SEC ISSUES DERIVATIVES CONCEPT RELEASE — SIGNIFICANT CHANGES MAY BE IN STORE FOR REGISTERED FUNDS

The Securities and Exchange Commission issued a concept release on August 31 with respect to the use of derivatives by registered investment companies and business development companies ("funds").[1] The SEC broadly defines the term "derivatives" to include "instruments or contracts whose value is based upon, or derived from, some reference asset."[2] The Concept Release recognizes that funds employ derivatives for a variety of purposes, including to increase leverage with the goal of augmenting returns, gain access to certain markets, achieve greater transaction efficiency, and hedge interest rate, credit and other risks.[3]

Statements from individual members of the SEC and from SEC staff over the past few years convinced many in the asset management business that any guidance issued by the SEC at this time dealing with funds and derivatives would seek to modernize and clarify the treatment of derivatives under the Investment Company Act of 1940. The SEC, however, took a different approach in the Concept Release, soliciting public comment on a wide range of issues relevant to the use of derivatives by funds, including the potential implications for (i) fund leverage, (ii) diversification, (iii) exposure to certain securities-related issuers, (iv) portfolio concentration and (v) valuation. The obvious unanswered questions in the Concept Release are whether or when the SEC or its staff will issue interpretive guidance on the use of derivatives by funds.

Significant Areas of Uncertainty

The SEC seeks comment regarding how particular provisions of the Investment Company Act and the regulations adopted under the Act should be interpreted in the context of derivatives. The SEC's ultimate resolution of the issues raised in the Concept Release could result in significant changes to both the ability of funds to engage in derivatives transactions and the manner in which derivatives are used by funds. Among the most significant questions left open by the Concept Release are:

- **Asset Coverage.** Will the SEC require funds to segregate assets to cover the full notional amount of a derivative (even if cash settled), thereby potentially reducing the use of derivatives by funds? Will the SEC require 300% asset coverage of derivatives to eliminate the distinction between asset segregation under Release 10666[4] and the

1 *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Company Act Release No. 29776 (August 31, 2011) ("Concept Release"), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

2 *See id.* at 11.

3 *See id.* at 5.

4 *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666").

300% asset coverage requirements of Section 18 of the Investment Company Act? Will the SEC impose a uniform standard for determining a fund's asset segregation requirements, such as notional value, mark-to-market, value at risk ("VaR") or another measure of the fund's derivatives exposure?

- **Derivatives Contract Counterparties as "Issuers" under the Investment Company Act.** Will the SEC require funds to treat the counterparty to a derivatives contract, the issuer of the reference asset of the derivatives contract, or both, as the "issuer" for purposes of diversification and concentration requirements under the Investment Company Act?

- **Derivatives as Securities.** Will the SEC assert that all over-the-counter ("OTC") derivatives are securities (*i.e.*, notes or evidences of indebtedness) under Section 2(a)(36) of the Investment Company Act for purposes of the diversification requirements[5] and limitations on investments in securities of securities-related issuers under Rule 12d3-1?[6] Alternatively, will the SEC determine that an OTC derivative constitutes an "interest in" a counterparty (rather than a "security" issued by that counterparty), rendering the exemption provided by Rule 12d3-1 unavailable for transactions with certain securities-related issuers?

- **ETFs.** How will the SEC treat the use of derivatives by exchange-traded funds ("ETFs")? Will the SEC continue its prohibition on the use of futures, options and swaps by active transparent ETFs?

Major Areas of SEC Inquiry Related to the Use of Derivatives under the Investment Company Act

A. Senior Securities Restrictions

Section 18 of the Investment Company Act limits the issuance of senior securities by registered investment companies and business development companies.[7] In Release 10666, the SEC considered the application of Section 18's restrictions on the issuance of senior securities to certain instruments and concluded that reverse repurchase agreements, firm commitment agreements and standby commitment agreements, while not securities for all purposes, may involve the issuance of senior securities and "fall within the functional meaning of the term 'evidence of 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."[8]

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[5] *See* Concept Release, *supra* note 1, at 50, n.134.

[6] *See id.* at 59-60.

[7] Section 18 is modified with respect to business development companies by Section 61 of the Investment Company Act.

[8] *See* Concept Release, *supra* note 1, at 21, citing Release 10666, *supra* note 4, at "The Agreements as Securities" discussion. The SEC also 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." *Id.*

Nonetheless, the SEC further noted that these agreements and similar arrangements would not raise the issue of Section 18 compliance if funds "covered" the arrangements by maintaining segregated accounts containing only liquid assets, such as cash, U.S. Government securities or other appropriate high grade debt obligations, equal to the indebtedness incurred by the fund under the arrangement.[9] In effect, Release 10666 requires asset coverage of 100% for reverse repurchase agreements, firm commitment agreements and standby commitment agreements, as opposed to the 300% asset coverage requirement imposed by Section 18 on the issuance of debt securities. Although Release 10666 dealt with these types of agreements in particular, its reasoning was also intended to apply to comparable trading practices that might affect the capital structure of investment companies in an analogous fashion.[10] The SEC staff subsequently applied the concepts set out in Release 10666 to other instruments, including futures, forwards and written options[11] and indicated that segregated assets that are used to cover derivatives may include cash or any security, including equity securities and non-investment grade debt, provided that the security is liquid and marked-to-market daily.[12] In addition, in these letters the SEC staff permitted an alternative method to the use of segregated accounts, namely "covering" leveraged transactions through the ownership of underlying instruments or maintenance of offsetting positions.

In the Concept Release, the SEC seeks to reexamine this approach and describes other methods of determining the risk of a fund's investments in derivatives instruments, including VaR, risk adjusted segregated amounts ("RASA"), maximum exposure limitations, limits in relation to a fund's net asset value and to each counterparty, and differentiated approaches depending on the type of derivative instrument. The Concept Release requests comment on whether one of these approaches, or the notional amount or mark-to-market amount of a derivative instrument, should be used to determine the asset segregation amount under Section 18. The SEC is also seeking views related to whether it should reconsider its position in Release 10666 and the staff's position in the Merrill Lynch Letter, and whether it should require diversification among derivatives counterparties under the Investment Company Act.

B. Diversification Requirements

Under the Investment Company Act, a diversified fund is one that, with respect to 75% of the value of its total assets, has, among other things, no more than 5% of the value of its total assets invested in the securities of any one issuer.[13] A fund must include the value of any derivatives in

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[9] *See* Concept Release, *supra* note 1, at 22, citing Release 10666, *supra* note 4, at text accompanying n.15. 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." *See* Concept Release at 23, quoting Release 10666, at text accompanying n.15.

[10] *See* Release 10666, *supra* note 4, at 38.

[11] *See* Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987).

[12] *See* Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) ("Merrill Lynch Letter").

[13] *See* Section 5(b) of the Investment Company Act.

which it invests for purposes of calculating its total assets under the diversification test. A fund must also consider how to value derivatives for purposes of calculating whether the fund has invested more than 5% of its total assets in any one "issuer" and identify the issuer with respect to each derivative.[14]

1. Derivatives as "Securities"

In the Concept Release, the SEC states: "[A]s a general matter, most derivatives appear to be notes or evidences of indebtedness and thus securities for purposes of the diversification requirements."[15] The SEC cites the ability of a fund, through the use of derivatives, 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 still classifying itself as diversified.[16] If the SEC were to reinterpret the diversification test to refer to notional exposure, rather than the value of total assets, a diversified fund's ability to enter into derivatives transactions could be significantly curtailed. If this were the case, diversified funds entering into derivatives transactions might need to reduce their notional exposure to derivatives and/or expand the number of counterparties with which they are willing to transact (particularly if the counterparty is considered the "issuer" for diversification testing purposes).[17]

2. Valuation for Diversification Purposes

Under the Investment Company Act, derivatives must generally be valued for diversification purposes using market values (when readily available) and fair values, at the end of the fund's last preceding fiscal quarter, or, if subsequently acquired, their cost.[18] The SEC noted that using mark-to-market valuation of derivatives, rather than market or fair valuation of the full notional amount, could permit a fund to maintain an ongoing exposure to a single issuer or group of issuers in excess of the 5% limitation, because 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 contract.[19] The SEC seeks comment on how derivatives should be valued for purposes of applying the diversification test, including whether the full notional amount or the mark-to-market value of a derivative should be used.

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[14] *See* Concept Release, *supra* note 1, at 51.

[15] *Id.* at 50, n.134.

[16] *Id.* at 52.

[17] A recent American Bar Association committee task force report on the use of derivatives and leverage by funds expresses the view that it is not appropriate to include certain derivatives as "securities" for purposes of the diversification requirements. *See 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) ("ABA Report").

[18] *See* Concept Release, *supra* note 1, at 51; Rule 5b-1 under the Investment Company Act.

[19] *See* Concept Release, *supra* note 1, at 52.

3. Identity of Derivatives "Issuer" for Diversification Purposes

Diversified funds that invest in derivatives must identify the issuer of the securities in their portfolio in determining their compliance with Section 5(b) of the Investment Company Act. The SEC queries in the Concept Release whether the counterparty to the derivatives contract, the issuer of the reference security, or both, should be considered an "issuer" for purposes of the diversification requirements under the Investment Company Act.

C. Exposure to Securities-Related Issuers through Derivatives

Under Section 12(d)(3) of the Investment Company Act, funds generally may not purchase or acquire securities issued by (or any other interest in) securities-related issuers, which include brokers, dealers, underwriters and registered investment advisers. Rule 12d3-1 provides a limited exemption from the restriction under Section 12(d)(3) if certain conditions are met. [20]

The exemption provided by Rule 12d3-1 requires valuation of derivatives to determine whether more than 5% of a fund's total assets are invested in the securities of an issuer. For purposes of this calculation, the Concept Release posits that a fund's exposure to its counterparty or to the issuer of a reference security may be understated if the current market or fair value of the derivative (rather than notional exposure) is used as the measure.[21] In this regard, the Concept Release notes that the potential future exposure of a fund to the securities-related issuer is likely to be unaccounted for by a current mark-to-market standard.[22]

The SEC notes that the exemption afforded by Rule 12d3-1 may provide an exemption in certain instances when a fund engages in an OTC derivatives transaction with a securities-related issuer as a counterparty, if the "security" is issued by that counterparty.[23] Further, the SEC states in the

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[20] *See* Rule 12d3-1 under the Investment Company Act. The Rule provides, in general, that a fund may acquire the securities of any person that, in its most recent fiscal year, (1) derived 15 percent or less of its gross revenues from "securities related activities," as long as the fund does not control the person after acquisition; or (2) derived more than 15 percent of its gross revenues from "securities related activities" if, among other things, the fund does not acquire more than 5% of a class of the issuer's outstanding equity securities, or more than 10% of the outstanding principal amount of the issuer's debt securities, and the fund does not have more than 5% of the value of its total assets invested in the securities of the issuer.

[21] *See* Concept Release, *supra* note 1, at 62.

[22] *Id.*

[23] *See id.* at 59. The SEC notes that a derivative is likely to be categorized as a debt security subject to the 10% limitation of Rule 12d3-1. *Id.* at n.156. The SEC further notes that its staff has not objected to the assertion that, in acquiring an exchange-traded derivatives contract, a fund generally would not appear to be acquiring securities issued by, or an interest in, a securities-related issuer. *See id.* at 59, citing Institutional Equity Fund, SEC No-Action Letter (Feb. 27, 1984). In contrast, the SEC indicates that the counterparty to a fund in an OTC derivatives contract could be a securities-related issuer, and any transaction between the fund and the counterparty to the OTC derivatives contract may represent the acquisition of a security issued by, or an interest in, that issuer for purposes of Section 12(d)(3) and Rule 12d3-1. *See* Concept Release, *supra* note 1, at 59-60.

Concept Release that if an OTC derivative is not a security issued by the counterparty, but the transaction may be deemed to be the fund's acquisition of "an interest in" a securities-related issuer (*i.e.*, the counterparty), then Rule 12d3-1 would not be available because it exempts only acquisitions of securities, and thus the transaction would be prohibited under the Investment Company Act.[24] While noting that there is no "bright-line test," the Concept Release does not explain the legal reasoning for how an acquisition of an OTC derivative would constitute an acquisition of "an interest in" a securities-related issuer under the Investment Company Act.[25] The SEC also notes that it may be necessary to analyze a fund's exposure to the reference asset underlying the derivative in determining whether an OTC derivatives transaction is prohibited or limited under the Investment Company Act as an acquisition of a security issued by, or an interest in, a securities-related issuer.[26]

The SEC seeks comment regarding funds' exposure to securities-related issuers through derivatives, including whether (i) derivatives transactions between funds and securities-related issuers implicate the purposes of Section 12(d)(3) and (ii) Rule 12d3-1 is the appropriate framework for exempting certain derivatives transactions from Section 12(d)(3).

D. Portfolio Concentration

Funds must disclose in their registration statements their policies concerning "concentrating investments in a particular industry or group of industries."[27]

A fund will be considered concentrated in a particular industry or group of industries if it proposes to invest more than 25% of its net assets in a particular industry or group of industries.[28] A fund that enters into a derivatives transaction may gain exposure to more than one industry or group of industries (*i.e.*, to both the counterparty's industry and the industry associated with the reference asset), and thus a fund engaged in these transactions might have a higher concentration than would appear if measuring concentration based upon a percentage of a fund's net assets in a particular industry.[29] Another derivatives-related concern set out in both the Concept Release and the ABA Report is related to valuation for purposes of this calculation — a fund's use of notional, rather than market, value of a derivative instrument might inflate the fund's industry position relative to its economic exposure.[30]

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[24] *See id.* at 59-60.

[25] *See id.*

[26] *See id.* at 60.

[27] *See*, *e,g.*, Form N-1A, Item 9 (Instruction 4); Form N-2, Item 8(2)(B)(2); Section 8(b)(1) of the Investment Company Act.

[28] *See* Concept Release, *supra* note 1, at 65.

[29] *See id.* at 65-66.

[30] *See id.* at 66; ABA Report, *supra* note 17, at 30, n.57.

Although not cited in this part of the Concept Release, the ABA Report cautions that it "would lead to odd results to take the counterparty for OTC derivatives into account" for concentration purposes "because a fund could be deemed to be concentrating in the financial services industry merely because of counterparty exposure, although the relevant derivative instruments were designed to and did in fact give the fund exposure to many different industries."[31] The ABA Report asserts that the concentration provisions were not designed to set rules pertaining to exposures to financial intermediaries and counterparties, which are addressed in other sections of the Investment Company Act, such as Section 12(d)(3).[32]

The SEC seeks comment regarding the application of concentration requirements to funds' investments in derivatives, including whether funds (i) consider current market value or the notional amount of a derivatives contract for purposes of determining whether they have invested 25% or more of the value of their net assets in a particular industry or group of industries, and (ii) should 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 for purposes of the concentration requirements.

E. Valuation

Generally, the Investment Company Act provides that securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by a fund's board of directors.[33] The SEC acknowledges that for purposes of valuing derivatives, market quotations are typically available for exchange-traded derivatives. For other derivatives, however, there may be no readily available independent information or quotations, or the fund's counterparty may be the only available source of pricing information.[34]

The SEC seeks comment on funds' valuation of derivatives, including how funds (i) take into account contractual restrictions on transferability or their ability to close out transactions or enter into offsetting transactions when valuing derivatives and (ii) treat derivatives that have negative value.

Request for Comment

The SEC solicits comment on the questions posed in the Concept Release and any other matters the public believes are relevant to the use of derivatives by funds. The deadline for commenting on the Concept Release is November 7, 2011.

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[31] *See* ABA Report, *supra* note 17, at 30.

[32] *Id.*

[33] *See* Section 2(a)(41) of the Investment Company Act.

[34] *See* Concept Release, *supra* note 1, at 69.

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