

SEC Concept Release Requests Industry Comments on Funds' Use of Derivatives

September 2, 2011

At an open meeting on August 31, the Securities and Exchange Commission (SEC) unanimously voted (4-0) to approve the issuance of a Concept Release on the regulatory framework governing the use of derivatives by investment companies under the Investment Company Act of 1940 (1940 Act).¹ The Concept Release solicits comments from investors, industry participants, and industry professionals on a broad range of topics relating to use of derivatives by mutual funds, exchange-traded funds,² closed-end funds, and business development companies (funds) in connection with a comprehensive review being conducted by the SEC and its staff. The purpose of the review is to assist in determining whether regulatory guidance or changes are needed and, if so, what type of changes would be appropriate. Comments will be due during the first week of November and may be submitted online or via email. All comments received will be publicly available.

At the open meeting, Chairman Mary Schapiro noted that the derivatives markets have recently undergone significant changes and that the limits on leverage and senior securities set forth in the 1940 Act were historically intended to apply to stocks and bonds and did not contemplate derivatives. Chairman Schapiro stated that the regulatory framework surrounding funds' use of derivatives has developed on an *ad hoc* basis and that the Concept Release will help the SEC determine whether the regulatory regime needs to be updated. Eileen Rominger, Director of the Division of Investment Management, noted at the open meeting that derivative instruments are widely used in the industry and emphasized the importance of obtaining information, analysis, and opinions from investors, industry participants, and professionals in response to the Concept Release.

The Concept Release states that during its review—which substantially predates the formal announcement in March 2010—the SEC staff has been exploring a number of issues related to the use of derivatives by funds, including the following:

- The benefits, risks, and costs of using derivatives
- Whether current market practices are consistent with the leverage, concentration, and diversification provisions of the 1940 Act

1. See Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Rel. No. 29,776 (Aug. 31, 2011) [hereinafter Concept Release], available at <http://www.sec.gov/rules/concept/2011/ic-29776.pdf>.

2. The Concept Release addresses only those exchange-traded funds that are investment companies registered under the 1940 Act.

- Whether funds that rely substantially on derivatives maintain and implement adequate risk management procedures
- Whether fund boards are providing appropriate oversight of the use of derivatives by the funds they oversee
- Whether existing rules sufficiently address a fund's pricing and liquidity determinations with respect to its derivative investments
- Whether existing prospectus disclosures adequately address the particular risks associated with investing in derivatives
- Whether funds' investments in derivatives should be subject to any special reporting requirements

Although the SEC staff has been exploring fund investments in derivatives for some time, the Concept Release notably marks the first formal instance of the SEC itself soliciting information from industry participants.

The Concept Release was even-handed in its approach, so it is difficult to determine what direction the SEC may take. Further, because the Concept Release will likely elicit many comments, it will be some time before the SEC and its staff are able to review information received and determine what changes, if any, should be made to the regulatory landscape. The tone of the SEC at the open meeting and the language of the Concept Release, however, suggest that the SEC is approaching the question of whether or not to change the current regulatory structure in a measured, open-minded way. Given the focus on industry input and the acknowledgement that derivatives offer benefits to funds and fund investors, it seems unlikely that the SEC would prohibit or substantially restrict the ability of funds to use derivatives. At this juncture, the SEC appears to be focused on collecting the information necessary to allow it to enhance the current regulatory framework. However, it would not be surprising if the SEC proposes rule making in the area to address concerns highlighted by the SEC both in the Concept Release and in prior speeches by the staff, including (i) the *ad hoc* nature of the current regulatory regime, (ii) whether the degree of economic leverage achieved by funds through derivatives is consistent with the 1940 Act, and (iii) the compliance infrastructure adopted by funds in connection with their use of derivatives.

Although it is too early to tell exactly what the SEC will do, we would expect interpretive guidance or rulemaking to seek to accomplish the following:

- Combine the roughly 30 years of SEC interpretive and no-action guidance into a cohesive scheme that clarifies existing ambiguities, including (a) how to satisfy coverage requirements; (b) application of Section 12(d)(3); (c) whether concentration tests should look to the counterparty, reference instruments, or both; and (d) how to evaluate derivatives in connection with the diversification rules.
- Require enhanced compliance procedures by funds around coverage, valuation of derivatives, and use of counterparty collateral to mitigate counterparty risk.

As a result, we believe that it will be important for funds, investors, and other interested parties to focus particularly closely on these areas when submitting comments. When drafting comments for the SEC,

industry participants may wish to consult [an article written by Morgan Lewis attorneys](#) that discusses the various legal issues implicated by fund investments in derivatives.³

Description of the Concept Release

The Concept Release begins with a discussion of the broad use of derivatives by funds and a summary of existing regulatory framework under the 1940 Act. The discussion then focuses on senior security issues under Section 18 of the 1940 Act and solicits comments as to whether the current asset segregation/earmarking approach used to address senior security issues continues to be appropriate, particularly in light of the 1940 Act's focus on investor protection and, in particular, how exposure should be measured. In this area, the Concept Release suggests that the current choice of mark-to-market exposure or notional may not be appropriate and that a measure that allows for risk weighting of exposure, such as "value at risk" may be appropriate. The SEC seeks comments on whether fund boards would have sufficient expertise to oversee such an alternative approach.

The Concept Release also reviews the evolution of the regulatory framework under Section 18, discussing the 1979 SEC release on funds' use of leverage⁴ and subsequent patch-work quilt of guidance in the form of no-action letters and interpretations, and then notes common criticisms of the current approach. The Concept Release goes on to ask about possible alternative approaches, including those used by foreign regulators⁵ and those suggested by the American Bar Association Section of Business Law in the July 6, 2010 report of its Task Force on Investment Company Use of Derivatives and Leverage.⁶

The Concept Release also addresses other issues under the 1940 Act that are implicated by funds' use of derivatives, including diversification, concentration, issuer restrictions, and valuation. Specifically, the Concept Release asks how derivatives should be valued for diversification and concentration purposes

3. See P.G. Bullitt, T. Harman, C. Menconi, B. Zimmerman, and C. Jackson, *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 1*, Vol. 17 No. 8 INV. LAWYER 12–27 (Aug. 2010); P.G. Bullitt, T. Harman, C. Menconi, B. Zimmerman, and C. Jackson, *Legal Considerations for Registered Investment Companies Investing in Derivatives: Part 2*, Vol. 17 No. 10 INV. LAWYER 19–33 (Oct. 2010); available at http://www.morganlewis.com/pubs/InvestmentLawyer_LegalConsiderationsCompaniesInvestingInDerivatives_AugOct10.pdf. Mr. Jackson is General Counsel of Calamos Investments.

4. See Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10666 (Apr. 18, 1979), available at <http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf>.

5. The approaches used by the European Securities and Markets Authority (formerly the Committee of European Securities Regulators), the Monetary Authority of Singapore, the Central Bank of Ireland, the Canadian Securities Administrators, and the Hong Kong Securities and Futures Commission are also discussed at length in the Concept Release.

6. See American Bar Association Section of Business Law, Committee on Federal Regulation of Securities, Report of the Task Force on Investment Company Use of Derivatives and Leverage, at 47–48 (July 6, 2010) (ABA Task Force Report), available at http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf. Among other suggestions, the Task Force suggested that the SEC require funds to establish board-approved written policies that would set forth minimum asset segregation requirements using risk-adjusted segregation amounts that would be tailored to each instrument, address the types of assets that could be used as segregated assets, and describe offsetting transactions. The Task Force also recommended that these policies be described in a fund's statement of additional information and that segregation not be required where a fund does not use explicit leverage (i.e., where it carries leverage through an investment in another fund). The ABA Task Force Report resulted from the challenge to the American Bar Association from then-Director of the Division Management Andrew Donohue to consider new approaches that would address concerns regarding fund investments in derivatives. See A. Donohue, Speech by SEC Staff: Luncheon Address Before a Meeting of the Bus. Law Section of the Am. Bar Ass'n Comm. on Fed. Reg. of Sec. (Apr. 24, 2010), available at <http://www.sec.gov/news/speech/2010/spch042410ajd.htm>.

and requests that funds provide the SEC with information about how they value derivative instruments. With respect to issuer restrictions under Section 12(d)(3) of the 1940 Act, the Concept Release discusses possible implications of entering into derivative transactions with a broker-dealer or with respect to a reference asset of a broker-dealer or investment adviser.

Although several other issues arising under the 1940 Act relating to funds' use of derivatives were not mentioned during the open meeting and are not expressly addressed in the Concept Release—namely custody issues, liquidity limitations, compliance with Rule 35d-1 (the so-called “names rule”), and tax implications—these areas may be addressed by commenters in response to a general request for information in the Concept Release. The SEC notes in the Concept Release that it may consider these and other significant derivatives-related issues, such as disclosure, at a later date.⁷

In any event, it is too soon to know for certain what will result from the Concept Release and the information it solicits. Morgan Lewis will continue to monitor these developments and will be issuing more comprehensive analyses as to the possible direction and scope of regulatory changes that may result from the Concept Release.

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7. See Concept Release at n.20.

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