

**MEMO# 25503**

September 19, 2011

## **SEC Issues Concept Release on Funds' Use of Derivatives**

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TO: TAX COMMITTEE No. 57-11 RE: SEC ISSUES CONCEPT RELEASE ON FUNDS' USE OF DERIVATIVES

The Securities and Exchange Commission has published a concept release ("Concept Release" or "Release") and request for comments on a wide range of issues relevant to the use of derivatives by funds. [\[1\]](#) Noteworthy is the SEC's interest in the application of the diversification test under the Investment Company Act (the "Act") to portfolios that include derivatives.

The Release identifies two principal compliance issues concerning the use of derivatives: (1) valuation of derivatives and (2) identification of the issuer of a derivative for purposes of determining a fund's classification as diversified or non-diversified.

On valuation, the Release notes how funds currently value derivatives (and all other assets) for diversification testing by using market values, fair values, or cost. If a derivative's mark-to-market value at a given point does not accurately reflect the fund's potential future exposure, the Release asks whether the SEC should consider requiring a different method of valuation for diversification testing.

With regard to the identification of issuers, the fund has potential exposure to two credit profiles: (1) the counterparty to the contract and (2) the issuer of the reference security. The Release asks whether counterparties should be considered "issuers" for these purposes, or whether counterparty exposure should be addressed separately under Section 12(d)(3) of the Act (an approach recommended by the ABA Task Force).

In addition to diversification, the SEC is interested in the potential implications of the use of derivatives for fund leverage, exposure to certain securities-related issuers, portfolio concentration, and valuation. Comments are due sixty days after the Release is published in the Federal Register. We will discuss the Concept Release during the next Tax Committee conference call scheduled for Wednesday, September 21st.

**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>. For purposes of the Release, “funds” include management investment companies registered under the Investment Company Act and companies that have elected to be treated as business development companies (“BDCs”) under the Act.

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