

SEC Issues “Concept Release” on Funds’ Use of Derivatives

The Securities and Exchange Commission recently issued a “Concept Release” stating that the Commission and its staff are reviewing the use of derivatives by mutual funds, closed-end funds and business development companies (collectively, “funds”).¹ The Commission requests comments on such derivative-related topics as fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration and valuation.

The Commission intends to determine whether further regulatory initiatives or guidance is needed to improve the current regulatory framework. The Concept Release itself provides little regulatory guidance, although it does provide a synopsis of previous guidance and some insights into the ways in which regulators outside the United States have attempted to address certain issues, particularly the leveraging impact of certain derivatives.

The comment period for the Concept Release ends on November 7, 2011.

Background

The Commission, in the Concept Release, noted the dramatic growth in the volume and complexity of derivative investments over the past two decades, and funds’ increased use of derivatives. In response to this evolving business landscape, the staff has been

exploring the benefits, risks, and costs associated with funds’ use of derivatives. The staff also has been reviewing associated regulatory issues. The Concept Release, however, does not address disclosure-related issues, which the Commission stated it may consider at a later date.²

In preparing the Concept Release, the Commission was significantly informed by the report of the American Bar Association’s Section of Business Law, *Investment Company Use of Derivatives and Leverage* (2010) (the “ABA Report”) which provided an analytical framework in which to address the derivative-related topics discussed above.³

Senior Securities Restrictions

The Concept Release notes that Section 18 of the Investment Company Act of 1940 (the “1940 Act”) restricts a fund’s ability to issue or

¹ *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Company Act Release No. 29776 (Aug. 31, 2011) (“Concept Release”).

² The SEC Staff has previously detailed its observations on derivatives-related disclosures by investment companies in registration statements and shareholder reports. See Letter from Barry D. Miller, Assoc. Dir., Office of Legal and Disclosure, Div. of Inv. Mgmt., SEC, to Karrie McMillan, Gen. Counsel, ICI (July 30, 2010).

³ *Report of the Task Force on Investment Company Use of Derivatives and Leverage*, ABA Committee on Federal Regulation of Securities (July 6, 2010); see also [“ABA Task Force Report and SEC Letter Regarding Investment Company Use of Derivatives and Leverage,”](#) DechertOnPoint Issue 20 (Aug. 2010).

sell “senior securities.” Generally, obligations evidencing indebtedness are considered senior securities. Section 18 generally requires a fund to maintain appropriate asset coverage for these obligations.

The SEC and its staff have taken the position that investments in many different types of derivatives (including reverse repurchase agreements, firm commitment agreements, standby commitment agreements, short sales, written options, futures and forwards) are potentially senior securities, because investing in them involves a potential obligation for the fund to make a payment to another party at a future date. However, the staff has determined that issues regarding Section 18 compliance are not raised with regard to fund investments in derivatives if a fund “covers” its obligation in various ways addressed in *ad hoc* guidance that the staff has provided over the years. Most commonly, a derivative position can be “covered” by an economically offsetting position (e.g., a fund writes a call option on a security currently in its portfolio) or by covering either the fund’s notional or “mark-to-market” exposure of the instrument. The Concept Release points out that while covering notional exposure may be overly restrictive, covering mark-to-market could leave a fund vulnerable to large intra-day movements. The Concept Release also suggests other potential approaches, such as covering for “value at risk,” and notes the ways in which regulators in other jurisdictions have grappled with leverage.

The ABA Report pointed out that the prior “basic framework” worked well, but “there are open issues and inconsistencies” in the current guidance. For example, the SEC has not addressed asset segregation procedures for all types of derivatives.

The SEC is requesting comments regarding:

- Whether the appropriate amount of assets to be segregated should be the notional amount of the transaction, the unrealized gain or loss on the transaction (also referred to as the “mark-to-market” value) or some other measure;
- The appropriateness of its current approach to senior securities limitations for funds; and
- Industry views concerning potential alternative approaches the SEC could implement.

Diversification Requirements

Section 8 of the 1940 Act and related registration form requirements require funds to disclose whether they are diversified or non-diversified. Under Section 5 of the 1940 Act, a diversified fund is a fund that, with respect to 75% of the value of its total assets, has no more than 5% of its value invested in any one issuer. Diversification disclosure raises several issues for funds investing in derivatives: (i) whether derivatives should be treated as securities for the purpose of this test; (ii) how those derivatives are valued; and (iii) how to determine the “issuer” of the derivatives.

The SEC observed that, due to the leveraged characteristics of derivatives, using the same measure of “value” as is used for the calculation of net asset value (“NAV”) (which may be market value, fair value or cost) could undervalue the amount of exposure a derivative is providing to a specific issuer. With regard to identifying the issuer of a derivative, the Concept Release suggests looking at the counterparty rather than the reference instrument though it also recognizes there may be more parties involved than simply the counterparty or clearinghouse (in the case of an exchange-traded or cleared derivative).

The SEC is requesting industry comments on:

- How to value derivatives for diversification determination purposes; and
- How to treat counterparty issues under the diversification requirements, including whether the reference asset issuer is relevant to any regulatory consideration.

Exposure to Securities-Related Issuers

The Concept Release reviewed Section 12(d)(3) of the 1940 Act and Rule 12d3-1, which govern a fund’s exposure to securities-related issuers (“SRIs”). Section 12(d)(3) generally prohibits funds from acquiring any security issued by, or any other interest in the business of, an SRI. SRIs are brokers, dealers, underwriters, investment advisers of funds and registered investment advisers. Rule 12d3-1 provides a limited exception based upon the percentage of the SRI’s securities (but not “other interests” in the SRI) acquired by the fund. Accordingly, if a particular transaction is deemed an “other interest” in a securities-related issuer, but not a security, the transaction would not be permitted under Rule 12d3-1. If an SRI is the fund’s counterparty in a

derivatives transaction, the contractual obligation may be deemed a security issued by, or other interest in the business of, the SRI, and a Section 12(d)(3) violation is possible.

Additionally, the policy concerns addressed by Section 12(d)(3)—conflicts of interest and exposure to the “entrepreneurial risks” of SRIs—may be raised where the securities issued by, or other interests in, an SRI are the reference asset underlying a derivative transaction or where credit support providers that are SRIs are involved in a fund’s derivative transaction.

The SEC is requesting comments to better understand:

- Whether and to what extent funds’ derivatives activities involving SRIs implicate the policy concerns addressed by Section 12(d)(3);
- Whether the presence of collateral is relevant to this analysis; and
- Whether Rule 12d3-1 is the best approach for providing relief from Section 12(d)(3) for derivative transactions.

Portfolio Concentration

Section 8(b) of the 1940 Act and related registration forms require funds to disclose their policies concerning concentration of investments in a particular industry or group of industries. Funds may not deviate from policies regarding concentration as set forth in their registration statements, without obtaining shareholder approval. The SEC has generally stated that a fund is concentrated if it invests, or proposes to invest, more than 25% of the value of its net assets in a particular industry or group of industries.

The limits on fund concentration raise two issues relating to derivatives. First, when a fund enters into a derivative transaction, it can gain exposure to the industry associated with the fund’s counterparty, as well as the industry associated with the issuer of the reference asset. Second, a fund could consider the notional amount or current market value of a derivative for purposes of compliance with its concentration policies. The SEC noted that its standard relating to fund concentration does not address whether a fund should focus on the industry of the issuer or the industry of the reference asset for purposes of the fund’s concentration policies.

The SEC is requesting comments concerning:

- Whether funds consider the current market value or the notional amount of a derivative, or some other measure, and what industry exposure (*i.e.*, counterparty or reference asset) funds focus on for purposes of compliance with their concentration policies;
- Whether a focus on counterparty or reference asset industry exposure is consistent with the policies and purposes of the concentration requirements; and
- Whether the SEC should provide guidance regarding concentration requirements and derivatives generally.

Valuation

Investment companies other than money market funds must calculate their NAVs by using (1) the market values of their portfolio securities or (2) the “fair value” of their portfolio when market quotations are not readily available. Market quotations are not readily available for many derivatives. This may present special challenges for funds because of customized terms (*e.g.*, contractual restrictions on transfer), limited liquidity, and limited availability of pricing information.

The SEC is requesting comments on:

- How funds determine fair values of derivatives;
- How funds assess the accuracy and reliability of pricing information obtained from counterparties and others;
- How funds account for aspects of derivatives such as customizable terms in calculating fair values;
- Whether funds calculate the values of derivatives with negative values (due to their underlying assets) in the same manner as they value derivatives with positive values; and
- Whether the SEC should provide guidance regarding fair valuation of derivatives generally.

Conclusion

The Commission and its staff are increasing their focus on, and the staff is ramping up its capabilities in, the area of derivatives regulation for funds. The investment management industry should be attentive to additional important developments. Please also let us know if we can assist you in commenting on the issues raised in the Concept Release.



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