The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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ICI Submits Comment Letter on SEC's Concept Release on Funds' Use of Derivatives

[25625]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 28-11
CHIEF COMPLIANCE OFFICER COMMITTEE No. 17-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 77-11
COMPLIANCE MEMBERS No. 43-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 46-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 45-11
ETF ADVISORY COMMITTEE No. 68-11
SEC RULES MEMBERS No. 131-11
SMALL FUNDS MEMBERS No. 64-11 RE: ICI SUBMITS COMMENT LETTER ON SEC'S CONCEPT RELEASE ON FUNDS' USE OF DERIVATIVES

In late August, the Securities and Exchange Commission published a 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. [1] ICI filed a comment letter today commending the Commission for issuing the Concept Release and for seeking to take a more comprehensive and systematic approach to the regulation of derivatives under the Investment Company Act.

The Concept Release seeks input on a wide range of complex issues. The letter notes that it was not possible, within the comment period, to develop an industry response to each and every question posed by the Commission. Instead, we focus primarily on two broad topics: leverage and the Act's prohibition on funds' issuance of senior securities; and the diversification, concentration, and securities-related issuer tests, particularly as they relate to the regulation of counterparty exposures.

Our principal recommendations include the following:

- Clearly define "leverage." We recommend that the Commission define "leverage" for

purposes of section 18 of the Act to include only those transactions that create actual or potential indebtedness. By adopting a definition of “leverage” in the context of section 18 that relates solely to indebtedness leverage and clearly distinguishes it from economic leverage, the Commission could alleviate some of the confusion in this area while appropriately protecting investors and serving the purposes of the Act.

- Take a principles-based approach to asset segregation. We recommend that the Commission take a principles-based approach to the practice of segregating or earmarking assets to “cover” for potential indebtedness leverage. Under such an approach, funds would be required to adopt rule 38a-1 policies and procedures concerning asset segregation that would address each type of derivative instrument that they intend to use, subject to Commission guidance that imposes appropriate “guardrails” (discussed below). The policies would establish asset segregation standards in view of the characteristics of particular derivatives and other relevant factors, such as liquidity and volatility, in keeping with other standards used by investment, risk and compliance professionals to manage portfolio risk and exposures. The policies would govern the amount to segregate, the types of assets that can be used for such purposes, and what constitutes an appropriate offsetting exposure. Funds would be required to describe the policies in reasonable detail in their Statement of Additional Information (SAI), and the policies would be subject to approval and oversight by the fund’s board. As with other fund policies subject to rule 38a-1, they also would be overseen by the Chief Compliance Officer for the fund and adviser and subject to SEC staff inspection and examination. [2]
- Issue guidance that creates appropriate “guardrails” to protect investors. We recommend that the Commission or its staff, while taking a principles-based approach, also issue general guidance that provides “guardrails” to ensure appropriate protections for investors. We suggest that such guidance include:
    - Advisers should design asset segregation policies with the objective of maintaining segregated assets sufficient to meet obligations arising from the fund’s derivatives under extreme but plausible market conditions, as determined on a current basis; [3]
    - When segregating less than the most conservative full notional amount, the segregation policy should require a more in-depth analysis to ensure that the fund has a “cushion” to address the potential loss from derivative contracts that could arise before the next time obligations are marked-to-market (often, the end of the next day), pursuant to which instruments with higher potential for loss or intra-day volatility would warrant a higher level of segregation;
    - A segregation policy should include measures such as back-testing and/or stress-testing in order to help verify the assumptions and models used to determine the amount of assets to be segregated; and
    - Advisers must have internal processes and infrastructure to perform the analysis suggested above and monitor for ongoing compliance.
- Require funds to “look through” derivatives and apply the diversification, concentration, and securities-related issuer tests to reference assets. The letter recommends that existing, traditional tests for diversification, concentration, and exposure to securities-related issuers should be applied with respect to the reference assets of derivatives, and not counterparties.
- Deal separately with counterparty exposures, in a rule designed specifically for that purpose. Such a rulemaking would be complex, but is necessary to address the ways in which counterparty exposures are different from investment exposures. The letter outlines a counterparty rule that would, similar to counterparty-specific rules in Europe and elsewhere:

- Address the appropriate way to calculate counterparty exposure;
- Set an appropriate limit on uncollateralized exposure to any one counterparty; and
- Require additional counterparty risk disclosure in certain contexts.

The letter also contains a section briefly describing funds' current uses of derivatives. In this section, the letter notes that derivatives have become an integral tool in modern portfolio management, offering fund managers an expanded set of choices, beyond the traditional "cash securities" markets, through which to implement the manager's investment strategy and manage risk. The letter also argues that, while it is appropriate that much of the discussion in the Concept Release focuses on the potential for creating leverage through investments in derivatives, it is essential to recognize that the use of derivatives does not necessarily mean a fund has an aggressive or leveraged investment objective. Finally, in this section, the letter argues that the Commission should lift its moratorium on approving new applications for exchange-traded funds that use derivatives. While it is true that some ETFs, such as leveraged or inverse ETFs, make substantial use of derivatives, all ETFs must comply with the same regulatory framework as other funds registered under the Investment Company Act and should not be singled out for unique treatment in this regard.

Recognizing the complexity of these issues and their importance, the letter notes that ICI is planning to host a forum in the coming months to discuss these issues in depth. We strongly believe that a wide range of perspectives provides tremendous benefit in this context, and accordingly we will seek to bring together policymakers, regulatory staff, outside counsel, and experts from funds' legal, compliance, risk management, accounting, and portfolio management areas to join that discussion.

Robert C. Grohowski
Senior Counsel
Securities Regulation - Investment Companies

Attachment

endnotes

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

[2] In general, the extent and complexity of a fund's asset segregation policies and procedures should be consistent with the derivatives it anticipates using and its approach to segregated asset coverage. Funds with more complex policies may be likely to take a two-tier approach, where overarching policies are approved by the board and more detailed procedures (sometimes referred to as "desk procedures") are used for day-to-day implementation purposes.

[3] We see this concept as similar to the types of cushions being used or considered in other contexts, such as for initial margin and in the development of swap execution facilities (SEFs) and derivatives clearing organizations (DCOs). "Extreme but plausible market conditions" is a statutory standard used by SEFs and DCOs to determine the minimum amount of financial resources such entities must have to ensure, with a

reasonably high degree of certainty, that they will be able to satisfy their obligations. See, e.g., Section 5b(c)(2) of the Commodity Exchange Act, as amended by Section 725(c) of the Dodd-Frank Act. In the letter, we recognize that this term is new and lacks context under the Investment Company Act, and that upon further consideration the Commission or staff may find that other standards are more appropriate. To the extent the standard is considered, we recommend that the guidance recognize that the goal of asset segregation is to reasonably assure the availability of adequate funds, and afford advisers appropriate flexibility to interpret what constitutes “extreme but plausible” market conditions. The guidance also could provide examples of “extreme but plausible market conditions” and explain how advisers should take the results of their analysis into account when developing segregation policies.
