

MEMO# 25463

September 6, 2011

SEC Issues Concept Release on Funds' Use of Derivatives; Conference Call Wednesday, September 21

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TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 13-11 RE: SEC ISSUES CONCEPT RELEASE ON FUNDS' USE OF DERIVATIVES; CONFERENCE CALL WEDNESDAY, SEPTEMBER 21

The Securities and Exchange Commission has 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. [\[1\]](#) Comments on the Concept Release will be due approximately 60 days after it is published in the Federal Register.

Committee Conference Call

We will have a conference call to discuss the Release and potential ICI comments at 2:00 p.m. Eastern time on Wednesday, September 21. If you would like to participate on the call, please RSVP to Gwen Kelly at gwen.kelly@ici.org or 202/326-5818.

Background

The SEC issued the Concept Release to assist it and its staff in their ongoing review of the use of derivatives by funds. The Release states that the goal of the review is to evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Investment Company Act and is consistent with investor protection.

General Request for Comment

The Concept Release broadly requests data and invites comment on the types of derivatives used by funds, the purposes for which funds use derivatives, and whether funds' use of derivatives has undergone or may be undergoing changes.

As part of this general request for data and comment, the Release asks a number of somewhat more specific questions about the types, purposes, costs, benefits, and risks of derivatives and the role of collateral in mitigating risks. [2] The Release also specifically asks whether ETFs use derivatives for the same purposes that other open-end funds use them, and whether such use raises any unique investor protection concerns. [3]

Specific Topics Addressed in the Concept Release

The remainder of the Concept Release is divided into five major topics: the senior securities restrictions of the Investment Company Act (including concepts of leverage and segregated asset coverage); diversification requirements; exposure to securities-related issuers; portfolio concentration; and valuation.

1. Senior Securities, Leverage, and Asset Coverage

A substantial part of the Concept Release focuses on the application of the limitations on senior securities in Section 18 of the Act to derivatives. The Release provides a history of the SEC's and staff's interpretations in this regard and the development of its current segregated account approach, from the SEC's 1979 general statement of policy in Release 10666 [4] through the more than twenty no-action letters issued since that time. [5] The approach allows funds to "cover" potential liabilities by segregating certain assets on its books or in a segregated account at its custodian.

The Release notes that the SEC's segregated account approach has drawn criticism on several grounds. For example, an instrument-by-instrument assessment of the amount of coverage required may create uncertainty about the treatment of new products or may result in differing treatment for arguably equivalent products. It also may result in a less than optimal amount of coverage by relying on either notional amounts or mark-to-market amounts in determining the amount of assets to segregate.

The Concept Release then discusses potential alternatives to the regulation of portfolio leverage. It describes the approach advocated by an American Bar Association task force last year [6] and other approaches taken outside the U.S., including those by European regulators, Singapore, Ireland, Canada, and Hong Kong. [7] It then contains 11 pages of specific questions. [8] We encourage ICI members to review these questions closely, which in general relate to the appropriateness and effectiveness of the SEC's current approach and whether the approach might be improved to better serve the statutory purposes of the Act and protect investors. Many of the questions relate to the optimal amount of cover that should be required (whether notional, mark-to-market, the ABA Task Force's suggestion for a "risk adjusted segregated amount" (RASA), or some other metric like value at risk (VaR)), or the appropriate types of assets that should be eligible to use for coverage.

2. Diversification

The next section of the Concept Release focuses on the application of the Act's diversification test to portfolios that include derivatives. The Release explains that the diversification requirements are designed to prevent a fund that holds itself out as diversified from having heightened exposure to one or a few issuers and help to accurately inform investors about the nature of the fund.

This section of the Release describes two principal compliance issues: the valuation of derivatives and the identification of the issuer of a derivative for purposes of determining a fund's classification as diversified or non-diversified.

Valuation. The Release explains how funds currently value derivatives (and all other assets) for diversification testing by using market values, fair values, or cost. The Release notes that a derivative's mark-to-market value at a given point does 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 investment. It then asks several questions, including whether the SEC should consider whether funds should be required to use a different method of valuation for diversification testing (e.g., whether the use of the notional amount would better achieve the purposes of the diversification provisions of the Act). [\[9\]](#)

Identification of Issuer. The Release then discusses the identification of issuers, noting that a fund may have potential exposure to two issuers through a derivative: both the counterparty to the contract and the issuer of the reference security. The Release asks a number of related questions, including 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). [\[10\]](#)

3. Exposure to Securities-Related Issuers - Section 12(d)(3) and Rule 12d3-1

The next section of the Concept Release discusses the application of Section 12(d)(3) and Rule 12d3-1, which address a fund's exposure to securities-related issuers, to funds' use of derivatives. This can be complex. In certain types of derivative transactions, counterparties, reference asset issuers, and credit-support providers (or entities performing similar roles) each may constitute securities-related issuers. Further, the exception in Rule 12d3-1 is based in part upon a condition that the fund has not invested more than five percent of its assets in the securities of the issuer. Compliance with that condition raises questions over the valuation of the derivative, similar to those discussed above.

The Concept Release asks a number of questions about the application of Section 12(d)(3) and Rule 12d3-1 to derivatives. [\[11\]](#) These questions range from general questions about whether there is any reason to distinguish between derivatives and other investments for purposes of these provisions, to specific questions about the effect of collateral provided by the issuer. The Release also asks whether these provisions would provide an appropriate framework for dealing with counterparty exposures more generally, as suggested by the ABA Task Force.

4. Portfolio Concentration

The next section of the Concept Release discusses portfolio concentration (i.e., limits on a fund's ability to invest more than 25 percent of its assets in a particular industry or group of industries). Compliance with this test raises similar issues to those discussed above with respect to diversification and exposure to securities-related issuers. Funds have to determine which entity or entity to use (the counterparty and/or the reference asset), and how to value the fund's exposure to that entity (notional or marked-to-market). The Release notes that the ABA Task Force indicated that funds typically comply with the 25 percent test by looking to the reference asset and not any counterparty, and by using market values for the calculations. The Release asks whether this is the case, whether collateral posted by the counterparty makes a difference, and whether the SEC should provide additional guidance in this area.

5. Valuation

The final section of the Release discusses valuation of derivatives for purposes of calculating a fund's net asset value. The Release notes that valuation of some derivatives may present special challenges for funds because of customized terms, restrictions on transferability, or restrictions on a fund's ability to close out the contract or to enter into an offsetting transaction. In addition, there may be no market quotations available from independent sources or the fund's counterparty may be the only available source of pricing information.

The Release seeks comment on how funds determine the fair values of derivatives that they hold, how they assess the accuracy and reliability of pricing information on derivatives, how they take into account contractual restrictions on transferability or their ability to close out the transactions or to enter into offsetting transactions, and how they value derivative positions with negative values. The Release also asks whether the SEC should issue guidance on the fair valuation of derivatives under the Act.

Next Steps

The SEC intends to use the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime and the specific nature of any such initiatives.

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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.

[2] Concept Release at 18.

[3] Concept Release at 18.

[4] Securities Trading Practices of Registered Investment Companies, Release No. IC-10666 (Apr. 18, 1979).

[5] Concept Release at 19-26.

[6] 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, available at <http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf>. See also Concept Release at 30.

[7] Concept Release at 31-37.

[\[8\]](#) Concept Release at 37-48.

[\[9\]](#) Concept Release at 53. The Release contains additional questions on valuation for these purposes on pages 54-55.

[\[10\]](#) Concept Release at 55-56.

[\[11\]](#) Concept Release at 62-64.

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