, or may use "cross-currency" hedging or "proxy" hedging when, for instance, it is difficult or expensive to hedge a particular currency against the U.S. dollar.<sup>37</sup> Apart from hedging, funds may use currency derivatives to seek returns on the basis of anticipated changes in the relative values of two currencies.<sup>38</sup>

- Interest rate derivatives.<sup>39</sup> A fund may use interest rate derivatives to modify its exposure to the gains or losses arising from changes in interest rates and to seek enhanced returns. For example, a fund may use an interest rate swap to hedge against the risk of a decline in the prices of bonds owned by a fund due to rising

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based on the level and type of exposure the adviser seeks to obtain and the costs that are associated with the particular instrument.

<sup>36</sup> For example, if a fund enters into a short currency forward (which obligates the fund to sell the currency at a future date, at a predetermined price, and in the currency in which the foreign debt security is denominated), the fund's exposure to a decline in the value of the currency is reduced. *See* 2010 ABA Derivatives Report, *supra* note 8, at 6.

<sup>37</sup> For example, a fund may use a forward contract on one foreign currency (or a basket of foreign currencies) to hedge against adverse changes in the value of another foreign currency (or basket of currencies). *See id.*

<sup>38</sup> *Id.* at 7.

<sup>39</sup> Interest rate derivatives include interest rate or bond futures, Eurodollar futures, caps, floors, overnight indexed swaps, interest rate swaps, and options on futures and swaps. *See, e.g., id.* *See also* Swap Definition Release, *supra* note 25, at III.B.1 (briefly describing interest and other monetary rate swaps, and discussing that when payments exchanged under a Title VII (of the Dodd-Frank Act) instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on securities, the instrument would be a swap but not a security-based swap.).

interest rates. Similarly, a fund could shorten the duration of its portfolio by selling futures contracts on U.S. Treasury bonds or notes, or Eurodollar futures. Apart from hedging, a fund might use interest rate derivatives to seek to enhance its returns based on its investment adviser's views concerning future movements in interest rates or changes in the shape of the yield curve.<sup>40</sup>

- Credit Derivatives.<sup>41</sup> Credit derivatives allow a fund to assume an investment position concerning the likelihood that a particular bond, or a group of bonds, will be repaid in full upon maturity. When a fund purchases credit protection, it pays a premium to a counterparty in return for which the counterparty promises to pay the fund if a bond or bonds default or experience some other adverse credit event. When a fund sells (or writes) credit protection, the fund agrees to pay a counterparty if a bond or bonds default or experience some other adverse credit event, in exchange for the receipt of a premium from the protection purchaser. A fund may purchase credit protection using credit derivatives to hedge against particular risks that are associated with a bond that it owns, such as the risk that the bond issuer will default, a rating agency will downgrade the bond or the credit of the counterparty, or the risk that credit "spread" will increase.<sup>42</sup> A fund may sell (or write) credit protection to enhance its income and return by the amount of

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<sup>40</sup> For example, if a fund's investment adviser believes that the London Interbank Offered Rate ("LIBOR") will decrease compared to a federal funds rate, the adviser could enter into an interest rate swap whereby the fund would be obligated to make payments based upon the application of LIBOR to an agreed notional amount in exchange for payments from the counterparty based upon the application of the federal funds rate to the notional amount. 2010 ABA Derivatives Report, *supra* note 8, at 7.

<sup>41</sup> Credit derivatives include single-name and index-linked (or basket) credit default swaps. *See, e.g., id.* at 7-8. For additional description of CDS, *see* Swap Definition Release, *supra* note 25, at III.G.3.

<sup>42</sup> *See* 2010 ABA Derivatives Report, *supra* note 8, at 7.



the payment that it receives for providing such protection, or to obtain some investment exposure to the reference asset (that is, the underlying bond), without owning the bond. The Commission understands that selling protection may be more cost effective than an outright purchase of a bond.<sup>43</sup>

- Equity Derivatives.<sup>44</sup> Funds may use equity derivatives to enhance investment opportunities (for example, by using foreign index futures to obtain exposure to a foreign equity market). Equity derivatives also can be used by funds as an income-producing strategy by, for example, selling equity call options on a particular security owned by the fund.<sup>45</sup> A fund also may use equity derivatives (usually stock index futures) to “equitize” cash.<sup>46</sup>

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<sup>43</sup> See *id.* at 8. The 2010 ABA Derivatives Report, *supra* note 8, at 8, also observes that “a fund could write a CDS, offering credit protection to its counterparty. In doing so the fund gains the economic equivalent of owning the security on which it wrote the CDS, while avoiding the transaction costs that would have been associated with the purchase of the security.”

<sup>44</sup> Equity derivatives include equity futures contracts, options on equity futures contracts, equity options, and various kinds of equity-related swaps (such as a total return swap on an equity security). See, e.g., *id.* at 8.

<sup>45</sup> By selling the options, a fund can earn income (in the form of the premium received for writing the option) while at the same time permitting the fund to sell the underlying equity securities at a targeted price set by the fund’s investment adviser. See, e.g., *id.*

<sup>46</sup> As an example of “equitizing” cash, the 2010 ABA Derivatives Report, *supra* note 8, at 8, states that:

[W]hen a fund has a large cash position for a short amount of time, the fund can acquire long futures contracts to retain (or gain) exposure to the relevant equity market. When the futures contracts are liquid (as is typically the case for broad market indices), the fund can eliminate the position quickly and frequently at lower costs than had the fund actually purchased the reference equity securities.

### **C. Request for Comment**

The Commission generally requests data and comment on the types of derivatives used by funds, the purposes for which funds use derivatives, and whether funds' use of derivatives has undergone or may be undergoing changes and, if so, the nature of such changes. The Commission specifically requests comment on the following:

- What are the costs and benefits to funds from the use of derivatives? What are the factors that influence those costs and benefits? What are the risks to funds from investing in derivatives? What role does or could collateral used in derivatives transactions play in mitigating the concerns relating to the use of derivatives? Please be specific and provide data or statistics, if possible.
- Do different types of funds use different types of derivatives or use derivatives for different purposes? If so, what are the differences in the types of funds that account for the differences in their use of derivatives? For example, do BDCs use derivatives in a manner different from other funds and, if so, how and what are the differences?
- How do ETFs use derivatives? Do they use derivatives for the same purposes that other open-end funds use them? Does an ETF's use of derivatives raise unique investor protection concerns under the Investment Company Act?

## **II. DERIVATIVES UNDER THE SENIOR SECURITIES RESTRICTIONS OF THE INVESTMENT COMPANY ACT**

In this section, the Commission discusses the limitations on senior securities imposed by section 18 of the Investment Company Act, summarizes related Commission and staff guidance, discusses certain alternative approaches, and highlights issues for comment.

## A. Purpose, Scope, and Application of the Act's Senior Securities Limitations

### 1. Statutory Restrictions on Senior Securities and Related Commission Guidance

The protection of investors against the potentially adverse effects of a fund's issuance of "senior securities"<sup>47</sup> is a core purpose of the Investment Company Act.<sup>48</sup> Congress' concerns underlying the limitations in section 18 included, among others: (i) potential abuse of the purchasers of senior securities;<sup>49</sup> (ii) excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities;<sup>50</sup> and (iii) funds operating without adequate assets and reserves.<sup>51</sup> To address these concerns, section 18(f)(1) of the Investment Company Act prohibits an open-end fund<sup>52</sup> from issuing or selling any "senior security" other than borrowing from a bank, and unless it maintains 300% "asset coverage."<sup>53</sup> Section 18(a)(1) of the Investment Company Act prohibits a closed-

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<sup>47</sup> Section 18(g) of the Investment Company Act defines "senior security," in part, as "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.

<sup>48</sup> See, e.g., Investment Company Act sections 1(b)(7), 1(b)(8), 18(a), and 18(f). See also, e.g., 1994 Report, *supra* note 3, at 20-22.

<sup>49</sup> See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency, 76<sup>th</sup> Cong., 3d Sess., pt. 1, 265-78 (1940) ("Senate Hearings"). See also 1994 Report, *supra* note 3, at 21 (describing the practices in the 1920s and 1930s that gave rise to section 18's limitations on leverage, and specifically discussing the potential abuse of senior security holders).

<sup>50</sup> See section 1(b)(7) of the Investment Company Act. See also, e.g., Release 10666, *supra* note 10, at n. 8.

<sup>51</sup> See section 1(b)(8) of the Investment Company Act; Release 10666, *supra* note 10, at n. 8.

<sup>52</sup> Section 5(a)(1) of the Investment Company Act defines "open-end company" as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."

<sup>53</sup> "Asset coverage" of a class of securities representing indebtedness of an issuer generally is defined in section 18(h) of the Investment Company Act as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities,

end fund<sup>54</sup> from issuing or selling any “senior security that represents an indebtedness” unless it has at least 300% “asset coverage.”<sup>55</sup>

In a 1979 General Statement of Policy (Release 10666), the Commission considered the application of section 18’s restrictions on the issuance of senior securities to reverse repurchase agreements, firm commitment agreements, and standby commitment agreements.<sup>56</sup> The Commission concluded that such agreements, while not securities for all purposes,<sup>57</sup> may involve the issuance of senior securities and “fall within the functional meaning of the term ‘evidence of

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bears to the aggregate amount of senior securities representing indebtedness of such issuer.”

<sup>54</sup> Section 5(a)(2) of the Investment Company Act defines “closed-end company” as “any management company other than an open-end company.”

<sup>55</sup> Section 18(a)(1)(A). A BDC is also subject to the limitations of section 18(a)(1)(A) to the same extent as if it were a closed-end investment company except that the applicable asset coverage amount is 200%. *See* Investment Company Act section 61(a)(1).

<sup>56</sup> As described in Release 10666, *supra* note 10, in a typical reverse repurchase agreement, the fund transfers possession of a debt security, often to a broker-dealer or a bank, in return for a percentage of the market value of the security (“proceeds”), but retains record ownership of, and the right to receive interest and principal payments on, the security. At a stated future date, the fund repurchases the security and remits to the counterparty the proceeds plus interest. *Id.* at nn. 2-3 and accompanying text. A firm commitment agreement (also known as a “when-issued security” or a “forward contract”) is a buy order for delayed delivery in which a fund agrees to purchase a debt security from a seller (usually a broker-dealer) at a stated future date, price, and fixed yield. *Id.* at text accompanying n. 12. A standby commitment agreement is a delayed delivery agreement in which a fund contractually binds itself to accept delivery of a debt security with a stated price and fixed yield upon the exercise of an option held by the counterparty to the agreement at a stated future date. *Id.* at discussion of “Standby Commitment Agreements.”

<sup>57</sup> Release 10666, *supra* note 10, at “The Agreements as Securities” discussion. The Commission notes, however, that the Investment Company Act’s definition of the term “security” is broader than the term’s definition in other federal securities laws. *Compare* section 2(a)(36) of the Investment Company Act with sections 2(a)(1) and 2A of the Securities Act and sections 3(a)(10) and 3A of the Exchange Act. For example, the definition of “security” in the Investment Company Act includes any “evidence of indebtedness,” which is not included in the definition of “security” in section 3(a)(10) of the Exchange Act. Further, the Commission has interpreted the term “security” in light of the policies and purposes underlying the Act. For example, the brief for the United States as Amicus Curiae in *Marine Bank v. Weaver*, No. 80-1562, 1980 U.S. Briefs 1562 (Oct. Term, 1980) (July 29, 1981) (“*Marine Bank v. Weaver* Amicus Brief”) stated that the issue of whether a particular instrument is a “security” depends on the context, including the statute being applied, and further stated that the Investment Company Act “presents a significantly different context” (*i.e.*, the regulation of the operation and management of investment companies) than the context of the Securities Act and the Exchange Act (*i.e.*, the issuance or trading of such securities). *Marine Bank v. Weaver* Amicus Brief at 38, 40.

indebtedness' for purposes of section 18 of the Act," which generally would include "all contractual obligations to pay in the future for consideration presently received."<sup>58</sup> Further, the Commission stated that "trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18."<sup>59</sup> The Commission also explained that:

[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a r eturn.... Through a reverse repurchase agreement, an investment company can achieve a return on a very large capital base relative to its cash contribution. T herefore, the reverse repurchase agreement is a highly leveraged transaction.<sup>60</sup>

Leveraging of a fund's portfolio through the issuance of senior securities "magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities."<sup>61</sup> Each of the agreements discussed by the Commission in Release 10666 – the reverse repurchase agreement, the firm commitment agreement, and the standby commitment agreement – "may be a substantially higher risk investment" than direct investment in the underlying securities "because of the additional risk of loss created by the substantial leveraging in each agreement, and in light of the volatility of interest rates in the marketplace."<sup>62</sup>

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<sup>58</sup> Release 10666, *supra* note 10, at "The Agreements as Securities" discussion.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at n. 5 (citation omitted).

<sup>61</sup> *Id.* at text accompanying n. 5.

<sup>62</sup> *Id.* at discussion of "The Agreements as Securities." The Commission also stated that, "[t]he gains and losses from the transactions can be extremely large relative to invested capital; for this reason, each agreement has speculative aspects. Therefore, it would appear that the independent investment decisions involved in entering into such agreements, which focus on their distinct risk/return characteristics, indicate that, economically as well as legally, the agreements should be treated as securities separate from the underlying Ginnie Maes for purposes of Section 18 of the

In Release 10666, the Commission further stated that, although reverse repurchase agreements, firm commitment agreements, and standby commitment agreements are functionally equivalent to senior securities, these and similar arrangements nonetheless could be used by funds in a manner that would not warrant application of the section 18 restrictions. The Commission noted that in circumstances involving similar economic effects, such as short sales of securities by funds, our staff had determined that the issue of section 18 compliance would not be raised if funds “cover” senior securities by maintaining “segregated accounts.”<sup>63</sup> The Commission stated that the use of segregated accounts “if properly created and maintained, would limit the investment company’s risk of loss.”<sup>64</sup> To avail itself of the segregated account approach, a fund could establish and maintain with the fund’s custodian a segregated account containing liquid assets, such as cash, U.S. government securities, or other appropriate high-grade debt obligations, equal to the indebtedness incurred by the fund in connection with the senior security (“segregated account approach”).<sup>65</sup> The amount of assets to be segregated with respect to reverse repurchase agreements lacking a specified repurchase price would be the value of the proceeds received plus accrued interest; for reverse repurchase agreements with a specified repurchase price, the amount of assets to be segregated would be the repurchase price; and for firm and standby commitment agreements, the amount of assets to be segregated would

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Act.” *Id.*

<sup>63</sup> Release 10666, *supra* note 10, at text accompanying n. 15.

<sup>64</sup> *Id.* at discussion of “Segregated Account.”

<sup>65</sup> The Commission stated that, under the segregated account approach, the value of the assets in the segregated account should be marked to the market daily, additional assets should be placed in the segregated account whenever the total value of the account falls below the amount of the fund’s obligation, and assets in the segregated account should be deemed frozen and unavailable for sale or other disposition. *See id.* The Commission also cautioned that as the percentage of a fund’s portfolio assets that are segregated increases, the fund’s ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with stated its investment objective may become impaired. *Id.*

be the purchase price.<sup>66</sup> As the Commission stated in Release 10666, the segregated account functions as “a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock,” and “will assure the availability of adequate funds to meet the obligations arising from such activities.”<sup>67</sup>

## **2. Staff No-Action Letters Concerning the Segregated Account Approach<sup>68</sup>**

Following the Commission’s issuance of Release 10666, the Commission staff issued more than twenty no-action letters to funds concerning the maintenance of segregated accounts or otherwise “covering” their obligations in connection with certain senior securities, primarily interest rate futures, stock index futures, and related options.<sup>69</sup>

In a 1987 no-action letter issued to two Dreyfus funds, the staff summarized and expanded upon the methods by which, in its view, obligations could be covered by funds

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<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> This release includes extensive discussion of staff no-action letters; accordingly the Commission notes that its discussion of staff statements is provided solely for background and to facilitate comment on issues that the Commission might address. The discussion is in no way intended to suggest that the Commission has adopted the analysis, conclusions or any other portion of the staff statements discussed here. Staff no-action letters are issued by the Commission staff in response to written requests regarding the application of the federal securities laws to proposed transactions. Many of the staff no-action letters are “enforcement-only” letters, in which the staff states whether it will recommend enforcement action to the Commission if the proposed transaction proceeds in accordance with the facts, circumstances and representations set forth in the requester’s letter. Other staff no-action letters provide the staff’s interpretation of a specific statute, rule or regulation in the context of a specific situation. *See Informal Guidance Program for Small Entities*, Investment Company Act Release No. 22587 (Mar. 27, 1997).

<sup>69</sup> *See* “No-Action Letters and Releases from 1982–1985 Regarding Covering Futures and Options” at Senior Security Bibliography, *supra* note 10. (Certain of these letters also addressed the use of when-issued bonds, currency forwards, and other senior securities.)

transacting in futures, forwards, written options, and short sales.<sup>70</sup> The staff provided no-action assurance that the Dreyfus funds could:

- cover a long position in a futures or forward contract, or a written put option, by establishing a segregated account (not with a futures commission merchant or broker) containing cash or certain liquid assets equal to the purchase price of the contract or the strike price of the put option (less any margin on deposit); and
- cover short positions in futures or forward contracts, sales of call options, and short sales of securities by establishing a segregated account (not with a futures commission merchant or broker) with cash or certain liquid assets that, when added to the amounts deposited with a futures commission merchant or a broker as margin, equal the market value of the instruments or currency underlying the futures or forward contracts, call options, and short sales (but are not less than the strike price of the call option or the market price at which the short positions or short sales were established).<sup>71</sup>

The staff also provided no-action assurance that the Dreyfus funds could cover these transactions by owning, or holding the right to obtain, the instrument or cash that the fund has obligated itself to deliver. For example:

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<sup>70</sup> Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987) (“Dreyfus no-action letter” or “Dreyfus Letter”), *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

<sup>71</sup> *But see* Robertson Stephens Investment Trust, SEC Staff No-Action Letter (Aug. 24, 1995), *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm> (the staff agreed not to recommend enforcement action where the value of the segregated account, to cover a short position in a security, was equal to the daily (fluctuating) market price of the security sold short (less certain amounts pledged with the broker as collateral), even if the value of the segregated account was less than the price at which the short position was established).



- a fund could cover a long position in a futures or forward contract by purchasing a put option on the same futures or forward contract with a strike price as high or higher than the price of the contract held by the fund; and
- a fund could cover a written put option by selling short the instruments or currency underlying the put option at the same or higher price than the strike price of the put option or, alternatively, by purchasing a put option with the strike price the same or higher than the strike price of the put option written by the fund.

The Commission staff has also discussed the types of assets that may be segregated and the manner in which, in the staff's view, segregation may be effected. In Release 10666, the Commission stated that the assets eligible to be included in segregated accounts should be "liquid assets," such as cash, U.S. government securities, or other appropriate high grade debt obligations. In a 1996 staff no-action letter issued to Merrill Lynch Asset Management, the staff took the position that a fund could cover its derivatives-related obligations by depositing any liquid asset, including equity securities and non-investment grade debt securities, in a segregated account.<sup>72</sup> In the Merrill Lynch no-action letter, the staff explained that, in the staff's view, segregating any type of liquid asset would be consistent with the purposes underlying the asset segregation approach because it would place a practical limit on the amount of leverage that a fund may undertake and on the potential increase in the speculative character of its outstanding shares.<sup>73</sup> With respect to the manner in which segregation may be effected, the Commission staff

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<sup>72</sup> Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) ("Merrill Lynch no-action letter" or "Merrill Lynch Letter"), *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

<sup>73</sup> *Id.* The staff noted that "the type of asset placed in the segregated account would have no effect on the maximum amount of leverage that a fund can assume."

took the position that a fund could segregate assets by designating such assets on its books, rather than establishing a segregated account at its custodian.<sup>74</sup>

Asset segregation practices with respect to other derivatives investments have not been addressed by the Commission, or by the staff in no-action letters.<sup>75</sup> Certain swaps, for example, that settle in cash on a net basis, appear to be treated by many funds as requiring segregation of an amount of assets equal to the fund's daily mark-to-market liability, if any.<sup>76</sup> Similarly, some funds have disclosed that they segregate only their daily, mark-to-market liability, if any, with respect to futures and forward contracts that are contractually required to cash-settle.<sup>77</sup>

## **B. Alternative Approaches to the Regulation of Portfolio Leverage**

### **1. The Current Asset Segregation Approach**

As noted above, the segregated account approach serves both to limit a fund's potential leverage and to provide a source of payment of future obligations arising from the leveraged transaction. In determining the amount of assets required to be segregated to cover a particular instrument, the Commission and its staff have generally looked to the purchase or exercise price of the contract (less margin on deposit) for long positions and the market value of the security or other asset underlying the agreement for short positions, measured by the full amount of the

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<sup>74</sup> See Dear Chief Financial Officer Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (Nov. 7, 1997), *available at* <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

<sup>75</sup> Our discussion of current and past industry practices is not intended to indicate any Commission approval or disapproval of those practices.

<sup>76</sup> See, e.g., 2010 ABA Derivatives Report, *supra* note 8, at 13-14.

<sup>77</sup> For a discussion of asset segregation practices involving futures and forwards that are contractually required to cash-settle, see, e.g., *id.* at 14-15.

reference asset, *i.e.*, the notional amount of the transaction rather than the unrealized gain or loss on the transaction, *i.e.*, its current mark-to-market value.<sup>78</sup>

The segregated account approach has drawn criticism on several grounds. For example, we understand that some industry participants argue that the segregated account approach calls for an instrument-by-instrument assessment of the amount of cover required, further arguing that this may create uncertainty about the treatment of new products, and that new product development will inevitably lead to circumstances in which available guidance does not specifically address each new instrument subject to section 18 constraints. Other industry participants have argued that the staff's application of the segregated account approach results in differing treatment of arguably equivalent products.<sup>79</sup>

Others have argued that, with respect to the amount to be segregated, both notional amount and a mark-to-market amount have their limitations.<sup>80</sup> For example, for many futures contracts, the notional amount may, as a practical matter, exceed the maximum loss or total risk

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<sup>78</sup> See Release 10666, *supra* note 10, at discussion of “Segregated Account” (with regard to each reverse repurchase agreement that lacks a specified repurchase price, the fund should maintain in a segregated account “liquid assets equal in value to the proceeds received on any sale subject to repurchase plus accrued interest. If the reverse repurchase agreement has a specified repurchase price, the investment company should maintain in the segregated account an amount equal to the repurchase price, which price will already include interest charges.” With regard to each firm commitment agreement, the fund should maintain in a segregated account “liquid assets equal in value to the purchase price due on the settlement date under the . . . agreement.” With regard to each standby commitment agreement, the fund should maintain in a segregated account “liquid assets equal in value to the purchase price under the . . . agreement.”).

<sup>79</sup> They argue, for example, that a physically-settled and a cash-settled future or forward are equivalent products, and that segregation of the delivery obligation amount for a physically-settled future or forward, and segregation of the generally smaller mark-to-market liability amount for a cash-settled future or forward, constitutes different treatment of equivalent products. See the 2010 ABA Derivatives Report, *supra* note 8, at 14-15 for a discussion of cash-settled futures and forwards and the asset segregation treatment of those products.

<sup>80</sup> *Id.* at 16-17.

on the contract.<sup>81</sup> Consequently, it is argued with respect to such derivatives that segregation of assets equal to the notional amount may limit the use of such derivative products and strategies that could potentially benefit funds and their investors. Conversely, it is argued that segregation of an amount equal to only the daily, mark-to-market liability, if any, with respect to cash-settled derivatives,<sup>82</sup> may fail to take into account potential future losses on such instruments.

Consequently, it is argued that segregation of this amount may understate the risk of loss to the fund, permit the fund to engage in excessive leveraging, fail to adequately set aside sufficient assets to cover the fund's ultimate exposure, and, therefore, perhaps not adequately fulfill the purposes underlying the segregated account approach and section 18.<sup>83</sup>

The significant disparity between these two widely recognized measures – notional amount and mark-to-market amount – is illustrated by data relevant to actual swap positions held by funds. A recent study of the use of credit default swaps (“CDS”) by a group of the 100 largest US corporate bond funds analyzed data relevant to the notional amount and “book value,” *i.e.*, unrealized gains and losses, of the funds' CDS positions during the period 2004 through

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<sup>81</sup> See BIS Guide, *supra* note 18, at 30, commenting in the context of OTC derivatives that “[n]ominal or notional amounts outstanding provide a measure of market size and a reference from which contractual payments are determined in derivatives markets. However, with the partial exception of credit default swaps, such amounts are generally not those truly at risk. The amounts at risk in derivatives contracts are a function of the price level and/or volatility of the financial reference index used in the determination of contract payments, the duration and liquidity of contracts and the creditworthiness of counterparties.”

<sup>82</sup> This is also a concern with respect to the coverage of short sales.

<sup>83</sup> See 2010 ABA Derivatives Report, *supra* note 8, at 15 (“reducing the amount of assets subject to segregation increased the practical ability of funds to engage in derivatives on an increasing scale”), and at 16 (where only the mark-to-market liability, if any, is segregated, “a fund’s exposure under a derivative contract could increase significantly on an intraday basis, resulting in the segregated assets being worth less than the fund’s obligations (until the fund is able to place additional assets in the segregated account . . . ). To the extent that a fund relying on the Merrill Lynch Letter segregates assets whose prices are somewhat volatile, this ‘shortfall’ could be magnified.”).

2008.<sup>84</sup> Among the 65 funds in the sample group that used CDS sometime between 2004 and 2008, the total notional amount of CDS positions increased from an average of \$103 million per fund in 2004 to an average of \$632 million in 2008. The mean total notional amount of a fund's CDS positions relative to its net asset value ("NAV") increased from 2% to almost 14%.<sup>85</sup> At three funds, the notional amounts of CDS positions held in 2008 exceeded those funds' NAVs. During the same period, reported CDS book losses (*i.e.*, unrealized losses) remained, on average, less than 1% of a fund's NAV.<sup>86</sup>

Critics of the notional and mark-to-market standards often advocate use of a more complex analysis of the risk of a fund's investments, including its derivatives positions, such as Value at Risk ("VaR") or another methodology for assessing the probability of portfolio losses.<sup>87</sup> VaR and other alternative approaches are discussed in the following section.

## 2. Other Approaches

The 2010 ABA Derivatives Report observed that the "the basic framework as articulated in Release 10666 has worked very well" as applied to funds' derivatives investments,<sup>88</sup> but "there are open issues and inconsistencies in the current [Commission] and staff guidance

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<sup>84</sup> Adam and Guettler Article, *supra* note 7.

<sup>85</sup> *Id.* at 12.

<sup>86</sup> *Id.* at 13.

<sup>87</sup> See, e.g., 2010 ABA Derivatives Report, *supra* note 8, at 18. As discussed *infra*, some non-U.S. regulatory schemes have incorporated VaR or comparable methodologies in their approach to derivatives. See, e.g., *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, Committee of European Securities Regulators (July 28, 2010) ("CESR's Global Exposure Guidelines"), available at <http://www.esma.europa.eu/popup2.php?id=7000>. See also Henry T.C. Hu, *The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model*, 60 BUS. LAW. 1303 (2005) (advocating disclosure by funds of VaR data). We note that the Commission has permitted VaR to be used by certain registrants in other circumstances. For example, the Commission permits certain registered broker-dealers to use VaR models to compute net capital charges. See, e.g., Exchange Act rule 15c3-1f.

<sup>88</sup> 2010 ABA Derivatives Report, *supra* note 8, at 16.

regarding the application of Section 18 of the 1940 Act to transactions in derivatives.”<sup>89</sup>

Accordingly, the 2010 ABA Derivatives Report states that the Commission “should issue revised guidance in this area, which would set forth an approach to segregation that would cover all types of derivative instruments in a comprehensive manner.”<sup>90</sup> The 2010 ABA Derivatives Report, however, considers comprehensive guidance unlikely to be achievable, given that any generalized approach will likely fail to take into account significant variations in individual transactions. Consequently, in lieu of comprehensive guidance concerning the asset segregation approach, the 2010 ABA Derivatives Report proposes an alternative approach pursuant to which individual funds would establish their own asset segregation standards for derivative instruments that involve leverage within the meaning of Release 10666. Under this approach, each fund would be required to adopt policies and procedures that would include, among other things, minimum asset segregation requirements for each type of derivative instrument, taking into account relevant factors such as the specific context of the transaction. In developing these standards, fund investment advisers could take into account a variety of risk measures, including VaR and other quantitative measures of portfolio risk, and would not be limited to the notional amount or mark-to-market standards. These minimum “Risk Adjusted Segregated Amounts” would be reflected in policies and procedures that would be subject to approval by the fund’s board of directors and disclosed (including the principles underlying the Risk Adjusted Segregated Amounts for different types of derivatives) in the fund’s statement of additional information.<sup>91</sup>

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<sup>89</sup> *Id.* at 15.

<sup>90</sup> *Id.* at 17.

<sup>91</sup> *Id.* at 18.

The challenge of designing a regulatory standard by which leverage can be measured and limited effectively also has drawn the attention of regulators in jurisdictions around the globe. Internationally, limitations on leveraged exposure take a variety of forms, including maximum exposure limitations, asset segregation requirements, and other measures. In the context of maximum exposure or leverage limitations, the notional or principal amount of the reference asset underlying the derivative has commonly been used as a conservative measure of the exposure created by derivatives. In addition to limitations on aggregate positions or leveraged exposure, some regulatory frameworks include restrictions on concentrated exposures to individual counterparties and some provide for specialized funds that may assume derivatives exposure exceeding otherwise applicable limits.

The Committee of European Securities Regulators (“CESR”) (which, as of January 1, 2011, became the European Securities and Markets Authority, or “ESMA”), conducted an extensive review and consultation concerning exposure measures for derivatives used by Undertakings for Collective Investment in Transferable Securities (“UCITS”), investment vehicles authorized for sale to retail investors. In 2010, CESR’s Global Exposure Guidelines for UCITS were issued,<sup>92</sup> addressing implementation of the European Commission’s 2009 revised UCITS Directive.<sup>93</sup> Under the revised UCITS Directive, UCITS are permitted to engage in derivatives investments subject to a “global exposure” limitation, under which the derivatives

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<sup>92</sup> See *supra* note 87. In order for CESR’s Global Exposure Guidelines to be binding and operational in a particular EU Member State, the Member State must adopt them. To date, it appears that a few EU Member States, *e.g.*, Ireland and Luxembourg, have adopted them.

<sup>93</sup> See Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities (“2009 Directive”), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF>.

exposure of a UCITS may not exceed the total net value of the UCITS' portfolio.<sup>94</sup> CESR's Global Exposure Guidelines extensively address the calculation of derivatives exposure under the "global exposure" limit and define two permissible, alternative methods for this purpose: (i) the "commitment" approach; and (ii) the advanced risk measurement method to measure maximum potential loss, such as the VaR approach.<sup>95</sup>

The commitment approach is a method for standard derivatives that uses the market value of the equivalent position in the underlying asset but may be "replaced by the notional value or the price of the futures contract where this is more conservative."<sup>96</sup> CESR's Global Exposure Guidelines incorporates a schedule of derivative investments and their corresponding conversion methods to be used in calculating global exposure.<sup>97</sup> The conversion method to be used depends on the derivative.<sup>98</sup>

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<sup>94</sup> *Id.* at Article 51(3) at 62 ("The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions").

<sup>95</sup> *See* CESR's Global Exposure Guidelines, *supra* note 87. The CESR's Global Exposure Guidelines note that the "use of a commitment approach or VaR approach or any other methodology to calculate global exposure does not exempt UCITS from the requirement to establish appropriate internal risk management measures and limits." *Id.* at 5. In addition, with respect to the selection of the methodology used to measure global exposure, CESR's Global Exposure Guidelines note that the "commitment approach should not be applied to UCITS using, to a large extent and in a systematic way, financial derivative instruments as part of complex investment strategies." *Id.* at 6.

<sup>96</sup> *See id.* at 7.

<sup>97</sup> *See id.* at 7-12.

<sup>98</sup> *Id.* at 8. For example, for bond futures, the applicable conversion method is the number of contracts multiplied by the notional contract size multiplied by the market price of the cheapest-to-deliver reference bond. For plain vanilla fixed/floating interest rate and inflation swaps, the applicable conversion method is the market value of the underlier (though the notional value of the fixed leg may also be applied). *Id.* For foreign exchange forwards, the prescribed conversion method is the notional value of the currency leg(s). *Id.* at 9. With respect to non-standard derivatives, where it is not possible to convert the derivative into the market value or notional value of the equivalent underlying asset, CESR's Global Exposure Guidelines note that "an alternative approach may be used provided that the total amount of the derivatives represent a negligible portion of the UCITS portfolio." *Id.* at 7.



The second method is VaR or a comparably sophisticated risk measurement method, designed to measure the maximum potential loss due to market risk rather than leverage.<sup>99</sup> When using the VaR approach to calculate global exposure, either the relative VaR approach or the absolute VaR approach may be used.<sup>100</sup> Under the relative VaR approach, the VaR of the portfolio cannot be greater than twice the VaR of an unleveraged reference portfolio.<sup>101</sup> The absolute VaR approach limits the maximum VaR that a UCITS can have relative to its NAV, and as a general matter, the absolute VaR is limited to 20 percent of the UCITS NAV.<sup>102</sup>

In addition to the global exposure limitation, CESR's Global Exposure Guidelines subject UCITS to "cover rules" for investments in financial derivatives.<sup>103</sup> Under these cover rules, UCITS should, at any given time, be capable of meeting all its payment and delivery obligations incurred by financial derivatives' investments, and cover should form part of the UCITS' risk management process.<sup>104</sup> More specifically, in the case of a derivative that provides, automatically or at the counterparty's choice, for physical delivery of the underlier, the UCITS should hold: (i) the underlier in its portfolio, or, if the underlier is deemed to be sufficiently

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<sup>99</sup> *Id.* at 22 ("More particularly, the VaR approach measures the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions.")

<sup>100</sup> *Id.* at 23. A global exposure calculation using the VaR approach should consider all the positions in the UCITS' portfolio. *Id.* at 22. The VaR approach measures the probability of risk of loss rather than the amount of leverage in portfolio. *Id.* at 22. The absolute VaR of a UCITS cannot be greater than 20% of its NAV. *Id.* at 26. For both VaR approaches, the calculation must have a "one-tailed confidence interval of 99%," a holding period of one month (20 business days), an observation period of risk factors of at least one year (unless a shorter observation period is justified by a significant increase in price volatility), at least quarterly updates, and at least daily calculation. *Id.* at 26. UCITS employing the VaR approach are required to conduct a "rigorous, comprehensive and risk-adequate stress testing program." *Id.* at 30-34.

<sup>101</sup> CESR's Global Exposure Guidelines note that the relative VaR approach does not measure leverage of the UCITS' strategies but instead allows the UCITS to double the risk of loss under a given VaR model. *Id.* at 24.

<sup>102</sup> *Id.* at 25-26.

<sup>103</sup> *Id.* at 40.

<sup>104</sup> *Id.*

liquid, (ii) cash or other liquid assets on the condition that these other assets (after applying appropriate haircuts), held in sufficient quantities, may be used at any time to acquire the underlier that is to be delivered.<sup>105</sup> In the case of a derivative that provides, automatically or at the UCITS's choice, for cash settlement, the UCITS should hold enough liquid assets after appropriate haircuts to allow the UCITS to make the contractually required payments.<sup>106</sup>

Singapore has adopted a bifurcated approach similar to that applicable under CESR's Global Exposure Guidelines for UCITS. The Monetary Authority of Singapore (the "MAS") requires that the risks of derivatives used by investment companies are "duly measured, monitored and managed on an ongoing basis."<sup>107</sup> An investment company's exposure to derivatives is limited to 100% of its NAV, and global exposure is calculated using the commitment approach as the default method. Under the commitment approach, which is similar to the commitment approach in CESR's Global Exposure Guidelines, global exposure is calculated by converting the investment company's derivatives positions into equivalent positions in the underlying assets and then is quantified as the sum of the absolute values of the individual positions.<sup>108</sup> The investment company's exposure to the counterparty of an OTC

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<sup>105</sup> *Id.*

<sup>106</sup> *Id.* On April 14, 2011, ESMA published a final report on the guidelines on risk measurement and the calculation of the global exposure for certain types of structured UCITS. *See Guidelines to Competent Authorities and UCITS Management Companies on Risk Measurement and the Calculation of Global Exposure for Certain Types of Structured UCITS* (final report) (Apr. 14, 2011) (ref.: ESMA/2011/112), available at <http://www.esma.europa.eu/popup2.php?id=7542> (these guidelines, which will need to be adopted and implemented by Member States, propose for certain types of structured UCITS, an optional regime for the calculation of the global exposure).

<sup>107</sup> The Monetary Authority of Singapore, *Code on Collective Investment Schemes*, Chapter 3, section 3.1(f) (April 2011) at 7, available at [http://www.mas.gov.sg/resource/legislation\\_guidelines/securities\\_futures/sub\\_legislation/110408%20Revised%20Code\\_8%20April\\_final.pdf](http://www.mas.gov.sg/resource/legislation_guidelines/securities_futures/sub_legislation/110408%20Revised%20Code_8%20April_final.pdf).

<sup>108</sup> MAS allows for the use of a VaR approach, with prior approval and submission of specific information on the investment company manager's risk management process. *Id.* at Appendix 1, section 3.2(b).

derivative is limited to 10% of its NAV and is measured on a maximum potential loss basis that may be incurred by the investment company if the counterparty defaults.<sup>109</sup> Cash or money market instruments and bonds issued by a government with a rating of AAA may be tendered as collateral to reduce counterparty exposure.<sup>110</sup>

Other jurisdictions have adopted approaches to investment companies' use of derivatives that limit aggregate exposure and/or require maintaining liquid assets equal to the notional or "exercise" value of derivatives contracts. For example, the Central Bank of Ireland, in addressing non-UCITS investment companies offered to the public generally, has issued guidelines that provide standards analogous to a 'notional amount' or commitment approach and generally limits the maximum potential exposure to 25% of the investment company's NAV.<sup>111</sup> Separately, the Central Bank of Ireland permits the use of techniques and instruments by investment companies for the purposes of "efficient portfolio management," subject to certain conditions. These include a requirement that an investment company selling a futures contract must own the security that is the subject of the contract. Alternatively, the investment company's assets, or a proportion of its assets at least equal to the exercise value of the futures contracts sold, must reasonably be expected to behave in terms of price movement in the same manner as the futures contract.<sup>112</sup>

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<sup>109</sup> *Id.* at Appendix 1, sections 5.2 and 5.4.

<sup>110</sup> *Id.* at Appendix 1, sections 5.7 and 5.8.

<sup>111</sup> Central Bank of Ireland, NU SERIES OF NOTICES: *Conditions Imposed in Relation to Collective Investment Schemes Other than UCITS* (July 2011) at 13.12, available at <http://www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Documents/Non%20UCITS%20Notices.pdf>

<sup>112</sup> *Id.* at 16.10. In addition, certain requirements are imposed on the use of OTC derivatives. *Id.* at 16.10.

A similar approach is followed by the Canadian Securities Administrators, which permits investment companies sold to the general public to use derivatives for hedging and non-hedging purposes but limits the derivatives exposure and requires certain “cash cover” intended to limit leverage.<sup>113</sup> For example, an investment company may enter into a swap if, among other things, the investment company holds cash cover in an amount that, together with margin on account for the swap and the market value of the swap, is not less than the underlying market exposure of the swap.<sup>114</sup>

The Hong Kong Securities and Futures Commission (the “SFC”) applies a differentiated approach, limiting investment companies generally to the use of derivatives for non-hedging positions that are capped at 15% of NAV for options and warrants and 20% for futures.<sup>115</sup> For investment companies that may acquire financial derivative instruments extensively for investment purposes, the investment companies’ global exposure relating to the financial derivative instruments should not exceed 100% of the total net asset value of the investment companies. For purposes of calculating global exposure, investment companies must use the commitment approach. This approach requires that derivative positions be converted into the

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<sup>113</sup> National Instrument 81-102 *Mutual Funds* (Jan. 2011) at sections 2.7 and 2.8, available at <http://www.bsc.bc.ca/uploadedFiles/securitieslaw/policy8/81-102%20Mutual%20Funds%20%5BNI%5D%20Jan-1-11.pdf>. In addition, for periods when the investment company would be required to make payments under the swap, the investment company is required to hold an equivalent quantity of the reference asset of the swap, a right or obligation to acquire an equivalent quantity of the reference asset of the swap and cash cover that, together with the margin on account for the swap, have a value at least equal to the aggregate amount of the obligations of the investment company under the swap, or a combination of the positions, without recourse to other assets of the investment company, to enable it to satisfy its obligations under the swap. *Id.* at sections 2.7 and 2.8.

<sup>114</sup> *Id.* at section 2.8.

<sup>115</sup> Hong Kong Securities and Futures Commission, *Code on Unit Trusts and Mutual Funds* (June 2010), Chapter 7, available at [http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng\\_UT.pdf](http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_UT.pdf). See also Hong Kong Securities and Futures Commission *Handbook for Unit Trusts and Mutual Funds*, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products.

equivalent position in the underlying assets of the derivative, taking into account the prevailing value of the underlying assets, counterparty risk, futures market movements, and the time available to liquidate the positions. There are also requirements for: (a) the over-the-counter derivative counterparties (or their guarantors, if applicable) of these investment companies to be substantial financial institutions (as defined in the Code on Unit Trusts and Mutual Funds); (b) the net exposure for these investment companies to a single over-the-counter derivative counterparty to be no greater than 10% of NAV; and (c) the acceptability criteria of collateral as provided by the over-the-counter derivative counterparties.<sup>116</sup>

### **C. Request for Comment**

The Commission requests comment concerning the current approach to the application of the senior securities limitations of section 18 of the Act to funds' use of derivatives. The Commission seeks views concerning the appropriateness and effectiveness of the asset

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<sup>116</sup> Hong Kong Securities and Futures Commission, *Code on Unit Trusts and Mutual Funds* (June 2010), Chapter 8, *available at* [http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng\\_UT.pdf](http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_UT.pdf). Other requirements include a restriction on premium paid to acquire identical options exceeding 5% of the NAV of the investment company, open positions in any futures contract month or option series may not be held if the combined margin requirement represents 5% or more of the NAV of the investment company, and the investment company may not hold open positions in futures or options contracts concerning a single commodity or a single underlying financial instrument for which the combined margin requirement represents 20% or more of the NAV of the investment company. *Id.*

Futures and options investments companies are subject to still different requirements, including that at least 30% of the investment company's NAV be held on deposit in short-term debt instruments and may not be used for margin requirements and no more than 70% of the NAV of the investment company may be committed as margin for futures or option contracts and/or premium paid for options purchased. Other requirements applicable to futures and options investment companies include a restriction on premium paid to acquire options outstanding with identical characteristics exceeding 5% of the NAV of the investment company, open positions in any futures contract month or option series may not be held if the combined margin requirement represents 5% or more of the net asset value of the investment company, and the investment company may not hold open positions in futures or options contracts concerning a single commodity or a single underlying financial instrument for which the combined margin requirement represents 20% or more of the net asset value of the investment company. *Id.*

segregation approach as a basis for section 18 compliance, and ways in which the approach might be improved to better serve the statutory purposes and protect investors. The Commission also seeks views concerning potential alternative approaches under which funds could capture the benefits of using derivatives that would meet these same important goals. Commenters are requested to consider these broad questions as well as the specific questions that follow:

**1. Issues Concerning the Current Asset Segregation Approach**

- Is the definition of leverage articulated by the Commission in Release 10666 – that is, the right to a return on a capital base that exceeds a fund’s investment in the instrument producing the return – sufficiently precise, and appropriate to limit the risks addressed by the senior security prohibition of section 18? Are other measures of leverage equally pertinent to, and sufficiently objective, precise, and transparent to achieve the investor protection purposes of section 18? Do funds make use of any leverage measurements as part of their own portfolio oversight procedures? Are leveraged transactions involving derivatives subject to any special approval or review procedures?
- Does the segregated account approach adequately address the investor protection purposes and concerns underlying section 18 of the Act? What are the benefits and the shortcomings of the segregated account approach? What benefits may be lost under an approach that is more restrictive than the current segregated account approach?
- Derivatives can raise risk management issues for funds, such as leverage, illiquidity (particularly with respect to complex OTC derivatives), and

counterparty risk, among others.<sup>117</sup> The segregated account approach addresses leverage, but may not address liquidity and counterparty concerns. Should funds that use derivatives be required to consider and address these concerns? For example, should funds be required to undertake an ongoing credit analysis of their derivatives counterparties, and an ongoing analysis of the liquidity of the derivatives, and to take action should the creditworthiness of the derivatives counterparties and the liquidity of the derivatives themselves decline below a certain point? Should diversification among counterparties be a requirement? Are there other risk considerations that funds engaged in derivatives investments should be required to take into account?

- What is the optimal amount of assets that should be segregated for purposes of complying with the leverage limitations of section 18? In general, should a fund segregate assets in an amount equal to the notional amount of a derivative contract? In what situations, if any, would a lesser amount satisfy the purposes and concerns underlying section 18's leverage limitations and why? Since futures, swaps, and similar derivatives generally have zero market value at inception and subsequent mark-to-market amounts may fluctuate widely, how effectively does segregating an amount equal to the daily, mark-to-market amount serve the Act's objective of limiting leverage and assuring the availability of adequate assets to cover a fund's ultimate obligations? To what extent do funds

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<sup>117</sup> See 2008 IDC Report, *supra* note 3, at 12-13. See also 2008 JPMorgan Article, *supra* note 6, at page 25.

rely upon the mark-to-market standard to determine the amount of assets to be segregated? Are CDS, or some subset thereof, generally covered based on their notional amount, their mark-to-market value, or some other measure? Does it depend on whether the CDS cash-settles or involves physical delivery of the underlier?

- To what extent does the asset segregation approach cause funds to refrain from derivatives investments or strategies that could benefit investors? Please describe specific scenarios in which a fund might be deterred from engaging in derivatives activities for this reason. Does the asset segregation approach create particular impediments for certain types of funds or strategies? Please also provide any information relevant to assessing the impact upon the funds of asset segregation as contemplated by Release 10666.
- In Release 10666, the Commission stated that it believed that only liquid assets should be placed in the segregated accounts. The Commission listed cash, U.S. Government securities, or other appropriate high-grade debt obligations as examples of liquid assets that could be placed in a segregated account.<sup>118</sup> Subsequently, in the Merrill Lynch no-action letter, the staff took the position that “cash or liquid securities (regardless of type)” may be segregated for section 18 purposes. Should the Commission permit funds to segregate any liquid asset? Or should the Commission further limit the types of assets that may be placed in a

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<sup>118</sup> See Release 10666, *supra* note 10, at discussion of “Segregated Account.”



segregated account? The 2010 ABA Derivatives Report has observed that the practical effect of segregating “any liquid asset” rather than segregating only the assets specifically noted as examples in Release 10666 “greatly increase[s] the degree to which funds [may] . . . use derivatives.”<sup>119</sup> Is segregation of “any liquid asset” for purposes of section 18 consistent with the purposes and concerns underlying section 18’s limitations on leverage? Should any restrictions be placed on the types of liquid assets that may be used for asset cover, *e.g.*, excluding assets that replicate the fund’s exposure under the covered obligation?

- What types of liquid assets are currently used by funds for asset segregation purposes? Do funds commonly include equities among the liquid assets that they segregate? If so, what types of equities?
- Is owning, or having the right to obtain, the cash or other assets that a fund obligates itself to deliver in connection with senior securities an adequate substitute for segregation of liquid assets? To what extent do funds rely on this cover approach rather than asset segregation? Are cover methods that do not involve asset segregation as effective as asset segregation in terms of limiting a fund’s ability to engage in leverage, limiting a fund’s risk of loss, and making sure that a fund has set aside sufficient assets to cover its obligations under derivatives and other senior securities?
- Should the Commission revise its position in Release 10666 to provide expressly for cover methods in addition to asset segregation? If so, should

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<sup>119</sup> 2010 ABA Derivatives Report, *supra* note 8, at 14.

the Commission take the position that a fund may only enter into such non-asset segregation cover methods with the same counterparty to the senior security being covered? If so, what conditions, if any, should be imposed on such cover methods?

- The Commission also requests comment on the different treatment afforded conventional bank borrowings under section 18, which generally require 300% asset coverage, and other transactions, such as reverse repurchase agreements, that may be functionally equivalent to borrowings but, under Release 10666, may be covered by segregation of assets equal to 100% of the fund's obligations. Why, if at all, should other senior securities be treated differently from bank borrowings for purposes of the amount of cover required? Should the Commission revise its position in Release 10666 so that all borrowings and their functional equivalents are subject to the same asset segregation requirements?

## **2. Alternatives to the Current Asset Segregation Approach**

- What alternatives to the segregated account approach, if any, should the Commission consider to fulfill the investor protection purposes of section 18 of the Act? Please identify any alternative measures that would assure adequate coverage of the fund's ongoing exposures under a derivative investment, and provide a cushion to cover future exposure.
- What benefits would be lost, and/or what costs would increase, if an alternative approach to the segregated account were to limit funds' use of derivatives?

- As discussed above, the 2010 ABA Derivatives Report recommends a more flexible approach to section 18 compliance, under which funds would specify a Risk Adjusted Segregated Amount (“RASA”) for each derivative investment used by the fund.<sup>120</sup> Under this recommended approach, the amount of assets to be segregated would be determined by each fund, based on the risk profiles of the derivative instruments (including issuer- and transaction-specific risk) and its assessment of risk based upon consideration of relevant risk measures, such as VaR, potentially subject to Commission guidance of a general nature.<sup>121</sup> What benefits would accrue to funds and investors from the ABA’s RASA approach? What would be the costs of this approach? In what respects would fund-determined asset segregation policies be expected to deviate from the current segregated account approach? Would such policies be likely to incorporate VaR or other risk methodologies? Do boards, as currently constituted, have sufficient expertise to oversee an alternative approach to leverage and derivatives management such as RASA and/or VaR? If funds were permitted to determine the cover amount for their derivatives investments, should the Commission give guidance concerning minimum requirements for cover amounts or methodologies for determining cover amounts? If funds were permitted to determine the cover amount for their derivatives investments, would the result be that

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<sup>120</sup> 2010 ABA Derivatives Report, *supra* note 8, at 1, 17-18.

<sup>121</sup> *Id.* at 17.

different funds would likely reach different determinations, resulting in different cover amounts, for the same derivatives?

- Should the Commission consider a bifurcated approach to funds' use of derivatives, similar to that set out in CESR's Global Exposure Guidelines (which provides two methodologies, the commitment approach or an advanced risk measurement method such as VaR)? If the Commission were to pursue a bifurcated approach, should funds be permitted to elect to use notional amount (or similar reference) or a quantitative risk assessment such as VaR, or should funds with different levels of derivatives activities be required to choose one or the other measure based upon their level of derivatives activities or other factors?
- If funds are permitted to choose which quantitative risk assessment approach to use, under what circumstances, if any, should they be allowed to switch to a different assessment? Should a fund's proposed change in assessment require consideration and approval of its board of directors? Should shareholder approval of a fund's proposed change in assessment be required? For what reason(s) should a fund be permitted to change assessments, if any?
- We note that bank capital standards incorporate methodologies by which the current exposure and potential future exposure created by derivative investments are calculated. The potential future exposure calculation is based upon application of a specified multiplier, varying with the type and

maturity of the derivative, to the notional amount of the investment.<sup>122</sup>

Would a formula combining the current mark-to-market value of a fund's derivative investments with a measure of potential future exposure based upon a percentage of the notional amount of its derivative contracts provide a more robust measure of risk than the notional amount or mark-to-market value of the derivative? If so, are bank capital standards a relevant reference point for our consideration of the potential future exposure and asset segregation amount? If not, are there other preferable standards for measuring the potential future exposure of a derivative investment? How, if at all, would such an approach address the leverage concerns underlying section 18 of the Act? What would be the costs and benefits of employing an asset segregation calculation that reflects both current mark-to-market values and a potential future exposure approximation calculated by reference to notional amount? Given the purposes of section 18, should an additional cushion amount be considered in addition to current mark-to-market value and potential future exposure?

- The Commission also requests comment concerning the desirability of incorporating a VaR approach or other comparable risk measurement methodology in the segregated account approach to section 18. To what extent do funds currently employ VaR or a comparable risk measure as part of their routine portfolio oversight procedures? Would a VaR measure, potentially supplemented by stress testing and a leverage

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<sup>122</sup> See 12 C.F.R. § 3 at Appendix C to Part 3 (2011) (Capital Adequacy Guidelines for Banks: Internal-Ratings-Based and Advanced Measurement Approaches).

measure, provide an adequate methodology for addressing leverage risks in fund portfolios? What procedures would be required so that any VaR methodology chosen by a fund would be implemented in a way that adequately captures any additional risks associated with the use of leverage and derivatives by a fund? What other quantitative criteria might be employed in lieu of, or as a supplement to, VaR? Would adoption of VaR or a comparable risk standard require review by the Commission or Commission staff of particular risk measurement methodologies in order to establish an appropriate level of investor protection? What would be the costs and benefits of adopting a VaR standard in lieu of an asset segregation approach in addressing the treatment of derivatives under section 18?

- UCITS using VaR approaches to measure global exposure limits are required to disclose in their prospectus their expected level of leverage and the possibility of higher leverage.<sup>123</sup> In the event that the Commission were to accept a VaR approach in connection with funds' use of derivatives, should funds be required to disclose their expected and/or actual leverage levels?
- UCITS using VaR approaches to comply with global exposure limits are also required to maintain "a rigorous, comprehensive and risk-adequate stress testing program."<sup>124</sup> Should a stress testing requirement be imposed

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<sup>123</sup> See CESR's Global Exposure Guidelines, *supra* note 87, at 35.

<sup>124</sup> *Id.* at 31.

upon funds that use derivatives, at least where a risk-based methodology is used to determine the required asset segregation value? What standards, if any, should the Commission establish for stress testing if such a requirement were to be imposed?

- Are there any alternative measures that would provide adequate coverage of a fund's future obligations throughout the life of a derivative instrument as well as the availability of resources to cover unanticipated price movements?
- During the recent credit crisis, did funds that used derivatives and leverage demonstrate the ability to foresee and manage the risks that manifested themselves in connection with derivatives and leverage? Are there examples during the credit crisis where funds incurred losses or experienced gains specifically attributable to their derivatives usage?
- Is it the case that most futures contracts are highly liquid, and that this facilitates rapid liquidation of a losing position, enabling funds to minimize losses? Are there futures contracts that are not highly liquid? Have there been instances where futures contracts, that may typically be considered liquid, have become less liquid, or illiquid? If so, please describe. Could there be instances in the future where derivatives that have historically been considered to be liquid become less liquid, or illiquid? If so, please describe.

### **3. Related Matters**

- Do derivatives that create economic leverage, but that do not impose future payment obligations on funds, such as purchased options or commodity-linked notes, raise the same or similar concerns as derivatives that create indebtedness leverage? Do such derivatives present any other material concerns to funds or their investors, or raise other concerns under the Investment Company Act? If so, how should the Commission address them?
- Please comment on these, or any other, alternative approaches to the regulation of leverage under the Act. The Commission requests comment on whether any other regulatory frameworks provide relevant and useful approaches that the Commission should consider.
- Are there special considerations that need to be taken into account for smaller funds? How might taking such considerations into account impact investor protection?

### **III. DERIVATIVES UNDER THE INVESTMENT COMPANY ACT'S DIVERSIFICATION REQUIREMENTS**

In this section of the release, the Commission discusses the diversification requirements of the Investment Company Act. The Commission also explores, and requests comment on, issues that arise in the course of applying those requirements to funds' use of derivatives.



## A. The Diversification Requirements

Funds are required to disclose in their registration statements whether they are classified as diversified or non-diversified.<sup>125</sup> A fund that discloses in its registration statement that it is classified as diversified is prohibited from changing its classification to non-diversified without first obtaining shareholder approval.<sup>126</sup> A diversified fund is a fund that, with respect to 75% of the value of its total assets (the “75% bucket”),<sup>127</sup> has (among other things) no more than 5% of the value of its total assets invested in the securities of any one issuer.<sup>128</sup> A non-diversified fund is any fund that does not meet these requirements.<sup>129</sup>

The purpose of the diversification requirements is to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies.<sup>130</sup> As one commentator has noted, the requirements are designed to ensure that investors receive a clear statement of the character of the portfolio of the fund in which they

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<sup>125</sup> Section 8(b)(1)(A) of the Act; Form N-1A, Items 16, 4(a) and 4(b)(1); Form N-2, Item 17.

<sup>126</sup> Section 13(a)(1) of the Act.

<sup>127</sup> Rule 5b-1 under the Investment Company Act generally defines “total assets,” when used in computing values for purposes of sections 5 and 12 of the Act, as “the gross assets of the company with respect to which the computation is made, taken as of the end of the fiscal quarter of the company last preceding the date of computation.”

<sup>128</sup> Section 5(b)(1) of the Act. The term “issuer” is defined in sections 2(a) and 2(a)(22) of the Act as “unless the context otherwise requires, . . . every person who issues or proposes to issue any security, or has outstanding any security which it has issued.” In addition, a diversified fund, with respect to the 75% bucket, may not own more than 10% of the outstanding voting securities of any one issuer. *See* Section 5(b)(1) of the Act. A fund seeking to qualify as a “regulated investment company” must comply with the diversification requirements of section 851 of the IRC, even if the fund is not diversified under the Investment Company Act. The diversification requirements under the IRC are similar, but not identical, to the diversification requirements of the Investment Company Act. *See* 26 U.S.C. § 851(b)(3)(2010).

<sup>129</sup> Section 5(b)(2) of the Act.

<sup>130</sup> Senate Hearings, *supra* note 49, at 188 (Statement of David Schenker, Chief Counsel, Investment Trust Study, SEC, commenting on a version of section 5(b)(1) that was similar, but not identical, to the current version) (“a diversified company must have at least several different securities in its portfolio, and cannot make investments which will put them in a controlling position . . .”).

have invested,<sup>131</sup> and are intended to prevent any diversified fund from becoming non-diversified without the prior approval of its shareholders.<sup>132</sup>

For purposes of determining whether a fund is diversified or non-diversified, the value of the fund's "total assets" is generally determined as of the end of the fund's last preceding fiscal quarter and includes the value of derivatives held by the fund. Under the Investment Company Act's definition of "value,"<sup>133</sup> the appropriate valuation methodology to be used by a fund generally depends upon: (a) whether market quotations for the fund's portfolio securities<sup>134</sup> are readily available; and (b) whether the fund owned the particular portfolio securities or other assets at the end of its last preceding fiscal quarter. Specifically, the Act states that, "unless the context otherwise requires," the value of a fund's assets for purposes of the diversification requirements is as follows:

- for each portfolio security owned at the end of the fund's last preceding fiscal quarter for which market quotations are readily available, the value of the security is the market value of the security at the end of such quarter;

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<sup>131</sup> See, e.g., Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 Wash. U. L. Q. 303, 314 n. 34 (Apr. 1941) ("Jaretzki") (the "distinction between diversified and non-diversified companies is due in large part, it is believed, to a desire to inform stockholders of the character of the portfolio of the company in which they have invested.")

<sup>132</sup> *Id.* at 316-17.

<sup>133</sup> "Value" is defined in section 2(a)(41) of the Act.

<sup>134</sup> Sections 2(a) and 2(a)(36) of the Act provide that, "unless the context otherwise requires," the term "security" includes, among other things, any "note" or "evidence of indebtedness." As discussed *supra* note 57, the definition of the term "security" in the Act is broader than the definitions of that term in the other federal securities laws and the Commission has interpreted the term "security" in light of the policies and purposes underlying the Act. As a general matter, most derivatives appear to be notes or evidences of indebtedness and thus securities for purposes of the diversification requirements. Treating derivatives as securities for diversification classification purposes appears to be consistent with the policies and purposes underlying the diversification requirements, including the concern that funds that classify themselves as diversified indeed have diverse portfolios of investments, the performance of which is not tied too closely to the success of one or a few issuers.

- for any other portfolio security or asset owned at the end of the fund’s last preceding fiscal quarter, the value of the security or asset is the fair value of the security or asset at the end of such quarter, as determined in good faith by the fund’s board of directors; and
- for any security or asset acquired by the fund after the last preceding fiscal quarter, the cost thereof.<sup>135</sup>

**B. Application of the Diversification Requirements to a Fund’s Use of Derivatives**

A diversified fund that contemplates investing in derivatives must consider how to value these instruments for purposes of calculating the 75% bucket based upon its “total assets” and for purposes of calculating whether the fund has invested 5% of the value of its total assets in the securities of any one “issuer.” In addition, the fund must determine the identity of the issuer of each such derivative.

**1. Valuation of Derivatives for Purposes of Determining a Fund’s Classification as Diversified or Non-Diversified**

When determining the value of a fund’s total assets for purposes of determining the fund’s classification as diversified or non-diversified, the fund must calculate the value of any derivative held by the fund. Under the Act, “unless the context otherwise requires,” derivatives (and all other assets) held by a fund must be valued for diversification purposes using market values and fair values, at the end of the fund’s last preceding fiscal quarter, or, if subsequently acquired, their cost.<sup>136</sup>

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<sup>135</sup> Sections 2(a)(41)(A)(i), (ii), and (iii) of the Act. Market value and fair value are discussed *infra* at Section VI. (Valuation of Derivatives). *See also Adoption of Rules Relating to the Classification of Management Investment Companies as either Diversified or Non-Diversified*, Investment Company Act Release No. 178 (Aug. 6, 1941) [6 FR 3966 (Aug. 8, 1941)].

<sup>136</sup> *See* section 2(a)(41)(A) of the Act.

For purposes of calculating NAV under the Act’s valuation provisions, derivatives are generally valued using a “market value” measure for exchange-traded derivatives and a “fair value” measure for OTC derivatives; under either measure, the value of a derivative would appear to be the value at which the derivative could be sold or otherwise transferred at the relevant time.<sup>137</sup> Compliance with the valuation provisions of the Act helps to ensure, among other things, that the prices at which fund shares are purchased and redeemed are fair and do not result in dilution of shareholder interests or other harm to shareholders.<sup>138</sup>

The diversification requirements are designed to prevent a fund that holds itself out as diversified from having heightened exposure to one or a few issuers and help to accurately inform investors about the nature of the fund. 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.<sup>139</sup>

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<sup>137</sup> For additional discussion of valuation requirements and guidance, *see infra* Section VI. (Valuation of Derivatives).

<sup>138</sup> *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] *available at* <http://www.sec.gov/rules/final/ia-2204.pdf>.

<sup>139</sup> For example, a fund that holds itself out as diversified may have invested four percent of its assets in securities of an issuer to which it has additional exposure through a total return swap that creates exposure equal to another four percent of its assets on a notional basis, yielding a combined exposure to the issuer of eight percent of the fund’s total assets. The current mark-to-market value of the total return swap would likely be sufficiently low to enable the fund to calculate its investments in the issuer at less than five percent of its total assets, but, its total exposure to that issuer is over five percent of its total assets.

Should the Commission consider whether application of the diversification requirements to derivatives is a “context [that] otherwise requires” a different measure of value than the statutory definition of “value?” The value at which the derivative can be sold or otherwise transferred will reflect the gains or losses on that investment at a point in time. Would the use of the notional amount of the derivative, rather than its liquidation value, better achieve the purposes of the diversification provisions of the Act? The Commission requests comment on these issues and related questions set forth below.

## **2. Identification of the Issuer of a Derivative for Purposes of Determining a Fund’s Classification as Diversified or Non-Diversified**

The diversification requirements restrict a fund that is classified as diversified from investing, with respect to its 75% bucket, more than 5% of the value of its total assets in the securities of any one issuer. The Act defines the term “issuer” as “every person who issues or proposes to issue any security, or has outstanding any security which it has issued,”<sup>140</sup> unless the context otherwise requires.<sup>141</sup> In general, the “issuer” of an OTC derivative entered into by a fund would appear to be the fund’s counterparty, and the “issuer” of an exchange-traded derivative would appear to be the clearinghouse due to the novation.<sup>142</sup> However, a derivative may have a reference asset that also has an issuer, *e.g.*, a total return swap on the common stock of a corporate issuer. In such a case, the potential exposure of the fund created by the derivative is to both the counterparty to the contract and the issuer of the reference security.

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<sup>140</sup> Section 2(a)(22) of the Act.

<sup>141</sup> Section 2(a) of the Act.

<sup>142</sup> *See Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies*, Securities Act Release No. 9222 (June 9, 2011) [76 FR 34920 (June 15, 2011)] at n. 18 and accompanying text, available at <http://www.sec.gov/rules/proposed/2011/33-9222.pdf> (also describing “novation” as a process through which the original obligation between a buyer and seller is discharged through the substitution of the central counterparty as seller to buyer and buyer to seller, creating two new contracts).

### **C. Request for Comment**

The Commission requests comment concerning the application of the Act's diversification requirements to derivatives held in fund portfolios, including the following specific issues:

- Valuation of Derivatives for Purposes of the Diversification Requirements. As discussed above, the diversification requirements are designed to preclude a fund that has classified itself as “diversified” from concentrating its portfolio investments in the securities of any single issuer. In light of this purpose, how should a derivative be valued for purposes of applying the diversification tests? Could investors be misled by a fund’s disclosure that it is diversified when it has ongoing exposure to a single issuer or group of issuers in excess of 5% of the fund’s assets on a notional basis? In what circumstances, if any, would mark-to-market value provide an adequate measure of a fund’s exposure to an issuer such that the purposes of the diversification requirements would be fulfilled? If a current market value measure is appropriate for this purpose, should any additional safeguards be adopted to address circumstances in which a derivative’s potential future exposure may materially exceed its current market value? For example, should the “diversification” classification be qualified or supplemented to reflect the impact on the fund’s diversification of the notional exposures created by derivatives? The Commission also requests comment concerning the potential for derivatives exposures to be understated. Further, if derivatives exposures are potentially understated, how should the issue be addressed? For example, should funds be required to provide additional information to investors? Also, if mark-to-market values are ascribed to derivatives for purposes of the

diversification requirements, how should negative values for derivatives be treated?

- Alternative Diversification Standards. Should different or additional diversification standards be developed that would better address the types of exposures attainable through derivatives?
- Treatment of Counterparty Issues under the Diversification Requirements. In light of the statutory purpose of preventing a fund from holding itself out as diversified even though it is dependent upon the performance of a small number of issuers, should counterparties to derivatives investments with funds be considered issuers of securities for purposes of the diversification requirements? If counterparty obligations under a derivative investment are considered securities of an issuer for purposes of the diversification requirements, how should such obligations be measured for this purpose? The 2010 ABA Derivatives Report recommends that, for purposes of determining a fund's classification as diversified or non-diversified, a fund should be able to disregard its exposures to its derivative investment counterparties and that counterparty exposures should be addressed separately under section 12(d)(3) of the Act, in part to assure that counterparty exposures would be addressed for non-diversified as well as diversified funds.<sup>143</sup> Would it be preferable to address counterparty exposures under section 12(d)(3)?<sup>144</sup> If so, should diversification issues relating to

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<sup>143</sup> 2010 ABA Derivatives Report, *supra* note 8, at 27-28.

<sup>144</sup> Under section 12(d)(3) of the Investment Company Act, funds generally 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 issuer"). *See infra* discussion in Section IV. (Exposure to Securities-Related Issuers Through Derivatives).

counterparties that are not securities-related issuers continue to be addressed under the Act's diversification provisions?

- Relevance of Reference Assets Under Derivatives to Diversification Requirements. Under the 2010 ABA Derivatives Report's suggested approach, a derivative's reference asset would be considered a security issued by an issuer for purposes of the diversification requirements, an approach that the 2010 ABA Derivatives Report indicates is already followed by many funds when calculating "long exposures" to the fund.<sup>145</sup> Should the issuer of reference assets underlying a derivative entered into by a fund be considered to be the issuer of a security for purposes of the diversification requirements in lieu of, or in addition to, the counterparty? If not, how, if at all, should exposure to the issuer of a reference asset be disclosed to investors and the potential inconsistency of such exposure with diversification categorization be addressed?
- Are there special considerations that need to be taken into account for smaller funds? How might taking such considerations into account impact investor protection?

#### **IV. EXPOSURE TO SECURITIES-RELATED ISSUERS THROUGH DERIVATIVES**

Funds engaging in derivatives investments may also confront issues under the Act's restrictions upon acquisition of interests in securities-related issuers. In this section of the release, the Commission discusses the application of section 12(d)(3) and rule 12d3-1, which address a fund's exposure to securities-related issuers, to funds' use of derivatives. The Commission seeks comment on the manner in which the Act's prohibition on such acquisitions

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<sup>145</sup> 2010 ABA Derivatives Report, *supra* note 8, at 26.



and the Commission’s exemptive rule granting limited relief from that prohibition should apply in the context of derivatives.

**A. Investment Company Act Limitations on Investing in Securities-Related Issuers**

Under section 12(d)(3) of the Investment Company Act, funds generally 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 issuer”).<sup>146</sup> There are two reasons for this prohibition. First, it limits a fund’s exposure to the entrepreneurial risks of securities-related issuers, including the fund’s potential inability to extricate itself from an illiquid investment in a securities-related issuer.<sup>147</sup> Second, it is one of several Investment Company Act provisions which, taken together, prohibit fund sponsors, which include broker-

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<sup>146</sup> Section 12(d)(3) of the Act. *See also Statement of the Commission Advising All Registered Investment Companies to Divest Themselves of Interest and Securities Acquired in Contravention of the Provisions of Section 12(d)(3) of the Investment Company Act of 1940 within a Reasonable Period of Time*, Investment Company Act Release No. 3542 (Sept. 21, 1962) [27 FR 9652 (Sept. 29, 1962)] (“1962 Statement”) (stating that “prohibited purchases or acquisitions occur not only when a security or interest is originally purchased or acquired, but also when investment companies . . . hold an interest in a portfolio company which thereafter by merger, consolidation, reorganization . . . or otherwise, acquires an interest in a dealer, broker, underwriter or investment adviser”); *Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses*, Investment Company Act Release No. 13725 (Jan. 17, 1984) [49 FR 2912 (Jan. 24, 1984)] (“1984 Proposing Release”) at n.2 and accompanying text (discussing the 1962 Statement).

<sup>147</sup> *See* 1984 Proposing Release, *supra* note 146, at n. 7 and accompanying text (discussing that “[i]n 1940, securities related businesses, for the most part, were organized as private partnerships. By investing in such businesses, investment companies would expose their shareholders to potential losses which were not present in other types of investments; if the business failed, the investment company as a general partner would be held accountable for the partnership’s liabilities; if the business floundered, the investment company would be locked into its investment.”). Rule 12d3-1 under the Act has, since 1984, provided a limited exemption from section 12(d)(3) for acquisitions of certain securities and, until 1993, addressed the liquidity concern underlying section 12(d)(3) by limiting the equity securities of a securities-related issuer that a fund may acquire to “margin securities,” as defined in Regulation T of the Board of Governors of the Federal Reserve System, and generally limiting the permissible debt securities to “investment grade securities,” as determined by at least one nationally recognized statistical rating organization. *See, e.g.*, 1984 Proposing Release, *supra* note 146, at nn. 24-25 and accompanying text. The rule has never permitted a fund to acquire a general partnership interest in a securities-related business.

dealers, underwriters, and investment advisers, from taking advantage of the funds that they sponsor.<sup>148</sup> Specifically, the prohibition has the effect of limiting the possibility of abusive reciprocal practices<sup>149</sup> between funds and securities-related issuers.

Rule 12d3-1 under the Act provides funds with a limited exception from this prohibition. Under the rule, a fund may acquire securities of any person that (a) derives 15 percent or less of its gross revenues from “securities related activities,”<sup>150</sup> as long as the fund does not control such person after the acquisition, or (b) derives more than 15 percent of its gross revenues from “securities related activities,” subject to limits on the percentage of the issuer’s securities that may be acquired by a fund.<sup>151</sup> The rule does not permit a fund to acquire a general partnership interest in a securities-related issuer.<sup>152</sup>

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<sup>148</sup> See *id.* at n. 8 and accompanying text.

<sup>149</sup> See, e.g., *id.* at n. 9 and accompanying text (“Such reciprocal practices include the possibility that an investment company might purchase securities or other interests in a broker-dealer to reward that broker-dealer for selling fund shares, rather than solely on investment merit. Similarly, the staff has expressed concern that an investment company might direct brokerage to a broker-dealer in which the company has invested to enhance the broker-dealer’s profitability or to assist it during financial difficulty, even though that broker-dealer may not offer the best price and execution.”)

<sup>150</sup> The rule defines “securities related activities” as “activities as a broker, a dealer, an underwriter, an investment adviser registered under the Investment Advisers Act of 1940, as amended, or as an investment adviser to a registered investment company.”

<sup>151</sup> Under these limits, a fund may not acquire more than 5% of that class of the issuer’s outstanding equity securities or more than 10% of the outstanding principal amount of the issuer’s debt securities, and may not have more than 5% of the value of the fund’s total assets invested in the securities of the issuer. Rule 12d3-1 defines “equity security” in accordance with rule 3a11-1 under the Exchange Act, which in turn includes “any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.” Rule 12d3-1 under the Act defines “debt security” as “all securities other than equity securities.”

<sup>152</sup> Rule 12d3-1 also does not permit the acquisition of a security issued by the fund’s promoter,

## B. Counterparty to a Derivatives Investment

When a fund invests in an OTC derivative, the fund receives the obligation of its counterparty to perform under the contract. If the counterparty is a securities-related issuer, a fund's acquisition of that obligation may constitute an acquisition of a security or another interest in a securities-related issuer within the scope of section 12(d)(3) of the Investment Company Act.<sup>153</sup> As noted above, in the case of exchange-traded derivatives that are cleared, the issuer of the derivative typically is the clearinghouse. In a no-action letter, the staff did not object to the assertion that, in acquiring an exchange-traded option, a fund generally would not appear to be acquiring securities issued by, or an interest in, a securities-related issuer.<sup>154</sup> In the case of OTC derivatives, if a fund's counterparty is a securities-related issuer, the fund's transaction with the counterparty may represent the acquisition of a security issued by, or an interest in, that issuer.<sup>155</sup>

If an OTC derivative with a securities-related issuer as the counterparty is a security issued by that counterparty, then the fund may be able to rely on rule 12d3-1 to engage in the transaction.<sup>156</sup> If such a derivative is not a security issued by the counterparty, but the transaction

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principal underwriter, or investment adviser, or an affiliated person of the promoter, principal underwriter, or investment adviser, subject to an exception for certain subadvisory relationships.

<sup>153</sup> If the counterparty is not a securities-related issuer, the fund may enter into the transaction without being limited by section 12(d)(3). The fund will need to monitor the status of its counterparty during the term of the transaction to ensure that the counterparty remains a non-securities-related issuer. *See* 1962 Statement, *supra* note 146.

<sup>154</sup> *See, e.g.*, Institutional Equity Fund, SEC Staff No-Action Letter (Feb. 27, 1984).

<sup>155</sup> The Commission has stated, for example, that in entering into a repurchase agreement, a fund may be acquiring an interest in the counterparty that is prohibited by section 12(d)(3). *See, e.g.*, *Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities*, Investment Company Act Release No. 25058 (July 5, 2001) at n. 5 and accompanying text [66 FR 36156 at note 5 (July 11, 2001)].

<sup>156</sup> A derivative is likely to be categorized as a debt security subject to the 10% limitation of rule 12d3-1. Rule 12d3-1 defines "debt security" as "all securities other than equity securities." The Commission also by order has exempted certain transactions from section 12(d)(3) that may have involved a fund's acquisition of a security from a securities-related issuer. *See, e.g.*, the following orders issued by the Commission involving principal-protected funds: AIG

may be deemed to be the fund’s acquisition of “an interest in” a securities-related issuer (the counterparty), then rule 12d3-1 would not be available because it exempts only acquisitions of securities, and the transaction would be prohibited under the Investment Company Act. There is no bright-line test distinguishing transactions that may or may not constitute a fund’s acquisition of an “interest in” a securities-related issuer. However, a fund’s acquisition of a general partnership interest in a securities-related issuer, whether or not the interest is a security, is not permitted by rule 12d3-1.<sup>157</sup>

### **C. Exposure to Other Securities-Related Issuers Through Derivatives**

The issue of whether an OTC derivative transaction is prohibited under the Investment Company Act as an impermissible acquisition of a security issued by, or an interest in, a securities-related issuer, also may require analysis of a fund’s exposure to a reference asset underlying the derivative. If the derivative transaction is based upon the price or value of securities issued by, or interests in, a securities-related issuer, the fund’s relationship to the issuer of the reference asset may raise both of the concerns underlying section 12(d)(3) – the fund’s

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SunAmerica Asset Management Corp., et al., Investment Company Act Release Nos. 26725 (notice) (Jan. 21, 2005) [70 FR 3946 (Jan. 27, 2005)] and 26760 (Feb. 16, 2005) (order) (by virtue of entering into a protection arrangement with an AIG affiliate that is a broker, dealer, underwriter, investment adviser to a registered investment company, or an investment adviser registered under the Investment Advisers Act, a fund may be deemed to have acquired a security from the AIG affiliate); Merrill Lynch Principal Protected Trust, et al., Investment Company Act Release Nos. 26164 (Aug. 20, 2003) (notice) [68 FR 51602 (Aug. 27, 2003)] and 26180 (Sept. 16, 2003) (order) (by virtue of entering into a protection arrangement with a Merrill Lynch affiliate that is a broker, dealer, underwriter, investment adviser to a registered investment company, or an investment adviser registered under the Investment Advisers Act of 1940, a fund may be deemed to have acquired a security from the Merrill Lynch affiliate).

<sup>157</sup> In addition, section 12(d)(3) of the Act prohibits a fund’s acquisition of any security issued by “or any other interest in” a securities-related issuer. The Commission has noted that, in enacting section 12(d)(3), Congress was particularly concerned with funds investing as general partners in securities-related issuers. *See Exemption of Acquisitions of Securities Issued by Persons Engaged in Securities-Related Business*, Investment Company Act Release No. 19204 (Jan. 4, 1993) [58 FR 3243 (Jan. 8, 1993)] at n. 10 and accompanying text. Rule 12d3-1(c) provides that “this section does not exempt the acquisition of: (1) a general partnership interest[.]”

exposure to the risks of that securities-related issuer and the potential for reciprocal practices. For example, if the issuer of the reference asset is a broker-dealer, and the fund's position in the derivative transaction benefits from increases in the market price of the reference asset, the fund might direct brokerage or other business to that broker-dealer to enhance the broker-dealer's profitability. Consequently, the fund could be considered to have assumed an exposure to a securities-related issuer that is in violation of section 12(d)(3). In that event, the fund would need to consider the availability and conditions of rule 12d3-1 with respect to that entity before determining whether the fund may, and if so, to what extent, enter into the derivative transaction.

Certain OTC derivative transactions involve credit support providers or entities performing similar roles. These entities also may be securities-related issuers. In that case, the fund would need to determine whether the provision of credit support or similar protection for the fund's benefit in the derivative transaction constitutes the fund's acquisition of a security issued by, or an interest in, the credit support provider that is a securities-related issuer.<sup>158</sup> If it does, then the fund would need to analyze the derivative transaction under section 12(d)(3) with respect to the credit support provider as well.

#### **D. Valuation of Derivatives for Purposes of Rule 12d3-1 under the Investment Company Act**

As noted above, if a derivative transaction involves an acquisition by the fund of a security issued by a securities-related issuer, the fund may be able to rely on rule 12d3-1 under the Investment Company Act, which provides a conditional exemption to the prohibition in section 12(d)(3). For purposes of the conditions of rule 12d3-1, if the securities-related issuer, in its most recent fiscal year, derived more than 15% of its gross revenues from securities-related

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<sup>158</sup> See rule 12d3-1(d)(7)(v) under the Act, deeming an acquisition of demand features or guarantees as not being the acquisition of securities of a securities-related issuer provided certain conditions are met.

activities, as defined in the rule, the fund would need to determine whether such derivative is an equity or debt security and apply the percentage limitations in the rule accordingly.<sup>159</sup> Among other things, the fund would need to determine whether, immediately after the acquisition of such derivative, the fund has invested not more than five percent of the value of its total assets in the securities of the issuer. For purposes of this calculation, the exposure of the fund to its counterparty or its exposure to the issuer of a reference security may be understated were the current market or fair value of the derivative the appropriate measure. The potential future exposure of the fund to the securities-related issuer is, in each case, likely to be unaccounted for by a current mark-to-market standard. Neither the Commission nor the staff has addressed this point. The Commission understands that many funds perform the calculation under rule 12d3-1 based upon the notional amounts of derivatives transactions, although this practice is not uniform.

#### **E. Request for Comment**

The Commission asks for comment on all aspects of the application of section 12(d)(3) and rule 12d3-1 to funds' derivative transactions.

- Do commenters believe that OTC derivative transactions between funds and securities-related issuers implicate the purposes of section 12(d)(3), *i.e.*, protection against the entrepreneurial risks of securities-related issuers and the potential for reciprocal practices that disadvantage fund investors? If so, in what respects? If not, on what basis should a fund's exposure to a securities-related issuer in a derivatives transaction be distinguished from other types of investments to which section 12(d)(3) applies?

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<sup>159</sup> See *supra* discussion at note 151.

- Do commenters believe that a fund’s exposure to price movements or performance of a reference security issued by a securities-related issuer implicates the purposes of section 12(d)(3)? If not, on what basis would such exposure be distinguished from other types of investments subject to section 12(d)(3)?
- Should the extent to which the securities-related issuer’s obligations are secured by collateral provided by the issuer affect this analysis? If so, what specific effect should collateral arrangements be accorded and by what criteria should qualifying collateral arrangements be defined?
- The 2010 ABA Derivatives Report suggests that section 12(d)(3) “provides an appropriate framework for dealing with fund counterparty exposures.”<sup>160</sup> The 2010 ABA Derivatives Report states that the counterparties to fund derivative transactions generally fall within the categories of securities-related issuers addressed by section 12(d)(3) and that, unlike the diversification requirements discussed above, section 12(d)(3) applies to all registered investment companies, regardless of diversification status. The 2010 ABA Derivatives Report also suggests that the Commission or the staff issue guidance concerning the manner in which the various provisions of rule 12d3-1 under the Act should apply to derivatives.<sup>161</sup> Is rule 12d3-1 the appropriate framework for exempting certain derivatives transactions from section 12(d)(3)? Are the existing percentage limitations in rule 12d3-1 appropriate in the context of derivatives? Should there

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<sup>160</sup> 2010 ABA Derivatives Report, *supra* note 8, at 33. The Report states that “counterparty exposure” presents “the concern that a counterparty cannot pay a fund the amount that the fund is due under the derivative instrument....” *Id.*

<sup>161</sup> *Id.* at 34-35.

be additional limitations or conditions to an exemption from section 12(d)(3) for derivative transactions? If so, what types of conditions or limitations? The Commission also asks commenters to identify and discuss the interpretive issues that may arise when rule 12d3-1 is applied to funds' use of derivatives.

## **V. PORTFOLIO CONCENTRATION**

In this section, the Commission discusses the Investment Company Act's provisions regarding portfolio "concentration" and the application of these provisions to a fund's use of derivatives.

### **A. Investment Company Act Provisions Regarding Portfolio Concentration**

Funds are required to disclose in their registration statements their policy concerning "concentrating investments in a particular industry or group of industries."<sup>162</sup> This requirement reflects the view that such a policy is likely to be central to a fund's ability to achieve its investment objectives, and that a fund that concentrates its investments will be subject to greater risks than funds that do not follow the policy.<sup>163</sup> The concentration requirements also are intended to prevent funds from substantially changing the nature and character of their businesses without shareholder approval.<sup>164</sup> Funds are prohibited from deviating from their policy concerning "concentration of investments in any particular industry or groups of industries" as recited in their registration statements without obtaining shareholder approval.<sup>165</sup>

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<sup>162</sup> See Section 8(b)(1)(E) of the Act; Form N-1A, Items 4, 9 (instruction 4) and 16(c)(1)(iv); and Form N-2, Items 8.2.b(2) and 17.2.e.

<sup>163</sup> *Registration Form Used by Open-End Management Investment Companies*, Investment Company Act Release No. 23064 (Mar. 13, 1998) ("Release 23064") [63 FR 13916 (Mar. 23, 1998)] at nn. 98-99 and accompanying text.

<sup>164</sup> See Jaretzki, *supra* note 131, at 317. The concentration requirements focus on all of the funds' investments, and not solely on their investments in securities.

<sup>165</sup> Section 13(a)(3) of the Act. See also Securities and Exchange Commission's Brief Amicus Curiae dated March 25, 2010, *In re: Charles Schwab Corp. Securities Litigation*, Master File No.



The Investment Company Act does not include definitions of the terms “concentration” and “industry or groups of industries.” The Commission has stated generally that a fund is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries.<sup>166</sup> The Commission also has stated that, in determining industry classifications, a fund may select its own industry classifications, but such classifications must be reasonable and should not be so broad that the primary economic characteristics of the companies in a single class are materially different.<sup>167</sup>

**B. Issues Relating to the Application of the Act’s Concentration Provisions to a Fund’s Use of Derivatives**

When a fund enters into a derivatives transaction, the fund may gain exposure to more than one industry or group of industries. 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

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C-08-01510-WHA (N. D. Cal.)(“SEC Schwab Amicus Brief”) at 2-3; *In re: Charles Schwab Corp. Securities Litigation*, No. C 08-01510 WHA, 2010 U.S. Dist. LEXIS 32113 (N. D. Cal. Mar. 30, 2010)(“Schwab Opinion”) at \*3-\*4.

<sup>166</sup> See also Form N-1A, Item 9, instruction 4 (defining industry concentration for Form N-1A disclosure purposes as “investing more than 25% of a Fund’s net assets in a particular industry or group of industries”); *but compare* Form N-2, Item 8.2.b (instruction) (defining industry concentration for Form N-2 purposes as “25 percent or more of the value of Registrant’s total assets invested or proposed to be invested in a particular industry or group of industries”). See also, *e.g.*, Release No. 23064, *supra* note 163, (“The Commission’s staff has taken the position for purposes of the concentration disclosure requirement that a fund investing more than 25% of its assets in an industry is concentrating in that industry.”).

<sup>167</sup> See SEC Schwab Amicus Brief, *supra* note 165, at 8 and 9. See also Schwab Opinion, *supra* note 165, at \*20 (“This order agrees . . . that a promoter is free to define an industry in any reasonable way when it establishes a fund and assumes for sake of argument that the promoter may unilaterally, even after the fund is up and running, clarify in a reasonable way a definitional line that may otherwise be vague. But once the promoter has drawn a clear line and thereafter gathers in the savings of investors, the promoter must adhere to the stated limitation unless and until changed by a stockholder vote.”)

counterparty) as well as exposure to the pharmaceuticals industry (*i.e.*, the industry associated with the issuer of the reference asset). As noted above, the Commission has stated that generally a fund is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries. This standard does not, by its terms, address derivative transactions by which a fund obtains exposure to a particular industry or group of industries, whether through exposure to the counterparty to the transaction or through its contractual exposure to a reference asset.

Another issue relevant to determining industry concentration is whether a fund values its derivatives using notional amount or market value. The 2010 ABA Derivatives Report states that “using the notional value, rather than the market value, of a derivative instrument may inflate an industry position relative to the fund’s current economic exposure.”<sup>168</sup> The 2010 ABA Derivatives Report further states that “funds typically comply with their concentration policies by looking to the reference asset and not any counterparty to the derivative instrument. Funds typically use market values for these calculations . . . .”<sup>169</sup>

### **C. Request for Comment**

The Commission requests comment on the application of concentration requirements to funds’ investments in derivatives, including the following questions.

- How do funds apply the concentration requirements to their investments in derivatives? Do they consider current market value or the notional amount of a derivative (or some other measure) for purposes of determining whether they have invested 25% or more of the value of their net assets in a particular industry or

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<sup>168</sup> 2010 ABA Derivatives Report, *supra* note 8, at n. 57.

<sup>169</sup> *Id.* at 29.

group of industries? Do funds focus solely upon the exposures to the industries with which their derivatives counterparties are associated, or do they also take into account their exposures to the industry or industries (if any) of the reference assets underlying those derivatives?

- Is it consistent with the policies and purposes underlying the concentration requirements for funds to focus on the industry of the issuer of the reference asset and disregard the exposure to the industry or industries with which the derivatives counterparty is associated? Should this depend on the level of collateral (if any) posted by the counterparty?
- Should the Commission provide guidance to funds on how they should comply with the concentration requirements when they use derivatives? If so, what should that guidance entail?
- Are there special considerations that need to be taken into consideration for smaller funds? How might taking such considerations into account impact investor protection?

## **VI. VALUATION OF DERIVATIVES**

In this section, the Commission discusses, and requests comment on, the valuation of derivatives used by funds for purposes of applying the various provisions of the Investment Company Act.

### **A. Investment Company Act Valuation Requirements**

When calculating their NAVs, funds must determine the value of their assets, including the value of the derivatives that they hold. The Investment Company Act specifies how funds must determine the value of their assets. Under the Act, all funds (other than money market

funds),<sup>170</sup> whether open-end or closed-end, must calculate their NAVs by using the market values of their portfolio securities when market quotations for those securities are “readily available.”<sup>171</sup> When market quotations for a fund’s portfolio securities or other assets are not readily available, the fund must calculate its NAV by using the fair value of those securities or assets, as determined in good faith by the fund’s board of directors.<sup>172</sup>

There is no single methodology for determining the fair value of a security or other asset because fair value depends upon the facts and circumstances of each situation.<sup>173</sup> As a general principle, however, the fair value of a security or other asset held by a fund would be the amount that the fund might reasonably expect to receive for the security or other asset upon its current sale.<sup>174</sup> When determining the fair value of a security or other asset held by a fund, all indications of value that are available must be taken into account.<sup>175</sup>

## **B. Application of the Valuation Requirements to a Fund’s Use of Derivatives**

For many derivatives that are securities, such as exchange-traded options, market quotations typically are readily available. As a result, a fund generally must use market values to value such derivatives. For many other derivatives, however, market quotations are not readily

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<sup>170</sup> Money market funds that comply with the provisions of rule 2a-7 under the Act [17 CFR 270.2a-7], however, may value their portfolio securities on the basis of amortized cost. In addition, under certain circumstances, open-end funds may value certain of their portfolio securities on the basis of amortized cost. *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, Investment Company Act Release No. 9786 (May 31, 1977) [42 FR 28999 (June 7, 1977)], available at <http://www.sec.gov/rules/interp/1977/ic-9786.pdf>.

<sup>171</sup> Section 2(a)(41)(B) of the Act. *See also* ASR 118 and ASR 113, *supra* note 14. “Readily available” refers to public market quotations that are current, *i.e.*, “[r]eadily available market quotations refers to reports of current public quotations for securities similar in all respects to the securities in question.” ASR 113, *supra* note 14, at 2.

<sup>172</sup> ASR 113, *supra* note 14.

<sup>173</sup> ASR 118, *supra* note 14.

<sup>174</sup> ASR 113 and ASR 118, *supra* note 14.

<sup>175</sup> ASR 118, *supra* note 14.

available, and a fund that holds such derivatives is required to value those derivatives at their fair values as determined by the fund's board of directors.

Valuation of some derivatives may present special challenges for funds. Some derivatives may have customized terms, including contractual restrictions on their transferability. Some derivatives also may restrict a fund's ability to close out the contract or to enter into an offsetting transaction. For some derivatives, there may be no quotations available from independent sources, and for some derivatives the fund's counterparty may be the only available source of pricing information.

### **C. Request for Comment**

The Commission requests comment on funds' valuation of derivatives, including the following questions:

- How do funds determine the fair values of derivatives that they hold? To what extent do valuation determinations depend upon the type of derivative, reference asset, trading venue, and other factors?
- How do funds, when fair valuing derivatives, assess the accuracy and reliability of pricing information that is obtained from their counterparties or from other sources?
- How do funds take into account, when valuing derivatives, contractual restrictions on transferability, and restrictions on their ability to close out the transactions or to enter into offsetting transactions?
- Some derivatives held by funds may have negative values due to, among other things, changes in the value of the reference assets underlying the derivatives. Do

funds calculate the values of such derivatives in the same manner as they value derivatives that have positive values? If not, why not?

- Should the Commission issue guidance on the fair valuation of derivatives under the Investment Company Act? If so, what issues should be addressed by that guidance?
- Are there special considerations that need to be taken into consideration for smaller funds? How might taking such considerations into account impact investor protection?

## **VII. GENERAL REQUEST FOR COMMENT**

In addition to the specific issues highlighted for comment, the Commission invites members of the public to address any other matters that they believe are relevant to the use of derivatives by funds.

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: August 31, 2011