MEMO# 25577

October 24, 2011

# Draft ICI Letter on SEC's Concept Release on Funds' Use of Derivatives; Comments Requested by Monday, October 31

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 16-11
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 48-11
CHIEF COMPLIANCE OFFICER COMMITTEE No. 15-11
COMPLIANCE ADVISORY COMMITTEE No. 5-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 41-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 44-11
ETF ADVISORY COMMITTEE No. 66-11
SEC RULES COMMITTEE No. 89-11
SMALL FUNDS COMMITTEE No. 44-11 RE: DRAFT ICI LETTER ON SEC'S CONCEPT RELEASE ON FUNDS' USE OF DERIVATIVES; COMMENTS REQUESTED BY MONDAY, OCTOBER 31

As you know, in 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]

Last month, we formed a working group of interested members to assist us in formulating the ICI's response. We very much appreciate the working group members' time and input on early versions of the ICI's draft letter, which is attached.

The draft letter notes that the Concept Release seeks input on a very wide range of complex issues, and that we are not attempting to develop an industry response to each and every question the Commission poses. Rather, we focus primarily on two broad topics: leverage and the Investment Company Act's prohibition on senior securities; and the diversification, concentration, and securities-related issuer tests, particularly in how they relate to the regulation of counterparty exposures. In this regard, the letter recommends that the Commission:

- 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. We argue that 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 policies and procedures concerning asset segregation for each type of derivative instrument that they intend to use. These policies would govern, in detail, the amount to segregate, the types of assets that can be used for such purposes, and what constitutes an appropriate offsetting exposure. These policies would be subject to approval and oversight by the fund's board and subject to SEC staff examination.
- Issue Commission guidance that creates appropriate "guardrails" to protect investors. While we favor a principles-based policies and procedures approach, we are not advocating that funds have unfettered discretion in determining asset segregation policies. We recommend that the Commission set forth general guidance that provides "guardrails" to ensure appropriate protections for investors. We suggest that such guidance explain that:

    - Advisers should design asset segregation policies with the objective of reasonably ensuring that a fund maintains segregated assets sufficient to meet its outstanding obligations from derivatives, as determined on a daily basis;
    - The extent and complexity of a fund's asset segregation policies and procedures should be consistent with the degree and manner to which it anticipates using derivatives;
    - The segregation policy should explain what characteristics of the instrument were used to determine the appropriate level of segregation, including, at a minimum, anticipated volatility due to market risk or the structure of the instrument, the complexity of the instrument, anticipated liquidity, and the terms and frequency of settlement;
    - Advisers must consider the potential for intra-day exposures;
    - Asset segregation levels should be tested for effectiveness on a regular basis; and
    - Advisers must have the internal processes and infrastructure necessary to perform the analysis suggested above and monitor for ongoing compliance.
- Take an entirely new approach to the diversification, concentration, and securities-related issuer tests, dealing separately with counterparty exposures. We recommend a new paradigm with respect to the Act's provisions governing diversification, concentration, and investing in certain types of securities-related issuers:

    - The Commission should apply the existing, traditional tests for diversification, concentration, and exposure to securities-related issuers to the reference assets of derivatives, and not counterparties.
    - Counterparty risk should be dealt with separately, in a rule designed specifically for that purpose. Through additional concept releases, roundtables, and eventually rulemaking, the Commission could consider various options to address the ways in which counterparty exposures are different from investment

exposures.  For example, the Commission could explore: the changing nature of counterparties and counterparty relationships; the appropriate way to calculate counterparty exposure; whether and under what circumstances it would be appropriate to limit maximum exposure to one, or a certain number, of counterparties; and whether additional counterparty risk disclosure is warranted in certain contexts.

In addition to those recommendations, the draft letter includes a relatively short section at the outset describing funds' use of derivatives.  The draft letter stresses that derivatives have become an integral tool in modern portfolio management, and that the use of derivatives does not necessarily mean a fund has an aggressive or leveraged investment objective.  In response to the Concept Release question on exchange traded funds' use of derivatives, the draft letter argues that the moratorium on new ETF applications is unwarranted from a regulatory perspective and should be lifted. [2]

Comments on the Concept Release are due November 7.  Accordingly, please provide comments on the draft letter to me by email at rcg@ici.org or by fax to 202/326-5827 no later than Monday, October 31.

Robert C. Grohowski
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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] Since March 2010, the SEC has deferred consideration of exemptive requests by new ETFs that make significant use of derivatives.